PROCURADURÍA GENERAL DEL ESTADO
ECUADOR

OXY Case:

The Defense

of a sovereign and legal decision of the Ecuadorian State

2008 • 2014 Administration

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…Ecuador is a country that neither prosecutes nor condemns private national or foreign investment. Ecuador is a country that encourages investment, but in its encouragement of investment, obviously requires contractors to observe the law of Ecuador as well as the provisions in the contracts that they have entered into voluntarily with the State of Ecuador.

Dr. Diego García Carrión
Attorney General
Opening Statement
at the Hearing on Jurisdiction
Paris, 22 May 2008

Prologue

During my six years of defending the State since I was appointed by the National Constitutional Assembly in April 2008, one of the greatest challenges I faced as Attorney General consisted of leading the international arbitration proceedings initiated by the American company Occidental Petroleum Company against the Republic of Ecuador, stemming from the declaration of caducidad of the contract for the exploration and exploitation of hydrocarbons in Block 15.

Although the case was nothing new for me, as I had assumed the position of Secretary General of Legal Affairs at the Presidency of the Republic under the Government of Dr. Alfredo Palacio González in May 2006, when the then Minister of Energy and Mines decided to declare the caducidad of the contract, I was responsible for defending the State in an investment arbitration that would mark the beginning of a hard road ahead in an unprecedented international dispute for Ecuador. The State´s Defense had never handled a case of this magnitude, complexity and quantum.

During my first meeting with the President of the Republic, economist Rafael Correa Delgado, after being appointed by the National Constitutional Assembly, I became aware of the importance attributed by the National Government to the OXY case, as a landmark trial in the defense of a matter of national interest, as part of a vision of strengthening the protection of the States´s interests through its legal defense, in which the public interest is defended as its own interest. This calling, aside from the great honour and the enormous professional challenge that it represented, demanded a high degree of commitment to the country.

I arrived at a turning point in the discussion on the jurisdiction of the Arbitral Tribunal under the ICSID Convention. I took office just days before the deadline set by the Tribunal for the submission of the memorial on liability and one month prior to the hearing on jurisdiction which was scheduled for the end of May, in Paris.

Two weeks prior to my appointment as Attorney General, my predecessor had added a second international law firm, Dechert LLP, to the defense team, which joined Squire Sanders LLP that had been working with the Attorney General's Office since 2007. Although both were renowned law firms in the field of international arbitration, these groups of prestigious professionals, each with their own structures and working practices, were denied the opportunity to begin working as a team due to the unexpected departure of the previous Attorney General. This was the first challenge that I faced upon my arrival. A week before I was scheduled to travel to Paris, we laid the foundation for a productive working relationship through a meeting in Quito with Eduardo Silva Romero and George Von Mehren, the team leaders of each firm. From that point forward, we were able to provide a solid defense based on our presentation of the facts and legal arguments, which we set out with complete transparency for general information.

The OXY case illustrates the troubled history of a Sovereign State and its struggle within a system of administration of international justice designed by and for investors and the defense of their interests. The development of this investment arbitration, within a system that accords few guarantees to the States that are the recipients of the investment and shows scant regard for the exercise of the State´s regulatory power and its national legislation, including investment agreements, under the auspices of bilateral investment treaties concluded with more enthusiasm than knowledge by our own countries, reflects a general pattern of legal uncertainty that will ultimately have to change or be destined to failure. The history and development

of this dispute, which you will be acquainted with in detail through this publication, is a clear example of the system's failures.

The State of Ecuador has spared no effort in defending the State in these arbitration proceedings. All of the facts, arguments and evidence were filed and defended in a timely manner and on a sound legal basis. Although, at the time, the State did not appoint its arbitrator, as it was entitled to do in accordance with the ICSID Rules, as part of its initial defense strategy in the arbitration, the State's defense subsequently decided to intervene in each stage of the process, without prejudice to its rights, and submitted convincing arguments in terms of jurisdiction as well as the merits of the case. Ecuador´s appearance was always under an objection to the Tribunal's jurisdiction, given that under Ecuadorian procedural law, a party can make a court appearance without such an appearance entailing waiver of an objection to jurisdiction.

In this publication, for reasons of space, the arguments will be presented from the annulment proceeding standpoint. The absurd and arbitrary nature of the Award, which is to some extent evident in the strongly-worded dissenting opinion of Professor Stern, allows us to present it in this manner, addressing the most important points of the dispute that were included in the request for annulment of the Award submitted by the State, in a style that the reader can understand – even readers who are not lawyers or investment arbitration experts.

Before analyzing the legal arguments, we believe that nothing could reflect Ecuador's position with greater clarity than the statement of facts, describing the events as they occurred, and as they were put to the Tribunal. Reading the facts gives us a coherent and convincing view of the way in which Occidental acted. Occidental concealed an assignment of rights that was not authorized by the State, when it should have obtained such authorization contractually and legally. Occidental acknowledged and accepted the consequences of its actions and, what is even more serious, was aware of and agreed to the effects of such an omission in the contract that it entered into with the State. Reading the facts will make it difficult to comprehend the Tribunal's decision. This was the case for the State's defense team.

It is impossible in a publication such as this one to address, in detail, every legal argument that was made over the course of more than 7 years of legal debate. These proceedings were not only unprecedented for Ecuador, but also in the entire history of international investment arbitration.

Proceedings with 9 oral hearings and endless pleadings, many of them far lengthier than this publication, simply defy any editorial endeavour. The purpose of this document is nevertheless to record, for posterity, the exercise of a professional and responsible defense which, despite the substantiated facts and legal arguments, has arrived at the stage of annulment of the Award, when the proceedings should never have gone beyond the jurisdiction phase.

The reader will find it hard to believe that despite the fact that the contract expressly provided that the declaration of Caducidad was excluded from arbitration, the Tribunal unanimously declared that it had jurisdiction over the case. The Tribunal merely argued that, as far as it was concerned, the exclusion of Caducidad from arbitration was not included in the arbitration clause. The reader will then ask himself what the contractors meant when they stated that Caducidad was excluded from arbitration. There is absolutely no doubt that express declaration of intent of the contracting parties' intention was of no significance to the Arbitral Tribunal in the OXY case. This absurd and arbitrary decision led the Tribunal to render an Award granting the largest amount of damages that a State has ever been ordered to pay in the history of arbitration under the ICSID Rules.

As if this were not enough, the Tribunal made an extremely serious error. It failed to acknowledge the existence of a cooling-off period of six months stipulated in the Treaty between the United States of American and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment signed between the United States of America and the Republic of Ecuador, by allowing Occidental to present its request for arbitration just two days after the declaration of Caducidad, even though the Treaty provided for a six-month waiting period, thereby disregarding the agreement of the countries that were party to the Treaty. Other ICSID Tribunals have acknowledged that this requirement is part of the consent to arbitration and, hence, constitutes a requirement for the jurisdiction of the Tribunal.

And while this series of misjudgments begins with unsubstantiated grounds for the most part, the Tribunal saved its most serious errors for later, including absurd and contradictory interpretations, to such an extent that one of the co-arbitrators, Professor Stern, in an unwonted dissenting opinion, drew attention to the fact that it was impossible to following the reasoning from point A to B. The language used by Professor Stern in her dissenting opinion provides even more evidence of Ecuador's right to obtain the annulment of the Award.

Incredibly, the majority of the Tribunal accepts that OXY assigned 40% of its rights to a third party, without obtaining the authorization of the state authority required by law. And yet, in order to compensate OXY for 100% of the rights, the Tribunal declared the assignment to be inexistent, concluding in its interpretation of the law of Ecuador, that the nullity referenced in the Hydrocarbons Law occurs automatically, which is tantamount to inexistence. This is all exacerbated by the fact that the party holding these rights was not protected by the Treaty between Ecuador and the United States Concerning the Encouragement and Reciprocal Protection of Investment, as it is not a national of the signatory States.

The legal dispute continues and is now at the stage of review of Ecuador's request for the annulment the Award. It is expected to be concluded this year, once the Annulment Committee, appointed by ICSID, has had an opportunity to consider all of the evidence. The arguments by the parties, the Award of the Arbitral Tribunal, the dissenting opinion of Professor Stern, and the ruling by the Annulment Committee will be topics of discussion for many years to come in the investor-state dispute settlement system. This may be an opportunity for the system to achieve the necessary changes from within.

This publication establishes the strength of the arguments set forth by Ecuador's defense throughout these proceedings that have lasted over 8 years. A lawyer is unable to assure his or her client of the outcome of the proceedings; he is expressly prohibited by law from doing so. I am not going to do so. But I can assure you that the State's defense did a good job and acted professionally and loyally towards its client. This publication is a testimony to this work and the commitment of the Attorney General's Office and its team of lawyers to the fundamental interests of the country.

This is the account of the legal defense of a sovereign decision which did nothing other than apply the law and the contract. It is an account that we Ecuadorians need to know. We acted in accordance with the law and mounted a defense under the protection of the law. We complied with our responsibility to posterity. Only justice remains to be addressed and it is still possible to obtain it.

I should like to express my appreciation to the Presidents of the Republic, Dr. Alfredo Palacio González, whose Government assumed responsibility for the declaration of Caducidad; and to his Excellency Rafael Correa Delgado, who supported the actions of the Attorney General's Office in defending the country, respecting the technical autonomy of our actions, while *continuing to follow the situation closely and ensuring that such actions kept a clear vision of the defense of the national interest. It would not have been possible to defend the interests of the country without the decision and historic performance of the authorities and lawyers who were part of this national cause.*

My appreciation also go to all the lawyers and paralegals of the Attorney General's Office and the law firms that were part of our defense team, for undertaking working professionally. I should like to express my gratitude to the legal and technical experts, to the factual witnesses and to everyone who took it upon themselves to contribute to the defense of the State.

Dr. Diego García Carrión
Attorney General

Quito, June 2014

OEPC (Occidental Exploration and Production Company) transferred rights to AEC (Alberta Energy Company) and formed a consortium without the authorization of the Ministry. Ecuador did not approve this and could not have approved it as no one can consent to something they know nothing about.

When Ecuador discovered the truth, it imposed the same penalty that OEPC had agreed to in the Participation Contract as the appropriate and, hence, proportionate consequence of its conduct.

The evidence at the hearing demonstrated with equal force that OEPC had engaged in a pattern of deceit in its dealings with Ecuador from the moment it entered into its transaction with AEC in 2000 until its attempt at a cover-up when the auditors from the Ecuadorian National Hydrocarbons Directorate discovered the Farm-out Documents in 2004."

Dr. Diego García Carrión
Attorney General
Opening Statement
at the Quantum Hearing
Washington, 4 November 2009

"*[...] In addition, the distinguished members of the Arbitral Tribunal will be able to verify how the Claimants have abused this process; for example, by claiming damages of 100% of the value of the Participation Contract, even though it has been proved in these proceedings that OEPC had transferred 40% of the economic interest resulting from the Participation Contract to AEC.*"

Dr. Diego García Carrión
Attorney General
Opening Statement
at the Quantum Hearing
Washington, 4 November 2009

1 The Facts of the Case

1.1 OXY's Operation in Ecuador

On 25 January 1985, Occidental Petroleum Company (OXY) and Ecuador's state-owned oil company (CEPE), which would subsequently become PETROECUADOR, entered into a contract to provide services related to the exploration and production of oil in Block 15. That contractual arrangement provided that if OXY discovered crude oil, even if it belonged to PETROECUADOR, the company would be entitled to reimbursement of its costs and other expenditures in accordance with the contract.

OXY and its parent company are US companies, incorporated under the laws of Delaware and California, and are based in Los Angeles, California.

In May 1993, OXY identified exploitable oil deposits in Block 15. That same year, the Hydrocarbons Law was amended to introduce so-called "*participation contracts*". As before, contractors undertook and financed the activities that were necessary to explore and produce oil, but they only received compensation by participating in oil production, which was calculated according to a contractual formula.

On 21 May 1999, OXY and the state-owned company PETROECUADOR entered into a contract to amend the Services Contract, which they converted into a Participation Contract. OXY´s contractual rights with respect to Block 15 were due to terminate on 22 July 2012 for the areas designated as "*production base*", and on 22 July 2019, for the areas designated as "*additional exploration*."

The contract expressly stipulated that OXY was not authorized to transfer or assign its rights and obligations under the Participation Contract to a third party, without the prior authorization of the then Ministry of Energy and Mines. Similarly, OXY was not authorized to participate in or create a consortium that involved the Participation Contract without the prior authorization of the State. Failure to obtain such authorization constituted grounds for Termination of the Participation Contract through Caducidad, which was also contemplated by the Hydrocarbons Law.

