THE ERA OF PETROLEUM ARBITRATION MEGA CASES

Commentary on Occidental v. Ecuador, ICSID Award, 2012

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Occidental v. Ecuador arbitration award announced on October 5, 2012,[1] represents the largest ICSID award in history

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1. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award (Oct. 5, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C80.

in the new era of mega cases in international arbitration related to the oil industry.[2] The idea of mega cases refers to the amount of claims and compensations awarded which makes "ordinary" amounts that swing in the hundreds of millions and billions of U.S. dollars, in arbitration cases dealing with expropriations, tax reforms or environmental accidents in the oil and gas sector.[3] This, for sure, may surprise the general public, politicians and mass media, however, having in mind factors such as the current prices of commodities, the devaluation of the U.S. dollar and the current value of investments in natural resources producing high rates of returns, these larger amounts should not be unexpected at all.

But, considering the relevance of these figures in the economy of states and corporations, the ideal of a fair and efficient system of transnational dispute resolution is not exempted of risks. One of this is that since these claims are so large, split decisions will probably dominate international awards, instead of decisions strictly decided under applicable laws.[4] In these mega cases, we are witnessing a trend of arbitrators trying to find a balance between the expectations of foreign investors and host governments facing the dilemma of "too big to fail" using the law in a way that tries to favor both

2. *See* George Kahale III, *Is Investor-State Arbitration Broken?*, 9 TRANSNAT'L DISP. MGMT. 1, 28, 31 (Oct. 2012), *available at* http://www.curtis.com/siteFiles/Publications/tv9-7-article19%20(2).pdf (describing this era of mega cases and the outcome of the *Occidental* award decision). Two arbitration awards have been reported against the Nigerian National Petroleum Corporation (NNPC) in favor of companies ESSO and Shell for 1.8 billion dollars and 3.4 billion dollars, respectively, in disputes on the interpretation of Nigerian tax regulation. Both awards were voided by the Federal High Court sitting in Abuja. *See* Innocent Anaba & Ikechucwu Nnochiri, *Court Voids Two Arbitration Awards Worth N840bn Against NNPC*, VANGUARD, April 23, 2012. It is also important to recall the *Chevron v. Ecuador* case filed in 2009 before the Permanent Court of Arbitration at The Hague, which deals with Ecuadorian violation of the U.S.-Ecuador BIT for the Ecuadorian court decision that commanded Chevron to pay nineteen billion dollars for the release of massive quantities of toxic petroleum in the Ecuadorian Amazon.

3. Kahale, *supra* note 2, at 28.

4. This may involve political and reputation considerations of the parties, or even risk to follow in the influence of the reputation of the own arbitrators. *See* Alec Stone Sweet, *Investor State Arbitration: Proportionality's New Frontier*, 4 L. & ETHICS HUM. RTS. 48, 62 (2010) (noting tribunals are now applying sub-principles, including good faith, access to justice and due process, and the legitimate expectations of both parties).

parties.[5] This position may work in some cases, but in others would be criticized when the solution provided by the arbitrator lessens the expectation of fairness of a community of states and investors who sought the settlement of the dispute through a specialized panel, in this case, a specialized panel deciding petroleum industry disputes avoiding unclarity and uncertainties.

From a historical perspective, the case *Occidental v. Ecuador* is anchored in the wave of expropriations and tax legislation reforms that occurred in Latin America after 2000, as oil prices increased.[6] The rise in oil prices expanded litigation and arbitration between host states and international oil companies in situations where oil and gas contracts failed to adapt to the new realities of the market, and renegotiations called for by governments were unable to result in an agreement under the new conditions.[7] Ecuador, as well as Venezuela, Bolivia and Argentina are among the Latin American countries with an increased number of cases being filed before the International Centre for Settlement of Investment Disputes (ICSID) related to the oil and gas industry.[8] The *Occidental* case is particularly relevant due to the substantial size of the award from a complex claim arising from the performance of a farmout agreement, the breach of a petroleum participation contract, and the state violation of a bilateral investment treaty (BIT).[9]

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5. *Id.*

6. Osmel Manzano & Francisco Monaldi, *The Political Economy of Oil Production in Latin America*, 9 ECONOMÍA 59, 59, 90–91 (2008) (discussing the tax and expropriation policies of Ecuador in relation to oil exports, as well as its effect on the oil contract with Occidental).

7. *See* Alexia Brunet & Juan Agustin Lentini, *Arbitration of International Oil, Gas, and Energy Disputes in Latin America*, 27 NW. J. INT'L L. & BUS. 591, 595–96, 609–10 (2007) (discussing Latin America's increasing number of energy-related disputes that are settled by international arbitration); James Loftis et. al., *Latin America: Arbitration Overview*, THE ARBITRATION REVIEW OF THE AMERICAS 13, 14 (2007) (explaining the large amount of litigation that followed the rise in oil prices, which was accompanied by the vast expropriation of oil revenues by Latin America governments).

8. Brunet & Lentini, *supra* note 7, at 609–10, 628 app. II.

9. *See* Memorandum from Lori Wallach & Ben Beachy of Global Trade Watch (Nov. 21, 2012) (on file with author) (expressing alarm over the imposition of ICSID's largest investor-state award and the rationale behind the award); Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award, ¶ 876

Ecuador was ordered to pay Occidental $1.77 billion, plus interest, for expropriating Occidental's interest in a participation contract over "Block 15" in the Ecuadorian Amazon.[10]

The ICSID Tribunal, composed of Mr. L. Yves Fortier (President), Mr. David Williams, and Professor Brigitte Stern, unanimously found that Occidental violated national law and breached the participation contract by transferring rights under a farmout agreement to a foreign investor, AEC, without the authorization of the Ecuadorian government.[11] However, the tribunal found that the reaction of Ecuador through the unilateral termination of the contract was disproportionate to Occidental's breach, thus finding that Ecuador not only violated Ecuadorian law and customary international law, but also that Ecuador failed to accord a fair and equitable treatment standard and that the administrative sanction was a measure that "tantamount to expropriation" under the U.S.-Ecuador BIT.[12]

Despite the unanimous decision concerning the liability of the parties under the case, the Tribunal reached a split decision on the principles that were applied to calculate the quantum of the award relating to: (i) whether the assignment of rights meant that claimants could only claim a percentage of the fair market value of the participation contract; (ii) whether the effects of the tax legislation enacted by the Ecuadorian government after the participation contract was entered into force should be taken into account in the calculation of damages; and (iii) how much the claimants' damages should be reduced in light of OEPC's contribution to its own losses.[13]

The case created some optimism among oil and gas

(Oct. 5, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C80 (explaining how the various breaches relate to the damages awarded).

10. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 876 (2012).

11. *See id.* ¶¶ 649, 876 (reducing the award to Occidental by twenty-five percent).

12. *Id.* ¶¶ 455, 876.

13. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Dissenting Opinion, ¶¶ 1, 7–13, 160–61 (Oct. 5, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C80.

corporations because of the amount of compensation awarded under standard provisions of a BIT, especially in light of existing skepticism on the effectiveness of these treaties.[14] However, the possibility of enforcing these decisions against states is still unclear, although Ecuador has previously complied with arbitration awards despite political declarations of their officials.[15] The decision has also generated some criticism caused by what has been qualified as a non-rigorous application of law by the strong dissenting opinion of Arbitrator Stern, concerning the calculation and attribution of damages imposed on Ecuador, which may echoed in the pending annulment procedure already filed by Ecuador before the ICSID.[16]

In Section I, this Article intends to present an overview of the facts and the tribunal's reasoning in this award. Section II will provide commentary on the possible impacts of this decision for the petroleum industry in terms of the assignment of rights, the application of the proportionality analysis in international investment law and the expectations of foreign investors for compensation in cases where investors have incurred in violations of national law.

I. THE AWARD.

The Award dispatched on October 5, 2012, provides the decision on liability and compensation to a foreign investor in a

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14. *See* Tai-Heng Cheng & Lucas Bento, *ICSID's Largest Award in History: An Overview of Occidental Petroleum Corporation v. the Republic of Ecuador*, KLUWER ARBITRATION BLOG (Dec. 19, 2012), http://kluwerarbitrationblog.com/blog/2012/12/19/icsids-largest-award-in-history-an-overview-of-occidental-petroleum-corporation-v-the-republic-of-ecuador (predicting the ICSID's power to radically alter the wealth of shareholders and investor companies).

15. Alison Sider & Mercedes Alvaro, *Occidental Awarded $1.77 Billion in Ecuador Case*, WORLD OIL NEWS CENTER (Oct. 8, 2012), http://www.worldoil.com/Occidental_awarded_1.77_billion_in_Ecuador_case.html (questioning Occidental's ability to collect its award from Ecuador). *See also*, *Ecuador Pays Oxy VAT Award*, WIKILEAKS.COM, http://wikileaks.org/cable/2008/04/08QUITO314.html.

16. *See Occidental*, ICSID Case No. ARB/06/11, Dissenting Opinion, ¶ 1 (2012) (arguing that the damages rested on grossly incorrect legal bases); Wallach & Beachy, *supra* note 9 (laying out the main critiques of the large award received by Occidental against the Ecuadorian government); *see also* Sider & Alvaro, *supra* note 15 (discussing Ecuador's decision to appeal the decision rendered by the ICSID).

dispute that lasted six years.[17] Although this is above the average duration of a regular ICSID case, it is similar to other complex oil and gas disputes in front of the ICSID which range among five to six years.[18] The arbitration started in May 2006, when the Secretary General of the ICSID acknowledged receipt of the Request for Arbitration presented by Occidental Petroleum Corporation and Occidental Exploration and Production Company (respectively, Occidental and OEPC), two U.S. companies incorporated in Delaware and California, against the Republic of Ecuador and the Empresa Estatal Petróleos del Ecuador (PetroEcuador)."[19]

The dispute concerned the termination of a 1999 participation contract entered into by Occidental and PetroEcuador "for the exploration and exploitation of hydrocarbons in Block 15 of the Ecuadorian Amazon,"[20] one of the richest oil regions in the country.[21] ICSID obtained jurisdiction through both PetroEcuador's consent to arbitration in the participation contract[22], and Ecuador's consent to arbitration in a 1993 treaty with the United States concerning the encouragement and protection of investments.[23]

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17. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 1, 457 (2012).

18. *See* Georges R. Delamue, *ICSID Arbitration Proceedings: Practical Aspects*, 5 PACE L. REV. 563, 575 n.44 (1985) (stating that the average duration for an ICSID proceeding is 2.5 years). However, other oil and gas disputes, such as ConocoPhillips v. Venezuela, Burlington Resources v. Ecuador, and Mobil Investments Canada v. Canada, have surpassed five years. *See ICSID: List of Pending Cases*, WORLDBANK.ORG (last updated Apr. 17, 2013), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=GenCaseDtlsRH&actionVal=ListPending (showing the pending cases and their registration dates).

19. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 1, 4 (2012).

20. *Id.* ¶ 2.

21. *Ecuador: Country Analysis Brief*, U.S. ENERGY INFO. ADMIN., Oct. 26, 2012, *available at* http://www.eia.gov/countries/cab.cfm?fips=EC.

22. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Decision on Jurisdiction, ¶ 31 (Sept. 9, 2008), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C80.

23. *Id.* ¶ 34.

