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International Arbitration Case Law

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OCCIDENTAL PETROLEUM CORPORATION AND OCCIDENTAL EXPLORATION AND PRODUCTION COMPANY, V. THE REPUBLIC OF ECUADOR (ICSID CASE NO. ARB/06/11) AWARD

Case Report by María Lucila Marchini**
Edited by Ignacio Torterola ***

An Award rendered on October 5, 2012, in accordance with ICSID Convention and Arbitration Rules. Prof. Stern issued her Dissenting Opinion on September 20, 2012.

Tribunal:	Mr. L. Yves Fortier (President), Mr. David A.R. Williams, Prof. Brigitte Stern
Claimant's counsel:	Mr. David W. Rivkin, Ms. Marjorie J. Menza, DEBEVOISE & PLIMPTON LLP / Mr. Gaëtan J. Verhoosel, Ms. Carmen Martínez López, COVINGTON & BURLING LLP / Mr. Donald P. de Brier, Ms. Laura C. Abrahamson, OCCIDENTAL PETROLEUM CORPORATION
Defendant's Counsel:	Dr. Diego García Carrión, GENERAL ATTORNEY OF ECUADOR / Mr. George von Mehren, Ms. Stephen P. Anway, SQUIRE, SANDERS (US) LLP / Mr. Eduardo Silva Romero, Mr. Pierre Mayer, Mr. José Manuel García Represa, DECHERT LLP

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1. Facts of the Case

Block 15 is located in the most prolific oil-producing region of Ecuadorian Amazon. It includes the producing fields of Limoncocha, Yanaquincha, the Indillana Complex, and the Edén Yuturi field. The Limoncocha and Edén Yuturi fields are located partially within, and partially outside Block 15. They straddle the border between Block 15 and properties managed by Petroproducción, the operating subsidiary of Petroecuador[1]. Under Ecuador's Hydrocarbons Law ("HCL"), fields such as these, once declared to be common to both a contractor and Petroecuador by the Minister of Energy and Mines, must be "unitized" and run jointly by the contractor and Petroproducción pursuant to unitized field agreements.

In 1985, Occidental Petroleum Corporation ("OPC") and Occidental Exploration and Production Company ("OEPC"), two U.S. companies (together the "Claimants"), entered into a services contract with Corporación Estatal Petrolera Ecuatoriana (now PetroEcuador). Pursuant to that contract, OEPC provided 100% of the services required to produce oil in Block 15. If OEPC discovered oil, it was reimbursed for its costs and investments. However, 100% of the crude oil produced belonged to Petroecuador.

In 1993, Ecuador amended its HCL to allow the negotiation of "participation contracts." A participation contract is a type of production sharing agreement: the State and contractors share in the production of crude oil, with all expenditures borne by the contractor. It gave producers a stake in the production that made exploration risks more palatable, while it guaranteed Ecuador a profit from its production share, since it no longer had any expenses associated with oil production.

On May 21, 1999, OEPC and Ecuador signed a participation contract ("Participation Contract"). The contracting parties were Ecuador, through PetroEcuador, and OEPC, and it was to be governed exclusively by Ecuadorian law. Under its terms, OEPC had the right to develop and to exploit the Indillana Complex until 2012, and

[1] *PetroEcuador* was Ecuador's national oil company and the successor to *Corporación Estatal Petrolera Ecuatoriana* ("CEPE").

other fields from which production began after the signing of the Participation Contract, such as the Edén Yuturi and Yanaquincha, until 2019.

As a matter of fact, it transformed the conditions under which OEPC had been operating: in return for accepting the obligation to explore, develop and exploit Block 15, and being responsible for all the associated expenditures -among other obligations-, OEPC received a share of the oil produced from Block 15, referred to as OEPC's "participation". The amount of OEPC's participation was determined on the basis of an equation, which took into account several factors, including the field, the rate of production, and certain agreed-upon percentages. In turn, Ecuador's participation was calculated as the balance of the oil produced from Block 15 over and above OEPC's participation.

Although OEPC was allowed to dispose freely of its share of the production from Block 15 as it wished according to the Participation Contract, its ability to transfer or assign its rights and obligations under the Participation Contract was subject to stringent conditions. Accordingly, Articles 16.1 and 16.2 stated that the transfer of the Participation Contract or assignment to third parties of the rights under the Participation Contract, must had the authorization of the Corresponding Ministry,. Moreover, it provided that the prohibition to transfer or assign rights under the Participation Contract without the approval of the Corresponding Ministry, was not an obstacle to freely trade Contractor's stock, without need of said authorization, provided that the trading of said stock does not change, modify or extinguish the legal existence of Contractor, nor constitute a decrease in its administrative, financial and technical capacities with reference to theParticipation Contract.

The Tribunal also noted that these provisions were mirrored in the "Termination and Forfeiture [*Caducidad*]" provisions of the Participation Contract, which stated that the Participation Contract shall terminate due to a transfer of rights and obligations of the Participation Contract without prior authorization from the Corresponding Ministry (Article 21.1.2).

The Tribunal also observed that these provisions of the Participation Contract refer to many of the provisions of Ecuador's HCL. According to Articles 74-79, the Ministry of Energy and Mines may declare the *caducidad* of contracts, if the contractor transfers rights or enters into a private contract or agreement for the assignment of one or more of its rights, without the Ministry's authorization. The

declaration of *caducidad* of a contract implied the immediate return to the State of the contracted areas, and the delivery of all equipment, machinery and other exploration or production items, industrial or transportation installations. It also provide that the transfer of a contract or the assignment to third parties of rights derived from a contract shall be null and void and shall have no validity whatsoever if there is no prior authorization from the Ministry of Energy and Mines.