Block 15 facilities in the Amazonian Region of Ecuador

The relevant provisions of the Contract are:

> *"SECTION IX*
>
> *Caducidad, Sanctions and Transfers*
>
> *Art. 74. The Ministry of Energy and Mines may declare the Caducidad the contracts if the contractor:*
>
> *[...] 11. Transfers rights or enters into a private contract or agreement for the assignment one or more of its rights, without the authorization of the Ministry;*
>
> *12. Forms consortia or associations for exploration and exploitation operations, or withdraws from them, without the authorization of the Ministry; and,*
>
> *13. Commits repeat violation of the Law and its regulations thereto.*

[…] Art. 75. - The declaration of Caducidad of a contract implies the immediate return to the State of the contracted areas and the delivery of all the equipment, machinery and other exploration or production items, industrial or transportation facilities, at no cost whatsoever to PETROECUADOR and, in addition, the automatic loss of bonds and securities provided in accordance with the Law and the Contract, which will remain in the benefit of the State.

Art. 76.- Before Caducidad, of a contract is declared, the Ministry responsible will notify the contractor, providing it not less than thirty days and a maximum period of sixty days, commencing from the date of notification, to perform its unmet obligations or to dismiss the charges.

Art. 77.- A breach of the Contract, that does not cause Caducidad effects or a violation of the Law or Regulations, shall be punished with a fine imposed by the National Hydrocarbons Director, of twenty to five hundred minimum general living wages, depending on the seriousness of the violation, in addition to compensation for the damages caused.

[…] Art. 79.- The transfer of a contract or the assignment to third parties of rights derived from a contract shall be null and void and shall have no validity whatsoever if there is no prior authorization from the Ministry of Energy and Mines, without prejudice to the declaration of Caducidad as provided for in this Law.

The State shall receive a premium for the transfer and the beneficiary company shall enter into a new contract under more favorable economic conditions for the State and for PETROECUADOR than the ones contained in the original contract."

On the same day the Participation Contract was signed, OXY and PETROPRODUCCIÓN also signed joint operating agreements for the unitized exploitation of the common reservoirs in both the Edén Yuturi and Limoncocha fields (the **"Unitized Fields Joint Operating Agreements"**). These Agreements allowed the company to operate these unitized fields in the same manner and in accordance with the same rights and obligations that it had under the Participation Contract, except that it shared the rights to manage and operate the unitized fields with PETROPRODUCCIÓN.

1.2 The "Farm-in" transaction: OXY transferred the rights and obligations to AEC and formed a consortium

1.2.1 The "Farm-out" Agreement

OXY and AEC signed a Farm-out Agreement on 19 October 2000. However, this transaction had begun much earlier.

In 1999, the same year in which the Participation Contracts were signed, OXY and AEC (now, City Investing)[1] commenced the negotiations that were originally for the sale of Block 15 to AEC and subsequently for the "*Farm-in*" of AEC in Block 15.

Pursuant to the "*Farm-in*" mechanism, OXY was to assign and transfer a 40% interest in Block 15 to AEC, with all of the concomitant rights and obligations, in accordance with the terms of the Participation Contracts. During the arbitration proceedings, OXY maintained that the "*Farm-in*" mechanism consisted of two phases: an initial phase (**"Phase One"**) in which OXY transferred 40% of the "*economic interest*" in Block 15 to AEC, and for which AEC paid OXY money for oil; and a second phase (**"Phase Two"**), in which OXY officially transferred "legal title" to 40% of its rights arising under the Participation Contract to AEC.

This contractual model was in fact a pretence, since the Farm-out Agreement was used to enable OXY *to make an immediate transfer of* the 40% interest in the Participation Contract to AEC without surrendering nominal legal title. It was even clearer, when AEC decided to sell 40% of its interest in the Participation Contract to a third party, in a document called the "AEC Information Memorandum" it described itself as a "full partner" in the operation of Block 15 during Phase One:

"*EnCana has participation as a joint venture partner in the block even though legal title for EnCana's 40% interest (although fully earned) has still to be conveyed. Under the voting procedure EnCana's concurrence is required for all key votes such as field development plans, and annual work-program approval […]. During this period, EnCana's 40% interest has been held by Occidental, although in all material respects EnCana is a full partner in the operation of the block.*"[2]

This AEC Information Memorandum – drafted during Phase One of the Farm-out – directly contradicted the position adopted by OXY before the Tribunal, namely that it never transferred rights in the Participation Contract. It even refused to

[1] Alberta Energy Company Ltd. (**"AEC"**) was an Alberta province, Canada-based oil and gas exploration and production company. In May 1999, Alberta Energy, through one of its subsidiary entities, acquired City Investing Company Limited (**"City Investing"**), a Barbados company registered to do business in Ecuador and that operated certain oil blocks (not at issue here) in Ecuador. Thereafter, Alberta Energy International, Ltd. (**"AEIL"**), another Alberta Energy subsidiary, assumed ownership of City Investing and City Investing re-domiciled in Bermuda. In December 2001, City Investing changed its name to AEC Ecuador, Ltd. (**"AEC"**). In April 2002, Alberta Energy merged with PanCanadian Energy Corporation (**"PCE"**), a Canadian company, to create Encana Corporation (**"Encana Corp."**), a Canadian company. Thereafter, AEIL (AEC Ecuador's direct parent), changed its name to EnCana International, Ltd. (**"Encana International"**).

[2] EnCana Corporation Information Memorandum – Proposed Divestment of EnCana's Business in Ecuador' dated 1 July 2004.

produce this document voluntarily, which was not presented until an order was issued by the Tribunal.

The AEC Information Memorandum confirms the plain language of the Farm-out Agreements and the testimony of multiple witnesses – i.e., that AEC was in all materials respects a "*full partner*," with full rights and responsibilities, in the operation of Block 15 during Phase One. As a result, OXY's transaction with AEC was, from the outset, a transfer *that required prior Government approval*.

According to the Farm-out Agreement, OXY "*agreed to transfer to [AEC] [...] all obligations that originate, accrue or arise after the Effective Time with respect to, a 40% economic interest [...] in the Farm-out Property.*"[3] The term "*Farm-out Property*" included all of OXY's rights and obligations and assets and liabilities, whatever their nature, under the Participation Contracts, or any other legal instrument pertaining to Block 15, that existed or had accrued by 1 October 2000[4].

Article 2.01 of the Farm-out Agreement also stated that "*The Farm-out Interest to be transferred to [AEC] on [1 October 2000] includes a 'working interest or participating interest' in the Participation Contracts and Block 15*", and that OXY had an obligation to "*hold legal title to the Agreements and Block 15 as a 'nominee'*" on behalf of AEC.[5] This provision also indicated that OXY was obliged to "*act with respect to the Farm-out Interest of [AEC] as [AEC] shall direct from time to time as if [AEC] 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.*"[6]

OXY´s rights and obligations were limited to 60% of the Farm-out, including during Phase One

In other words, OXY and AEC were directly liable, from the outset, for the rights and obligations arising from or attendant to their respective ownership percentages in the Farm-out Property starting with Phase One.[7] Thus, while nominal title over 100% of the Farm-out Property fictitiously remained with OXY during Phase One, AEC was immediately "*entitled to the rights and benefits attributable to [its] Farm-out Interest [...] in the same manner and to the same extent as if [AEC] held legal title to a 40% economic interest as a participant in the Farm-out Property [...]*".[8] OXY´s rights and obligations pertaining to the Farm-out Property, even during Phase One, were similarly limited to its 60% stake[9].

Cognizant that Ecuadorian law did not recognize their fictitious bare share-holding mechanism during Phase One, OXY and AEC agreed to disguise the taxable consequences of their operation. In this respect, they "*recognize[d] and agree[d] that taxable items attributable to the Farm-out Interest will be required to be included on the Ecuadorian tax returns of OXY registered in Ecuador and that OXY will pay [AEC]'s Farm-out Interest share of Ecuadorian Tax on behalf of [AEC].*"[10] However, revealing the true nature of the operation, "*[AEC] agreed to reimburse OXY for any Ecuadorian Taxes payable by OXY, or its subsidiary in Ecuador, that are attributable to the Farm-out Interest.*"[11]

The parties were highly aware that they required the approval of the Ecuadorian Government for this Agreement as demonstrated by the fact that they stipulated that either party was contractually entitled to terminate the Farm-out Agreement "*without any further liability or obligation if such government approval was not obtained.*"[12]

1.2.2 The Joint Operating Agreement

To enable AEC to exercise its rights during Phase One, the parties agreed to execute a joint operating agreement (the **"Joint Operating Agreement")**[13]. This Agreement "*was to govern exploration, exploitation, development, maintenance, operation and production of Block 15.*"[14] In the Joint Operating Agreement, OXY and AEC sought to "*define their respective rights and obligations with respect to their operations under the Participating Agreements.*"[15]

Article 3.2.1 stipulated that this participation interest:

a. Be conveyed immediately upon the closing of the transaction;
b. Be economically equivalent to what AEC would possess if it held "*nominal legal title*" *as a*

[3] Farm-out Agreement, Article 2.0. The "Actual Time" was 4:00 a.m. local time in Ecuador, on October 1, 2000.EnCana Corporation Information Memorandum – Proposed Divestment of EnCana's Business in Ecuador dated 1 July 2004

[4] Ibid., Article 1.01

[5] Ibid., Article 2.01.

[6] Ibid., Article 2.01.

[7] Ibid., Article 2.02.

[8] Ibid., Article 2.02.

[9] Ibid., Article 2.02 *("Upon Conclusion, OXY will be obliged to fulfill all the obligations and assume and pay all the costs, charges, expenditures and liabilities attributable to the 60% interest remaining in the Farm-out that is owned and held by OXY for its own account, and will be in a position to exercise the rights and benefits that derive from this remaining 60% interest which have accumulated in the meantime and are payable for the periods after the Actual Time in accordance with and subject to the terms and conditions of the [Joint Operating Agreement] applicable to OXY as the Operator and owner of this remaining 60% interest").* Ibid., Article 2.01.

[10] Ibid., Article 2.03.

[11] Ibid., Article 2.03.

[12] Ibid., Article 2.07

[13] Ibid., Article 2.02.

[14] Ibid

[15] Joint Operating Agreement, last "point", Articles 1.51 and 3.1.1.

formal party to the Participation Contract; and,

c. Entitle AEC to share in all the benefits derived from the Participation Contract as of the "*Effective Date*" (*i.e.*, 1 October 2000).

The Joint Operating Agreement described the relationship of the parties in greater detail. It specified that OXY and AEC "*owned […] in accordance with their respective Participation Interests […] all the rights and interests in and under the Participation Contracts, all Joint Property and any Petroleum produced from the Contract Area.*"

Likewise, the Joint Operating Agreement established a Management Committee composed of OXY and AEC officials, which had the "*power and duty to authorize and supervise Joint Operations that are necessary or desirable to fulfill the Participating Agreements and properly explore and exploit the Agreement Area […].*"[16] In essence, OXY had to seek the prior approval of the Management Committee to undertake any of its obligations under the Participation Contract[17].

The Joint Operating Agreement also imposed upon OXY a host of additional duties related to the Participation Contract[18]. One is example is the reporting requirements on OXY´s activities in Block 15, information that was clearly confidential under the Participation Contract.

The Farm-out Agreement and the Joint Operating Agreement (the **"Farm-out Agreements"**) ultimately gave AEC substantial control over the operations of Block 15.

Despite this, OXY never informed the Ecuadorian government about these Agreements.

1.3 OXY concealed and misrepresented the participation of AEC

Through a series of purposefully and carefully orchestrated acts, OXY prevented disclosure of the Farm-out Agreements to the Ecuadorian government until 2004. Cognizant that full disclosure of the consummated transaction would have raised intense Government scrutiny and potentially triggered *Caducidad* proceedings. OXY instead misrepresented to Ecuadorian Government officials the full extent of their agreement with AEC.

1.3.1 Claimants and AEC arrange a meeting with the Ecuadorian government

The seeds of OXY's misrepresentation were planted at an October 2000 meeting with

16 Ibid., Articles 5.1, 5.2. The Joint Operating Agreement provided for two types of operations: "Joint Operations" whose costs could be charged proportionately to OXY and AEC in accordance with their participation interests; and "Exclusive Operations", which costs were borne solely by the party which proposed the operation. However, the Contract imposed strict and very onerous conditions on each party that proposed Exclusive Operations (Article 7). And even then, the Joint Operating Agreement provided that "*Each Party […] will be entitled to participate in the proposed [exclusive] operation.*" Article 7.2.2. In general, the Joint Operating Agreement encouraged and demanded "Joint Operations."

17 For example, Joint Operating Agreement, Articles 5.2, 6.1-6.7, 10.1-10.3 and 11.1-11.2.

18 Ibid., Article 4.2.2.

Ecuador's then Minister of Energy and Mines, Mr. Pablo Terán Ribadeneira. On or about 19 October 2000, OXY scheduled a meeting with Minister Terán for 24 October 2000.

