Rockhopper vs Italy: Weighing Legitimate Expectations Up Against Investor's Due Diligence in M&A Deals

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Introduction

Following the denial by Italian authorities to grant Rockhopper Exploration PLC (a UK upstream company; hereafter, RKH) the production concession for an oil and gas field, in May 2017, the company lodged (jointly with its Italian subsidiary, hereafter collectively referred to as the Claimant) a request for arbitration against Italy with the ICSID by relying on the Energy Chart Treaty (ECT).

This post gives a brief overview of the pending case and comment on the balance between investor's legitimate expectations and due diligence in M&A transactions with the aim to warn the interested M&A practitioner – who spots a target company with a potential investment arbitration claim – about the timing of the purchase completion and its consequences on claimable damages.

Facts

In August 2014, the Claimant completed the acquisition of Mediterranean Oil & Gas PLC (a UK upstream company, MOG hereafter) for GBP 29.3 million in a cash and shares deal. MOG had onshore and offshore interests in Italy, Malta, and France. Among its interests in Italy, was the *Ombrina Mare*, a field located in the central Adriatic Sea whose exploration permit was applied for and obtained in 2005. In 2008, a hydrocarbon deposit was found and the relevant production concession submitted. However, pending the administrative procedure for the granting of the relevant production concession, the Italian Government brought about several reforms in the extraction sector which made unfeasible the exploitation of the *Ombrina Mare* field, given its proximity to the coastline (4 miles offshore) and to a natural reserve.

Although during the administrative procedure, MOG was given some reassurances that eventually it would have been awarded the necessary authorizations to start with the drilling, eventually, the concession application was denied by the competent Ministry.

Consequently, MOG applied for an administrative review before the Administrative Court, which upheld the Ministry's refusal to grant the concession, both in first instance and on appeal (on 16 April 2014 and 17 December 2015, respectively).

After the Claimant acquired MOG, it resumed the authorization process despite the many setbacks, hoping for a different outcome. However, when in February 2016 the Ministry of Economic Development denied for the umpteenth time to grant the Production Concession covering the *Ombrina Mare* field, the Claimant took the decision to file an arbitration request by invoking the breach of the ECT, after securing a third-party funding.

(Most likely) Arbitral Claim: FET violation

Since RKH claimed that Italy breached the ECT, the Claimant is going to maintain that Italy breached Part III of the ECT and, in all likelihood, specifically Article 10(1), which establishes the FET standard under the ECT. As a result of the acquisition, RKH indeed subrogated to MOG in all its legal relations, and accordingly RKH substituted MOG in its rights against the Italian Republic, including its rights under the ECT.

It is sensible to contend that Italy failed to accord the Claimant fair and equitable treatment by failing to protect its legitimate expectations with respect to its asset (the Ombrina Mare field). Among the measures – that violated Article 10(1) of the ECT and are directly attributable to Italy under Article 4 of the ILC Articles on State Responsibility – are the following:

1. The **failure to observe the time-frame** to conclude the administrative procedure for the issuance of the Environmental Impact Assessment Decree concerning the *Ombrina Mare* project (which also may constitute *per se* an infringement of legitimate expectations and give rise to indemnification under Italian Administrative Law, Articles 1(1), 2-bis(1) of Law No. 241/1990 (Administrative Procedure Act) and Article 97(1) of the Italian Constitution (impartiality and good-government conduct);
2. The introduction and retroactive application of the **Legislative Decree 128/2010** to the *Ombrina Mare* oilfield, thereby paralysing MOG's project, an act which is in contrast with the exploration permit B.R269.GC previously granted in 2005;
3. A **Ministerial Note** demanding MOG in July 2013 to submit an additional environmental compliance (the so-called AIA, *e.* integrated environmental authorisation), which is inconsistent with MEPLS's previous specific representation to MOG in October 2012, ensuring that the AIA was not necessary, and which is also incompatible with Article 23(4) of the Environmental Code[fn]Since the 30 days, that the competent authority has to verify the completeness of the documentation, were already elapsed.[/fn], and Articles 3, 21-octies(1), 21-nonies(1) of the (Administrative Procedure Act)[fn]Since every administrative measure must include a statement of reasons, failing which it may be vitiated by excess of power and, therefore, be voidable.[/fn].