A. The Facts

Occidental has had a presence in Block 15 since 1985 as a service contractor for the Corporación Estatal Petrolera Ecuatoriana (now PetroEcuador), whereby Occidental provided substantial services for the initial development of Block 15.[24] In 1993, shortly after Occidental began production from Block 15, "Ecuador amended its [hydrocarbons law] to allow the negotiation of 'participation contracts.'"[25] The participation contract was "essentially a type of production sharing agreement" where the state and contractors share in the production of crude oil and all of the expenditures are borne by the contractor.[26] Thus, "[t]his contractual model gave producers a stake in the production that made exploration risks more palatable[,]" thereby "guarantee[ing] Ecuador a profit from its production share, since it no longer had any expenses associated with oil production."[27] The new conditions promoted negotiation with foreign investors, and Occidental was among the companies interested in participating in the oil exploration and production activities in Ecuador.[28]

Subsequently, Occidental signed a participation contract with PetroEcuador in May 1999 and began increasing daily production of Block 15 from approximately 28,000 barrels per day to allegedly over 100,000 barrels per day, which production level then remained constant through 2006.[29]

This increase of production was not an exclusive success of Occidental. In October 2000, Occidental entered into a farmout agreement with Alberta Energy Corporation "AEC", through the related entity AEC International (collectively referred to as AEC), which "was looking to expand its investments in Ecuador" for the performance of exploration and production activities.[30]

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24. *See Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 111–13 (2012) (discussing Occidental's presence in Ecuador resulting from its services contract with Petroecuador).

25. *Id.* ¶¶ 113–14.

26. *Id.* ¶ 114.

27. *Id.*

28. *Id.* ¶¶ 114–15; Manzano & Monaldi, *supra* note 6, at 90.

29. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 115, 126 (2012).

30. *Id.* ¶¶ 127–28.

Occidental sought this agreement to provide the necessary funds, as well as to diversify and reduce its exposure following a current and common practice in the upstream petroleum industry.[31]

"In the Farmout's first phase, AEC purchased 40% Occidental 'economic interest' in Block 15"; "[e]ssentially, through contributions to Occidental's Block 15 investments, AEC purchased the right to 40% of Occidental's share of Block 15's production."[32] The letter of intent, signed in August 2000, described the proposed farmout as a two-stage transaction, first:

> AECI would farmin to Block 15 to acquire a 40% economic interest in Block 15 from [Occidental]. . . . While [Occidental] would continue to own 100% of the legal title of the participating interest in Block 15 under the Participation Contract, [Occidental] would hold AECI's 40% economic interest as a "nominee" or "bare trustee" with the obligation to convey legal title, subject to government approvals, at a mutually agreeable time following AECI's payment of all amounts required to earn its interest. Prior to such conveyance, while [Occidental] holds AECI's interest in trust, [Occidental] shall be obligated to represent the interest of AECI, as if AECI were a participant with a 40% interest under the terms of a standard joint operating agreement to be mutually agreed.[33]

The second stage of the farmout was conditioned on AEC making the required payments, and the government giving its prior authorization.[34]

These conditions are in the heart of the discussion during a large part of the award rendered at the ICSID.[35] Through the farmout agreement, the parties agreed on an economic operation and a promise of transfer of forty percent of Occidental's position

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31. *See* A. Timothy Martin, *Bifurcation of Title in International Oil & Gas Agreements*, A LIBER AMICORUM: THOMAS WALDE — LAW BEYOND CONVENTIONAL THOUGHT 171, 171–74 (Jacques Werner & Arif Hyder Ali eds., 2012) (explaining why owners of oil and gas rights often want to employ farmout agreements).

32. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 130 (2012).

33. *Id.* ¶ 128.

34. *Id.* ¶ 131.

35. *See generally id.* ¶¶ 114–39.

in Block 15.[36] However, not considering this enough, the parties also signed a joint operating agreement (JOA), with Occidental acting as operator, for the purpose of implementing the farmout agreement and continuing exploration and production operations.[37] The parties closed the deal on October 31, with an effective date of October 1, 2000.[38] Since then, AEC paid its forty percent share of Block 15's capital expenditure plus the annual carry amount to satisfy Occidental's carry.[39]

Simultaneously, a series of events occurred that generated dramatic consequences in the execution of the participation contract.[40] In August 2001, Ecuador's tax authority, the *Servicio de Rentas Internas, ("*SRI"), "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."[41] Occidental "interpreted this decision to be a violation of Ecuadorian tax laws and the U.S.-Ecuador BIT, and in November 2002 filed an international arbitration claim against Ecuador to recover the VAT refunds."[42] In July 2004, Occidental was awarded seventy-five million dollars, following a finding that Ecuador's conduct was in breach of its duty to provide fair and equitable treatment.[43] Ecuador challenged the award in the English courts by claiming the arbitrators had exceeded their jurisdiction; the application was rejected by the High Court in March 2006,[44] and that rejection was upheld by the Court of Appeals in July 2007.[45] Ecuador honored this international commitment in March 2008, paying

36. *Id.* ¶ 128.

37. *Id.* ¶¶ 129, 311.

38. *Id.* ¶ 129.

39. *Id.* ¶ 128. The annual carry amount constituted a cap on AEC's obligation to pay Occidental's carry.

40. *See id.* ¶¶ 139–41 (describing the decision to build another pipeline with another company, Oleoducto de Crudos Pesados).

41. *Id.* ¶ 170.

42. *Id.*

43. Occidental Exploration & Prod. Co. v. Republic of Ecuador, 138 I.L.R. 35, ¶¶ 187, 212 (London Ct. of Int'l Arb. 2004).

44. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 39, 172 (2012).

45. *Id.* ¶ 172.

the VAT refunds award in full.[46]

The VAT-refunds arbitration and the farmout operation each troubled the relations between Occidental and the government of Ecuador, resulting in a sequence of events ending with the termination of the participation contract.[47] The situation received media attention and spurred public demonstrations.[48] Partially because of the demonstrations, Ecuador's congress removed President Gutierrez from office in April 2005.[49]

As a result of the VAT award and the farmout agreement, Ecuadorian officials began to examine the possibility that Occidental had breached its original participation agreement.[50]

On July 15, 2004, just two weeks after the VAT award was released, Occidental requested approval of the transfer to AEC of forty percent of legal title in Block 15 in the execution of the second phase of the farmout agreement.[51] The approval sought by Occidental was not granted.[52]

Several weeks later, on August 24, 2004, "the Attorney General of Ecuador wrote to the Minister of Energy and Mines and requested that he terminate the Participation Contract[;]" he also wrote to the head of PetroEcuador, requesting that the

46. *Ecuador Pays Oxy VAT Award*, WIKILEAKS.COM, http://wikileaks.org/cable/2008/04/08QUITO314.html.

47. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 173–99 (2012).

48. *See id.* ¶¶ 175, 181 (noting radio interviews that led to civil unrest in the country of Ecuador as civilians protested the Occidental contract).

49. *See id.* ¶ 186 (describing the ouster of Gutierrez, along with other top officials); Juan Forero, *Ecuador's Leader Flees and Vice President Replaces Him*, N.Y. TIMES, Apr. 21, 2005, http://www.nytimes.com/2005/04/21/international/americas/21ecuador.html?_r=0.

50. *See Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 173 (2012) (describing the Ecuadorian Minister of Energy's response to the "VAT Award as well as OEPC's alleged failure to comply with Ecuadorian laws and regulations"); *id.* ¶ 174 (describing the Ecuadorian Attorney General's similar reaction); *id.* ¶ 176 (detailing the DNS auditing coordinator's opinion that OEPC had not complied with applicable Ecuadorian laws regarding the farmout agreement).

51. *See Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 171, 180, 213 (2012) (explaining the series of events leading to Occidental's requested approval to transfer forty percent of legal title in Block 15 to AEC).

52. *Id.* ¶ 213.

contract process of *caducidad* (forfeiture) be followed.[53] The decisions were all postponed until early 2005, when anti-American and anti-foreign investor groups voiced their concern that OPEC's contract had not yet been terminated by protesting in the streets of Quito and in front of OEPC's offices.[54] The demonstrators increased the pressure over Ecuadorian authorities and subsequently, in February of 2005, Minister López and PetroEcuador Executive President Hugo Bonilla, "were called before the Ecuadorian Congress and questioned with respect to their perceived procrastination over the termination of Occidental's contract."[55]

On May 15, 2006, Minister Rodríguez issued the *Caducidad* decree on the grounds that Occidental violated contractual engagements and Ecuadorian law through the assignment of rights under the participation contract by the farmout agreement.[56]

> 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 . . . .
>
> On 16 May 2006, State officials arrived at OEPC's offices in Quito and seized all of its property, including computers, files and other equipment, which were now said to be the property of the State. The next day, 17 May, other State officials, accompanied by the National Police, seized OEPC's oil fields in Block 15, including wells, drills, storage facilities and other oil exploration and production assets.[57]

As a consequence, Occidental presented an arbitration claim before the ICSID on the grounds that the *Caducidad* decree approved by the Ecuadorian government amounted to an unlawful expropriation of its investments.[58]

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53. *Id.* ¶¶ 177, 179.

54. *Id.* ¶ 181.

55. *Id.* ¶ 182.

56. *See id.* ¶ 199 (explaining that the decree terminated the participation contract and cited Articles 74.11, 74.12 and 74.13 of the HCL as a legal basis for terminating the contract); *id.* ¶ 173.

57. *Id.* ¶¶ 199–200.

58. *See id.* ¶¶ 201, 208–09, 453 (noting the principal contention of the arbitration

> The Claimants' principal contention . . . [was] that the termination of the Participation Contract was made without legitimate cause, *i.e.* in the absence of legal grounds for termination under both the Participation Contract itself . . . and Ecuadorian law.[59]
>
> . . . .
>
> [T]he Claimants maintain that by terminating the Participation Contract without cause . . . [Ecuador] breach its obligations under both the Participation Contract and the Treaty . . . .[T]he Claimants essentially allege that (i) the Farmout Agreement did not operate an assignment of contractual rights and obligations in violation of Article 74.11 of the HCL, and (ii) the Farmout Agreement and the Joint Operating Agreement did not create a consortium in violation of Article 74.12 of the HCL.[60]

Article 74.11 of the HCL provides:

> 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 . . . .[61]

Further, "assuming a Termination Event is found to have occurred, the Claimants contend that the *Caducidad* Decree would still be in breach of the Respondent's obligations under the Treaty and Ecuadorian law because it was unfair, arbitrary, discriminatory and disproportionate."[62]

Occidental argued that the farmout agreement had not reduced its ability to execute the participation contract "and that even if AEC had operated Block 15, Ecuador did not dispute that "it had already fully vetted and was prepared to approve

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claim was made without legitimate cause because there was a breach under international law prohibiting expropriation).

59. *Id.* ¶ 201.

60. *Id.* ¶ 205.

61. Ley de Hidrocarburos [Law of Hydrocarbons], Decreto Supremo No. 2967, R.O. 711, Art. 74 (Nov. 16, 1978) (interpretation and translation by ICSID arbitral body at *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 121 (2012)).

62. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 206 (2012).