On the same day that the Participation Contract was signed, OEPC and Petroproducción also signed joint operating agreements for the unitized exploitation of the common reservoirs in both the Edén Yuturi and Limoncocha fields (the "Unitized Fields Joint Operating Agreements"). The same rights and obligations of the Parties under the Participation Contract, in whatever was pertinent, would be applicable to the Operational Agreement.

In order to finance the expansion of its operations in Ecuador, OEPC sought an arrangement that could provide the necessary funds, as well as diversify and reduce its exposure. In this sense, Alberta Energy Corporation Ltd. ("AEC") proposed to "farmin" to Block 15. OEPC and AEC signed on October 19, 2000, a Farmout Agreement (the "Farmout" or "Farmout Agreement"). The parties also signed an operating agreement for the purpose of implementing the Farmout (the "Joint Operating Agreement" or "JOA" and, together with the Farmout Agreement, the "Farmout Agreements").

The Farmout, governed by the laws of New York, provided for two phases. In the first phase of the transaction, AEC purchased the right to 40% of OEPC's share of Block 15's production. The second stage of the Farmout referred to the assignment of Legal Title. This phase could not occur until AEC had made the required payments, and the Government had given its prior authorization.

On October 24, 2000, senior executives of both OEPC and AEC went to Ecuador in order to meet with the Minister of Energy and Mines, Pablo Terán. The purpose of the meeting was to inform the Minister about the Farmout and discuss new projects in Ecuador. The next day, President and General Manager of OEPC, wrote to Minister Terán regarding the previous day's meeting, with a request to the Minister to confirm consent with respect to the transfer of economic interests in favor of AEC. There was no immediate response from Minister Terán.

On November 2000, the Director of the National Hydrocarbons Directorate, Dr. Raúl Salgado, wrote to OEPC requesting information regarding the technical and financial capabilities of AEC. On December, Dr. Salgado met with OEPC's representatives to discuss OEPC's letter to Minister Terán. On January 2001, Dr. Salgado sent a memorandum to Minister Terán in which concluded that the Company was not requesting authorization to transfer rights, but only reporting on a possible transaction to be made in the immediate future. It also stated that when the company would decide to make that transfer, it would request the corresponding approval from the Ministry of Energy and Mines

Finally, on January 17, 2001, Minister Terán responded to OEPC's letter, noting the company's intention to transfer in the future 40% of the rights and obligations of Block 15 and indicating that such a future transfer would require prior government approval. Minister Terán also stated that OEPC shall be the sole company that would continue participating in the current contract with the Ecuadorian State since it was the owner of 100% of the rights and obligations. The record does not disclose any response on the part of OEPC to Minister Terán's letter of 17 January 2001.

It is worth mentioning that on August 2001, Ecuador's tax authority, contrary to its established practice of refunding value added taxes ("VAT") to oil companies, refused to grant such refunds in the future and, retroactively, claimed refunds of the taxes already paid. OEPC interpreted this decision to be a violation of Ecuadorian tax laws and the Treaty and, in November 2002, filed an international arbitration claim against Ecuador to recover the VAT refunds. On July 1, 2004, the VAT Tribunal issued a $75 million VAT Award in OEPC's favor -confirmed by the English Court of Appeal, finding that Ecuador's conduct had been unfair and discriminatory.

The issue of transfer of rights by OEPC to AEC surfaced again when, in 2003, an audit requested by Director of the National Hydrocarbons Directorate of Ecuador was conduct in OEPC. Audit's report, on July 14, 2004, noted that the assignment of rights and obligations contemplated in the Farmout was made contingent on future events, and that the assignment "might or might not happen" at the end of the four years during which the conditions were to be satisfied.

By February 2004, AEC had made all payments due to OEPC under the Farmout. On 15 July 2004, OEPC wrote to the new Minister of Energy and Mines, Mr.

Eduardo López Robayo, requesting the Ministry to approve the transfer by OEPC to AEC Ecuador of legal title to a 40% interest in Block 15, as contemplated under the Farmout. In this request, OEPC referred to its letter of October 2000, as well as Minister Terán's response of January 2001.

The approval sought by OEPC was not granted. Rather, on August 24, 2004, the Attorney General of Ecuador ordered the Ministry of Mines and Energy to terminate the Participation Contract and the Unitized Fields Joint Operating Agreements through a declaration of *caducidad*.

The attorney general of Ecuador asserted that, in 2000, OEPC transferred 40% interests and obligations from the Participation Contract for Exploration and Exploitation of Hydrocarbons in Block 15 in favor of AEC without having received the authorization of the Ministry of Energy and Mines, as provided by HCL and the Participation Contract. He also alleged that OEPC had committed a number of technical infractions, which, he claimed, constituted a cause for termination, and considered that OEPC had not fulfilled its investment obligations with respect to Block 15, which, he claimed, constituted a cause for termination of the Participation Contract under the HCL.

On the same day, the Attorney General sent a letter to the Executive President of PetroEcuador requesting that PetroEcuador follow the process set out in the Participation Contract: in cases where there may be cause for forfeiture (i.e. *caducidad*) of the contract, PetroEcuador must serve OEPC with a notice of non-compliance and provide OEPC ten days to deny or accept the allegation. If OEPC admitted the allegation of non-compliance, it had thirty days to cure its breach.

PetroEcuador notified OEPC. On September 24, 2004, OEPC denied the Attorney General's allegations. Nothing further happened until the first few months of 2005 when anti-American and anti-foreign investor groups of demonstrators protested in the streets of Quito, in particular in front of OEPC's offices. The demonstrators voiced their concern that OEPC's contract had not yet been terminated.