During the meeting, the oil companies informed Minister Terán that during Phase One, OXY would transfer an "*economic interest*" *to AEC*, which OXY and AEC described as "*AEC […] provid[ing] the funding of the 40 per cent financing, and in return would receive crude oil until the second stage of the transaction.*" During the arbitration, the manager of OXY testified that the "*economic interest*" was "*really no more than a right to 40 percent of Occidental's share of crude produced from Block 15.*" During the arbitration proceedings, the manager of the company stated that he had informed Minister Terán that there would be no change in OXY´s rights and obligations.

Consistent with this misleading description of the "*economic interest*", the manager informed Minister Terán that AEC would only achieve the status of "*full partner*" after the transfer of legal title and subject to the approval of the Ecuadorian government.

As of the date of the meeting, OXY and AEC had already signed the Farm-out Agreement and, in less than a week were planning to (i) close the Farm-out; (ii) execute the Joint Operating Agreement; (iii) immediately transfer significant rights in Block 15; and (iv) immediately transfer USD 67 million from AEC to OXY. OXY and AEC knew these facts as they attended the meeting with Minister Terán on 24 October 2000, but at no point did they inform him of any of this information.

To the contrary, OXY and AEC informed Minister Terán that they were still "*negotiating*", and did not state when they would transfer the economic interest, thereby clearly misleading him.

1.3.2 Events after the meeting on 24 October 2000

1.3.2.1 Letter sent by OXY on 25 October 2000

On 25 October 2000, the day after the meeting with Minister Terán, the manager from OXY sent Minister Terán a letter in order to put on record what, according to him, had taken place at the meeting on 24 October 2000. The letter stated:

> "*In our meeting held on October 24 of this year, we had the opportunity to notify you about the imminent transaction pursuant to which Occidental Exploration and Production Company (OXY) intends to transfer to [AEC] 40% of its economic interests in the*

Participation Contract for the Exploitation and Additional Exploration of Hydrocarbons in Block 15 (the Block 15 Contract). This transfer shall also include the rights of OXY in the Operating Agreements for Unified Exploitation of the Eden Yuturi and Limoncocha Unified Fields.

After concluding this transaction, OXY shall continue being the only Contractor under the Block 15 Contract. Once [AEC] has complied with its obligations contemplated in the transfer agreement, OXY shall transfer to [AEC] the legal title corresponding to 40% of its interests in the Block 15 Contract and in the Operating Agreements for Unified Exploitation, subject to the approvals that the Government of Ecuador may require at that time.

This transaction will not adversely affect any of the operations contemplated in the Block 15 Contract or in the Operating Agreements for Unified Exploitation.

We are sure that this transaction will bring significant benefits to both the Government of Ecuador and the companies. Therefore, we respectfully request that the Ministry of Energy and Mines confirm as soon as possible, your consent with respect to the aforementioned transfer of economic interests in favor of [AEC]."

That letter was inaccurate, confusing and misleading:

- The transaction was misleadingly referred to as "*imminent*", despite the fact that it closed on 19 October, 2000, the date on which the Farm-out Agreement was signed. Furthering this confusion, the letter states that OXY "*intends to transfer*" an economic interest to AEC, when in reality OXY had already transferred that economic interest on 19 October 2000.

- OXY´s requested *the Ministry's approval of* the transaction, which is not consistent with the position adopted by OXY in the arbitration proceedings, as it maintained at the meeting on 24 October 2000 that the approval of Ecuador was not necessary. However, just one day after the meeting, OXY specifically requested government approval.

It would seem that OXY hoped that the skillfully and carefully drafted letter, which was confusing and contrary to what *all parties* remembered as having taken place at the meeting on the previous day, OXY was hoping to obtain a prompt and positive reply from the Minister (who was completely unaware of the true nature of the so-called "*economic interest*"), which OXY would subsequently use to maintain that the Minister, as a representative of the Government, had "*approved*" the contracts, when in fact he had not.

Unfortunately for OXY, ex-Minister Terán was more thorough than that.

Ex-Minister Terán sent the letter to the Director of the then National Hydrocarbons Directorate (*DNH*). Six days after sending its letter dated 25 October 2000, OXY had not received a reply from the Ministry, but nevertheless subsequently closed the Farm-out Agreement.

This was done without prior notice to the Ministry and while the request for approval submitted by OXY and AEC was still pending.

The Farm-out Agreement became effective retroactive to 1 October 2000, and OXY and AEC signed the Joint Operating Agreement. Following the execution of the Agreement, AEC transferred approximately USD 67 million to OXY. Despite having heard nothing from the Ecuadorian government in response to their request for approval, OXY and AEC executed a mutual release waiving any and all requirements for government approval[19].

The Director of the National Hydrocarbons Directorate replied to the letter dated 25 October 2000, on the assumption that it was a request for authorization to assign rights, in accordance with the Hydrocarbons Law. He requested information about AEC´s financial situation as the first step in determining whether the Ministry would grant the necessary approval.

The letter from the Director of the National Hydrocarbons Directorate undoubtedly caused OXY great concern. The letter specifically stated that prior approval of the State was *required* for the proposed transaction. However, OXY had already closed on the transaction without that approval, had issued releases and had received more than USD 67 million from AEC.

Feigning "*confusion*" over the letter from the director of the DNH, OXY requested a meeting, allegedly "*to ensure that there had been no misunderstanding about the Farm-out*," according to the statement by the manager of OXY. That meeting took place on 14 December 2000, at the offices of the DNH, and was attended by OXY'S Vice President of Government Relations and two of his colleagues.

Although the Farm-out Agreements had already been executed and closed, OXY did not provide

[19] Letter sent by OXY to AEC dated 31 October 2000.

copies of any of the Agreements to the Director of the DNH. As he expressly stated during the arbitration, the Vice President assured the Director of the DNH that "*[AEC] is not going to operate the block.*"

On 17 January 2001, ex-Minister Terán sent his reply to OXY´s letter dated 25 October, 2000 from OXY. The letter from Minister Terán stated:

> "*I acknowledge receipt of your letter […] dated 25 October 2000, in which the company that you represent made known to this Minister its intention to transfer in the future 40% of the rights and obligations in block 15, including the Operating Agreements for Unified Exploitation of the Edén Yuturi and Limoncocha Unified Fields to [AEC], and further to the meeting with officers of Occidental, please be advised of the following:*
>
> *Executive Decree No. 809, which contains the Regulation to Art. 79 of the Hydrocarbons Law, published in the Official Register No. 197, dated May 31, 1985, in its Article 1 stipulates that the total or partial transfer of rights and obligations derived from a contract may be assigned in favor of third parties with the prior authorization of the Corresponding Ministry, otherwise such transfer will be invalid and may give rise to the contract's termination.*
>
> *In the meeting held at the National Directorate of Hydrocarbons, officers from Occidental said that the 40% transfer of rights and obligations previously mentioned would not be implemented yet, therefore once the company you represent decides to perform said transfer, you must request to this State Ministry the corresponding authorization and the issuance of the Ministerial Decree through which such transfer will be legalized, with the prior payment of the transfer fees and enhancement of the economic conditions of the contract, as it is stipulated in Art. 1 of the Executive Decree 2713, published in the Official Register No. 694, dated May 12, 1995.*"

In sum, Ecuador never knew the true nature of the Farm-out.

1.3.2.2 Ecuador discovered the fraud

The Farm-out would remain a secret for more than three years. It only came to light when it was discovered by the DNH's auditors during an audit of OXY in 2004.

Main headquarters of the Attorney General's Office, in Quito

In 2003, the DNH commissioned the audit firm Moores Rowland to conduct the annual audit of OXY in accordance with y the Hydrocarbons Law.

During its audit, Moores Rowland analyzed the invoices issued by OXY to AEC for the sale of crude oil during the calendar year 2002. Moores Rowland initially noticed the transactions entered into by OXY with AEC in the context of "*examination of the entry interest earned by OXY in 2002.*" OXY stated that the source of this interest income was an account to cover the sale of a portfolio to the parent company of OXY. During the arbitration it was established that OXY and AEC falsely accounted for inexistent "*sales*", in an attempt to prevent disclosure and discovery of the Farm-out. In order to conceal the transaction, AEC channeled payments through its "*mother company*" (i.e., the parent company) OPC in Los Angeles, rather than to OXY in Ecuador. This made it extremely difficult for the auditors and the tax authorities in Ecuador to uncover the transaction.

In February 2004, OXY gave the audit firm unsigned copies of the Farm-out Agreements by mistake.

Moores Rowland informed DNH of this discovery during the first week of March 2004 in a business meeting, and upon DNH's instructions, requested a copy of the signed Farm-out. OXY refused.

This demonstrates that OXY was aware that it had transferred the rights in Block 15 to AEC without the prior approval of the State, and was extremely worried about the consequences of its actions, even going so far as to suggest to the auditors that they should attach little importance to this fact.

In a letter sent on 15 March 2004, OXY acknowledged, for the first time, that it had signed the transaction with AEC and regurgitated the same false description of the "*economic interest*."[20]

On 15 July 2004, OXY requested permission from the then Ministry of Energy and Mines to assign its rights to AEC.

1.3.2.3 Following the disclosure by OXY of the Farm-out, Ecuador declared *Caducidad* in a timely and appropriate manner

On 24, August 2004, the Attorney General, Dr. José María Borja, issued a statement to the new Minister of Energy and Mines, Mr. Eduardo López Robayo, asking him to terminate the Participation Contract. The relevant part of this letter read as follows:

"*Based on provisions in [...] the Codification of the Organic Law for the Attorney General's Office, I hereby request that you, after complying with procedures foreseen in the Hydrocarbons Law and in the Participation Contract for Exploration and Exploitation of Hydrocarbons in Block 15, signed on May 21, 1999, between PETROECUADOR and Occidental Exploration and Production Company, apply the provisions in the Law and the referred contract, with regards to the causes for caducity of same.*

It is important to observe that according to the Participation Contract for Block 15 signed on May 21, 1999, Occidental Exploration and Production Company was empowered to explore and exploit hydrocarbons in that Block, with the warning that only said Company was authorized to carry out these hydrocarbon activities.

The foundation for my request is [...] [that] on November 1, 2000, Occidental Exploration and Production Company transferred 40% interests and obligations from the Participation Contract for Exploration and Exploitation of Hydrocarbons in Block 15 in favor of [AEC], without having received authorization from the Ministry of Energy and Mines, as provided by Article 79 of the Hydrocarbons Law and the same Participation Contract)."[21]

On the same day, the Attorney General sent a similar letter to PETROECUADOR, requesting that PETROECUADOR give notice to OXY, in accordance with Section 21.2 of the Participation Contract, of its violation of the Hydrocarbons Law and breach of the Participation Contract.[22]

On 8 September 2004, Minister López requested the Chief Executive Officer of PETROECUADOR to commence *Caducidad* proceedings in accordance with Section 21.2 of the Participation Contract.[23]

On 15 September 2004, PETROECUADOR notified OXY of its breach under the Participation Contract and of the commencement of the Caducidad proceedings. It granted OXY 10 days to remedy the breach. OXY replied on 24 September 2004.[24]

A specially-constituted group within PETROECUADOR ultimately concluded that Caducidad was required for two independent reasons: (i) because OXY had committed an unauthorized assignment of rights and obligations of the Participation Contract; and (ii) because OXY had repeatedly violated the Hydrocarbons Law.[25]

Ultimately, on 2 August 2005, and after fully considering the evidence he had collected, PETROECUADOR's Executive President, Carlos Pareja, requested that the then Minister of Energy and Mines, Iván Rodríguez, declare Caducidad of the Participation Contract.[26]

OXY alleged, in the arbitral proceedings, that during this period, "*political pressure*" was building for the Government to declare Caducidad and that Minister Rodríguez was somehow the subject of that political pressure. The opposite is in fact true. The evidence before the Tribunal established that OXY exerted significant diplomatic

20 Letter sent by OXY to Moores Rowland dated 15 March 2004.

21 Letter sent by OXY to Moores Rowland dated 15 March 2004.
22 Letter sent by the Attorney General to PETROECUADOR dated 24 August 2004.
23 Letter sent by the Minister of Energy and Mines to the Chief Executive Officer of PETROECUADOR dated 8 September 2004.
24 Letter sent by OXY to PETROECUADOR dated 24 September 2004.
25 Letter sent by PETROECUADOR to the Minister of Energy and Mines dated 2 August 2005.
26 Letter sent by PETROECUADOR to the Minister of Energy and Mines dated 2 August 2005.

and political pressure, and marshaled the support of the United States Government.[27]

On 15 November 2005, Minister Rodríguez gave OXY 60-days notice and an opportunity to respond. On 7 February 2006, OXY responded with a lengthy (but legally insufficient) submission[28]. None of the evidence or arguments submitted by OXY could change the plain terms of the Farm-out Agreement or the Joint Operating Agreement or, for that matter, OXY's flagrant and repeated violations of the Hydrocarbons Law and the Participation Contract.