AEC as an operator of Block 15."[63] Further, Occidental argued that Ecuadorian authorities "admitted that a financial relationship between [Occidental] and AEC was beneficial to [Ecuador]" having in mind that the increase of production of Block 15 provided a significant benefit rather than a harm.[64] Thus, Occidental argued that the termination of the participation contract was "grossly unfair, arbitrary, discriminatory and disproportionate," and was a result of political expediency, rather than on the basis of evidence or law.[65] Occidental also emphasized that:

> [Ecuador had] not terminated the contracts of other oil and gas operators in Ecuador (namely, Tripetrol and Petrobras), even though these operators have assigned rights and obligations subject to government approval, and others (such as Petrobell, Perenco, Tecpecuador and Canada Grande) have allegedly committed as many or more technical infractions as Occidental in relation to production.[66]

B. The Tribunal's Reasoning

First, in analyzing Occidental's position, the tribunal pointed out the contractual provision related to assignment under the participation contract and noted:

> Crucial to this issue of the alleged prohibition to transfer or assign rights under the Participation Contract are Clauses 16.1 and 16.2, which will be quoted again for ease of reference. They read as follows:
>
> SIXTEEN: TRANSFER AND ASSIGNMENT []
>
> 16.1 Transfer of this Participation Contract or assignment to third parties of the rights under the Participation Contract, must have the authorization of the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions

63. *Id.* ¶ 226.
64. *Id.* ¶ 226.
65. *Id.* ¶ 239.
66. *Id.*

> contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179.
>
> 16.2 The prohibition to transfer or assign rights under this Participation Contract without the approval of the Corresponding Ministry, as determined in Art. 79 of the Hydrocarbons Law, is 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 this Participation Contract.[67]

In the light of these contractual provisions, the tribunal reviewed the instruments of the farmout agreement and the JOA signed by the parties in order to determine whether there was evidence of a transfer of rights under the participation contract.[68] First, in the study of the JOA, the tribunal found that provisions of the JOA gave AEC specific managerial and voting rights in connection with Block 15 and thereby sought to confer rights under the participation contract.[69] Second, in analyzing the farmout agreement, the tribunal called experts from both sides to listen to opinions in the execution of the operation and contribute with the practice of risk allocation in the petroleum industry:

> The Claimants' expert on this point, Mr. Norman E. Maryan Jr., opined as follows: "I believe that the Parties intended the JOA in this case to be broadly drafted to enable its use both before and after legal title vested. I do not believe that such broadly drafted Joint Operating Agreements, such as the JOA in this case, can support the conclusion that AECI was vested with

67. *Id.* ¶¶ 298–99.

68. *See id.* ¶¶ 300–01 (explaining that the tribunal found evidence to determine the purpose of the farmout agreement and the JOA).

69. *See id.* ¶ 316 (noting that the number of acts where AEC could exercise a voting power comprised of the "Approval of a Development Plan;" "Approval of a Work Program and Budget or any amendment or modification thereof"; "Overexpenditures;" and "Decisions on financing Joint Operations . . . prior to the Transfer Date").

> full rights of a non-operator from the inception of the JOA."
>
> The Tribunal notes however that Mr. Maryan nuanced his opinion and admitted that the rights were indeed granted, albeit "apparently". He stated as follows: "I believe *that many of the rights apparently granted* AEC under the JOA *could, in fact, not be fully exercised* until after legal title vested."
>
> The Respondent's expert, Mr. A. Timothy Martin, when questioned at the Hearing on Mr. Maryan's views in this regard, opined as follows: "I disagree with this conclusion. It is my opinion that most of the rights that you would normally see in an industry JOA are, in fact, existent in this Operating Agreement, and *they are fully exercised both before and after legal title vested*."[70]

The debates of the experts were concentrated on the performance of farmout agreements with the specificities of the industry practice. However, the tribunal found the debate between the experts was not relevant or convincing, stating:

> Thus, the parties' experts are in agreement that, on its face, the Joint Operating Agreement operated, at a minimum, an apparent transfer of rights, but they disagree as to whether such rights could be exercised by AEC prior to the transfer of legal title. In the Tribunal's view, the fact that the debate between the experts focussed [sic] on whether certain rights *could be exercised*, as opposed to whether such rights *were to be transferred*, is irrelevant for purposes of the findings the Tribunal has made in respect of its interpretation of the Joint Operating Agreement. The true issue is whether a transfer of rights was to occur between OEPC and AEC upon execution of the Farmout Agreement and the Joint Operating Agreement, *i.e.* whether a purported transfer of rights has been established, and the Tribunal has conclusively found this to be the case. *The issue of whether such rights, once transferred, could or could not be immediately exercised is not relevant to the Tribunal's analysis.*[71]

70. *Id.* ¶¶ 325–27.
71. *Id.* ¶ 328 (emphasis added).

After discarding the expert's opinion over the practice in the industry, the tribunal subsequently searched other instruments of the assignment operations and found that Article 2 of the JOA represented a real transfer of rights and obligations of the participation contract:

> Art. 2.01 [. . .] The Farmout Interest to be transferred to AECI as of the Effective Time includes a "working interest" or "participating interest" in the Participating Agreements and Block 15 *except that it does not include nominal legal title to an interest in Block 15* or an interest as a party to the Participating Agreements. *OEPC shall continue to own 100% of the legal title to the Participating Agreements* and to the interests in Block 15 granted or provided for in the Participating Agreements; provided that from and after the Effective Time *OEPC shall hold legal title to the interest in the Farmout Property represented by the Farmout Interest of AECI in the Participating Agreements and Block 15 as a "nominee" with the obligation to convey legal title to such interest to AECI, subject to obtaining required governmental approvals, promptly following AECI's payment of all amounts required to earn the interest in the Farmout Property* represented by the Farmout Interest as hereafter provided and the expenditure of such amounts by OEPC as Operator under the JOA for Block 15 Capex (as hereinafter defined). *Prior to such conveyance, while OEPC holds legal title to AECI's interest in the Farmout Property on behalf of AECI, OEPC shall be obligated, at the sole risk, cost and expense of AECI, to act with respect to the Farmout Interest of AECI as AECI shall direct from time to time as if AECI were a party to the Participating Agreements owning legal title to a 40% interest in the Participating Agreements and the interests therein granted in Block 15,* subject to and in accordance with the terms and provisions of the JOA provided for in Section 2.02.[72]

72. *Id.* ¶ 330 (quoting FARMOUT AGREEMENT, ALBERTA ENERGY CORP. AND OCCIDENTAL EXPLORATION AND PROD. CO., art. 2.01 (Oct. 19, 2000)).

Based on the analysis of this Article, the tribunal concluded that the transfer of rights and obligations of the participation contract was "*de facto*" based on the term "as if," which, according to the opinion of the tribunal, resulted in a transfer of the participation contract rights under the JOA.[73] Under the JOA, Occidental agreed to share with AEC some of the rights and obligations it had under the participation contract and in doing so, Occidental breached its contractual obligations:

> It is clear to the Tribunal that this crucial Section 2.01 of the Farmout Agreement confirms 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. This provision further confirms that 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 reality, as between OEPC and AEC, the situation was identical both before and after conveyance of legal title in so far as the Participation Contract was concerned; they were operating *de facto* pursuant to the Joint Operating Agreement "as if" legal title had already been conveyed, and the ministerial authorization for the conveyance of legal title was a mere formality. More fundamentally, in the view of the Tribunal, this meant that OEPC was sharing with AEC its exclusive right to carry out Block 15 operations and was obligated "to act with respect to the Farmout Interest of AECI as AECI shall direct from time to time." This Section 2.01 of the Farmout Agreement, coupled with those provisions of the Joint Operating Agreement which the Tribunal reviewed previously, comfort the Tribunal in its conclusion that OEPC did indeed seek to transfer to AEC under these agreements rights it acquired from Ecuador under the Participation Contract.[74]

73. *Id.* ¶ 331.
74. *Id.*

At this point, the tribunal seems to enter into confusion between whether the assignment was referring only to the assignment of the contract or if it was related to the transfer of rights and obligations.[75] The tribunal rejected Occidental's interpretation that authorization from Ecuadorian authorities —was necessary to place AEC in privity with PetroEcuador.[76]

Instead, the tribunal concluded that a *de facto* transfer of rights occurred under the farmout agreement, Article 4, and Article 2 of the JOA.[77] Hence, the tribunal focused its analysis on the question of whether Occidental should have sought governmental authorization for the farmout agreement.[78] The tribunal focused on the "de facto" analysis and in the review of evidence which provided information of two different paths proposed by Occidental's executives to perform the farmout transaction and the request of governmental authorization:

> The proponents of Version A within OEPC (and AEC) were in good company which included the Claimants' expert on this issue, Mr. Andrew Derman. In his report submitted as part of this proceeding, Mr. Derman concluded, very categorically, that "[t]here was no transfer of legal title or rights and obligations under the Participation Contract by OEPC to AEC under either the Farmout Agreement or the Operating Agreement." As he explained later in his report: "Under the Farmout Agreement, if AEC satisfied its payment obligations, AEC had a right to receive from OEPC a portion of OEPC's oil produced under the Participation Contract. While OEPC could not guarantee that AEC would receive legal title, as legal title required approval by the Government of Ecuador, OEPC had a right to dispose of its oil freely, under the Participation Contract, and it could give AEC a portion of such produced oil. AEC essentially financed a portion of OEPC's financial exposure and, *like a bank*, AEC was repaid and compensated under the pre-agreed terms of the Farmout Agreement. If the Government of Ecuador did

75. *Id.* ¶¶ 333–35.
76. *Id.* ¶¶ 333–34.
77. *Id.* ¶¶ 331, 335.
78. *Id.* ¶¶ 331, 334–36.

> not approve the assignment of legal title, AEC would be repaid and compensated for its financing, but it would never secure its position and it would never obtain legal title. *Like a bank*, AEC's financing would remain uncollateralized."[79]

The court further noted that,

> On the other hand, the proponents of Version B, probably the lawyers, advocated that it was prudent to ask for "prior approval" for the "earn-in" phase. They had obviously carried out a cursory examination of the agreements at issue. But tellingly, the proponents of Version B were not dogmatic about the requirement of ministerial authorization. As noted earlier, the key paragraph of their draft concluded ". . . or else indicate that no such approval is required for such transaction."[80]

The tribunal observed that Occidental assumed the thinking of Version A and supposed that, for an earn-in phase, ministerial authorization of the Ecuadorian government was not required.[81] It considered this path to be a mistake under Ecuadorian law, and as a consequence, Occidental "breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL."[82] However, they concluded that the failure to seek authorization could not be interpreted as an act of bad faith.[83] The tribunal said: "They were business people, seasoned oilmen, for whom legal niceties were not as important as the business realities of the deal."[84] The tribunal concluded as follows:

> The Claimants' failure to seek ministerial authorization was a mistake, a serious mistake, but it was not done in bad faith. Should Paul MacInnes and his colleagues, during their visit with Minister Terán on

79. *Id.* ¶ 346 (quoting Expert Report of Andrew B. Derman ¶ 15, Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award (Aug. 10, 2012)).

80. *Id.* ¶ 347.

81. *Id.* ¶ 348.

82. *Id.* ¶¶ 348, 380–81.

83. *Id.* ¶ 380.

84. *Id.* ¶ 348.