Then, Attorney General wrote to PetroEcuador Executive, emphasizing that the termination process should already had been completed. The Minister of Energy and Mines, Minister Rodríguez, officially notified OEPC of PetroEcuador's findings

that there were causes for termination of the Participation Contract. In turn, OEPC contented that there was no basis at all for termination of the Participation Contract.

On May 15, 2006, Minister Rodríguez issued the *Caducidad* Decree. The Decree terminated, with immediate effect, OEPC's Participation Contract and ordered OEPC to turn over to PetroEcuador all its assets relating to Block 15. The Decree cited as a legal basis for *caducidad* the HCL provisions. The next days, State officials arrived at OEPC's and seized all of its property, which were now said to be the property of the State.

On May 17, 2006, OPC and OEPC filed with the International Centre for Settlement of Investment Disputes ("ICSID") a Request for Arbitration under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States ("ICSID Convention') against Ecuador and PetroEcuador[2], alleging breaches by Ecuador under both domestic and international law, especially under the Treaty Between the United States of America and the Republic of Ecuador Concerning the Encouragement and Reciprocal ("Treaty" or "BIT"). On June 16, 2008, the Respondent filed its Counter-Memorial on Liability, which also included a Counterclaim.

2. Legal Issues Discussed in the Decision

(a) The Tribunal's jurisdiction over Claimants' claims (paras. 291-296)

Respondent contended that Claimants were obliged to pursue a local challenge to the *Caducidad* Decree before the courts in Ecuador. It argued that the act of the Minister in issuing the *Caducidad* Decree cannot attach responsibility to the State as a substantive matter when there was a mechanism available for the review of that act, which the investor simply failed to invoke.

[2] By letter to the Centre of 29 September 2006, the Claimants withdrew their claims against PetroEcuador.

The Tribunal decided that the matter was "res judicata." In its Decision on Jurisdiction[3], the Tribunal stated that it did not accept that the parties agreed that *caducidad*-related disputes under the Participation Contract would solely be resolved by submission to the Ecuadorian administrative courts. Then, the Tribunal concluded that it had jurisdiction over the Claimants' claims.

(b) Whether OEPC, upon entering into the Farmout Agreement and the Joint Operating Agreement with AEC, breached the Participation Contract (paras. 297-339)

The Tribunal considered whether the Farmout Agreement and the Joint Operating Agreement operated a transfer or assignment of rights under the Participation Contract, contrary to its provisions and in violation of the HCL. The alleged prohibition to transfer or assign rights under the Participation Contract was in Clauses 16.1 and 16.2.

The Tribunal considered that there was ample evidence to conclude that the purpose of the Farmout Agreement and the Joint Operating Agreement was to transfer from OEPC as Contractor to AEC, certain of the Contractor's exclusive rights to carry out the oil exploitation activities under the Participation Contract. The evidence was found principally in the terms of the Joint Operating Agreement: its language explicitly evidenced that it served to operate a transfer of rights and obligations held under the Participation Contract, resulting in AEC's purported "ownership" over these rights to the extent of its Participating Interest.

The Tribunal also observed "[the fact that OEPC may have retained legal title in order to prevent any privity as between AEC and Ecuador in relation to the Participation Contract…does not, *per se*, mean that a transfer of rights and obligations was not intended by the Joint Operating Agreement"[4].

It also asserted that the reality was that by entering into the Joint Operating Agreement, OEPC agreed to share with AEC some of the rights and obligations it had under the Participation Contract and, in so doing, it agreed to a transfer of these rights and obligations. As such, prior authorization on the part of the Ecuadorian authorities was required.

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[3]*See* Decision on Jurisdiction dated September 9, 2008.
[4]Award, ¶306.

Moreover, the Tribunal found that the Joint Operation Agreement conferred to AEC real and specific managerial and voting rights in connection with Block 15, and thereby sought to confer rights under the Participation Contract.

The terms of the Farmout Agreement confirmed that AEC was to have *de facto* legal title to its interest in the "Farmout Property," but that this title was to be "held" by OEPC on its behalf until the required governmental approvals were obtained. OEPC had undertaken to act as the Contractor under the Participation Contract – a right it had acquired on an exclusive basis – "as if" AEC was a party to this Participation Contract.

In addition, the fact that OEPC may have retained legal title, and that no privity as between AEC and Ecuador existed in relation to the Participation Contract, did not necessarily lead to the conclusion, that the Farmout Agreement and/or the Joint Operating Agreement did not purport to transfer rights from OEPC to AEC.

In sum, the Tribunal concluded that OEPC did indeed seek to transfer to AEC under these agreements rights it acquired from Ecuador under the Participation Contract.

(c) Whether OEPC's authorization for the transfer of rights under the Participation Contract was duly obtained (paras. 340-381)

The Tribunal recalled it was undisputed that in order to proceed with a transfer of rights under the Participation Contract, OEPC was required to obtain prior authorization on the part of the Ecuadorian authorities. The Participation Contract tracked the requirements of Ecuador's HCL.

The Tribunal analyzed the evidence provided: draft letters prepared by OEPC officials to the Ecuadorian Minister of Energy and Mines; the script prepared for the meeting of October 24, 2000; the official letters sent between OEPC and the Ministry; the internal memorandums within the Ministry; and the meeting held between the Ministry and OEPC.

The Tribunal found that OEPC, by failing to secure the required ministerial authorization, breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of the HCL. However, Claimants' failure to seek ministerial authorization was a mistake, but it was not done in bad faith. OEPC and AEC were negligent in not required the authorization, but there was no intention on their part

to mislead. They were simply convinced that they were right and acted accordingly without seeking to mislead the Ecuadorian government.

