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ICSID's Largest Award in History: An Overview of Occidental Petroleum Corporation v the Republic of Ecuador

Tai-Heng Cheng (New York Law School) · Wednesday, December 19th, 2012 · Institute for Transnational Arbitration (ITA), Academic Council

By Tai-Heng Cheng* & Lucas Bento**

Introduction

On October 5th, 2012, a split ICSID tribunal determined that the Republic of Ecuador had breached the US-Ecuador bilateral investment treaty (“BIT”), and awarded damages of US\$1.77 billion (US\$2.3 billion with interest applied), reportedly the largest award ever to have been issued by an ICSID tribunal. This award is remarkable not only because of the large quantum of damages (and of the tribunal’s 326-page decision), but also because it addresses cutting edge issues in international investment law, including the principle of proportionality and the assessment of damages. The award also demonstrates the vast power that tribunals wield and raises important normative questions about ICSID.

Facts

Occidental Petroleum Corp. (“Oxy”) started doing business in Ecuador in the mid-1980s under a services contract with Petroecuador, Ecuador’s national oil company. In 1993, Ecuador amended its Hydrocarbons Law to allow parties to enter into participation contracts. After protracted negotiations, on May 21, 1999, Ecuador and Oxy entered into a Participation Contract to explore and exploit hydrocarbons in Block 15 of the Ecuadorian Amazon region.

On 19 October, 2000, Oxy sought to explore ways to finance the expansion of its operations in Ecuador and diversify and reduce its exposure in the country. Coincidentally, Alberta Energy Corporation Ltd (“AEC”) was looking to expand its investment in Ecuador. In order to further these goals, Oxy and AEC entered into a Farmout Agreement where AEC acquired a 40% economic interest in Block 15 in return for certain capital contributions. The transfer, however, violated both the Participation Contract and Ecuadorian law, which required ministerial approval.[1]

When the government learned of the Farmout Agreement, it came under heavy political pressure to terminate its relationship with Oxy. On May 15, 2006, following a number of demonstrations against the government and Oxy, the government of Ecuador issued a decree (the “Caducidad Decree”) terminating with immediate effect its Participation Contract with Oxy.

On May 16, 2006, government officials arrived at Oxy's offices in Quito and seized all of its property. The next day, officials and the Ecuadorian National Police seized Oxy's oil fields in Block 15, including wells, drills and storage facilities. Two days later, Oxy filed a request for arbitration.

Arguments

At its core, the dispute concerned the termination of the Participation Contract between Oxy and Ecuador. Specifically, Oxy advanced two arguments. First, in terminating the Participation Contract without cause (i.e. in the absence of a termination event under the Contract), Ecuador breached its obligations under both the Participation Contract and BIT. In particular, Oxy argued that the Farmout Agreement did not operate as an assignment of rights in violation of Ecuadorian law. Second, assuming a termination event was found to have occurred, Oxy argued that the termination would still be in breach of the Ecuador's obligations under the BIT and Ecuadorian law because it was unfair, arbitrary, discriminatory and disproportionate.[2]

In its defense, Ecuador argued that the Farmout Agreement effected an assignment and thus required ministerial approval, as required by Ecuadorian law. It also argued that Oxy was liable for a number of violations of Ecuador's Hydrocarbons Regulations. Finally, Ecuador argued that the Caducidad Decree complied fully with the BIT and international law, and that no expropriation took place.

Decision

The tribunal held that the Farmout Agreement effected an assignment in violation of Ecuadorian law, since it was not approved by the Ecuadorian government. However, the tribunal held that the termination of the Participation Contract was a disproportionate response to Oxy's assignment of rights under the Farmout Agreement.

As part of its proportionality analysis, the tribunal held that there were a number of alternatives to terminating the Participation Contract and that the latter should have thus been a measure of last resort. The tribunal also found that Ecuador did not suffer "any quantifiable loss as a direct result of AEC taking an economic interest in Block 15." [3] Thus, the Caducidad Decree was disproportionate to its objective.

The tribunal noted that the principle of proportionality is observed in a variety of international law settings, including its application to potential breaches of BIT obligations, such as fair and equitable treatment obligations.[4] To this end, the tribunal noted:

“. . . the overriding principle of proportionality requires that any [] administrative goal must be balanced against [the investor's] own interests and against the true nature and effect of the conduct being censured.”[5]

The Caducidad Decree was issued in violation of Ecuadorian law, which recognizes the proportionality principle, and in breach of the BIT and customary international law. The tribunal also held that Ecuador's measures were "tantamount to expropriation." [6]

Damages

Of particular interest here are the issues of contributory negligence and the impact of the Farmout Agreement on Oxy's damages.

With regard to contributory negligence, the tribunal reduced Oxy's damages because of its own wrongful conduct, namely its violation of Ecuadorian law in entering the Farmout Agreement without ministerial authorization. Accordingly, the tribunal found that Oxy contributed to the extent of 25% to the prejudice which it suffered when Ecuador issued the Caduciad Decree.