> 24 October 2000, have given him a copy of the Farmout Agreement and the Joint Operating Agreement so that his advisors could have formed their own opinion about the true nature of the transaction? As stated earlier, the Tribunal has no hesitation in answering its own question in the affirmative. OEPC and AEC were negligent in not doing so. But again, the Tribunal does not find that failure to do so amounted to bad faith. They may have been negligent 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. In a number of instances, in the fall of 2000, they revealed publicly in Ecuador that they had entered into a Farmout transaction with AEC. When they realized that their behaviour [sic], and in particular the last paragraph of their 25 October letter, created confusion within the Ministry, they tried to dissipate that confusion. Unfortunately, the confusion persisted until the spring of 2004 when officials of the Respondent sighted and analy[z]ed the Farmout Agreements.[85]

This paragraph is particularly relevant since it is the tribunal taking an approach that is outside the application of Ecuadorian law, but instead reasoned from a sociological approach in recognizing the practices of "seasoned oilmen" in the petroleum industry, to reach the conclusion that Occidental executives did not act in bad faith in the performance of the farmout transaction.

Then, given that the authorization was required by Ecuadorian Law and that Occidental failed to request it, the tribunal determined that Occidental's claims on legitimate expectations could not be satisfied.[86] Thus, the tribunal rejected the claim in this regard.[87] However, the tribunal found the sanction imposed by Ecuador on Occidental for failing to secure authorization to be manifestly disproportionate and contrary to the Ecuador-U.S. BIT and Ecuadorian law.[88] The tribunal

85. *Id.* ¶ 380.
86. *Id.* ¶ 383.
87. *Id.*
88. *Id.* ¶¶ 237, 452–55.

stated:

> The Tribunal agrees with the Claimants. Having found in the previous Section of the present Award that the *Caducidad* Decree was issued in breach of Ecuadorian law, in breach of customary international law and in violation of the Respondent's Article II.3(a) obligation to accord fair and equitable treatment to the Claimants' investment, the Tribunal now has no hesitation in finding that, in the particular circumstances of this case which it has traversed earlier, 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. [89]

The tribunal found that expropriation occurred based on a discretionary decision of a minister, and that it was disproportionate with Occidental's violation of Ecuadorian law.[90] Ecuador argued that the decision of termination was not discretionary since the sanction was imposed in Ecuadorian law and that the only other alternative was to do nothing.[91]

The relevant provisions of Ecuador's Law of Hydrocarbons are stated below:

CHAPTER IX

Caducidad, Sanctions and Transfers

Art. 74. The Ministry of Energy of Mines may declare the *caducidad* of contracts, if the contractor:

[. . .]

> 11. 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;
>
> 12. Forms consortia or associations for exploration and exploitation operations, or withdraws from them, without the Ministry's authorization.[92]

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89. *Id.* ¶ 455.

90. *Id.* ¶ 452.

91. *Id.* ¶ 28.

92. Ley de Hidrocarburos [Law of Hydrocarbons], Decreto Supremo No. 2967, R.O. 711 (Nov. 16, 1978) (translation by ICSID arbitral body at *Occidental*, ICSID Case No.

The tribunal reasoned in a different direction, finding that the *Caducidad* decree was an unsound solution based on the fact that the Ecuadorian government had three alternatives for dealing with their disagreement concerning the farmout agreement.[93] The alternatives quoted by the tribunal were:

> [1)] insistence on payment of a transfer fee in the order of USD 11.8 million; and/or [2)] improvements to the economic terms of the original contract; and/or [3)] a negotiated settlement which could of course have covered any areas that the parties so desired, including payment of the transfer fee which had been avoided, renegotiation of the contract and additional compensation.[94]

These alternatives placed in the historic period of the year 2004, had little chance to be performed in a situation post an international arbitration dispute with the State and anti-American trends in Ecuadorian politics. However, reviewing the Ecuadorian government actions the tribunal found Ecuador liable for unlawfully expropriating the rights of Occidental under the participation contract and under Article III.1 of the U.S.-Ecuador BIT.[95] Additionally, they found that Ecuador violated Article II.3(a) by failing to accord fair and equitable treatment.[96] The tribunal then continued with a discussion about the quantum of damages.[97]

The quantum phase of the award brought more elements into the discussion and created additional debate between the parties and arbitrators. In particular, the tribunal majority concluded that the farmout agreement produced no legal effect towards Ecuador and as a result, Ecuador was "obliged to compensate the Claimants for 100% of their interest in Block 15", but additionally, staying that the farmout agreement was still valid between OEPC and AEC, and that OEPC should compensate AEC and further recognize that AEC may have

ARB/06/11, Award, ¶ 121 (2012)).

93. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 434–36 (2012).

94. *Id.* ¶ 434.

95. *Id.* ¶ 455.

96. *Id.*

97. *Id.* ¶¶ 457–69.

legal actions to recover 40% of beneficial interest. Further, other points were highlighted as threshold issues before the tribunal reached the economic calculation of assets: (1) Ecuadorian Law 42; (2) the Ecuadorian VAT interpretative law; (3) the farmout agreement; and (4) The fault of Ecuador prior to the *Caducidad* decree.[98]

Occidental considered Ecuadorian Law 42[99] a windfall profit tax in light of Clause 5.3.2 of the participation contract.[100] According to Occidental, the participation contract set forth Occidental's right to "freely dispose" of its participation in production and enjoys the revenues of such disposal in connection with the formula set forth in Clause 8.1.[101]

Clause 8.1 of the participation contract "provides unequivocally that OEPC's participation will vary with volume and quantity, but *not* with price,"[102] while Law 42 was enacted "merely for the purpose of capturing a portion of the windfall profits that were . . . a result of an 'astounding and unforeseeable' increase in the price of oil."[103]

The tribunal found that "Law 42 is 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."[104] As a result, the tribunal concluded that Law 42 could not be included for the purpose of calculating damages related to Occidental expropriation:

> 525. Thus, the Tribunal finds that with the introduction

98. *Id.* ¶ 457.

99. Ley de Hidrocarburos [Law of Hydrocarbons], Decreto Supremo No. 2967, R.O. 711, Art. 55 (Nov. 16, 1978), amended Apr. 25, 2006 (granting Ecuador fifty percent of windfall profits from high oil prices).

100. *See id.* ¶¶ 465, 478 (observing that the windfall profit tax of Law 42 essentially writes Clause 5.3.2 out of the participation contract, making Clause 5.3.2 effectively meaningless); *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 465, 478 (2012).

101. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 512, 524 (2012).

102. *Id.* ¶ 476.

103. *Id.* ¶ 470.

104. *Id.* ¶ 527 (referencing Ecuador Bilateral Investment Treaty, art. II, ¶ 3(a), U.S.-Ecuador, Aug. 27, 1993, S. TREATY DOC. NO. 103–15).

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 and thereby violated Clauses 5.3.2 and 8.1 of the Participation Contract.

526. The considerable investments made by OEPC in Ecuador after the execution of the Participation Contract were based upon the explicit representations made by the Respondent during the negotiation of the Participation Contract which were then crystallized in the participation agreed by the parties in Clauses 8.1 and 8.5. The investor, OEPC, was justified in expecting that this contractual framework would be respected and certainly not modified unilaterally by the Respondent.

527. In conclusion, Law 42 is 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 and the Tribunal so finds. In the circumstances, the Tribunal need not rule on whether Law 42 is in breach of other provisions of the Treaty.

. . . .

529. There cannot be any doubt that a sovereign State has the undisputable sovereign authority to enact laws in order to raise revenue for the public welfare but, as is equally well established, "the exercise of such right is not unlimited and must have its boundaries."

530. As the tribunal stated in the ADC award, the rule of law, which includes treaty obligations, provides such boundaries. The ADC tribunal continued with a statement which the present Tribunal finds apposite and adopts:

Therefore, when a State enters into a bilateral investment treaty like the one in this case, it becomes bound by it and the investment-protection obligations it undertook therein must be honoured [sic] rather than be ignored by a later argument of the State's right to regulate.

. . . .

> 532. The Tribunal has already found that Law 42 did not create a royalty, a tax nor a levy. Since, as the Respondent itself submitted, "Clause 8.6 is triggered only if some measure fell within its ambit", there is accordingly no need for the Tribunal to enter into the debate between the parties with respect to the meaning of the "economy" of the Participation Contract as referred to in Clause 11.11 regarding a "tax regime modification."
>
> . . . .
>
> 536. Consequently, as advocated by the Claimants, the Tribunal will not take into account Law 42 for the purpose of its valuation of the quantum of the Claimants' damages.[105]

The tribunal then considered whether the fair market value should be reduced to take the VAT interpretative law into account.[106] Ecuador argued that, for valuation purposes, the relevant question was not whether OEPC had a legitimate expectation of VAT reimbursements.[107] Ecuador contended that a hypothetical purchaser, acquiring OEPC's interest in Block 15 prior to expropriation, but after the enactment of the VAT interpretative law, would not have had any such legitimate expectation.[108]

The majority held that the VAT interpretative law was passed in response to an international arbitral award finding that Ecuador had wrongfully issued decrees to OEPC denying VAT refunds.[109] Further, the majority held that the VAT interpretative law sought to do exactly the same things as those wrongfully-issued decrees, and that "[a]s such, as between the Claimants and the Respondent, the VAT Interpretative Law is without legal effect . . . ."[110]

> 567. It is clear that, for the correction factor to be

105. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 525–27, 529–30, 532, 536 (2012) (internal citations omitted).

106. *Id.* ¶ 560.

107. *Id.* ¶ 561.

108. *Id.*

109. *Id.* ¶¶ 554–57.

110. *Id.* ¶¶ 558, 560.

> triggered automatically into effect, the VAT Interpretative Law must be found to have an impact on the economy of the Participation Contract. The Tribunal notes that the parties to the Participation Contract did not in any way specify how that impact was to be measured. It is thus left to the Tribunal, in the exercise of its discretion, to do so.
>
> . . . .
>
> 570. In summary, in the opinion of the Tribunal, the VAT Interpretative Law should not be taken into consideration in its determination of the fair market value of the assets acquired by Ecuador as a result of the *Caducidad* Decree. Alternatively, if it is taken into consideration, the Tribunal can assume the application of a correction factor in accordance with Clause 8.6 of the Participation Contract and its Annex No. XIV which would neutralize the effect of the VAT Interpretative Law and the Tribunal so finds.[111]

The tribunal awarded compound interest in two phases: pre-award interest and post-award interest from the day of the expropriation. Ecuador was ordered to pay pre-award interest at the rate of 4.188% per year, compounded annually from May 16, 2006 until the date of the award.[112] Additionally, Ecuador was ordered to pay post-award interest from the date of the award at the U.S. six-month LIBOR rate, compounded on a monthly basis.[113] Each side was ordered to bear its own costs and share the fees of the tribunal and ICSID.[114]

II. OBSERVATIONS ON THE AWARD

In a first look at the award two elements are worth highlighting. First, this complex award analyzes the assignment of contractual rights under petroleum contracts and the different levels of liability between the parties under municipal law and international law.[115] Second, this award is extensive:

111. *Id.* ¶¶ 567, 570.
112. *Id.* ¶ 848.
113. *Id.* ¶ 849.
114. *Id.* ¶ 874.
115. *See generally id.*

the dispute lasted for more than six years and the award is 327 pages in length,[116] with a separate thorough dissenting opinion that spans 48 pages.[117] The density and length of the award is perhaps a testament to the complexity of the legal issues at hand.[118] One additional point of note is that, given its complexity, governments may react negatively to the tribunal majority's penalization of Ecuador for its "disproportionate" response to OEPC's breach and the subsequence declaration of validity of the farmout agreement in order to grant compensation.[119]

Such degree of confusion was foreseen by the tribunal which even drafted a paragraph to explain itself:

> For the avoidance of doubt, there is no inconsistency between the Tribunal's earlier conclusion that OEPC acted in breach of the HCL and Clause 16.1 of the Participation Contract in purporting to assign rights in Block 15 without authorization and its conclusion here that the assignment was invalid. Article 79 of the HCL itself makes it clear that the fact that an unauthorized assignment has no validity does not negate the breach caused by a purported assignment: " . . . shall have no validity whatsoever . . . without prejudice to the declaration of *caducidad* as provided for in this Law." Moreover, the fact that AEC and OEPC acted as though the assignment had taken place prior to the declaration of *caducidad* does not somehow cause an invalid

116. *See generally id.*

117. *See generally* Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Dissenting Opinion (Sept. 20, 2012).