"Ecuador maintained that it rightlty declared Caducidad in accordance with the Contract and the Hydrocarbons Law which allowed for it when the contracting company assigns its rights to a third party without obtaining prior approval from the Minister of Energy and Mines. Ecuador complied with the provisions of the Law and when the company executed the contract, it was aware of the consequences of any breach and violations of the Law".

Dr. Diego García Carrión
Expreso, 1 July 2011

On 15 May 2006, Minister Rodríguez declared *Caducidad* of the Participation Contract, as permitted by Ecuadorian law and agreed to by OXY in the Participation Contract. The decision was contained in a Caducidad Decree which, pursuant to the provisions of the Hydrocarbons Law and the Participation Contract terminated the Participation Contract and required OXY to orderly turn over to PETROECUADOR the operation of Block 15.

1.3.2.4 In parallel, AEC sold the entity holding title to the Farm-out Property to Andes, a Chinese controlled entity

On 30 August 2005, AEC (then known as EnCana) executed a Share Sale Agreement with Andes Petroleum Co. ("**Andes**"), whereby AEC sold AEC Ecuador to Andes.

Concurrently with the Share Sale and Purchase Agreement, AEC and Andes also executed a Supplementary Indemnity Agreement that was attached to the Share Sale Agreement as Appendix 1. This Supplementary Indemnity Agreement made clear that AEC and Andes were fully aware of the

[27] For example, E-mail sent by the U.S. State Department to OXY dated 27 July 2001 (describing the upcoming meeting with the Ecuadorian official Claimant's behalf); E-mail sent by the U.S. State Department to OXY dated 20 August 2001 (discussing the State Department representative's statement to be made to the Ecuadorian Government on behalf of Claimants); E-mail sent by the U.S. State Department to OXY dated 27 February 2002 (reporting the conversation with the Ecuadorian official involving Claimants); E-mail sent by the U.S. State Department to OXY dated 28 February 2002 (discussing diplomatic efforts to be undertaken by the President of the United State); Statements from United States Ambassador Linda Jewell to Ecuador, "*It's a dispute between States*": Jewell, *El Comercio*, 24 May 2006 (where the Ambassador Jewell referred to the Occidental dispute as the reason why the United States had suspended Free Trade Agreement negotiations with Ecuador, *"[t]he treatment received by American companies in Ecuador cannot be separated from the negotiations"*).

[28] Letter sent by OXY to PETROECUADOR dated 7 February 2006: letter sent by OXY to the National Hydrocarbons Directorate (*DNH*) dated 7 February 2006; letter sent by OXY to the Minister of Energy and Mines dated 7 February 2006.

Caducidad proceedings and of the fact that Ecuador had not approved the earlier Farm-out Agreements between AEC and OXY. To account for the possibility of *Caducidad*, AEC (as the seller) "*agree[d] to indemnify the Purchaser [Andes] or its permitted assignee as provided for in this Agreement in the event that the relevant Government Authorities take certain actions with respect to the Block 15 Contract.*"[29]

On 22 February 2006, only two weeks after OXY's submission opposing the PETROECUADOR Commission Report, Oxy entered into a letter agreement with Andes, forming a unified front to fight the anticipated declaration of *Caducidad*.

Pursuant to this Letter Agreement of 2006:

i. Andes released OXY of any liability arising out of the Caducidad proceedings and acknowledged that OXY had no obligation to compensate Andes in case of Caducidad. This provision reads as follows:

> *"Neither [AEC] nor Occidental shall make any claims against the other for liability or fault in connection with the Caducity proceedings or the fact that the Transfer has occurred and the Company and Occidental hereby specifically release each other from any and all such claims and liability."*[30]

ii. OXY agreed to share with Andes, 40% of whatever monetary award OXY received as a result of the *Caducidad* Proceedings*:*

> *"If Occidental receives any monetary award from the Government of Ecuador as a result of the Government's action to enforce caducity and terminate Occidental's contract with respect to Block 15, Occidental agrees that the Company is entitled to a 40% share in the net amount received, after all costs and expenses of the Caducidad proceedings have been reimbursed or paid (in calculating such amount there shall be no double counting)."*[31]

This new, additional obligation to share the amount of any monetary award is found nowhere in the Farm-out Agreements, and was entirely disconnected from Andes' 40% *economic interest* in the Farm-out Property. Under this new obligation, OXY promised Andes a 40% share of any monetary Award received from Ecuador.

[29] Letter Agreement of 2006, Clause 2(a).

[30] Letter Agreement of 2006, Clause 2(a).

[31] Letter Agreement of 2006, Clause 2(g).

"In this hearing, the fact witnesses, experts and attorneys for Ecuador will proceed to show once again that Occidental committed the three breaches indicated, that Occidental concealed from the State the existence and true nature of the Contracts that were entered into with Canadian company AEC, that the Caducidad Decree was the just and inevitable legal consequence of Occidental's strategy of concealment; that the Caducidad Decree was issued validly in its substance and form, and that, in sum, Ecuador acted in this case, as it has already done and does, as an honest State guided by and under the rule of law."

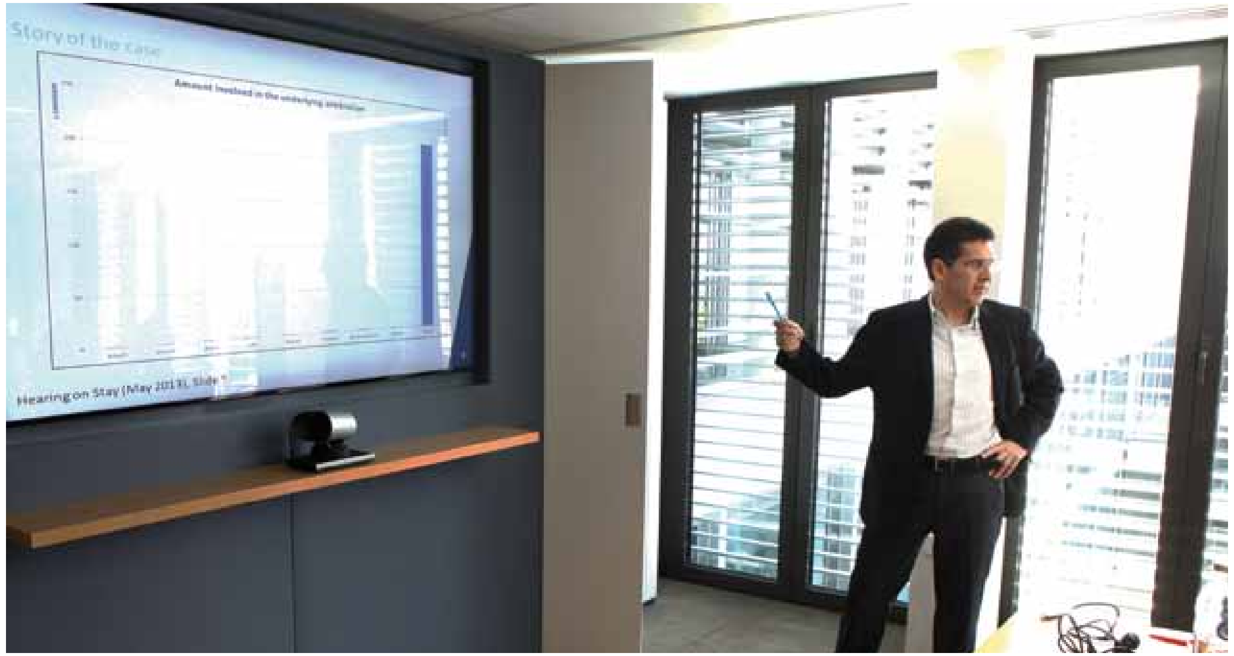
Dr. Diego García Carrión
Attorney General
Opening Statement
of the Hearing on Liability
Washington, 13 December 2008

"We have demonstrated to this Tribunal that Occidental transferred rights in establishing a consortium without the appropriate authorization by Ministry. We have demonstrated that Occidental concealed these breaches. We have shown that the only sanction provided for under Ecuadorian law and in the Participation Contract for said breaches was caducidad. We have demonstrated that this sanction was applied according to the rule of law and in the most fair and equitable manner."

Ecuador is present here today without prejudice to the jurisdictional objections it presented in due course. Ecuador is here despite all of its arguments as to the absence of liability in this case. So, undoubtedly, the presence of the Republic of Ecuador at this hearing cannot and must not be interpreted in any way as an admission of any kind of responsibility or liability whatsoever."

Dr. Diego García Carrión
Attorney General
Opening Statement
of the Hearing on Quantum
Washington, 30 June 2011

2 PROCEDURAL HISTORY



Paris, Saturday 5 April 2014, Offices of Dechert LLP. Preparatory meeting for the hearing on annulment. The Attorney General outlines his criteria with respect to the presentation of the procedural history of the case.

2.1 Registration of the case and constitution of the Tribunal

On 17 May 2006, two days after *Caducidad* was declared, OXY and its parent company, Occidental Exploration Corporation, OPC (hereinafter and jointly OXY), filed with the International Centre for Settlement of Investment Disputes (**ICSID**) a Request for Arbitration (the **"Arbitration Request"**) against the Republic of Ecuador and PETROECUADOR.

In its Arbitration Request, OXY invoked Ecuador's consent to ICSID arbitration, contained in the

Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment, and appointed Mr. David A.R. Williams, QC, as its party-appointed arbitrator.

On 13 July 2006, the Acting Secretary-General of the ICSID registered the Arbitration Request under ICSID Case Number ICSID ARB/06/11.

According to OXY, the *Caducidad* of the Contract constituted a breach by Ecuador of its obligations under the Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment (BIT).

Several months later, on 29 September 2006, Claimants sent a letter to ICSID purporting to withdraw all of their claims against PETROECUADOR. The withdrawal was accepted by the Secretariat of ICSID, despite Ecuador's and PETROECUADOR's requests to comment on the matter.

On 13 October 2006, due to Ecuador's failure to appoint an arbitrator, OXY requested ICSID to appoint the arbitrator not yet appointed and to designate an arbitrator as President of the Tribunal, pursuant to Article 38 of the ICSID Convention and ICSID Arbitration Rule 4(1).

On 25 January 2007, ICSID appointed Mr. L. Yves Fortier, QC, as President of the Tribunal, and Professor Brigitte Stern as co-arbitrator.

On 6 February 2007, ICSID informed the Parties that the Tribunal was deemed to be constituted.

Preliminary Phase

17 May 2006 to 23 July 2007

Execution of the Farm-out Agreement	Commencement of the Caducidad proceedings	Caducidad Decree Block 15	Request for Arbitration submitted by OXY	Registration of the Request for Arbitration before ICSID	Constitution of the Tribunal
On 19 October 2000, OXY and AEC executed the Farm-out Agreement. On 31 October 2000, OXY and AEC executed a Joint Operating Agreement (JOA).	As prior approval was not obtained to execute the Agreement, the Minister of Energy and Mines asked the CEO of PETROECUADOR to commence the Caducidad proceedings pursuant to Clause 21.2 of the Participation Contract.	Decision by the Ministry of Energy and Mines which terminated the Participatio Contract.	Notification to the Republic of Ecuador of the commencement of Arbitration.	Decision by the Secretary General of ICSID on whether the dispute set out in the request for arbitration was admissible or manifestly outside his jurisdiction.	Appointment and acceptance of the arbitrators: Yves Fortier (President), Brigitte Stern, David A. R. Williams.
19 October 2000	8 September 2004	15 May 2006	17 May 2006	13 June 2006	2 February 2007

2.2 The four main stages of the arbitral proceedings

The written and oral phases of the arbitral proceedings began with a preliminary conference call on 16 February 2007 and concluded with the Tribunal's Final Award dated 5 October 2012. Some of the phases of the arbitration overlapped and were conducted in parallel, which involved, for Ecuador, simultaneously performing many procedural commitments.

The arbitral proceedings were divided into four main phases (i) a provisional measures phase; (ii) a jurisdiction phase; (iii) a liability phase; and (iv) a quantum phase.

2.2.1 Provisional Measures

In the provisional measures phase, OXY requested that the Tribunal return to Oxy their ability to continue operating Block 15.

OXY specifically requested that the Tribunal:

i. order Ecuador to cease occupation of Block 15 and OXY's facilities;

ii. order Ecuador to take all necessary measures to enable OXY to resume its operations in Block 15;

iii. enjoin Ecuador from taking OXY's share in the production from Block 15; and

iv. enjoin Ecuador from entering into a contract to carry out exploration and exploitation activities on Block 15.[32]

The Parties submitted their written pleadings on the provisional measures in accordance with the schedule set by the Tribunal. On 17 August 2007, the Tribunal issued its decision on provisional measures and unanimously concluded that OXY had failed to demonstrate that an order for provisional measures was justified. The Tribunal therefore dismissed Claimants' application.

