Occidental v Ecuador: Partial annulment decision upholds the State's liability

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On November 2, 2015, an ICSID-appointed Committee issued its Decision on Annulment in *Occidental v Ecuador* (Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador, ICSID Case No. ARB/06/11). The Committee rejected twelve of the thirteen grounds for annulment raised by the Respondent and confirmed the majority of the award. The Committee accepted only one of the arguments made by the Respondent that, ultimately, was sufficient for the Committee to lower the amount, the State had been condemned to pay, from US$1.7 to US$1.1 billion.

Days before the award's release, there had been rumours of talks between the parties concerning a potential settlement. After the award came public, Ecuador's Minister of Finance announced that the State would comply with the decision and was looking for means to finance the payment.

The exit of Occidental from Ecuador back in 2006 arose in the middle of political hostility towards the operations of the multinational in the country. Furthermore, this case is thought to be one of the key motives to have led the Government to undertake a broad institutional review of its investment protection treaties and question investor-State arbitration as a legitimate system for the adjudication of international disputes.

The operation of Occidental in Ecuador and the dispute

On May 21, 1999, Occidental and the state-owned oil company PetroEcuador entered into a Participation Contract for the exploration and exploitation of oil in Block 15 (the "Participation Contract"). The Participation Contract gave Occidental the right to develop and exploit certain oil fields until 2012 and others until 2019 in exchange for a 70% share of all the oil extracted. The Participation Contract contained, among its provisions, the obligation of Occidental to request authorization from the Ministry of Energy and Mines (the "Ministry") in case it decided to transfer its rights under the Contract to a third party.

In 2000, Occidental entered into negotiations with Alberta Energy Company ("Alberta"), a Canadian company, to transfer part of its interests under Block 15. After a long period of negotiations and

without obtaining any governmental authorization, Occidental and Alberta signed a Farmout Agreement and a Joint Operating Agreement (the "Agreement"), according to which Occidental would transfer 40% of its economic interests in Block 15 pursuant to the Participation Contract.

As a consequence, in September 2004, PetroEcuador initiated a termination procedure for the Participation Contract by notifying Occidental of its alleged non-compliance with the Participation Contract. On May 15, 2006, the Minister of Energy and Mines issued the Caducidad Decree, which immediately terminated the Participation Contract and required that Occidental transferred all assets related to Block 15 to PetroEcuador.

Subsequently, Occidental started arbitration proceedings against the Ecuadorian State before ICSID under the Ecuador-US BIT. Among its various claims, Occidental alleged that the State had violated the fair and equitable treatment obligation and expropriated its investment.

The Tribunal found that the assignment of the rights to Alberta without the Minister's authorization was in breach of the Participation Contract and violated the Hydrocarbons Law provisions. Notwithstanding, the Tribunal also found that the Caducidad Decree was not a proportionate response to Occidental's breach of contract and that therefore, the Government had breached its obligations under the BIT by enacting the Caducidad Decree.

Key conclusions of the Tribunal

The Tribunal reached two major conclusions: (i) the use of the proportionality as a prong of fair and equitable treatment and, (ii) the assumption of jurisdiction over the 40% investment in Block 15 which was not owned by the Claimant at the time of the claim. The latter will be developed in the next section.

First, as to the use of proportionality, the Claimant argued, and the Tribunal agreed, that the Caducidad Decree was disproportionate in light of the circumstances under which Occidental breached the Participation Contract and Ecuador's Hydrocarbons law. The Tribunal considered that Ecuador had, at least, three alternatives to the termination of the Participation Contract: (i) the payment of a transfer fee; (ii) improvements to the economic terms of the original contract in its favour; or (iii) the negotiation of a settlement agreement. Any of those measures would have been less intrusive on Occidental's investment. In addition, the Tribunal compared the purposes a sanction such as the Caducidad could have towards oil companies operating in the country with the actual damage caused to Occidental. Finally, the Tribunal determined that the deterrent effect the sanction aimed to promote was not proportional to the damages that a non-complying party could face when in breach: the loss of all of its assets.