118. *See Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 875 (2012) ("[T]he Tribunal acknowledges the quality of the extensive written and oral submissions of both parties in respect of the myriad of factual and legal questions which were raised in the course of these length and very complex arbitral proceedings.").

119. *See* Kahale, *supra* note 2, at 31 ("In the long-awaited decision in the *Occidental* megacase, the ICSID tribunal found that [Occidental] had improperly transferred a 40% interest . . . . The law provided for a remedy of termination of contract in the event of an unauthorized transfer, and that is what [Ecuador] did, but the tribunal held that Ecuador nevertheless was liable because the remedy was 'disproportionate' . . . Ecuador has already withdrawn from the ICSID, but the *Occidental* award will fuel more discontent there and likely in other states as well." (citations omitted)).

assignment to become valid.[120]

Thus, having an award of that complexity and an engaging dissenting opinion by Arbitrator Stern, this paragraph reflected the tough deliberations made among the arbitral tribunal and their acknowledge of the impact of this decision in the transnational community of states and investors.

The tribunal's award in *Occidental* comprises three main legal discussions relevant to the performance and predictability of investment protection in the petroleum industry. The first issue is that investors and states will be more cautious in the observance and compliance relating to the performance of an international farmout agreement.[121] Second, the tribunal's approach of proportionality in the assessment of government administrative decisions marks a contemporary trend in investment arbitration.[122] Third, the fact that Occidental was found in breach of contractual and legal obligations[123] raises the question of whether a wrongful act may affect the amount of a claimant's compensation. Foreign investors have the obligation to respect the laws of the host country and can be penalized by an arbitral tribunal for violations to municipal law. This point was brought in the dissenting opinion of Arbitrator Stern around the discussion of the standard of penalization in the calculation of compensation[124]

A. The Execution of an International Farmout Agreement.

Literature on international farmout agreements is not abundant despite the fact that farmout agreements are in the heart of the petroleum upstream industry, at an important level, such as host government contracts or joint operation

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120. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 652 (2012).

121. *See* Thomas Walde & Abba Kolo, *Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty*, 35 INTERTAX 424, 425 (2007) ("Recent tax-related arbitral awards . . . indicate the growing importance of tax disputes between foreign investors and host states and the increasing reliance by foreign investors on investment treaties for protection").

122. *See Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 403–04 (2012).

123. *See id.* ¶ 381.

124. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Dissenting Opinion, ¶¶ 7–8 (Sept. 20, 2012).

agreements.[125] The reason why farmouts are so relevant for the oil industry is because they allow a party carrying out exploration and production activities to diversify geological, financial and political risk with other companies in the sector.[126] In a transnational industry that cooperates world-wide in joint agreements for upstream operations assignments occur in day-to-day basis.

As Talus et al. pointed out, "[u]nlike many other industries, the international oil industry has a long history of cooperation. While competition between large IOCs can be fierce in some areas, like the marketing of petroleum or the downstream operations, the exploration and production phase are marked by cooperation between competitors." [127]

In the U.S. oil industry, a farmout exists as a common practice between private owners of rights.[128] As a country where oil ownership resides privately with persons, and not the state, this arrangement took its shape from practices obtained in that country's agriculture business long ago, where sharecroppers could earn a share in the proceeds from the farmer's crop by working on the farm.[129] This practice was translated to the petroleum industry and it has been recognized and performed internationally.[130] However, when government authorization is required, as it is in most cases dealing with hydrocarbon rights under the control of the State, bureaucracy and government

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125. Only a few articles can be found about farmouts. Some examples are John S. Lowe, *Analyzing Oil and Gas Farmout Agreements*, 41 SW. L.J. 759 (1987); Kendor P. Jones, *Something Old, Something New: The Evolving Farmout Agreement*, 49 WASHBURN L.J. 477 (2010); and a special chapter on farmout agreements in CLAUDE DUVAL ET AL., INTERNATIONAL PETROLEUM EXPLORATION AND EXPLOITATION AGREEMENTS: LEGAL, ECONOMIC, AND POLICY ASPECTS 305 (Barrows Press 2009) (1986), among other few.

126. *See* John S. Lowe, *Analyzing Oil and Gas Farmout Agreements*, 41 SW. L.J. 759, 780 (1987).

127. Kim Talus et al., *Lex Petrolea and the Internationalization of Petroleum Agreements: Focus on Host Government Contracts*, 5 J. WORLD ENERGY L. & BUS. 181, 183 (2012).

128. *See* Lowe, *supra* note 125, at 763.

129. *See* Abayomi Akinjide, *Why Do Oil Companies Do Farm-Outs And Farm-Ins?*, MONDAQ (Mar. 29, 2000), http://www.mondaq.com/x/8501/Why+Do+Oil+Companies+Do+FarmOuFa+And+FarmIns.

130. *See, e.g.*, Martin, *supra* note 31, at 175.

policy priorities may play into the risk and performance of this operation by foreign investors.[131] Governmental approval may or may not occur.[132] For reasons of public policy the state is sovereign to choose its partners in strategic energy projects working in its territory, and this is also recognized by the oil industry. However, in performing international contracts submitted to international arbitration and also under the provisions of a BIT, the state has the duty to comply with international commitments regarding foreign investors.

The international practice of farmout agreements also has looked alternatives to the performance of this practice. One of them has been the possibility of bifurcating the title, as was tried by Occidental in the present case.[133]

This consists of executing a farmout agreement in two phases: (1) the earn-in phase; and (2) the transfer-of-title phase which occurs after the farmee has completed his obligations and government approval has been granted.[134] The *Occidental* case alerts us to be cautious in international operations because of issues that arise out of the bifurcation of title in farmout agreements. However, in standard situations where titles have not been transferred by contracts or "de facto", there is no possibility of liability in breaching contracts and national laws since privity never exists between the host government or the NOC, and the farmee maintaining the farmout operations as a financial transaction.[135].

According to the Industry practice, the Association of International Petroleum Negotiators (AIPN) published a Model Farmout Contract in 2004 (currently in the process of being updated).[136] It represents the international practice of these

131. *Id.*

132. *See id.*

133. *Compare id.* at 177, *with* Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award, ¶ 128 (Oct. 5, 2012).

134. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 130–31 (2012).

135. *Terrebonne Parish Sch. Bd. v. Mobil Oil Corp.*, 310 F.3d 870, 887 (5th Cir. 2002).

136. *In Development*, ASSOC. OF INT'L PETROLEUM NEGOTIATORS, https://www.aipn.org/mcvisitors.aspx (last visited Apr. 20, 2013).

transactions.[137] In the Model of Farmout Contract, the requirement of government approval is a fundamental element to conclude the transaction. It establishes that in the case of failure to receive government authorization, the farmor must compensate the farmee for his investment and the farmee has the right to terminate the contract.[138] This unilateral right of termination is a right granted to the farmee in order to protect his position in the worst scenario. The rule is inserted in a model contract from a specialized association in the petroleum industry which shows the generally accepted practice.

Further, two kinds of farmout agreements can exist: (1) farmout agreements in which the farmee has to perform operations in the country; and (2) farmout agreements in which the farmee only provides capital for investment.[139] In the first case, it is important that the operation comply with the national law in relation to operations carried out in that territory, due to national security, safety and public policy issues inherent in hydrocarbons upstream activities.[140] In the second possible farmout operation, a financial transaction, the lack of contact with the host country allow parties to agree the submission of the operation to other applicable laws different than the laws of the host country. This operation even belongs more to a transnational legal order than a state legal order since, as it was expressed by expert Andrew Derman; it is the farmee acting as a bank.[141] However, transparency, good faith and respect for confidentiality clauses shall prevail between the partners to a host government contract because no government desires to ignore the origin of capital being invested in its territory, As pointed out Tim Martin, also expert in the case, "… many countries' legal systems (particularly civil law jurisdictions) make no distinction between a 'beneficial' interest and a 'legal' title. One has to look to various sources to determine the legal validity of this practice."[142]

137. *See* AIPN Model Farmout Contract (2004).

138. *Id.* ¶¶ 2.7, 2.8, 3.1(B), 3.3, 3.4 (2004).

139. Martin, *supra* note 31, at 174–75.

140. *Id.* at 182.

141. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 251 (2012).

142. *Id.*

Assignment approaches in civil law countries have two different positions. The traditional approach considers the assignment as a transfer of rights and obligations of the contract (*le contenu obligationel*). The modern approach, currently accepted by the majority, considers the assignment as an operation that assigns the "quality of party" in a contractual relationship (*position contractuel*) or privity to a third party. Thus, in the first case, it is the transfer of rights and obligations version (*cession de credits ou de debts*), and in the second case it is the assignment of the contract version (*cession de contrat*).[143]

On this point, the tribunal's discussion relied on the analysis of Articles 16.1 and 16.2 of the participation contract and Article 74 of the Hydrocarbons Law.[144]

From the point of view of the analysis of sources of law, the tribunal did not consider whether Article 74 of the Hydrocarbons Law was in conflict with the practices of the international oil industry and the nature of the farmout agreement itself. This issue particularly called our attention since among the three main discussions of the award ((1) the performance of the farmout agreement, (2) the application of proportionality analysis, and (3) the method of calculation of compensation), only the analysis of the breach of the participation contract by the farmout agreement remained in an extensive discussion of municipal law and the "de facto" analysis thought document review without the balance of Ecuadorian regulation on assignment with international oil industry generally accepted practice or international law.

In the other two topics there is a different approach and we can find reference to international arbitration jurisprudence and international courts decisions for the case of the proportionality analysis. Also in order to justify the application of the proportionality analysis the Tribunal determined that

143. For the first approach, see PH. MALAURIE L. AYNES, LES OBLIGATIONS, COURS DE DROIT CIVIL VI (10th ed.). For the modern approach, see P. ANCEL, FORCE OBLIGATOIRE ET CONTENU OBLIGATIONAL DU CONTRAT, REVUE TRIMESTRELLE DE DROIT CIVIL 771 (1999). See in detail ALFREDO DE JESUS, *La Cession du Contract International*, Thèse Doctoral, Panthéon – Assas Paris II, Sorbonne Universités 2010.

144. *See generally Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 299, 381, 383 (2012).

