



Ad hoc committee orders record annulment

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In the first annulment of an ICSID arbitration award since 2010 and the largest ever reduction of an ICSID award by an annulment committee, an ad hoc committee has recently issued a decision partially annulling the arbitration award in the case of *Occidental Petroleum v Ecuador*¹ and reducing the damages payable by Ecuador to Occidental by 40 percent.

Background

The original dispute concerned the termination by the Ecuadorian government of a participation contract entered into in May 1999 for the exploration and exploitation of hydrocarbons in Block 15 in the Ecuadorian Amazon. Under the participation contract, which was subject to Ecuadorian law, Occidental received a share of the oil produced from Block 15, in return for undertaking the obligation to explore, develop and exploit Block 15 and assuming responsibility for all associated expenditures.

In October 2000, Occidental and City Investment Company Limited (AEC) executed a farmout agreement and a joint operating agreement, under which AEC paid approximately US\$180 million to Occidental as consideration for the acquisition of a 40 percent "economic interest" in the production from Block 15. Under a second phase of the deal, provided that AEC made regular payments to Occidental over a four-year period and Ecuador's prior approval was obtained, Occidental would transfer legal title over 40 percent of its interest to AEC and AEC would become a party to the participation contract and related agreements.

Occidental did not seek or obtain Ecuador's authorisation for the assignment of the "economic interest" in the participation contract to AEC in 2000. In July 2004, Occidental sought authorisation to transfer legal title over the 40 percent interest in Block 15 to AEC. Ecuador refused to authorise this transfer, and the Ecuadorian Minister of Energy and Mines instructed PetroEcuador to initiate the termination procedure of the participation contract. On 15 May 2006, the Ecuadorian government issued the *Caducidad* Decree terminating the participation contract with immediate effect.

The claimants filed a request for arbitration on 17 May 2006, alleging breaches by Ecuador of Ecuadorian and international law, in particular the 1993 Bilateral Investment Treaty between the United States and the Republic of Ecuador (the BIT).

The award

A tribunal consisting of Yves Fortier QC, David Williams QC and Professor Brigitte Stern upheld jurisdiction in 2008 and issued a final award in October 2012.

In its award, the tribunal unanimously held that, pursuant to the farmout agreement and joint operating

agreement, Occidental transferred rights under the participation contract to AEC. In doing so, Occidental breached both the participation contract and relevant Ecuadorian legislation. However, the tribunal found that Ecuador's issuing of the Caducidad Decree was a "disproportionate sanction" for Occidental's breach of law and contract, given that other recourses were available and AEC was an approved operator in Ecuador. The tribunal thus found that Ecuador's termination of the participation contract breached Ecuadorian law, customary international law and the prohibitions against expropriation and unfair treatment in the BIT.

Although the tribunal's conclusions as to liability were unanimous, in a dissenting opinion Professor Stern fundamentally disagreed with the majority's decision on quantum, which she believed relied upon "grossly incorrect legal bases". The majority concluded that Block 15 was worth US\$2.35 billion, but that damages should be reduced by 25 percent to reflect Occidental's contributory negligence in failing to obtain approval for the farmout. In contrast, Professor Stern proposed a 50 percent reduction in damages, stating that the claimants acted "both very imprudently and illegally".

However, the most significant disagreement between Professor Stern and the other members of the tribunal concerned the question of whether Occidental held a 60 percent or 100 percent beneficial interest in the participation contract. The majority held that the assignment of rights to AEC was void ab initio because of Occidental's failure to obtain prior approval from the Ecuadorian authorities, and therefore Occidental continued to own 100 percent of the investment and could receive 100 percent compensation. Professor Stern considered that until the assignment was declared void by a competent court, AEC (or Andes, a Chinese company that acquired AEC's stake), held a valid 40 percent beneficial interest in the investment. Professor Stern concluded that, by denying the legal effect of the assignment to AEC, the tribunal majority had "exceed[ed] its powers in annulling a transfer of rights to an investor that was not a party to the arbitration...".

The decision of the committee

The committee confirmed the tribunal's jurisdiction, rejecting Ecuador's arguments that would have entailed the annulment of the award as a whole for lack of jurisdiction.

However, the committee found fault with a number of the legal bases for the majority decision of the tribunal to calculate damages by reference to 100 percent of the investment. Echoing Professor Stern's dissenting opinion, the committee found that the tribunal had "manifestly exceeded its powers by wrongly assuming jurisdiction" with regard to the 40% percent investment beneficially owned by AEC/Andes and, in effect, accepting jurisdiction over the investment of a third party to the arbitration that did not benefit from the protection of the BIT. As a result, the compensation owed to Occidental has been revised down from 100 percent to 60 percent of the value of Block 15.

Comment: a warning to potential claimants

The award had already attracted significant attention in 2012, the order for Ecuador to pay Occidental damages of US \$1.77 billion plus interest being (at the time) reportedly the largest ever award to have been made by an ICSID tribunal. This decision of the committee may now reignite debate about the scope and effect of annulment proceedings in ICSID cases, in particular given that the committee was largely in agreement with the strong dissenting opinion given by Professor Stern in the underlying proceedings.

The decision also serves as a reminder to parties and ICSID tribunals that the scope of the jurisdiction of ICSID tribunals is narrow and that only beneficial owners of investments, who are covered by the protection of a relevant treaty, are able to claim compensation for breaches of that treaty. It should act as a warning to potential claimants carefully to consider the position in relation to beneficial ownership of the investment before bringing proceedings. As the committee indicated, allowing protected investors to transfer beneficial ownership of an investment to an unprotected third party while expecting a tribunal to retain jurisdiction over the third party would "open the floodgates to an uncontrolled expansion of jurisdiction *ratione personae*".

¹ *Occidental Petroleum Corporation and Occidental Exploration and Production Company v The Republic of Ecuador*, ICSID Case No. ARB/06/11, Award, October 5, 2012.

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