(Most likely) Defence: Lack of Due Diligence and Duty to Mitigate the Damages

An acquisition, just like a merger, is a lengthy process that may stretch over several months or even years, firstly, to allow the parties involved to get to know each other, secondly, to devise the yearned synergy and, thirdly, to come to a deal. During the negotiations, the seller and the buyer have the opportunity to exchange a series of non-binding and binding documents – ranging from the letter of intent (LOI) to the stock or asset purchase agreement (SPA or APA) – which outline parties' rights and obligations during and after the transaction. Once the non-disclosure agreement (NDA) and the LOI are signed, as a consequence of the *caveat emptor* principle, the buyer has the duty to conduct a thorough due diligence to know exactly what he/she is getting into, by reviewing and investigating various aspects of the target company. Especially in an oil and gas acquisition, legal and environmental due diligence – covering pending, threatened, or settled litigations and regulatory approvals, such as government-issued permits or concessions – is of the essence.

On this point, Italy could object to the Claimant that it did not carry out an exhaustive due diligence

prior to making the investment, as its failed to assess correctly the feasibility of its project on the basis of the circumstances available when it took the decision to invest. Indeed, tribunals have recognized that Claimant's own conduct in the course of obtaining the investment undermines the chances of a successful FET claim every time a failure to exercise due diligence is shown in the undertaking of a viability study of the project before investing therein. Even if RKH was subrogated to MOG in all its rights by means of its acquisition, the content of these rights is not the same where the core element of the *causa petendi* is the legitimate expectations the rightsholder might have at the time he/she made the investment (being these moments different in time). Since by the time the Claimant made its investment (by closing the acquisition of MOG in August 2014), the government had already enacted, in June 2010, a decree banning oil concessions near the coasts and an Administrative Court had already intervened in April 2014 by upholding the Government's refusal to grant MOG the relevant concession (because further environmental assessments were necessary due to the complexity of the project), RKH's expectations with respect to that oilfield definitely could not have been as high as those of MOG when it first discovered it in 2008.

In this respect, it is reasonable to draw a distinction between the transfer of rights from transfer of legitimate expectations from the selling company to the purchasing company: whereas the former is automatic, the latter is subjected to the circumstances in place and information available by the time the acquisition is executed.

Further, parties in a M&A can avail themselves of different ways to allocate the risks of the transaction, such as conditions precedent, representations and warranties and the pertaining indemnifications and damages, and post-closing price adjustments. Tribunals have also recognized claimant's duty to mitigate the damages suffered. Italy indeed could contend that it was Claimant's duty to reduce such damages by relying on the prudent means available in M&A deals. For instance, RKH should have set the grant of the production concession either as a condition precedent to the closing of the acquisition, or ask MOG to make it an item of a specific representation subject to an indemnity in the event of non-attainment thereof, or ask for a price reduction given that RKH was not awarded therewith. Of course, since the details of the acquisition are confidential, in case RKH did address this matter in such a cautious way in the SPA, there might be risk of double recovery.

(Most likely) Outcome: 50% off

In cases where the respondent proved investor's lack of due diligence or failure to minimize losses, tribunals often made the Solomonic decision of reducing by 50% the amount of damages awarded (e.g. MTD v Chile, Award § 244–246; EDF v. Argentina, Award § 1302-1312), by holding the claimant accountable for half of its own losses and the host State liable for the other half.

The Takeaway

The safest way a claim is transferred intact from an investor to another claimant is throughout a political-risk insurance covering the investment by virtue of the subrogation provision (often found in many BIT-MIT). However, most insurance contracts do not cover FET breaches (hence, they share to some extent the same limit of an acquisition similar to the one discussed above).

Thus, should a purchasing company smell the *fumus boni juris* of a target company's claim in an investment arbitration, the best option for the buyer might be to prompt the seller to initiate the arbitration on its own behalf by including in the SPA a condition precedent to that effect and backing up financially the selling company by means of a suitable third-party funding arrangement (since probably the seller will not have the necessary funds or may not be interested to keep on pouring money in a company for sale).