Occidental executives, despite incurred in a "de facto" transfer of title, they did not act in bad faith but as "seasoned oilmen" of the petroleum industry, adopting a sociological approach calling a practice that belongs to a specific sector. This argument causes a conflict between the foreign investor's wrongful acts under the contract and Ecuadorian law with an assumption of the arbitral tribunal that the investor did not act in bad faith and according the practice of "seasoned oilmen". This raises the question whether the tribunal is referring to a generally accepted practice in the oil industry, and if this is the case, the tribunal is putting into conflict state sources of law with a non-state source of law that has not yet identified as such. If this is the case the tribunal did not offer any clarity whether is referring whether the farmout agreement is a generally accepted practice? Or whether the earn-in-phase a generally accepted practice that Occidental failed to perform correctly? At this point we found in the analysis of the tribunal a lack of legal construction on what is the rule of law, extracted from a state legal order or from a transnational legal order of the petroleum sector to justify its perception. There is an analysis on the facts, over which the tribunal constructed the belief that Occidental acted as "seasoned oilmen", but, it still remains questions such as how this assumption is created when in 2004, both parties just finished an international dispute on the tax legislation and an anti-American environment dominated the political scene in Quito? Also, what would be the final decision if the tribunal, on the contrary, determined that Occidental acted in bad faith and the consequences of this on the proportionality analysis and the amount of compensation? The issue is discussed briefly in a paragraph, causing a big impact in the award but lacking of theoretical legal clarity.

Further, deciding the calculation of damages the majority and even the dissenting opinion included reference to arbitral jurisprudence and discussed non-state sources of law such as the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts.[145]

145. *Id* ¶ 665.

The two different approaches discussed on the use of different sources of law show how to tackle the legal questions in transnational petroleum arbitration. We observed how discussing the farmout agreement the approach was very narrow in terms of legal construction and sources of law ignoring rich discussions on the legal nature of the farmout agreement in international oil industry practice. This is characteristic of the kind of arbitral panel that is anchored in the contractual and legal merits of the dispute. The arbitral panel acted as it as was inserted in the contract. But, the subsequent issues where solved from a broad perspective that considered arbitral jurisprudence trends, reference for "seasoned oilmen" behavior or practice, as a Tribunal that belongs to a transnational community of states and investors in the petroleum sector.

All in all, the tribunal disregarded the analysis of the legal nature of the farmout and concentrated on analyzing the underlying facts.[146] There is probably more review of memoranda and minutes than law in this part of the award. It is apparent that the purpose of the tribunal was to reach a "de facto" transfer of operational rights, finding Occidental in breach of contract at any cost.[147] Thus the tribunal proceeded to a large document review in the search of a "de facto" transfer of rights, wasting the opportunity to address a relevant question of law in order to set up guidelines for the performance of international farmout agreements.

Another issue is the scrutiny of state measures in violation of its international commitments, such as those established under a BIT.[148] Farmout agreements are legitimate operations in international petroleum transactions.[149] A state should not reject them in bad faith, in an arbitrary and discriminatory

146. *Id.* ¶¶ 329–31.

147. *Id.* ¶ 331.

148. Andrew T. Guzman, *The Design of International Agreement*, 16 EUR. J. INT'L L. 579 (2005).

149. *Shell Rocky Mountain Prod., LLC v. Ultra Res., Inc.*, 415 F.3d 1158, n.1 (10th Cir. 2005).

manner.[150] This was partially ignored by the tribunal, which engaged in the search of any reason to find Occidental liable for breach of contract and the consequences of the *caducidad* decree.[151]

To study deeply this point let's consider the following example. Company A enters into a participation contract with a NOC 100% owned by the State or a State Agency, in which the Company A has the obligation to perform two exploratory wells. Then, after the first well is found dry, the company looks for a partner, named Company B, to participate in the exploration of the second well under a farmout agreement. The obligations of Company B, now farmee under the second well, are to provide financial support for the exploration of the second well. The well resulted in a commercial discovery that gives right to production to the consortium. At the moment the farmee has invested the capital requested to complete the earn-in phase, Company A, the farmor, must find the approval of the government to proceed to the production of the well.

When the request to assign to Company B is presented to the state, the state has the sovereign right to reject the request.[152] Every state has the right to choose what companies invest in its territory, even more so if this concerns a strategic natural resource such as hydrocarbons.[153] The rejection of authorization, however, must be justified since it could be breaching contractual obligations to its partner by diminishing the condition of the debtor, since it has to comply with investment obligations based in the petroleum contract. And further, it could be in breach of BIT standards such as to grant fair and equitable treatment since a rejection of authorization has not to be issued in an arbitrary and discriminatory manner. Additionally, it is worth to consider a case in which the state has not suffered economic harms, no environmental damage either and the farmee is a well-known company in the country with previous experience operations. These elements are more likely

150. *See* Guzman, *supra* note 148.

151. *See generally Occidental*, ICSID Case No. ARB/06/11, Award (2012).

152. *See* Martin, *supra* note 31, at 175–77 (discussing the possibility that government approval will not be obtained).

153. *Id.* at 180.

to be relevant in the analysis of compliance with good faith and FET standards in a BIT. In contracts representing billions in capital investments, and strategic hydrocarbons resources both parties, the foreign investor and the NOC or the state, have a duty to respect the other party position.[154]

In *Occidental*, the tribunal found that the phrase "as if" in the JOA was equivalent to a "de facto" transfer of rights that implied the violation of the participation contract and the Ecuadorian Hydrocarbons Law.[155] Respecting Ecuadorian law, Occidental executed the farmout agreement in two phases during July 2004, and sought the government's authorization for the transfer of title in the second phase of the farmout agreement.[156]

According to the AIPN Model Farmout Agreement, in the performance of farmout agreements, the farmor "shall promptly join in such actions as may be necessary or desirable to obtain any Government approvals required in connection with the . . . assignments."[157] Also, the farmee "shall use reasonable endeavors to assist the [farmor] in obtaining such approvals."[158] The Model Farmout Agreement further states:

> If the Government does not approve . . . [an] assignment to the other Parties, then the withdrawing Party shall at its option either (1) retract its notice of withdrawal by notice to the other Parties and remain a Party as if such notice of withdrawal had never been sent, or (2) to the extent allowed under the Contract and Laws hold its Participating Interest in trust for the exclusive benefit of the non-withdrawing Parties with the right to be reimbursed by the non-withdrawing Parties for any subsequent costs and liabilities incurred by it for which it would not have been liable, had it successfully withdrawn. Any penalties or costs incurred

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154. Ecuador Bilateral Investment Treaty, art. II, U.S.-Ecuador, Aug. 27, 1993, S. TREATY DOC. NO. 103–15.

155. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award, ¶ 259 (Oct. 5, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C80.

156. *See id.* ¶¶ 317–18, 322–23.

157. AIPN, MODEL INT'L JOINT OPERATING AGREEMENT, art. 13.7 (2012).

158. *Id.*

> by the Parties in connection with such withdrawal shall be borne by the withdrawing Party.[159]

With respect to the farmout practice in the international oil industry, what we can extract from the Occidental decision is that companies shall take due care in the drafting of farmout agreements since any transfer of voting powers in farmout agreements or in JOAs associated with operations may be interpreted as a "de facto" transfer of title. Thus, avoiding the contractual transfer of these powers an arbitral tribunal should not find such a violation in the economic transaction of an earn-in-phase.

B. Proportionality Analysis and Investment Arbitration

Notwithstanding that the claimants breached the participation contract, Ecuador was found to have acted disproportionately and to have violated the U.S.-Ecuador BIT.[160] The tribunal determined that the farmout agreement amounted to an unauthorized transfer of rights under the participation contract.[161] However, according to the Tribunal OEPC's failure to request the ministry's approval, "while imprudent and ill advised, did not amount to bad faith", since Occidental executives acted as "… business people, seasoned oilmen, for whom legal niceties were not as important as the business realities of the deal." This last sentence is the turning point of the whole award since it is the moment in which the breach of the contract, Ecuadorian law, and the *caducidad* decree entered in conflict with the tribunal's view that the investor did not act in bad faith but as business people of the petroleum industry. As we mentioned before this perception is out of the scope of the Ecuadorian legal regime and the tribunal did not provide elements to follow this argument raising doubts around What is the rule or the legal order it is referring to anchor that practice or perception that Occidental did not act in bad faith?. Are they discussing a practice of a transnational legal order of the petroleum sector? What is the legitimate practice they are

159. *Id.*
160. *See Occidental*, ICSID Case No. ARB/06/11, Award, 662 (2012).
161. *See id.* ¶ 419.

referring to? Is a practice of the petroleum sector set aside the legal niceties when they are not as important as the business realities of the deal? Is this encouraging a careless legal practice in the petroleum industry?

The point here is that the award did not offer clear guidelines in an issue that caused the inclination of the arbitral tribunal to analyze the application of the proportionality principle, which finally ended in the determination of Ecuadorian violation of the FET standard in the BIT. This, we must say, is the 1.7 billion dollar award,162

As a result, the tribunal considered that Ecuador by terminating the agreement with Occidental failed "to accord fair and equitable treatment to the Claimants' investment," and to accord to the claimants treatment no less than that required under international law."[163] Ecuador also breached the BIT by capturing the claimants' investment in Block 15 through "a measure 'tantamount' to expropriation."[164]

The discussion on the principle of proportionality was based on the analysis of municipal law, international law, and arbitral jurisprudence.[165] In the analysis under Ecuadorian law, the tribunal concluded that based on expert evidence, administrative acts under Ecuadorian law must be in accordance with the principle of proportionality.[166] As it was pointed out by Sebastien Manciaux, the analysis of proportionality principle under Ecuadorian Law seems to be pointless since it is only relevant for the space of a national legal order, while the tribunal is rendering its decision outside the municipal legal order.[167] Manciaux explained:

162. *Id.* ¶¶ 380, 384.

163. *Id.* ¶ 455.

164. *Id.*

165. *See id.* ¶¶ 402–09.

166. *See id.* ¶¶ 396–99.

167 Sebastien Manciaux, Chronique des Sentences Arbitrales, JOURNAL DU DROIT INTERNATIONAL (Clunet) 31 (2013) (Fr.).

> The conduct of a State under its laws does not mean that the same conduct conforms to the standards of behavior laid down in the Treaty on the basis of which the arbitration was conducted. The concept of control of international legality of the actions of the State expresses enough once the behavior of the identified and assessed state is under the international law that must be assessed (in the area we are concerned by the investment arbitral tribunals). One can certainly understand that in retaining the violation of law in addition to the violation of international law allows an arbitral tribunal to support its decision, but this show that is not at all necessary.

In a addressing the proportionality analysis it is evident that the tribunal sough transnational sources of law, such as arbitral jurisprudence or its subtle look for oil industry practices, which are separated from a pure Ecuadorian law analysis. Thus, without saying it, the reality is that the tribunal delivered in a autonomous arbitral legal order[168], despite it was not that skilled in the identification of industry practices, in order to balance of the application of Ecuadorian law and the acts of the Ecuadorian Government reviewed under international sources of law.

Further, the tribunal looked to arbitral jurisprudence, asserting that "[t]he obligation for fair and equitable treatment has on several occasions been interpreted to import an obligation of proportionality."[169] Thus, the tribunal based its analysis on ICSID precedent.[170] The tribunal acknowledged that the minister had discretionary authority to terminate the participation contract under the HCL.[171] The tribunal decided that the exercise of the authority's discretion should be proportionate to the relevant violation.[172]

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168 EMMANUEL GAILLARD, LEGAL THEORY OF INTERNATIONAL ARBITRATION (2010) (referring to the existence of a transnational and autonomous arbitration legal order).