(d) Whether the Caducidad Decree frustrated Claimants' legitimate expectations (paras. 382-383)

The Tribunal, having concluded that OEPC's failure to secure the required authorization on the part of the Ecuadorian authorities was negligent, considered that the Claimants could not be found to have had a legitimate expectation that the Minister would not exercise his discretion and impose *caducidad*.

In this sense, the failure to secure the required authorization meant that OEPC breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of the HCL which, as one option, expressly allowed the Minister to declare the *caducidad* of the Participation Contract and the Joint Operating Agreements.

(e) Whether the sanction for the unauthorized transfer of rights under the Participation Contract was proportional (paras. 384-456)

The purpose of the award was to examine the proportionality of the sanction imposed by the Respondent, *i.e.* the *Caducidad* Decree, which officially terminated with immediate effect OEPC's Participation Contract, and ordered OEPC to turn over all its assets relating to Block 15.

The Participation Contract provided that the contract was to be governed exclusively by Ecuadorian law. In this sense, the principle of proportionality applied generally in Ecuadorian law, originated in its Constitution. The wider application of the constitutional principle of proportionality is further confirmed in the Regulation for the Control of Discretion in Acts of Public Administration (Decree No. 3179 dated October 19, 2002).

The Tribunal observed that the principle of proportionality applied in a variety of international law settings. In the context of ICSID arbitrations, the principle of proportionality was applicable to potential breaches of bilateral investment treaty obligations. In the case at hand, the Treaty provides at Article II.3(a) that investments shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law. "The obligation for fair and equitable treatment has

on several occasions been interpreted to import an obligation of proportionality"[5], and it was the same principle which found expression in the Ecuadorian Regulation for the Control of Discretion in the Acts of Public Administration.

In addition, the Tribunal considered that any penalty the State chooses to impose, must bear a proportionate relationship to the violation which is being addressed and its consequences, which derived from the Respondent's own constitutional rules about proportionality. In cases where the administration wishes to impose a severe penalty, then it appears to the Tribunal that the State must be able to demonstrate (i) that sufficiently serious harm was caused by the offender; and/or (ii) that there had been a flagrant or persistent breach of the relevant contract/law, sufficient to warrant the sanction imposed; and/or (iii) that for reasons of deterrence and good governance it is appropriate that a significant penalty be imposed, even though the harm suffered in the particular instance may not have been serious.

"The test at the end of the day will remain one of overall judgment, balancing the interests of the State against those of the individual, to assess whether the particular sanction is a proportionate response in the particular circumstances".[6]

In addition, the fact that a contractor had agreed that *caducidad* may be a remedy in certain situations does not mean that the contractor has waived its right to have such a remedy imposed proportionately, or otherwise imposed in accordance with all relevant laws. That is particularly so when, as in the present case, the parties agreed that the contract is to be governed by a system of law (Ecuadorian law) which expressly requires the principle of proportionality to be observed.

Both parties agreed that, in issuing the *Caducidad* Decree, the Minister was exercising discretion. That is to say, the Minister was not obliged to terminate the Participation Contract. It was also common ground between the parties that, where the Minister had discretion, the principle of proportionality was relevant.

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[5] Award, ¶ 404 and ss., citing MTD Equity SDN.BHD. and other v. The Republic of Chile, ICSID Case No. ARB/01/7 (25 May 2004); LG&E Energy Corp. and others v. The Argentine Republic, ICSID Case No. ARB/02/1 (3 October 2006); Tecmed S.A. v. The United Mexican States, ICSID Case No. ARB (AF)/00/2 (29 May 2003); and Azurix Corp. v. The Argentine Republic, ICSID Case No. ARB/01/12 (14 July 2006).

[6] *Ibíd.*, ¶ 417.

Nonetheless, the Tribunal also considered that Respondent had other options existed as an alternative to *caducidad*. The final option was to have done nothing except perhaps issue a statement making it plain to all foreign oil companies that all transfers of economic interests must be authorized and that if not so authorized *caducidad* proceedings would be inevitable. The HCL was empowering only, and not directive.

It was evidenced that the Farmout was (or was likely to had been) beneficial to the State. Even if authorization could have been reasonably withheld, it did not follow that the Respondent had suffered a loss. Although the aim for the approval requirement was rational, the question was whether the loss of that opportunity to analyze the approval had actually occasioned any harm. According to the evidence presented to the Tribunal, it did not cause any harm to Respondent.

The overriding principle of proportionality required that any administrative goal must be balanced against the Claimants' own interests and against the true nature and effect of the conduct being censured. Thus, the *Caducidad* Decree was not a proportionate response in the particular circumstances. The *Caducidad* Decree was accordingly issued in breach of Ecuadorian law, in breach of customary international law, and in violation of the Treaty. As to the latter, the Tribunal expressly finds that the *Caducidad* Decree constituted a failure by the Respondent to honour its Article II.3 (a) obligation to accord fair and equitable treatment to the Claimants' investment, and to accord them treatment no less than that required by international law.

Moreover, the Tribunal had no hesitation in finding that the taking by the Respondent of the Claimants' investment by means of this administrative sanction was a measure "tantamount to expropriation" and thus in breach of Article III.1 of the Treaty.

(f) Determination of the quantum of the Claimants' damages (paras. 457-853)

i. The impact of Law 42

The Respondent maintained that any valuation of the Claimants' damages should take into account the impact of Law 42 (also referred to as the HCL Amendment) since any valuation of the Claimants' interest in Block 15 would have to reflect the

actual situation that a hypothetical purchaser of that interest would have faced in Ecuador on May 15, 2006 after the enactment of Law 42.