2.2.2 JURISDICTION

The second phase of the arbitration was dedicated to Ecuador's objections to jurisdiction. Ecuador raised several of objections in this regard, mainly:

a. That the legality of *Caducidad* was non–arbitrable and could only be decided by an Ecuadorian administrative court for two independent reasons: (i) disputes regarding the legality of *Caducidad* are inherently non-arbitrable under Ecuadorian law, which governs the Participation Contract; and (ii) the Participation Contract, by its terms, precludes ICSID arbitration regarding the legality of *Caducidad.*

Provisional Phase
19 October 2006 to 17 August 2007

Request for Provisional Measures submited by OXY	Ecuador's Reply to OXY's request for Provisional Measures	Hearing for Interim Relief	Tribunal's Decision on Provisional Measures
To allegedly protect its rights in the face of imminent loss.	The measures requested lack merit as neither urgency nor irreparable loss was demonstrated	Presentation of oral arguments by Ecuador and OXY before the Tribunal.	The arguments raised by OXY do not justify granting Provisional Measures.
18 October 2006	1 December 2006	2 - 3 May 2007	17 September 2007

[32] Request for Arbitrtion presented by the Claimants on 17 May 2006.

b. That since OXY initiated ICSID arbitration only two days after the declaration of *Caducidad,* it did not respect the six-month mandatory negotiation period under the Treaty; and

c. That the parent company Occidental Petroleum Corporation, as a non-signatory to the Participation Contract, was not an "*investor*" within the meaning of the Treaty, and did not have standing to bring its claims.

d. Ecuador also alleged that OXY's claims were premature and, hence, inadmissible because Claimants had not sought to overturn the *Caducidad Decree* before the Ecuadorian administrative courts.

The Parties submitted their respective briefs and evidence on these issues and the Tribunal held an evidentiary hearing from 22 to 23 May 2008. On 9 September 2008, the Tribunal issued its Decision on Jurisdiction (the "Decision on Jurisdiction"), manifestly exceeding its powers by asserting jurisdiction over OXY's claims.

In this Decision, the Tribunal ruled as follows:

With regard to caducidad:

"73. Clause 22.2.1 cannot, on its term, be construed as an exception or waiver ICSID jurisdiction over caducidad-related disputes. The Participation Contract is fraught with express and extensive references to caducidad under the very preceding section to the one in which Clause 22.2.1 is found. The parties fully understood the significance of caducidad in terms of the Participation Contract's potential forfeiture and resulting disputes. ***Had the parties wished to exclude such disputes from ICSID jurisdiction to the Ecuadorian administrative courts in this regard, they could have done so****. They did not and the Tribunal will not imply such wording in the clause."* (emphasis added).

Jurisdiction Phase
18 October 2006 to 9 September 2008

Memorial on Jurisdiction submitted by Ecuador.	OXY's Reply on Jurisdiction.	Hearin on Jurisdiction.	Tribunal's Decision on Jurisdiction
The Tribunal lacked jurisdiction to settle the dispute pursuantto the Cntract, the lawand the BIT.	The Contract and the BIT grant jurisdiction to the Tribunal for the settlement of the dispute.	Ecuador's and OXY's presentation of oral arguments before the Tribunal.	The Tribunal declared that it had jurisdiction to hear the dispute arising from the BIT as Ecuador had given its consent.
7 March 2008	9 April 2008	22 - 23 May 2008	9 September 2008

- **With regard to the 6-month waiting period in accordance with the BIT:**

*"92. In response, **the Claimants have emphasized that the very purpose of the waiting period requirement is to allow parties to enter into good faith negotiations before initiating arbitration. This requirement need not be respected if attempts at a negotiated solution have proven futile**, which the Claimants contend was the case in present circumstances.*

93. In this regard, the Tribunal recalls that the Caducidad procedure at issue in this arbitration was in fact initiated in 2004. As noted earlier, for some 18 months or so prior to the issuance of the actual Caducidad Decree on 15 May 2006, OEPC made a number of submissions seeking to rebut the allegations on the basis of which the Caducidad procedure was initiated, but to no avail.

94. Furthermore, the Tribunal accepts, albeit without prejudging the merits of the case, that attempts at reaching a negotiated solution were indeed futile in the circumstances." (Emphasis added).

Paris, Monday 7 April 2014, Hearing Room at the World Bank, minutes before the start of the hearing in the OXY case.

The Tribunal also failed to provide reasons for rejecting the argument that OPC is not an "*investor*" under the BIT. Nor did the Tribunal provide reasons for rejecting Ecuador's argument that the *Caducidad* Decree is inherently non-arbitrable under Ecuadorian law. In its Decision on Jurisdiction, the Tribunal also rejected, without any explanation whatsoever, the inadmissibility objection based on the premature nature of Claimants claim.

2.2.3 Liability

The third phase of the proceedings, which commenced before the Tribunal issued its Decision on Jurisdiction, was dedicated to liability.

On 23 July 2007, OXY presented its submission, requesting the Tribunal to declare that Ecuador had breached its obligations under the BIT, international law and the Participation Contract, and to accordingly declare that OXY had a right to be compensated for damages.

On 16 June 2008, after ratifying its objections to the jurisdiction of the Tribunal and reserving its rights, Ecuador, through the Attorney General's Office, submitted its reply on jurisdiction stating:

i. The Caducidad Decree complied fully with Ecuadorian Law. The assignment of rights between OXY and AEC gave rise to causes for Caducidad as provided under Article 74 of the Hydrocarbons Law. Caducidad was accordingly appropriate and proportionate.

Liability Phase
23 July 2007 to 5 October 2012

Oxy's Memorial on Liability	Ecuador's Rejoinder on Liability	OXY'sReply on Liability	Ecuador's Rejoinderon Liability	Hearing on Liability
Ecuador failed to fulfill its obligations under the BIT and international law.	Ecuador fulfilled its obligations under the BIT; OXY did not seek legal remedies against Caducidad	Caducidad breached investment protection standards under the BIT.	Caducidad was a mandatory legal remedy in accordance with Ecuadorian legislation.	Ecuador and OXY's presentation of oral arguments before the Tribunal.
23 July 2007	16 June 2008	11 August2008	9 September 2008	13-20 December 2008

ii. OXY misled Ecuador regarding the true nature of the contracts executed with AEC, which constituted an assignment of contractual rights and not a mere assignment of economic interests, as it had unofficially informed Ecuador.

iii. Ecuador observed OXY's due process rights during the Caducidad proceedings and afforded OXY the opportunity to challenge the Decree before the Ecuadorian courts.

iv. Ecuador did not breach the Participation Contract, the BIT or International Law.

v. OXY's claims lack merit as OXY did not challenge the Caducidad *Decree* before the Ecuadorian Courts.

vi. Ecuador did not expropriate OXY's investment. Termination of a contract in accordance with the governing law is not an expropriation.

Furthermore, the Republic presented the following counterclaims against OXY:

1. OXY's destructive and unlawful conduct following the *Caducidad* Decree.

2. OXY's failure to pay the required assignment

fee and failure to negotiate a new participation contract more favorable to the Republic.

The Tribunal held the Liability Hearing in Washington from 13 to 20 December 2008. The Liability Hearing was continued on 20 and 21 March 2009.

In an email dated 15 February 2011, after the matter had been fully briefed and more than one year after the Parties had presented closing arguments on liability, the Tribunal informed the Parties that it had reached a point in its deliberations where it needed more information on the quantum aspect of the case. In this context, Ecuador could not but conclude that the Tribunal had reached a decision on liability and had found against it. However, neither in that email nor in any other communication for the next eight months did the Tribunal ever provide any reason for its decision.[33]

2.2.4 Quantum

The fourth phase of the proceedings concerned Claimants' damages as a result of Ecuador' alleged violation of the BIT. During this fourth phase, which overlapped with the liability phase, the Parties submitted their respective pre-hearing briefs and evidence on quantum.

On 17 September 2007, OXY submitted its Memorial on Damages requesting the Tribunal to:

a. *"Declare that Ecuador has breached its obligations under the Treaty and international law;*

b. *Declare that Ecuador has breached its obligations under the Participation Contract and Ecuadorian law;*

c. *Order Ecuador to pay Claimants the fair market value of the Participation Contract, in the amount to USD 2.71 billion;*

d. *Order Ecuador to pay Claimants consequential damages in the amount of USD 201.2 million;*

e. *Order Ecuador to pay interest on the amounts under (c) and (d) at the monthly interest rate of the United States T-Bills, compounded monthly, through the date of full and effective payment of such amounts.*

f. *Order Ecuador to reimburse Claimants all their reasonable legal costs and fees".*

On 9 March 2009, the Attorney General's Office submitted Ecuador's reply, drawing the Tribunal's attention to the fact that it was considering the quantum phase, despite the non-existence of a decision on liability.

[33] E-mail from the Tribunal to the Parties dated 15 February 2011.

The positions adopted by the Parties were presented during the Quantum Hearing held from l 3 to 7 November 2009.

Throughout this phase, the Ecuadorian State maintained that in the unlikely event of the Tribunal awarding compensation to OXY, the following deductions would have to be made to the amount:

1. An amount to reflect OXY's contributory fault. In other words, OXY contributed to the loss that it had suffered.

2. In any event, OXY would only be entitled to 60% of the compensation as it is an indisputable fact that the company had assigned 40% of its rights. Awarding it 100% compensation would constitute an unjust enrichment which is not admissible under Ecuadorian law.

3. The amounts that OXY was required to pay pursuant to Law 42 and the VAT Interpretative Law.

In the quantum phase, the Tribunal also asked the Parties to file separate briefs on the impact on quantum of Law 42 and the VAT Interpretative Law.

As mentioned above, on 15 February 2011, the Tribunal wrote to the Parties informing them that the Tribunal had reached a decision on liability against Ecuador, but without disclosing its reasoning. In that same email, the Tribunal requested "*the assistance of the both parties' [damages] experts, Mr. Joseph Kalt and Mr. Daniel Johnston in order to help the Tribunal to assess the proper calculation of damages."* Both parties raised concerns about the Tribunal's approach.

Attempting to backtrack from its earlier indication that it had found against Ecuador on liability, but without providing its reasons, the Tribunal asserted that the deliberations as to both liability and quantum were allegedly ongoing. Nevertheless, the Tribunal altered the pre-established procedural order and required the Parties' *quantum* experts to issue a joint report on Block 15's estimated fair market value ("**FMV**") as of 16 May 2006.

Quantum Phase
17 September 2007 to 5 October 2012

OXY's Memorial on Quantum	Ecuador's Reply and Counterclaims on Quantum	Oxy's Reply to Counterclaim on Quantum	Hearing on Quantum	Hearing on Quantum - Review of the Joint Expert Report on Quantum	Tribunal's order to submit brief on the effects of assignment of rights without approval.	Hearing on Quantum – effects of the assignment of rights without Approval
OXY claimed damages on the grounds of Ecuador's alleged breaches.	The quantum submitted by OXY was overvalued and exaggerated OXY behaved destructively and unlawfully.	Ecuador failed to provide evidence of the loss caused by OXY.	Ecuador and OXY's presentation of oral arguments before the Tribunal.	Presentation of oral arguments on the assignment of rights without approval.	OXY claimed 100% of the value of the block. Ecuador took the view that it was only entitled to 60%.	Ecuador and OXY's presentation of oral arguments before the Tribunal. (Conclusion of the arbitration proceedings).
17 September 2013	9 May 2009	12 June 2009	3-7 November 2009	30 June 2001	6 October 2011	12 April 2012

For calculation purposes, the Tribunal, thereby obviously prejudging the issue, drew up a series of parameters for the quantum experts to use in their report. This report was issued on 11 April 2011 and was commented by both Parties.

The Tribunal remained silent for eleven months until it unexpectedly raised a new argument in favor of Claimants.

The Parties received an e-mail from the Tribunal on 6 October 2011. This e-mail arrived without prior notification and more than five years after the commencement of this case, after countless written submissions and after numerous in-person hearings. In the e-mail, the Tribunal invited the Parties to comment on a new argument, which *could only benefit OXY, and which neither party had argued before.*

It was on the basis of this new argument that the Tribunal would later award Claimants an additional

USD 943 million.

In this eleventh-hour e-mail, the Tribunal asked the Parties to comment on the possibility that, if the Tribunal were to agree with Ecuador's argument that OXY had unlawfully transferred 40% of its rights in the *Participation Contract,* then the Tribunal could nullify the transfer, cause the 40% to revert back to OXY, and OXY would again posses 100% of the rights in Block 15 and thus recover 100% of damages.