169. *See Occidental*, ICSID Case No. ARB/06/11 ¶ 404.

170. *See id.*

171. *See id.* ¶ 419.

172. *See id.* ¶¶ 416–17.

The tribunal considered that the participation contract provided for termination in the event of an unauthorized transfer of rights, but did not dispose of the minister's duty to act proportionately.[173] The termination decree had not been sought under the participation contract, but instead was issued pursuant to the provisions of the HCL.[174]

The tribunal reasoned that the consequences of the decree were disproportionate to the alleged wrongdoing.[175] As a result, the tribunal concluded:

> [T]he Caducidad Decree was not a proportionate response in the particular circumstances, and the Tribunal so finds. 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 [sic] 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.[176]

In the light of international arbitration, according to research by Alec Stone, no arbitral tribunal referred to proportionality, even implicitly, before 2000.[177] "In that year, a NAFTA tribunal, in the case of *S.D. Myers v. Canada*, gave a restrictive interpretation of the FET, [fair and equitable treatment] contained in the NAFTA."[178] Since 2003, "ICSID arbitrators have pushed further" by explicitly adopting the proportionality principle while citing the European Court of Human Rights (ECtHR) and its case law as a source.[179] The ECtHR requires national courts to use proportionality analysis when it weighs in on governmental decisions.[180] For example, in

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173. *See id.* ¶¶ 410, 416.
174. *See id.* ¶¶ 418–19.
175. *See id.* ¶ 450.
176. *Id.* ¶ 452.
177. *See* Sweet, *supra* note 4, at 63.
178. *Id.*
179. *Id.* at 64.
180. *See id.*

what appears to be the leading ICSID holding on the matter, *Tecmed v. Mexico*, the tribunal declared that "there must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure."[181] In *Azurix v. Argentina* (2006), another tribunal referred to ECtHR jurisprudence, *S.D. Meyers* and *Tecmed*, to justify employing "the public purpose criterion as an additional criterion to the effect of the measures under consideration . . ."[182]

Proportionality analysis is increasingly applied by investment tribunals, in the determination of whether host state measures constitute an indirect expropriation or violation of some standards such as fair and equitable treatment.[183] The proportionality analysis has also been applied by tribunals to determine whether departures from investment treaty obligations to protect specified vital interests of the host state are permissible.[184] In all these situations, the arbitral tribunal should weigh and balance the conflict between private-property type interests and other public interests.[185] From an investment protection viewpoint, reviewing whether the balance struck by the host state is proper can be done, in part, through proportionality analysis.[186]

Proportionality analysis has its critics[187] because it gives arbitrators the power to make policy-driven decisions and encourages a focus on principles above rules.[188] The application of proportionality analysis by arbitrators to constitutional rights has some parallels with its application in the context of

181. *Id.*; Tecnicas Medioambientales Tecmed S.A. v. The United Mexican States, ICSID Case No. ARB (AF)/00/2, Award, ¶ 122 (May 29, 2003) (explaining that arbitral tribunals should consider public pressure for governmental action against a foreign investor when assessing the proportionality of that action).

182. Sweet, *supra* note 4, at 64.

183. *See* STEPHAN W. SCHILL, INTERNATIONAL INVESTMENT LAW & COMPARATIVE PUBLIC LAW 102 (Oxford Univ. Press 2010).

184. *See id.*

185. *See* Sweet, *supra* note 4, at 64 (citing Saluka Investments BV v. The Czech Republic, Partial Award, ¶¶ 305–06 (UNCITRAL Mar. 17, 2006)).

186. *See* SCHILL, *supra* note 183.

187. *See id.* at 100–04.

188. *See id.* at 102.

interpreting investor rights under investment treaties.[189] National constitutional courts and standing international courts, however, may be in a better institutional position to make these decisions than investment treaty tribunals, such as ICSID, however, the trend is turning recurrent.[190]

Indeed, a proportionality analysis certainly seems preferable as a rational process in contrast to approaches in which an extensive summary of the facts of the case is followed by an abrupt determination of a violation. Especially when such determinations contain little intelligible legal reasoning, supporting a conclusion that a state's measure does or does not violate fair and equitable treatment, or constitute a measure tantamount to expropriation, or does or does not fall under a non-precluded measures clause of an investment treaty. In rebuttal, proportionality analysis can be criticized as legitimizing judicial law-making and generating a review process of governmental decisions.[191]

Proportionality may be a more predictable balancing test as long as it focuses on the procedural aspect as opposed to more substantive versions undertaken by some domestic courts.[192]

An advantage of proportionality analysis is that it is open to "different strands of political theory and different substantive preferences on investment protection."[193] It has the potential to be attractive to both those who believe tribunals should more broadly take into account noninvestment related interests of non-represented parties that are affected by the outcome of a tribunal's decisions, and those seeking to tighten the legal framework of state interferences with foreign investment.[194] Furthermore, the methodological structure of proportionality analysis may have the effect of improving arbitrator accountability because arbitrators must also justify their decision in a detailed fashion.[195] Thus, proportionality has the

189. *See id.* at 102–03.
190. *See id.*
191. *See id.*
192. *See id.*
193. *Id.* at 104.
194. *See id.*
195. *See id.*

potential to help structure both the relationships between states and foreign investors and between states and investment tribunals, as well as the relationship between international investment laws.[196] As a result, it may provide one way to counter risks of clinical isolation of international investment law, and to build some degree of coherence into aspects of an international economic order.[197] Proportionality analysis, if done well and with due circumspection, could enhance the legitimacy of rule-governed legal institutions into global regulatory structures.[198]

Therefore, balancing under the fair and equitable treatment also makes it possible for arbitrators to incorporate concerns for third party interest.[199] This will likely be one expansion of investment arbitration in the coming decades. Francioni states that "a progressive interpretation of the 'fair and equitable standard' . . . entails that the investor who seeks equity for the protection of his investment must also be accountable, under principles of equity and fairness, to the host state's population affected by the investment."[200] Arbitrators following this approach end up balancing the "interests of the investor and the interests of individuals and social groups who seek judicial protection against possible adverse impacts of the investment on their life or their environment[.]"[201] Although the fair and equitable treatment standard makes these types of arbitrations more flexible, it also has an impact on public policy.[202] This broad philosophical approach to transnational law creates its own concept of transnational legal order for arbitration.[203] However, as Schill pointed out, "its very elasticity raises

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196. *See id.*

197. *See id.*

198. *See id.*

199. *See* Sweet, *supra* note 4, at 62.

200. Francesco Franconi, *Access to Justice, Denial of Justice and International Investment Law*, 20 EUR. J. INT'L L. 729, 739 (2009).

201. *Id.*; Sweet, *supra* note 4, at 62.

202. *See* Sweet, *supra* note 4, at 62.

203. *See* A. De Jesús O., *The Prodigious Story of the Lex Petrolea and the Rhinoceros: Philosophical Aspects of the Transnational Legal Order of the Petroleum Society*, 1 TPLI SERIES ON TRANSNATIONAL PETROLEUM LAW 1, 8–9 (2012) (noting the autonomy of transnational legal order).

anxieties about (a) the scope of arbitral authority (can it ever be constrained at the *ex ante* contractual moment?), and (b) the determinacy of rulings (can arbitrators always get to any decision they want?)."[204] He concludes:

> [i]f one accepts that these worries are well-founded, then one can also see why the adoption of proportionality would make sense, in so far as it would inject a measure of analytic, or procedural, determinacy to the balancing exercise. Proportionality, properly used, requires arbitrators to reduce the losses accruing to the loser as much as is legally possible, thus enhancing their legitimacy.[205]

Proportionality permits arbitrators to the assume a role balancing issues of public policy without allowing arbitration to be an excuse to evade public policy decisions by integrating public policy decisions in accordance with the interest and needs of a transnational community of investors and states.[206]

> In investor-State disputes, a move toward balancing would entail both the recognition of an investor's property rights and a "public interest" defense available to the State. In effect, the parties acknowledge that measures taken by the defendant State have infringed the investor's rights, [however,] that hindrance may nonetheless be mitigated or justified to the extent that the measures taken were not arbitral, and were meant to serve a proper public good. Arbitrators using the proportionality framework will deploy means-ends testing to evaluate the impact of the State's measures on their investment; they will weigh the investor's rights against the public interest being pleaded; and their conclusions will bear upon their dispositive ruling and remedies.[207]

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204. Sweet, *supra note* 4, at 63.
205. *Id.*
206. *See* Sweet, *supra* note 4, at 62–63.
207. *Id.* at 63.

C. Reduction of the Amount of Compensation Caused as a Consequence of Investo's Wrongful Acts and Tax Measures.

There was an attempt to reduce the award amount by three ways: (1) assessing the weight of Occidental's breach of the participation contract; (2) by enforcement of the farmout agreement which would give Occidental only sixty percent of the compensation instead of the one hundred percent awarded by the majority of the tribunal, which also raised the question of jurisdiction; and (3) by applying tax legislation approved by the Ecuadorian government which affected the economic balance of the participation contract.[208]

1) According to the majority decision, Occidental's conduct prior to the *Caducidad* decree justified a twenty-five percent reduction in damages.[209] The sum of $2,359,500,000, which corresponded to "the Net Present Value of the discounted cash flows generated by the Block 15 OEPC production as the day of the decree of 16 May 2006," was reduced by twenty-five percent to a sum of approximately $1.77 billion in damages.[210] The majority noted that international law provides for the reduction of damages in circumstances where an injured party has contributed to its own injury.[211] In this case the tribunal confirmed that foreign investors that incurred in the violation of its commitments may be punished in accordance with international law, making him also liable for his acts. Article 39 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts provides: "In the determination of reparation, account shall be taken of the contribution to the injury by willful or negligent action or omission of the injured State or any person or entity in relation to whom reparation is sought."[212]

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208. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award, ¶¶ 467, 655.

209. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 825 (2012).

210. *Id.* ¶¶ 824–25.

211. *Id.* ¶ 665 (2012) (citing Rep. of the Int'l Law Comm'n, 53 sess., Apr. 23–June 1, July 2–Aug. 10, 2001, art. 39, U.N. Doc. A/56/10; GAOR, 56th Sess., Supp. No. 10 (2001).

212. Rep. of the Int'l Law Comm'n, 53rd Sess., Apr. 23–June 1, July 2–Aug. 10, 2001, art. 39, U.N. Doc. A/56/10; GAOR, 56th Sess., Supp. No. 10 (2001).

The majority held, by referring to Article 39 of the ILC Articles and relying on the decision of the ad hoc committee in *MTD Equity Sdn Bhd & MTD Chile SA v. Republic of Chile*,[213] that it had "a wide margin of discretion in apportioning fault" and that the claimants "should 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."[214] The majority assessed the claimants' contribution to the loss at twenty-five percent, and reduced the damages by that amount.[215]

By contrast, the dissenting arbitrator proposed a fifty percent reduction in damages, noting that in the *MTD* case, in which damages were reduced by fifty percent, the investor "had acted imprudently from a business point of view though not illegally," while in this case claimants had "acted both very imprudently and illegally."[216]

Despite the two positions of the majority and the dissenting

213. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 666, 670 (2012) (citing MTD Equity Sdn Bhd & MTD Chile SA v. Republic of Chile, ICSID Case No. ARB/01/7, Decision on Annulment, ¶ 101 (Mar. 21 2007), *available at* http://www.italaw.com/sites/default/files/case-documents/ita0546.pdf.