The Tribunal recalled the title of the HCL Amendment: "State's Participation in surplus from oil sales prices not agreed upon or not foreseen." It considered that with the introduction of Law 42, the Respondent modified unilaterally and in a substantial way the contractual and legal framework that existed at the time the Claimants negotiated and agreed the Participation Contract. Thus, Law 42 was in breach of the Participation Contract and flouts the Claimants' legitimate expectations. It is, as a result, in breach of the Respondent's Article II.3 (a) Treaty obligation to accord fair and equitable treatment to the Claimants' investment.

For such reasons, the Tribunal disregarded Law 42 for the purpose of its valuation of the quantum of the Claimants' damages.

ii. The VAT Interpretative Law

On August 2, 2004, the Ecuadorian Congress adopted the VAT Interpretative Law, which established that reimbursement of VAT decided by the VAT Tribunal was not applicable to petroleum activities. The Respondent, echoing its position regarding Law 42, submitted that such law must be taken into account in the determination by the Tribunal of the value of the Claimants' investment because a hypothetical buyer would have acquired its interest after the enactment of the VAT Interpretative Law and would therefore have had no legitimate expectation to the VAT refunds.

The Tribunal recalled that VAT Tribunal found that Ecuador was obliged, under the Treaty, to reimburse OEPC for the VATs and that, furthermore, OEPC had a legitimate expectation that Ecuador would reimburse those taxes because Ecuadorian law had provided such reimbursement at the time OEPC made its investment.

In the view of the Tribunal, the VAT Interpretative Law, unfairly and arbitrarily, frustrated the legitimate expectations of the Claimants. Thus, as between the Claimants and the Respondent, the VAT Interpretative Law was without legal effect and would not be taken into account as a factor which impacted the fair market value of the Claimants' investment.

iii. Claimant's interest in Block 15.

The Respondent submitted that any calculation of damages to be awarded to the Claimants must be limited to a 60% interest in Block 15 because of the Claimants' transfer of 40% of their interest under the Participation Contract to AEC.

Contrary to Respondent's allegations, the Tribunal concluded that the Respondent was obliged to compensate the Claimants for 100% of their interest in Block 15 which it acquired upon the issuance of the *Caducidad* Decree. It stated pursuant to New York and Ecuadorian law, the purported assignment by OEPC to AEC of rights under the Participation Contract according to the Farmout Agreement, and the Joint Operating Agreement was null and void and had no validity whatsoever.

Under the doctrine of inexistence and under New York law, there was no requirement that the Court must first declare the assignment to be invalid. Indeed, even under the doctrine of absolute nullity, any purported assignment was not considered "valid" prior to a declaration of nullity – there is only the "appearance" of an act. As such, the purported assignment of rights under the Farmout Agreement and the Joint Operating Agreement was not valid and produced no legal effect. It was therefore disregarded by the Tribunal for purposes of determining the compensation to which the Claimants were entitled.

Consequently, the Tribunal found that OEPC continued to own, as of the date of the *Caducidad* Decree, 100% of the rights under the Participation Contract.

iv. Claimant's contributory fault.

The Respondent also submitted that any damages awarded to the Claimants should be "substantially reduced" on account of the Claimants' contributory fault.

In the view of the Tribunal, the Claimants would pay a price for having committed an unlawful act which contributed in a material way to the prejudice which they subsequently suffered when the *Caducidad* Decree was issued. Considering the extent of the contribution of the Claimants' negligence to their injury, the Tribunal noted that the issuance of the *Caducidad* Decree which ensued, as the Tribunal had found, was a disproportionate sanction and a measure tantamount to expropriation of the Claimants' substantial investment in Ecuador. The totally of the Claimants' damages were caused by *Caducidad* Decree.

Having considered and weighed all the arguments which the parties had submitted, in the exercise of its wide discretion, the Tribunal found that, as a result

of their material and significant wrongful act, the Claimants had contributed to the extent of 25% to the prejudice which they suffered when the Respondent issued the *Caducidad* Decree. The resulting apportionment of responsibility as between the Claimants and the Respondent, to wit 25% and 75%, was fair and reasonable in the circumstances of the present case.

v. The fair market value of Claimants' investment.

The Tribunal then determined, as mandated by Article III of the Treaty, the fair market value of Claimants' investment. The Tribunal was of the view that, in this case, the standard economic approach to measuring the fair market value today of a stream of net revenues (i.e., gross revenues minus attendant costs) that can be earned from the operation of a multi-year project such as OEPC's development of Block 15, was the calculation of the present value, as of May 16, 2006, of the net benefits, or "discounted cash flows".

These net cash flows were appropriately determined by calculating the flow of benefits ("cash flows") that the Claimants would have reasonably been expected to earn in the "but for" state of the world in which the termination of the Participation Contract hypothetically did not occur relative to the actual cash flow that the Claimants will derive subsequent to the termination.

The difference between these two cash flow streams (the "but for" state of the world with no termination less the actual state of the world with contract termination), discounted to the date of the actual contract termination, was the economically appropriate and reliable measure of the cumulative economic harm suffered by the Claimants as a consequence of the contract termination.

vi. The alleged consequential damages suffered by Claimants.

The Claimants alleged that they had also suffered consequential damages as a result of the *Caducidad* Decree, such as ship-or-pay damages, employee termination costs, and value of a stranded cargo.

The Tribunal concluded that the Claimants' claim for ship-or-pay damages was inherently speculative. The employee termination costs could not be attributed to the *Caducidad* Decree, and Claimants' claim also fails for lack of sufficient and satisfactory evidence as to both the existence and the value of the cargo.

vii. Calculation of damages.