On 12 April 2012, the Tribunal – after expressing its reluctance to hear Ecuador on the matter – held a one-day hearing on its new-found argument. At the conclusion of that hearing, President Fortier declared that the proceedings were closed.

> *"Ecuador argued that Occidental was entitled to 60% only of what it claims because it assigned the remaining 40% to EnCana and which, in turn, assigned it to a Chinese company that was not even protected by the Bilateral Investment Agreement between Ecuador and the United States."*
>
> *Dr. Diego García Carrión*
> Vanguardia, 20 June 2011

2.3 The Arbitration Award

On 5 October 2012, a sharply-divided Tribunal issued the Award. The Tribunal concluded:

i. That the Participation Contract stated that Ecuador could declare Caducidad if OXY transferred any of its rights to a third party without Government approval;

ii. That OXY had, in fact, transferred such rights to a third party without Government approval; and

iii. That Ecuador could not, however, declare Caducidad. The rationale for this apparent non sequitur was that some amorphous principle of "proportionality" prevented Ecuador from exercising its express contractual rights. In other words, the Tribunal concluded that Claimants breached the Participation Contract and the Hydrocarbons Law by transferring rights to AEC without prior Government approval, but also found – paradoxically - that although this breach expressly called for Caducidad, the declaration of Caducidad was "disproportionate" and, therefore, unlawful.

"*Throughout the proceedings, we have seen evidence that, when Occidental assigned the rights in the Participation Contract that it had with Ecuador, it did not have authorization from the Minister for Energy and Mines, as required under the Hydrocarbons Law at that time, and that the Contract established that this was grounds for Caducidad.*"

Dr. Diego García Carrión
El Comercio,18 April 2012

The damages that flow from this audacious conclusion are nothing short of breathtaking.

The majority of the Tribunal, composed of President Fortier and Arbitrator Williams, then went even further. It increased the damages by an additional USD 943 million, when it adopted the argument that the Tribunal had itself raised. The majority held that the transfer was unlawful and thus should be declared null, which meant that the 40% of the interest reverted back to OXY, who then became entitled to 100% of the damages.

In response to this striking conclusion, Professor Stern issued one of the strongest dissents in the history of investment-treaty jurisprudence (the **"Dissent"**). In harshly criticising the majority's decision, Professor Stern used the exact language from the ICSID Convention that would require annulment of the Award:

> *"[...]there is the fundamental impossibility for me to follow the different statements in the Award relating to the effect this Tribunal should give to the Farm-out Agreement.* ***The majority's position on the effect of the Farm-out Agreement is, in my view, so egregious in legal terms and so full of contradictions, that I could not but express my dissent****. In my view, there are two major questionable aspects in the majority's approach to the question of the effectiveness of the Farm-out Agreement: the first is the analysis of the question of the effectiveness of a legal act under Ecuadorian law, which is based on a total lack of reasons, with the consequence that I* ***was not able to follow the 'reasoning' from point A to point B, as well as gross errors of law in the purported interpretation of the content of Ecuadorian law****; the second, which in my view is* ***even a more serious matter, is the manifest excess of power of the Award nullifying a contract concerning a company which not only was not a party to the arbitration, but moreover – even if it had been a party – could not be considered****, being a Chinese company, as an investor over which the Tribunal had jurisdiction under the US/Ecuador BIT.*"[34]

[34] Dissenting Opinion, § 5.

Professor Stern also vigorously disagreed with the majority's treatment of three other legal principles that drove its unprecedented damages award. *First,* Professor Stern explained that Claimants should be contributorily liable for 50% of their loss, rather than the 25% found by the majority. *Second,* Professor Stern disagreed with the majority's conclusion that Law 42 should not be taken into consideration to reduce Claimants' damages because, according to the majority, it was not a tax, even though the majority described Law 42 exactly as a taxation matter. *Lastly,* Professor Stern disagreed with the majority's conclusion that the VAT Interpretative Law should not be taken into consideration because, according to the majority, it violated the Participation Contract.

On 9 October 2012, Ecuador submitted its Application for Annulment.

2.4 Annulment

Faced with the inconsistencies revealed by the dissenting opinion as well as by the other excesses committed by the Tribunal during the proceedings, and for which express reservation was timely made, the State's defense, led by the Attorney General, submitted an application for annulment of the Award to the ICSID on 9 October 2012. This application was registered two days later, on 11 October 2012.

On 4 December 2012, the Secretary General of ICSID notified the parties of her intention to recommend to the Chairman of Administrative Council, the appointment of Mr. Juan Fernández Armesto, Judge Florentino P. Feliciano and Mr. Rodrigo Oreamuno to the *ad hoc* Committee.

On 11 December 2012, OXY objected to the appointment of one of the proposed arbitrators, raising concerns about his independence and impartiality.

ICSID dismissed these objections, and, on 18 January 2013, notified the Parties that the a*d hoc* Committee that would rule on the application for annulment, had been constituted.

The grounds for annulment invoked by Ecuador were:

The Tribunal clearly exceeded its powers.

Its decisions were rendered without providing any reasons or with insufficient or contradictory reasons.

Fundamental procedural rules were seriously breached which, according to the ICSID Convention, are grounds for annulment of an Award.

In accordance with the provisions of the ICSID Convention, once registration of the application for annulment had been made, the enforcement of the Award was provisionally suspended at the express request of the Ecuadorian State. On 13 February 2013, OXY submitted an application to lift the provisional stay. Faced with this request, the Attorney General's Office argued that because of the gross errors of law contained in the Award, the irreparable harm that the enforcement would cause to Ecuador and the absence of proof that Ecuador did not comply with its international obligations in the past, the *ad hoc* Committee should continue the stay of enforcement of the Award during the annulment procedure.

The *ad hoc* Committee scheduled a hearing to hear this application, which was carried out in Paris on 13 May 2013. The suspension was unanimously ratified by the *ad hoc* Committee on 30 September 2013.

The annulment hearing convened by the *ad hoc* Committee took place in Paris from 7-10 April 2014. The Committee heard the oral arguments of Ecuador and OXY. At this hearing, the Attorney General's Office set out the legal grounds for the annulment of the Award.

"The start of these Annulment proceedings generated huge expectations among Ecuador's legal defense team and, of course, in all other sovereign states that have ICSID arbitration proceedings, insofar as it opens up the possibility of rectifying the serious mistakes of the Award issued by the Tribunal on 5 October 2012, the inconsistencies which called into question the credibility and impartiality of the entire system of International Investment Arbitration".

Dr. Diego García Carrión
Attorney General
Press Release of the AGO
Quito,15 January 2013

"Ecuador was expecting to receive a decision from the Tribunal based on the rules of law. Instead, it received a decision taken by arbitrators who acted as amiable compositeurs, manifestly exceeding their powers and giving incomprehensible and/or contradictory reasons, and took their decisions without analyzing the legal arguments of the Republic of Ecuador. They overlooked the legal system and imposed their own capricious notion of justice.
Ecuador would like to remind you of the inconceivable paragraph of the Award (348) that praises oilmen, those who, unlike other human beings, should not worry themselves with 'legal niceties' and should ignore the recommendations of their lawyers. Whatever they do – lie, cheat, conceal –,as far as the Tribunal is concerned, these persons will — at most — be found merely negligent. Such prejudgment is unacceptable from a Tribunal that shall decide on the basis of rules of law."

Dr. Diego García Carrión
Attorney General
Opening address
at the Annulment Hearing
Paris, 7 April 2014

3 Grounds for annulment of the Award

The grounds for annulment invoked by Ecuador are based on a series of gross errors and excesses committed by the Tribunal at each stage of the proceedings, which sufficiently justify annulment of the Award and which are detailed on the following pages of this document.

Paris, Saturday, 5 April 2014, at the offices of Dechert LLP. Preparatory meeting for the hearing on the OXY annulment case. The Attorney General comments on the opening arguments for Ecuador's submission. To his right: Pierre Mayer (Dechert LLP).

3.1 Jurisdiction

In its Decision on Jurisdiction, the Tribunal rejected Ecuador's objections without stating the reasons for doing so and manifestly exceedings its powers.

Ecuador's objections to jurisdiction were submitted by the Attorney General in May 2008, when, leading Ecuador's defense team at the jurisdiction hearing set by the Tribunal as part of the proceedings initiated by OXY, he ratified the jurisdictional objections previously submitted by the Republic. However, he also explained to the Tribunal the essence of these objections, which is that they respond to a requirement of Ecuador whereby the signatories to any contract, and of course OXY, are obliged to comply with and abide the legally agreed clauses.

Ecuador argued that the Tribunal had no jurisdiction to rule on OXY's claim for the following reasons:

i. That *Caducidad*-related claims were not arbitrable;

ii. That OXY did not have standing to sue under the Treaty;

iii. That OXY's claims were premature and, hence, inadmissible because the Declaration of *Caducidad* had not been challenged before the Ecuadorian administrative courts; and

iv. That the six-month mandatory negotiation period set out in the Bilateral Investment Treaty signed between Ecuador and the United States had not been complied with.

Given that the Tribunal's Decision on Jurisdiction, in clear excess of powers, rejected these objections, the Attorney General submitted the following arguments in the annulment phase:

3.1.1 The Tribunal had no jurisdiction to rule on OXY's Caducidad-related claims

In the jurisdictional stage of the arbitration proceedings, Ecuador argued that *Caducidad*-related claims were not arbitrable under the 1998 Ecuadorian Constitution, and that the Tribunal did not have jurisdiction to rule over OXY's claims.

Article 196 of the 1998 Constitution provides for the exclusive jurisdiction of the Ecuadorian administrative courts to entertain claims pertaining to the legality or validity of administrative acts such as the *Caducidad* decree enacted by the former Minister of Energy and Mines, with regard to the Participation Contract for Block 15.

In response to this objection, the Tribunal, at paragraph 86 of its Decision on Jurisdiction, limited itself to: (i) holding that "*[...] the Respondent cannot invoke its domestic law for the purpose of avoiding ICSID jurisdiction under the Treaty [...]*"; and (ii) referring to Article 163 of the Ecuadorian Constitution which "*[...] recognizes that international treaties duly ratified by the Republic of Ecuador shall prevail over any laws in Ecuador [...]*".

These conclusions, drawn by the Tribunal, only show that it failed to understand Ecuador's position, or to appreciate the significant distinction between Ecuador's arbitrability objection and Ecuador's objection based on the argument that the Parties excluded *Caducidad*-related claims from the scope of the Tribunal's *ratione materiae* jurisdiction by way of Clauses 22.2.1 and 21.4 of the Participation Contract.

The Tribunal's confusion paradoxically contradicts paragraph 42 of the Decision on Jurisdiction, which reads:

> *"The Respondent characterises its first jurisdictional objection as a double-hurdle. In the Respondent's words:*
>
> *'There are two separate and distinct reasons why OXY's claims are non-arbitrable. First, disputes regarding a declaration of caducidad are inherently non-arbitrable under Ecuadorian law, which both Parties agree governs the Participation Contract. Second, the Participation Contract itself precludes ICSID arbitration regarding caducidad. Importantly, the Tribunal must overcome both hurdles before it can exercise jurisdiction of OEPC's claims.'"*

No reasons were given for rejecting Ecuador's objections, which warrant annulment pursuant to Article 52 (1) (e) of the ICSID Convention. And by exercising jurisdiction which it did not have, the Tribunal manifestly exceeded its powers, which also justifies annulment of the Award pursuant to Article 52(1)(b) of the ICSID Convention.

3.1.2 The Tribunal failed to state the reasons for rejecting Ecuador's objection that the parent company Occidental Petroleum Corporation (OPC) lacked standing to sue under the BIT

This objection was based on two main grounds:

First, OPC had failed to demonstrate its control over Occidental Ecuador and therefore had not established a basis for its standing as an investor.

Second, *Caducidad* only directly affected Occidental Ecuador and, as a consequence, OPC was replicating part of Occidental Ecuador's treaty claims, which is proscribed by international law.

After briefly summarising Ecuador's position with regard to OPC's lack of standing, in a single paragraph, the Tribunal rejected Ecuador's objections in two statements:

> *"It follows that the Tribunal has jurisdiction over the Claimants' claims under both the Participation Contract and the Treaty. For this reason, the Respondent's submission that Claimant OPC, the 'ultimate parent' of OEPC, lacks standing to assert claims as an investor in the circumstances because it is not a signatory to the Participation Contract is moot and need not be addressed as part of this Decision on Jurisdiction."*[35]

Clearly, the Tribunal failed to address: (i) OPC's lack of evidence of control over Occidental Ecuador; and (ii) that *Caducidad* affected only Occidental Ecuador and not its parent company. This objection was independent of other objections to the Tribunal's jurisdiction and consequently had to be settled independently and could not be ignored. The absence of any explanation, whatsoever, on how the Tribunal determined that it had *ratione personae* jurisdiction over OPC justifies the annulment of the Award.