In the Annulment decision, the Committee acknowledged that the application of proportionality was "one of the cornerstones" of the award (¶ 311). On his side, the Respondent argued that when a tribunal finds that the sanction applied, was the one agreed by the parties in a public contract, then the Tribunal has to respect it based on the *pacta sunt servanda* principle (¶ 313-315). The Committee pointed that the Tribunal had convincingly reasoned its decision, but even if the reasoning was less convincing, it was the Tribunal's prerogative to determine whether the Caducidad was proportional or not, since it implied an eminent fact evaluation and a review of a tribunal's prerogative falls outside of the scope of the Committee's review. *See,* ¶ 346.

The Committee's decision to partially annul the award

The Respondent invoked three grounds for annulment under the ICSID Convention: (i) manifest excess of powers, (ii) departure from a fundamental rule of procedure and, (iii) failure to state reasons in the award. The Respondent first attacked the Decision on Jurisdiction for lack of arbitrability pointing that under the Ecuadorian Constitution, administrative courts have exclusive jurisdiction to adjudicate claims relating to administrative acts such as the Caducidad Decree. *See,* ¶ 71. The Committee rejected this argument explaining that the State cannot rely on its own domestic law to avoid ICSID jurisdiction under a BIT.

The Respondent then raised a ground for partial annulment on the Tribunal's assumption of jurisdiction over the 40% investment assigned to Alberta and later transferred to Chinese investor Andres Petroleum ("Andes"). *See,* ¶ 136. Since the Ministry had never authorized the assignment agreement to Alberta, the Tribunal had to decide whether that lack of authorization entailed a valid enforceable assignment in light of Ecuadorian law and New York law (the law applicable to the Agreement). The Tribunal concluded that the lack of authorization affected the existence of the Agreement and therefore it had no legal effects over the parties. The Tribunal disregarded the assignment for purposes of determining the compensation to which Occidental was entitled and decided that the Respondent had to compensate Occidental for 100% of its interest in Block 15.

In her Dissenting Opinion, French arbitrator, Brigitte Stern strongly criticized the majority's findings explaining that the agreement was still binding given that neither a New York court nor an Ecuadorian court had formally invalidated it. The Committee extensively referred and agreed with her findings when analysing this ground.

The Tribunal viewed Occidental's position from a 'fairness perspective', noting that its damages were limited to 60% of the value of the block, because the remaining 40% interest had been transferred to Andes which had paid proper consideration for those rights. *See*, ¶ 188. Moreover, the Committee revised the Tribunal's conclusion on the inexistence of the Agreement as a sanction of illegality. The Committee disagreed with the Tribunal's conclusion that Ecuadorian law does recognize the "inexistence doctrine" and therefore no judicial determination on the validity of the contract was necessary. When analysing Ecuadorian case law on the subject as well as the relevant provisions of Ecuador's Civil Code, the Committee ruled that the agreement was valid until there was a final judgment invalidating it. *See*, ¶ 236-241.

Having studied Contract Law in Ecuador, I must say that when considering illegal contracts, we were always taught that the sanction to illegality was nullity and never the inexistence of the act! Fortunately, the Committee vindicated the majority's understanding and confirmed that, under Ecuadorian law, an agreement that lacks a statutory requirement needs a judicial declaration to be regarded as void.

Once the Tribunal established that Occidental indeed transferred its interests and Andes therefore owned 40% of the investment allegedly expropriated, the Committee found that the Tribunal had exceeded its powers by "compensating a protected investor for an investment which was beneficially owned by a non-protected investor." ¶ 266. In consequence, the Committee annulled the quantification of damages reducing the value of compensation in a 40%.

Lessons from *Occidental v Ecuador*?

The decision represents by far the largest amount ever annulled in an ICSID case and the first annulment at the centre since 2010.

The decision is a worthy example of the value given by Annulment Committees to dissenting opinions. Stern's sharp understanding of Ecuadorian contract law principles (that derive from Napoleon's Civil Code) show that the legal background of arbitrators seems to have a powerful effect on how an arbitrator would digest and comprehend a legal argument.

Certainly, many more claimants will benefit from the Committee's confirmation that the principle of proportionality, as a prong of fair and equitable treatment, applies to contractually agreed measures that rise to a violation of international law.

Finally, at one point of time, *Occidental v Ecuador* represented the second largest award on international arbitration (followed by Dow Chemical v. Kuwait with a US$2.5. billion dispute). Nowadays, Yukos (US$50 billion) leads the count followed by *Exxon Mobile v. Venezuela* (US$1.6 billion).