The Tribunal determined that the Net Present Value of the discounted cash flows generated by the Block 15 OEPC production as of May 16, 2006, was US$ 2,359,500,000 (US Two billion, three hundred fifty nine millions and five hundred thousand dollars). Having determined that the Claimants' damages should be reduced by a factor of 25% because of their own wrongful act which contributed in a material way to the damages which they subsequently suffered when the *Caducidad* Decree was issued on May 15, 2006, the Claimants' damages for the expropriation by Ecuador of their interest in the Participation Contract amounted to US$ 1,769,625,000 (US One billion, seven hundred sixty nine millions, six hundred twenty five thousand dollars) which the Tribunal ordered the Respondent to pay.

The Tribunal therefore considered that a 4.188% annual interest rate was reasonable in the circumstances, compounded annually from May 16, 2006, until the date of the Award. The Tribunal observed that this approach was consistent with the terms of the BIT, which expressly provided at Article III for "interest at a commercially reasonable rate from the date of expropriation."

(g) The inappropriateness of Respondent's counterclaim (paras. 854-869)

The Respondent alleged that the Claimants initiated and prosecuted the case in bad faith. The Tribunal considered that it followed from the circumstances that the proceeding as brought by the Claimants cannot be deemed to have been baseless or otherwise malicious or abusive.

As regards the respondent's allegation that OEPC breached the Participation Contract through the use of diplomatic channels, the Tribunal found no evidence that the Claimants ever sought assistance from the U.S. Government in connection with the *caducidad* dispute through diplomatic channels.

Moreover, the Tribunal dismissed the Respondent's allegation of destructive and unlawful conduct on the part of the Claimants on the basis that Respondent had not discharged its burden of proving such damages.

3. Decision

The majority of the Tribunal awarded that Ecuador acted in breach of Article II.3(a) of the Treaty by failing to accord fair and equitable treatment to the Claimants' investment, and to accord the Claimants treatment no less than that required by international law. It also determined that Ecuador breached Article III.1 of the Treaty by expropriating the Claimants' investment in Block 15 through a measure "tantamount to expropriation". In addition, it ruled that by issuing the *Caducidad* Decree, Ecuador breached Ecuadorian law and customary international law.

It considered also that OEPC breached Clause 16.1 of the Participation Contract by failing to secure the required ministerial authorization for the transfer of rights under the Farmout Agreement, and as a result of such breach, the damages awarded to the Claimants would be reduced by a factor of 25%.

In conclusion, Claimants were awarded the amount of US$ 1,769,625,000 (US One billion, seven hundred sixty nine millions, six hundred twenty five thousand dollars). Ecuador was ordered to pay pre-award interest on the above amount at the rate of 4.188% per annum, compounded annually from May 16, 2006, until the date of the Award, and to pay post-award interest from the date of the Award at the U.S. 6 month LIBOR rate, compounded on a monthly basis.

4. Dissenting Opinion

In accordance with Article 48(4) of the ICSID Convention, Arbitrator Stern dissented from the above majority.

Prof. Stern subscribed to the analysis of the facts and the law concluding that the Respondent acted in a disproportionate manner in its reaction to the serious violation of its laws by the Claimants. However, she was in complete disagreement with the way damages had been calculated, which she considered to be resting on grossly incorrect legal bases. To be accurate, she did not have a problem with figures; she had a problem with principles that were applied (or not) to reach these figures.

Firstly, she considered that the consequence of the fault committed by the Claimants, when they violated the Ecuadorian law, "is overly underestimated and

insufficiently taking into account the importance that each and every State assigns to the respect of its legal order by foreign companies"[7]. On the other hand, she had a different analysis of the laws applicable in the determination of damages.

Secondly, and as regards the Farmout Agreement´s effects, she considered that there were two major questionable aspects in the majority's approach to the question of the effectiveness of the Farmout Agreement: the first was the analysis of the question of the effectiveness of a legal act under Ecuadorian law, which was based on a total lack of reasons. The second, which in her view was even a more serious matter, was the manifest excess of power of the Award nullifying a contract concerning a company which not only was not a party to the arbitration, but moreover – even if it had been a party – could not be considered, being a Chinese company, as an investor over which the Tribunal had jurisdiction under the US/Ecuador BIT.

(a) The consequence of the fault of the Claimants (paras. 7-8)

She affirmed that the contribution of the Claimants to the damage had been overly underestimated, as the Claimants deliberately took the risk of *caducidad* by their behavior. As a result, a fair and reasonable apportionment of responsibility between the Claimants and the Respondent would more appropriately have been a 50/50 split, since both had acted very imprudently and illegally.

(b) The analysis of Law 42 (paras. 9-13)

She noted that it is generally admitted that sovereign States have a broad discretion when they exercise their fiscal powers. It was indeed uncontroversial that, absent a fiscal stabilization clause in a contract, nothing prevented a State to participate in the benefits of a changed economic situation, stemming out of its inalienable natural resources[8]. Windfall profit taxes are commonly-used measures to adjust the division of revenues from natural resources between States and private companies.

Although for the majority Law 42 was not a tax or a levy, since it was "a unilateral decision of the Ecuadorian Congress to allocate to the Ecuadorian State a defined

[7] *See* Dissenting Opinion, ¶ 4.
[8] Ibíd., ¶ 9.

percentage of the revenues earned by contractor companies"[9], in her view it described exactly what a tax or a levy does.

She could not admit that Law 42 was a violation of the Participation Contract, as Law 42 was dealing with a different issue than the ones regulated by the latter. Moreover, considering that Law 42 was evidently a tax, she would "have concluded that there was no violation, as a law permitting the contractor to benefit from 50% of unexpected profits does not impact on "the economy of the contract"[10].

As a result of the foregoing, she considered that Law 42 should have been taken into account in the calculation of damages.