3.1.3 The Tribunal failed to state the reasons for rejecting Ecuador's alternative objection that Claimants' claims were premature

This objection was based on the fact that OXY had made no attempt to challenge the *Caducidad* Decree before the Ecuadorian administrative courts prior to initiating the arbitration two days after *Caducidad* was declared. As a consequence, pending OXY's action before the Ecuadorian administrative courts, Ecuador requested that the arbitration be suspended.

In its Decision on Jurisdiction, the Tribunal once again rejected Ecuador's objection in a single paragraph:

> *"Finally, it is recalled that the Respondent has requested, as part of its second jurisdictional objection, 'an order that this arbitration be stayed until OEPC challenges the Caducidad Decree in the competent Ecuadorian administrative court and that court issues a final ruling on such challenge'. This request is made on the basis of the allegation that the Claimants' claims are premature because the Claimants have made no attempt to challenge the Caducidad Decree before the Ecuadorian administrative courts. For the reasons set forth in this Decision on Jurisdiction, the Claimants were not required to do so, and this request is accordingly denied."*[36]

Yet again, no reasons were given for rejecting Ecuador's objection, thus violating Article 52 (1)(e) of the ICSID Conventions and warranting the annulment of the Award.

[35] Decision on Jurisdiction, § 89.
[36] Decision on Jurisdiction, § 96.

Paris, Sunday 6 April 2014, offices of Dechert LLP. Preparatory meeting for the hearing on annulment. Ecuador's defense team, led by Dr. Diego García Carrión, exchange comments on the arguments to be developed in the hearing. From left to rigat: Audrey Caminades (DechertLLP), Diego García Carrión (Attorney General), Blanca Gómez de la Torre (Attorney General's Office), Ab. Diana Moya (Attorney General's Office), Juan Espinosa (Attorney General's Office), George von Mehren (Squire Sanders), Stephen Anway (Squire Sanders). Stephan Adell (Squire Sanders), Eduardo Silva Romero (Dechert LLP).

3.1.4 The Tribunal failed to give effect to the mandatory negotiation requirement in Article VI.3 of the BIT

The Tribunal manifestly exceeded its powers by refusing to give effect to the procedural requirements set out in Article VI.3 of the Treaty, which are conditions precedent that investors must fulfil before they can invoke the jurisdiction of an arbitral tribunal under the Treaty.

Article VI.3 of the Treaty states:

> "*Provided that the national or company concerned has not submitted the dispute for resolution under paragraph 2 (a) or (b) [to the national courts or in accordance with any previously agreed dispute settlement procedures] and that six months have elapsed from the date on which the dispute arose, the national or company concerned may choose to consent in writing to the submission of the dispute for settlement by binding arbitration.*"[37]

The phrase "*provided that*" of this Article specifies two cumulative conditions: (i) there must be a "*dispute*" that is later the subject of the arbitration; and (ii) the investor must wait six months after that dispute arises before initiating arbitration.

These are express conditions to which Ecuador subjected its consent to a binding arbitration.

Yet, the Tribunal wrongly asserted its jurisdiction over the dispute on the grounds that:

i. OXY would have complied with the Treaty's mandatory six-month waiting period; and
ii. negotiations between the two Parties would have been futile in any event.

However, these conclusions are grossly incorrect.

First, Claimants did not comply with the Treaty's mandatory six-month waiting period.

The Tribunal determined that the *"dispute"* did not arise with the declaration of *Caducidad.* On this incorrect basis, the Tribunal found that OXY had respected the six-month period – and thus that it had jurisdiction over the claims – because *"the Caducidad procedure at issue in this arbitration was in fact initiated in 2004"*[38] (and thus before any official decision was made by Ecuador).

Before the *Caducidad* decree, OXY did not claim – and could not have claimed– a breach of the Treaty, because the State had not decided to declare *Caducidad.*

37 Treaty, Article §VI.3.
38 Decision on jurisdiction, § 93.

OXY argued that the *"dispute"* arose out of the consequences of the *Caducidad* Decree itself, not from the proceedings leading up to the Decree. OXY's Request for Arbitration and Memorial on Liability made it clear that the dispute upon which OXY based its Treaty and contract claims is the *Caducidad* Decree itself, not the initiation of *Caducidad* proceedings. In the request for Arbitration, OXY stated:

> "*by adopting the Caducidad Decree, Ecuador has completely deprived Claimants of their interests under the Participation Contract and the Operating Agreements, as well as the benefit of ownership of an their investments in Ecuador. It has done so in an arbitrary and discriminatory fashion, […] Ecuador has therefore acted in breach of its obligations under Article III(I) of the Treaty.*"[39]

OXY repeated their insistence that Ecuador's *Caducidad* Decree caused the alleged breaches in the Memorial on Liability.

OXY never argued that the mere initiation of *Caducidad* proceedings was a breach of the Treaty. *Caducidad* was decreed on 15 May 2006 and a dispute with regard to the legality and the consequences of the *Caducidad* Decree could not arise prior to that date. Accordingly, the earliest the dispute could have arisen was on that day, and OXY could not have complied with the six-month cooling-off period when it filed their Request for Arbitration merely two days later.

> *At no time does Ecuador's appearance before ICSID imply acknowledgment or acceptance, because we have submitted our arguments without prejudice to the the objections to jurisdiction which we made from the beginning of the proceedings and which Ecuador still maintains.*
>
> *Dr. Diego García Carrión*
> El Universo, 15 June 2011

In fact, the *"dispute"* actually arose on the day that OXY filed its Request for Arbitration because that was the first day that Ecuador received notice of such claims.

The Tribunal's gross error is highlighted by the fact that other international tribunals have interpreted similarly-worded treaty provisions and concluded that a treaty dispute does not arise when the alleged

39 OXY's Request for Arbitration dated 17 May 2006, § 63.

breaches occur (*i.e.*, here, when *Caducidad* was decreed) but, rather, when notice of the existence of the dispute, under the treaty, is given by the investor.[40]

Furthermore, other investment tribunals, when ruling on the same Article VI.3 of the BIT (*Burlington v. Ecuador*[41] and *Murphy v. Ecuador*[42]), found that they lacked jurisdiction because the claimants did not provide notice of their treaty claims as required by the applicable treaty.

The Tribunal in the *Burlington* case, applying the same Treaty, explained that: *"the Request for Arbitration is too late a time to apprise Respondent of a dispute. The sixth-month waiting period requirement of Article VI is designed precisely to provide the State with an opportunity to redress the dispute before the investor decides to submit the dispute to arbitration."*[43]

In sum, the dispute which gave rise to the underlying arbitration could not have arisen before 15 May 2006 when the *Caducidad* Decree was issued.

> *Just like any other state governed by the rule of law, Ecuador does not act to avenge itself but rather acts in accordance with its constitution and its laws.*

Because OXY filed its Request for Arbitration on 17 May 2006 (only two days after *Caducidad* was decreed), it did not comply with Article VI.3 of the Treaty, and thus the Tribunal erred in exercising jurisdiction over the claims.

Second, the Tribunal purported to confirm its jurisdiction on the basis that negotiations could have been *"futile."*[44] With almost no discussion of the issue and no acknowledgement of OXY's burden to prove futility, the Tribunal simply concluded that "*attempts at reaching a negotiated solution were indeed futile in the circumstances*."[45]

Paradoxically, OXY admitted that *"[i]n fact, throughout 2006, the parties discussed several settlement proposals."*[46] Thus, OXY's own statement proved that: i) Ecuador was willing to negotiate; and ii) OXY did not believe settlement discussions were futile.

Therefore, the Tribunal's conclusion is completely

40 *Lauder v. The Czech Republic* (UNCITRAL), Final Award, 3 September 2001, § 185.
41 *Burlington Resources Inc., v. Republic of Ecuador* (ICSID Case No. ARB/08/5), Decision on Jurisdiction, 2 June 2010, §§ 284-340.
42 *Murphy Exploration and Production Co. Int'l v. Republic of Ecuador* (ICSID Case No. ARB/08/4), Award on Jurisdiction, 15 December 2010, §§ 101-109.
43 *Burlington Resources Inc., v. Republic of Ecuador* (ICSID Case No. ARB/08/5), Decision on Jurisdiction, 2 June 2010, § 312.
44 Decision on Jurisdiction, § 94.
45 Decision on Jurisdiction, § 94.
46 OXY's Answer on Jurisdiction dated 4 April 2008, § 71.

illogical. It should have found that it had no jurisdiction.

Despite the fact that in its Award, the Tribunal stated that its decisions were justified *"[f]or the reasons specified in this decision"*[47], the Tribunal failed to state any type of argument or reasoning. Put simply, the Tribunal rejected Ecuador's objections without making any reference to anything.

3.2 Liability

The liability stage was undertaken at the same time as the jurisdiction stage, which not only required a huge effort on the part of Ecuador's defense team but also required massive economic resources, lawyers and staff.

At first, Ecuador's strategy was not to appear in the proceeding. When assuming his position as legal representative for the case, Diego García Carrión believed it was essential to appear in the arbitration proceeding and to provide an active defense, declaring:

"In cases in which jurisdiction is argued, be it by the State or any legal person, we recommend appearing and arguing against that jurisdiction. It is necessary to make objections to jurisdiction, whether in Ecuador or at any other international level."

During this stage, the State defense countered OXY's allegations concerning Ecuador's violations of the BIT and the Contract. Ecuador demonstrated that:

i) OXY appeared at the arbitration without providing any tangible evidence to show that the *caducidad* of the Participation Contract was calculated revenge taken by the Republic of Ecuador for the fact that OXY prevailed in a previous arbitration concerning a VAT matter.

Ecuador provided evidence that OXY's allegations were offensive and absurd. As any legal order, Ecuador did not act out of vengeance but rather in accordance with its Constitution and laws and, therefore, the *caducidad* of the Participation Contract was issued in strict application of the Contract and of Ecuadorian law.

When OXY signed the Participation Contract, it expressly accepted all of its clauses, which included, *inter alia*, those pertaining to transfer and assignment, to termination of the contract and to *caducidad*. As such, Clauses 16.1 and 21.1 specifically set out that:

> *"16.1.* ***Transfer of this Participation Contract or assignment to third parties of the rights under this Participation Contract, must be authorized by the Corresponding Ministry****, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179 must be complied with […].*
>
> *21.1. Termination:* ***This Participation Contract shall terminate:***
>
> *21.1.1. By a declaration of Caducidad issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable.*
>
> *21.1.2.* ***Due to a transfer of rights and obligations of the Participation Contract without authorization from the Corresponding Ministry."***

Consequently, Occidental was aware of and accepted that *caducidad* had to be decreed and that all of the assets related to the contract would be handed over to Ecuador if there was a transfer of contractual rights to a third party without prior authorization from the Ministry of Energy and Mines.

ii) Occidental concealed from the State the existence and real nature of the contracts executed with the Canadian company AEC. Having already executed the contract, OXY nonetheless argued that it was in negotiations for a transfer of economic interests in its communications with the Ministry of Energy and Mines. This strategy of concealment clearly demonstrates that OXY was specifically aware of the fact that *Caducidad* was a fair and inevitable legal consequence of having carried out a transfer of rights.

iii) *Caducidad* was validly decreed in accordance with the applicable law in this case.

Although these allegations were submitted to the Tribunal, for the reasons set out below the Tribunal committed a series of gross errors by failing to state the reasons for its decisions and by manifestly exceeding its powers.

3.2.1 The Tribunal should have given the reasons based on which it ruled that OXY's claims were *res judicata*

The Tribunal also manifestly exceeded its powers and failed to state the reasons on which it based its decision when it rejected Ecuador's argument – with no analysis whatsoever – that the act of the Minister in issuing the *Caducidad* Decree cannot attach responsibility to the State under international

[47] Decision on Jurisdiction, § 96.

law, as a substantive matter, when there was a mechanism available for the review of that act, which OXY simply refused to invoke.

Ecuador argued that *Caducidad* is an *acto administrativo* and, as such, it carries with it a presumption of legality under Ecuadorian law that can be challenged in the Ecuadorian administrative courts. Ecuador argued:

> "*Ecuador is not contending that OXY's Treaty claims are procedurally improper based on a failure to exhaust local remedies.*
>
> *Rather, Ecuador is contending that the claims are substantively defective because the act of an isolated official or agency cannot attach responsibility to the State if the act could have been readily reviewed – and potentially corrected – by another State body upon a readily available challenge by the investor*."[48]

Thus, Ecuador's merits defense was not based on the failure of OXY to exhaust local remedies as a *procedural* matter but, rather, that OXY's failure to follow the proper administrative procedure made its claims defective as a *substantive* matter.[49] When a claimant fails to challenge an administrative order – such as the Minister's *Caducidad* Decree – in the proper administrative courts, any alleged breach stemming from that administrative order cannot constitute an international delict.