With respect to the impact of the Farmout Agreement on Oxy's recovery, the tribunal rejected Ecuador's argument that any calculation of damages to be awarded to Oxy must be limited to a 60% interest in Block 15 because of Oxy's transfer of 40% interest under the Participation Contract to AEC. The tribunal reasoned that the assignment of rights under the Participation Contract pursuant to the Farmout Agreement was null and void because it lacked ministerial authorization, as required by Ecuadorian law. Thus, no reduction based on the assignment was possible, given the nullity of the transfer of rights.

Applying these findings, the majority awarded Oxy US\$1.77 billion plus interest.

Professor Brigitte Stern dissented with respect to how the majority calculated damages, describing the majority's decision to nullify and void the assignment as "manifest excess of power."^[7]

Commentary

This decision illustrates the application of the proportionality principle as an element of fair and equitable treatment under BITs. To this end, the award is a valuable addition to a growing number of ICSID awards applying the proportionality principle in the international investment context. The award is also one of the largest in ICSID's history, though it may not be final. In October 11, 2012, a few days after the tribunal issued its award, Ecuador filed a request for annulment of the award.

Whatever the result of the annulment proceedings, the Oxy award demonstrates the great power of investment treaty arbitration tribunals. It is unsurprising that tribunals routinely allocate responsibility between governments and foreign corporations for failed investment projects. But observers should now realize that with this authority comes the power to impose damages of over a billion dollars to rectify wrongful acts. This power is nothing short of the ability to radically alter the wealth of shareholders and workers of investor companies, as well as the well-being of citizens and residents of host states. Fundamental issues about ICSID, such as its role in increasing foreign investment and its compatibility with democratic accountability, can no longer be reserved for polite academic discussions. After the Oxy award, these issues must also be confronted in rigorous policy debates.

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[1] An interesting issue considered by the tribunal involved whether the transfer of an economic interest amounted to an assignment of legal rights. See *Occidental Petroleum Corporation v The Republic of Ecuador*, Award, ICSID Case No. ARB/06/11 (Oct. 5, 2012) [hereinafter Award], ¶306.

[2] Award, ¶206.

[3] Award, ¶445.

[4] Award, ¶404; see also *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); *Azurix Corp. v. The Argentine Republic*, ICSID Case No. ARB/01/12 (14 July 2006).

[5] Award, ¶450. The tribunal also noted that the principle of proportionality was recognized under the Ecuadorian constitution.

[6] Award, ¶455.

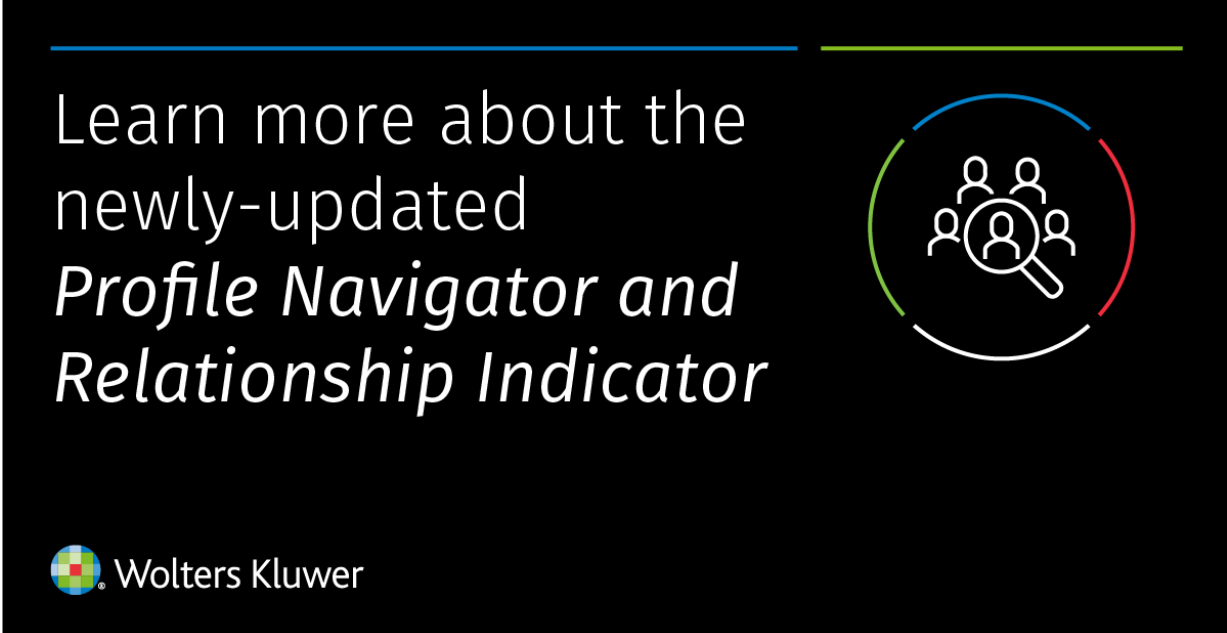
[7] *Occidental Petroleum Corporation v The Republic of Ecuador*, Dissent, ICSID Case No. ARB/06/11 (Oct. 5, 2012), ¶5.

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