214. *Id.* ¶¶ 670, 680.

215. *Id.* ¶ 687.

216. *See* Occidental Petroleum Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Dissenting Opinion, ¶ 7 (Sept. 20, 2012). Interestingly, in this case Arbitrator Stern based her argument on a precedent in an ICSID case; yet, in a parallel ICSID case where she was an Arbitrator, *Burlington v. Ecuador*, she dissented in the consideration of previous ICSID cases to be considered bound for future Tribunals. *Compare Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 670 (2012) *with* Burlington Res. Inc. v. Republic of Ecuador, ICSID Case No. ARB/08/5, Decision on Liability, ¶ 187 (Dec. 14, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C300. In that case, the court indicated:The Tribunal considers that it is not bound by previous decisions. Nevertheless, the majority considers that it must pay due regard to earlier decisions of international courts and tribunals. It believes that, subject to compelling contrary grounds, it has a duty to adopt solutions established in a series of consistent cases. It further believes that, subject to the specifics of a given treaty and of the circumstances of the actual case, it has a duty to seek to contribute to the harmonious development of investment law, and thereby to meet the legitimate expectations of the community of States and investors towards the certainty of the rule of law. Arbitrator Stern does not analyze the arbitrator's role in the same manner, as she considers it her duty to decide each case on its own merits, independently of any apparent jurisprudential trend

opinion, the figures of twenty-five percent and fifty percent lack an economic basis for their selection. Instead, they are individual determinations by the members of the tribunal based upon their own appreciation for the issues presented, and thus these determinations appear at least facially arbitrary, especially after such a long analysis on the quantum of the case.[217] This notion is critical because a reduction of an award by hundreds of millions of U.S. dollars may be decided in just a one or two of paragraphs of a decision with neither economic analysis nor further explanation to the claimant and respondent. With such arbitrary determinations regarding reductions, it is appropriate to ask: Why not a seventy percent? or why not a twenty percent standard of reduction? One may said that a split decision as Prof. Stern proposed was the solution was a rational standard, however, it seems to be more important for the good of the transnational community of states and arbitrators and an award shows perception of fairness to the community than rational or arbitrary determinations.

Leaving this question unanswered may diminish the appreciation of international arbitration and arbitrators. Given the increase of transparency and public decisions, the international community of investors will ask for more specialized answers from arbitrators with respect to the needs and interest of an international community involving States and Foreign investors.[218] Decisions with unanswered questions leading to a lack of transparency do not convey an image of a specialized and conspicuous arbitrator but instead present and image that arbitral decisions are in fact based upon arbitrary notions held by the arbitrators themselves.

2) The most significant disagreement between the majority and the dissenting arbitrator concerned whether OEPC held a one hundred percent beneficial interest in the participation contract, or only a sixty percent beneficial interest.[219] The

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217. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶ 825 (2012); *Occidental*, ICSID Case No. ARB/06/11, Dissenting Opinion, ¶ 7 (2012).

218. *See* John R. Crook, *Joint Study Panel on Transparency in International Commercial Arbitration*, 15 ILSA J. INT'L & COMP. 361, 364 (2009) (commenting that there have been steps to increase transparency in international arbitration).

219. *Occidental*, ICSID Case No. ARB/06/11, Dissenting Opinion, ¶ 144 (2012).

majority found that OEPC's purported assignment of contractual rights to AEC was "inexistent."[220] The purported assignment was automatically void due to the breach of the HCL restriction on assignment of rights; though the farmout agreement and the joint operating agreement—contracts purporting to effect that assignment—were not automatically void.[221] As a result, Occidental was still the beneficial owner of one hundred percent of the investment and could thus claim damages for expropriation based on the full fair market value of that investment.[222]

The majority found that, pursuant to the governing law clause of the farmout agreement, both New York and Ecuadorian law applied.[223] The majority relied on four decisions of the Ecuadorian Supreme Court to support its finding that Ecuadorian law recognizes the principle of "inexistence", and that "inexistence" is the type of invalidity resulting from failure to obtain authorization pursuant to Art. 79 of the HCL.[224] As to New York law, the majority found that a New York court, whether applying New York law or Ecuadorian law, would not "recognize an assignment in breach of a valid non-assignment clause."[225]

Accordingly, the purported assignment had not produced any legal effect, and as a result, Ecuador was "obliged to compensate the Claimants for 100% of their interest in Block 15 which it acquired upon the issuance of the Caducidad Decree."[226] Additionally, the majority decided that the farmout agreement was still valid between OEPC and AEC, and that OEPC should compensate AEC and recognize the right of AEC to exercise legal actions to recover 40% of beneficial interest. This conclusion ignored the solution offered by the AIPN farmout agreement mentioned previously, as a general practice of the industry, which considered that the assignment never

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220. *Occidental*, ICSID Case No. ARB/06/11, Award, ¶¶ 625–26 (2012).
221. *Id.* ¶¶ 627, 649–50.
222. *Id.* ¶¶ 650, 706–07.
223. *Id.* ¶¶ 615–16.
224. *Id.* ¶¶ 622–24, 626.
225. *Id.* ¶ 645.
226. *Id.* ¶¶ 650–51.

occurred until the State grants the authorization, thus, not beneficial interest can be transferred at this point.

In response, the dissenting arbitrator found that, pursuant to New York law and Ecuadorian law, Occidental's assignment of rights to AEC would have been considered valid until invalidated by a judge.[227]

As to the situation under Ecuadorian law, based on her review of the four Ecuadorian Supreme Court cases in their original Spanish, the dissenting arbitrator concluded: "The cases stand for the principle that inexistence does not result from the absence of other formalities than the solemnity of a legal deed. The absence of other formalities, like the absence of an authorization, entails an absolute nullity."[228] The dissenting arbitrator also criticized "the selective use of citations from the decisions of the Supreme Court made by the majority, as well as serious problems of translation."[229]

The dissenting arbitrator further disapproved of the majority's reasoning as follows: "[w]hether or not the majority has relied on the English translations to reach its decision, it was at least imperative to take into account the authentic Spanish texts, with regard to which the majority's approach to the content of Ecuadorian law is blatantly not sustainable."[230] The dissenting arbitrator concluded that by denying the legal effect of the assignment, the majority had "exceeded its powers in annulling a transfer of rights to an investor that was not a party to the arbitration."[231] Since AEC's interests under the farmout agreement were acquired by the Chinese company Andes, the dissenting arbitrator indicated that the majority's decision "amounts to 'expropriate' a Chinese company over which it has manifestly no jurisdiction under the rules of

227. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Dissenting Opinion, ¶ 44 (Sept. 20, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C80.

228. *Id.* ¶¶ 78, 105.

229. *Id.* ¶ 68.

230. *Id.* ¶ 107.

231. *Id.* ¶ 139.

international law."[232]

Further, in the dissenter's view, the majority had exceeded its powers by unjustly enriching the claimants.[233] If Occidental handed over forty percent of the compensation it receives to AEC, the tribunal would have compensated AEC through Occidental, with the result that the tribunal would have exceeded its *ratione personae* jurisdiction.[234] If Occidental did not hand over forty percent of the compensation, it would have been unjustly enriched in violation of international law.[235]

The dissenting opinion admits that while its reasoning could be seen as leading to an unfair result, where Ecuador pays for only sixty percent of OEPC's interest in Block 15 despite acquiring one hundred percent interest following the Caducidad decree, such result would simply be a function of the "limited jurisdiction of ICSID tribunals."[236]

3) Concerning the applicability of BIT standards in connection with taxation, the *Occidental* award was a precedent in how a state can violate investment protection standards by approving new tax law that modifies the conditions on the investment contract and violates standards under BITs.[237] The new ICSID award ratified this approach, enforcing contractual provisions that can be affected by the approval of new taxation, the VAT interpretive law, and Law 42.[238]

The tribunal decided not to consider the effect of this law on the calculation of damages, which is a relevant precedent for the oil industry in the case where contractual provisions and BIT standards meet the conditions for the tribunal to recognize the

232. *Id.* ¶¶ 36, 129.

233. *Id.* ¶¶ 131–32.

234. *Id.* ¶ 144.

235. *Id.*

236. *Id.* ¶¶ 166–67.

237. *See* Doak Bishop et al., *International Tax Arbitrations*, 5 LATIN LAW. 42, 42–43 (2006), http://www.kslaw.com/Library/publication/International%20tax.pdf (discussing Ecuador's changes to the tax framework and ensuring violations of its BIT obligations).

238. Occidental Exploration Corp. v. Republic of Ecuador, ICSID Case No. ARB/06/11, Award, ¶¶ 525, 527, 560 (Oct. 5, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C80.

violation of the contract and international law.[239] In particular, Law 42 is a windfall profit tax law approved as a response to the increment of oil prices during the 2000s.[240] A similar kind of law has been approved in the United Kingdom, Canada, and the United States, without such a criticism from investors.[241]

One may argue that in the absence of a stabilization clause there are no legitimate expectations that the fiscal regime will not change. However, fair and equitable treatment must be respected by states in the approval of these regulations, since the investors could claim the compliance of this standard.

III. Conclusion

After a year of its publication Occidental's Award will remain in discussion as a controversial case for the coming years, and is currently facing the annulment procedure before the ICSID. The award developed arguments in the performance of international farmout agreements; this is a significant contribution to the international oil industry since it highlights the respect of the sovereign right of the state to decide to grant or not the authorization required over this operation. Also, probably one of the major contributions is the developments on the proportionality analysis in international investment law and the use of arbitral jurisprudence. We observe how proportionality analysis was introduced based on the conflict between the breach of the contract, Ecuadorian law, and the *caducidad* decree by Occidental, and the fact that the tribunal considered that Occidental executives did not act in bad faith but as seasoned oilmen. This last element caused a conflict between the enforcement of contract engagements and Ecuadorian regulations against the perceptions that Occidental behaved in accordance with practices of the international oil industry. But, despite the interesting reasoning of the tribunal looking to the practices of seasoned oilmen, the tribunal

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239. *Id.* ¶ 536.

240. *Id.* ¶ 470.

241. Burlington Res. Inc. v. Republic of Ecuador, ICSID Case No. ARB/08/5, Decision on Liability, ¶ 137 (Dec. 14, 2012), https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=viewCase&reqFrom=Home&caseId=C300.

obviated legal developments in transnational law or in the specific practices and rules specific of the petroleum sector to justify its reasoning. Since transparency is turning the rule of international investment arbitration, more and more cases will take into account previous decisions, as in this case, to decide major questions like the assessment of compliance with international law of administrative decisions of the state in international investment projects under a BIT. Finally, the award contributed with the consequences that a foreign investors may suffer when incurred in a violation of the law of the host state. We cannot ignore the twenty-five percent reduction of the amount of compensation decided by the majority of the tribunal. Similarly, the fifty percent reduction proposed by Prof. Stern is a clear message to foreign investors that their wrongful acts can also be punished by the decision of an arbitral tribunal.