(c) The analysis of the VAT Interpretative Law (paras. 14-15)

She indicated that not every collection of VAT had ipso facto an impact on the economy of the contract. Such impact had to be analyzed, which the majority did not do. "[T]he fact that the law did not refund VAT and that this was not compensated by a modification in the percentages of participation in the volumes does not appear to be a violation of the Participation Contract".[11]

Consequently, she concluded that the VAT Interpretative Law should have been taken into account in the calculation of damages.

(d) The different issues raised by the Farmout Agreement (paras. 16-168)

The way the majority dealt with the consequences of the Farmout Agreement prompted Prof. Stern to write her dissenting opinion.

To start with, she stated that there were two questions: "what was the effect of the signature of the Farmout Agreement on OEPC's rights?" and "Can the Farmout Agreement be considered inexistent or automatically null and void on the occurrence of *caducidad*?"; both questions were independent one from the other. One thing was to know whether or not the legal situation created by the Farmout Agreement transferred rights or created only liabilities. This question was decisive in order to determine whether the Claimants have violated the Ecuadorian law. The second thing was to decide whether such transfer of rights was inexistent or

[9] Award, ¶ 510.
[10] *See* Dissenting Opinion, ¶ 12.
[11] *Ibíd*., ¶ 14.

automatically null, in other words whether the situation created by the Farmout Agreement – the transfer of rights – continued or not after *caducidad*. She considered that the majority had given a strange answer to that question: it stated that the initial situation of a transfer of rights had automatically ceased to exist by application of Article 79 of the HLC, but had at the same time stated that a liability of the Claimants towards AEC remained. As there was no such liability in the first place, these two aspects of the majority position were, in in her view, contradictory.

> i. What was the effect of the signature of the Farmout Agreement on OEPC's rights?

The majority of the Tribunal concluded that a major portion of the amounts invested in Block 15 was contributed by another entity than the Claimants (AEC - now Andes, a Chinese company). It is uncontested that the Tribunal has recognized that rights had been transferred to AEC, these having been later transferred to Andes. "I do not see how it would be possible to grant damages pertaining to rights that no longer belong to the Claimants, without disregarding the basic rules of international law".[12]

The Tribunal had concluded that, through the Farmout Agreement, the Claimants actually transferred 40% of theirs rights under the Participation Contract to AEC, conclusion with which she concurred. The question remained whether this situation changed on the occurrence of *caducidad*.

> ii. Can the Farmout Agreement be considered inexistent or automatically null and void on the occurrence of *caducidad*? Substantive aspects.

The issue that must be discussed was whether the transfer could be considered as inexistent or null and void by the Tribunal on the occurrence of *caducidad*, by application of New York and/or Ecuadorian laws. The majority had given a positive answer to this question. It had therefore granted damages to the Claimants as if they had never entered into the Farmout Agreement and as if this Agreement had not been fully executed, as far as the payments from AEC to the Claimants for the acquisition of their proprietary rights are concerned.

[12] *Ibíd.*, ¶ 36.

The first question, however, was whether under the application of the relevant law, inexistence or nullity resulting from an absence of authorization was automatic or had to be decided by a national court. In order to answer the question, it was necessary to determine the applicable law.

She considered that under both legal orders, inexistence is not relevant in the circumstances and that a nullity resulting from an absence of authorization had to be declared by a judge.

The majority had concluded that the Farmout Agreement had to be construed and interpreted by application of Ecuadorian law and that under such law it was either inexistent or automatically null, but had also stated that the same result followed from the application of New York law. In turn, she considered that both under New York and Ecuadorian law, inexistence was a concept of restrictive use and could not apply to a case of absence of authorization and that on the other hand, absolute nullity had always to be declared by a court.

She came to the conclusion that, whether one applies Ecuadorian Law or New York law, in isolation or in combination, the Farmout Agreement could not just be taken out of the picture for determining the amount of damages granted to the Claimants. The conditions for inexistence were not present and absolute nullity provided for in Article 79 of the HCL had to be declared by a competent court.

As a result of the foregoing, she concluded that the Farmout Agreement, having not been invalidated either by a New York court or an Ecuadorian court, should have been considered as still in force and binding.

> iii. Could the Farmout Agreement be considered inexistent or null and void on the occurrence of *caducidad* by this ICSID Tribunal? Jurisdictional issues.

The question was whether the Tribunal should had declared that the transaction, was inexistent or null and void from the beginning, with the consequence that AEC was then, by virtue of the Award rendered in a proceeding to which it is not a party, deprived of any rights in the Participation Contract.

She considered that in deciding as it did, the majority had both exercised a jurisdiction that it manifestly did not possess, and in exercising such jurisdiction

had not applied the basic principles of international law relating to international responsibility.

"I did not know that our ICSID Tribunal was empowered to act as an Ecuadorian judge and declare null and void a contract to which the applicable law is the law of New York. In fact, whatever the applicable legal order, no such power exists for our Tribunal"[13]. In declaring that the Farmout Agreement between a party to the arbitration and a non-party to the arbitration is inexistent/null and void, the majority had exercised, in her view, a power that it did not have, because "[t]he Tribunal was not seized of a contractual dispute involving the Farmout Agreement, nor has any argument been presented that the existence of the Farmout Agreement is a violation of the Ecuador/United States BIT".[14]

She stated that the majority's decision amounted to "expropriate" a Chinese company over which it had manifestly no jurisdiction under the rules of international law: the application of international law to the question of damages should had prevented the majority to assert jurisdiction in order to take drastic decisions in relation with an investment belonging to a Chinese company under the Ecuador/US BIT. In addition, she affirmed that in declaring the rights of AEC to be inexistent, the majority had deprived an entity over which it had no jurisdiction of its rights and therefore that it had not applied the proper law, which is international law, to the assessment of damages.

It also emphasized that the majority had disregarded the existence of the Farmout Agreement for the purpose of evaluating the damages – without at a minimum reinstating the situation that would have existed in the absence of the Farmout. In order to be fair, restore the situation that would have existed without the performance of the Farmout Agreement considered inexistent or declared null and void, before drawing conclusions based on its inexistence, when everyone knew that it existed and had been fully performed.

She concluded that the majority did not apply the applicable law, which is international law, to the assessment of damages. Or OEPC would not hand over 40% of the awarded damages to AEC, precisely relying on the Award -which

[13] *Ibíd.*, ¶ 124.
[14] *Ibíd*.

declared that AEC had no rights- but then the decision of the majority would have condoned the violation of the international principle against unjust enrichment.

> (iv) Had the majority not manifestly exceeded its powers in annulling AEC' rights, the Tribunal, could only have granted 60% of the damages to the Claimants in conformity with the principles of international law.

She stated that had the Farmout Agreement been taken into account as it should have been, the Tribunal could not have granted 100% of the damages to the Claimants since all principles of international law point to the same result, i.e. that OEPC could not be compensated for 100% of the value of Block 15, and hence was only entitled to 60% of the damages.

It was considered that firstly, granting 100% of the damages to the Claimants was in violation of the basic rules relating to this Tribunal's jurisdiction ratione personae, as far as nationality is concerned. AEC (now Andes) had been heavily investing in Block 15, but this meant thus that a major portion of the amounts invested in Block 15 was contributed by entities over which the Tribunal had no jurisdiction under the Ecuador/US BIT (AEC, now Andes). An investment, as was well known, required a contribution: it was uncontested that OEPC had contributed only for 60% of the value of the investment, 40% of that value, including both initial capital expenditures and operational expenditures during the life of the project, having been paid by AEC. In case two different investors were claiming an interference with their rights, they must both present a claim and one investor cannot bring a claim for the other, especially when they do not have the same nationality and cannot invoke the same BIT, as is the case here.

Thus, it was certainly not possible for the Claimants to claim under the US/Ecuador BIT for an economic value belonging to a Chinese company. As to OEPC, it could only claim, on its own behalf, the value of its reduced investment, and not of the investments made by another, non-American company.

Secondly, according to the international law principles relating to the jurisdiction of the Tribunal and international law principles applicable to compensation for international illicit acts, no damages ultimately benefiting to AEC could have been

awarded by the Tribunal, because, in case of split between a legal owner and a beneficial owner, it was only the beneficial owner which can be compensated.

As far as the 40% interest belonging to AEC are concerned, the relation between AEC and OEPC was not a relation between a creditor and a debtor, it is rather a situation of a splitting of title, between the legal title and the economic interest, between a nominee and a beneficial owner. According to the principles of international law dealing with this type of situation where there was a split of title, only the beneficial owner, AEC could claim for interference with his interests, OEPC having no standing to claim in the name of the beneficial owner.

In addition, according to the international law principles governing State responsibility, OEPC should only have received 60% of the total damages. In assessing damages for breaches of international law, it is the duty of a tribunal to ascertain the amount of damages directly and proximately caused by the wrongdoer, and to restore the claimant, as far as possible, to the position it would have occupied but for the wrongful act. Only the value of property, rights and interests which have been affected and the owner of which is the person on whose behalf compensation is claimed, or the damage done to whom is to serve as a means of gauging the reparation claimed, must be taken into account.

In the case at hand, the fact of compensating OEPC for 60% of its own remaining rights would have been perfectly in line with principle of full reparation. Restitution is the priority reparation, and that when it is not available, the amount of damages should be equivalent to the value that restitution would have afforded to the Claimants. The obligation to grant damages equivalent to restitution arises precisely because restitution itself is no longer possible.

Granting 60% of the value of Block 15 to the Claimants would have been perfectly in line with the principle of full recovery. The full value of the investment of OEPC was only 60% of the full value of the Participation Contract. The Tribunal should have concluded that OEPC was entitled to 60% of the value of Block 15, which is in line with the principle of full recovery. Ecuador would have indeed compensated the Claimants for the full value of their investment, which for the reasons explained did not include the portion of the rights financed by AEC/Andes and belonging to them.

Lastly, she considered that according to the international principle based on unjust enrichment, the Claimants would be unjustly enriched, if after having been fully paid by AEC for the acquisition of 40% of the economic rights under the Participation Contract, they receive the equivalent of 40% of these rights back.

Firstly, the Tribunal should not have granted 100% of the damages to the Claimants as it had no guarantee that the 40% will be transferred to Andes, as guaranteeing rights to AEC cannot be part of the Award of a Tribunal respecting the limits of its jurisdiction, as this would concern rights of a party which is not in the case. Secondly, I note that, if OEPC indeed will fulfill the obligation to give 40% of the granted damages to Andes, this precisely indicates that it is not claiming 100% for itself, but is claiming only 60% for itself and claiming 40% for Andes.

At first sight, it could appear that it would not be fair that the execution by OEPC of the Farmout Agreement with AEC would allow Ecuador, following *caducidad*, to be legally obliged to compensate OEPC for 60% only of its interest in Block 15, when it concretely had acquired 100% of Block 15 upon the issuance of the *Caducidad* Decree.

"I wish to mention that there is no unfairness here, as this is purely a result of the limited jurisdiction of ICSID tribunals. International investment tribunals are not here to redress any torts worldwide…As a matter of fact, each time an international tribunal does not have jurisdiction over a case that has some merits, it could be theoretically said that the State has been unjustly enriched. But this is nothing extraordinary, it is simply the result of the limited access to international arbitration, which the majority has blatantly disregarded".[15]

[15] *Ibíd.*, ¶ 167-168.