In any case, the Tribunal erred by invoking *res judicata* to bar Ecuador's defense.

There are three preconditions for the doctrine of *res judicata* to apply in international law. There must be (i) the same parties; (ii) seeking the same relief; and (iii) invoking the same legal grounds. In this case, there was no identity of grounds because the legal theories raised in the jurisdictional phase of the arbitration are different from those raised in the liability phase. There was also no identity of relief sought because, by definition, one argument is an inadmissibility defense and the other is a defense on the merits.

An inadmissibility objection based on exhaustion of remedies is not equivalent to a defense to the merits of a claim based on the fact that an administrative action cannot form a Treaty breach because it had not previously been challenged through the proper administrative channels. For example, the tribunal in *Generation Ukraine vs Ukraine* concluded that the claimant's failure to exhaust administrative remedies did not divest the tribunal of jurisdiction. Nonetheless, the tribunal concluded that claimant's "*failure to seek redress from national authorities disqualifies the*

48 *Burlington Resources Inc., v. Republic of Ecuador* (ICSID Case No. ARB/08/5), Decision on Jurisdiction, 2 June 2010, §§ 284-340.

49 *Burlington Resources Inc., v. Republic of Ecuador* (ICSID Case No. ARB/08/5), Decision on Jurisdiction, 2 June 2010, §§ 284-340.

international claim, not because there is a requirement of exhaustion of local remedies but because the very reality of conduct tantamount to expropriation is doubtful in the absence of a reasonable – not necessarily exhaustive – effort by the investor to obtain correction."[50]

The *Generation Ukraine* tribunal is not alone in such a finding. There is a "*clear trend of cases requiring an attempt to seek redress in domestic courts before bringing a claim for violations of BIT standards irrespective of any obligation to exhaust local remedies*."[51] For example, in *Loewen vs USA,* the tribunal rejected, on the merits, a claim by a Canadian investor that the United States had breached NAFTA's fair and equitable treatment provision by virtue of an allegedly unjust decision rendered by a court in Mississippi because the investor had failed to ask the U.S. Supreme Court to review and correct the decision, among other potential remedies, before filing its treaty claim. That decision again was made in the context of the merits of a claims, not an objection to jurisdiction.[52]

Accordingly, the objection raised by Ecuador at the jurisdictional stage rests on different legal grounds from the defense raised at the liability phase of the arbitration.

Had the Tribunal evaluated Ecuador's defense (and not merely dismissed it as a matter of *res judicata*), it would have been required to face the body of case law supporting Ecuador's position that OXY's Treaty claims were substantively defective because OXY was required to seek resolution of their claims in the Ecuadorian administrative courts.

It is undisputed that OXY did not seek a reasonable resolution in the Ecuadorian administrative courts before it submitted its Request for Arbitration. Instead, upon the Minister's declaration of *Caducidad*, OXY filed a Request for Arbitration almost immediately. Tribunals have concluded that in such instances, the behavior complained of (here, the Minister's *Caducidad* Decree) cannot amount to an international delict that could form the basis of a treaty claim.

50 *Generation Ukraine, Inc. v. Ukraine* (ICSID Case No. ARB/00/9), Award, 16 September 2004, § 20.30.

51 *Jan de Nul N.V. & Dredging National N.V. v. Arab Republic of Egypt* (ICSID Case No. ARB/04/13), Decision on Jurisdiction, 16 June 2006, § 121.

52 *Loewen Group, Inc. v. United States*, ICSID Case No. ARB(AF)/98/3, Award, 26 June 2003, § 212. See also, *Chevron Corporation and Texaco Petroleum Corporation v. The Republic of Ecuador* (UNCITRAL), Interim Award, 1 December 2008, §§ 233-34, (*"This exhaustion requirement can be viewed as a necessary element both for a denial of justice under customary international law and for the breach of a substantive BIT obligation such as fair and equitable treatment. However, in both cases, the question concerns the substance of the claims put before the Tribunal. Despite couching its objection in the language of ripeness and admissibility, what the Respondent raises is an issue affecting liability. Exhaustion of local remedies in this context is therefore an issue of the merits, not jurisdiction"*).

Paris,Saturday 5 April 2014, offices of Dechert LLP. Preparatory meeting for the hearing on the OXY annulment case. From left to right: George von Mehren (Squire Sanders), Stephen Anway (Squire Sanders) and Eduardo Silva Romero (Dechert LLP) analyze the case history elements together with the Attorney General.

This conclusion is echoed in *Helnan vs. Egypt*, where the Tribunal held that *“HELNAN’s [...] failure to take the legal steps to challenge the [administrative decision] disqualifies its claim before this Tribunal that such [decision] was made in breach of the Treaty*.”[53]

Likewise, the tribunal in *EnCana v. Ecuador* observed that a State tax agency’s decision to cease granting refunds for value-added taxes could not be deemed an expropriation on the merits because an avenue was available for the investor to challenge that decision before local courts.[54]

Ecuador presented this argument to the Tribunal both in its filings and at the relevant hearing. Nonetheless, the Tribunal’s decision failed to analyze or apply any of the applicable cases presented above, on the basis of an excuse shown to be blatantly wrong, and, in so doing, manifestly exceeded its powers.

This excess of power is not only evident but also serious. Had the Tribunal not dismissed Ecuador’s

[53] *Helnan Int’l Hotels A/S v. Egypt* (ICSID Case No. ARB/05/19), Award, 3 July 2008, § 162. See also, *Loewen Group, Inc. v. United States* (ICSID Case No. ARB(AF)/98/3), Award, 26 June 2003, §§ 142-156 and 207-17, rejecting treaty claims based on a decision rendered by a U.S. court because the investor failed to ask the U.S. Supreme Court to review and correct the decision, among other potential remedies.

[54] *EnCana Corporation v. Ecuador* (LCIA Case No. UN3481), Award, 3 February 2006, §§ 113 and 197-199.

defence, the arbitration would have ended. This disregard for the relevant and applicable international law constitutes a manifest excess of powers.[55]

Without any reasoning or analysis, the Tribunal stated, in a conclusory fashion, that it “*agrees with OXY. The issue [Ecuador's defense that the Treaty-based claims are defective] is res judicata*”[56].
In so holding, the Tribunal failed to discuss the applicable law governing *res judicata* and whether Ecuador’s defense was indeed barred under that doctrine.

The Tribunal seemed to recognize that Ecuador asserted that its prior inadmissibility objection was distinct from Ecuador’s defense on the merits to OXY’s Treaty claims.[57] Despite that recognition, the Tribunal did not analyze this difference in any respect and instead merely referred back to its Decision on Jurisdiction, where it concluded that it had jurisdiction over the Treaty claims because the Tribunal did “*not accept that [...] the parties agreed that caducidad-related disputes under the Participation Contract would solely be resolved by submission to the Ecuadorian administrative courts [...]*,”[58] an argument that the Tribunal did not even discuss with regard to Ecuador’s defense that OXY’s claims were premature.

3.2.2 The Tribunal failed to state its reasons and manifestly exceeded its powers in finding that OXY’s violation of the Hydrocarbons Law and the Participation Contract was mere negligence

The Tribunal also failed to state the reasons on which it based its decision and manifestly exceeded its powers when it held that OXY was merely negligent in failing *“to disclose the true nature of the Farm-out Agreement to Ecuador and to obtain ministerial authorization in 2000*.”[59] This finding had a case-determinative effect on the Tribunal’s holding in relation to two key issues: (i) whether the *Caducidad* Decree was a proportionate response to OXY’s conduct; and (ii) what OXY’s appropriate percentage of fault was in bringing about the loss of its investment.

The Tribunal heavily weighed OXY’s alleged *“negligent”* conduct in determining the

[55] *AMCO II* Annulment Decision, §§ 7.12 and 7.19 (explaining that the incorrect application of law might constitute a manifest excess of powers if “*it amounts to effective disregard of the applicable law*” or “*is of such a nature or degree as to constitute objectively (regardless of the Tribunal’s actual or presumed intentions) its effective non-application*”.) See also, *Sempra* Annulment Decision, § 163 *“incorrect application of law might constitute a manifest excess of powers if ‘it amounts to effective disregard of the applicable law’”; Azurix* Decision of Annulment, § 136, (“*the Committee accepts, that a tribunal may manifestly exceed its powers where the tribunal disregards the applicable law*.”).

[56] Award, § 293.

[57] Award, § 291 *(“But the overriding principle of proportionality requires that any such administrative goal must be balanced against the Claimants’ own interests and against the true nature and effect of the conduct being censured. The Tribunal finds that the price paid by the Claimants – total loss of an investment worth many hundreds of millions of dollars – was out of proportion to the wrongdoing alleged against OEPC’”).*

[58] Award, § 293-95.

[59] Award, § 662. See also, *ibidem*., §§ 380 et seq.

proportionality of the *Caducidad* Decree. As expressed in the Award, the requisite proportionality test is not that *"the State must prove harm, but that any penalty the State chooses to impose must bear a proportionate relationship to the violation which is being addressed and its consequences*."[60] The Tribunal further opined that:

> *"In cases where the administration wishes to impose a severe penalty, then it appears to the Tribunal that the State must be able to demonstrate (i) that sufficiently serious harm was caused by the offender; and/or (ii) that there had been a flagrant or persistent breach of the relevant contract/law, sufficient to warrant the sanction imposed; and/or (iii) that for reasons of deterrence and good governance it is appropriate that a significant penalty be imposed, even though the harm suffered in the particular instance may not have been serious*."[61]

Thus, as articulated in the Award, *"the true nature and effect of the conduct being censured"* –that is, OXY's alleged *"negligent"* violation of the Participation Contract and the Hydrocarbons Law was a key determinative factor in the Tribunal's proportionality analysis.[62]

Similarly, the Tribunal's characterization of OXY's conduct as merely negligent played a decisive role in the percentage of contributory fault that the Tribunal assigned to OXY's violation of the Participation Contract and the Hydrocarbons Law. As expressed by the Tribunal, in determining OXY's contributory fault, it *" consider[ed] the extent of the contribution of the Claimants' negligence to their injury […]*."[63] Logically, if a finding of mere negligence in violating the Participation Contract and the HCL rendered OXY 25% at fault for their injury, then a finding that OXY was more than merely negligent can only increase OXY's contributory fault.

It is therefore clear that the Tribunal's findings on the issues of proportionality and contributory fault were in significant part anchored on the Tribunal's earlier erroneous conclusion that OXY's conduct was merely negligent. These two key issues are of critical importance in this case because the first issue entails the possibility of entirely absolving Ecuador of liability for the Caducidad Decree and the second could reduce the amount of Ecuador's liability under the Award by more than USD 1 billion.

[60] Award, § 416.
[61] Award, § 416.
[62] Award, § 450 (*"But the overriding principle of proportionality requires that any such administrative goal must be balanced against the Claimants' own interests and against the true nature and effect of the conduct being censured. The Tribunal finds that the price paid by the Claimants – total loss of an investment worth many hundreds of millions of dollars – was out of proportion to the wrongdoing alleged against OEPC […]"*).
[63] Award, § 681.

3.2.2.1 OXY's negligence according to the Tribunal

The case presented with regard to the *caducidad* of the Participation Contract was simple.

If OXY had transferred 40% of its rights over the contract with the approval of the competent authority, then Ecuador would not have been permitted to declare *caducidad*. Had it done so, Ecuador would have had to recognize the corresponding damages due to OXY.

If OXY had transferred rights without approval from the competent authority, then Ecuador would have been expressly permitted to declare *caducidad*. Ecuador would accordingly not be liable for any damages.

The Tribunal concluded that the assignment of rights was carried out without Government approval.

It follows, therefore, that Ecuador was entitled to declare *caducidad* and owes OXY no damages.

There is simply no room in that analysis for considerations of whether OXY was merely "*negligent*" in not obtaining that approval or, conversely, whether it had some more specific intent to hide the transaction. Neither the Participation Contract nor the Hydrocarbons Law consider that the state-of-mind of the entity transferring the interest as relevant. Either approval was obtained or it was not; and the consequences flow from that simple fact.

Accordingly, the Tribunal's determination that OXY did not intend to mislead Ecuador cannot serve as a basis for a finding of mere negligence pertaining to OXY's conduct prompting the Caducidad Decree. This irrelevant determination is the only basis for the Tribunal's holding that OXY acted merely negligently when it violated the Participation Contract and the Hydrocarbons Law. The Award lacks any serious reasoning,[64] is based on an absurd and frivolous explanation,[65] or, at the very least, is so unclear as to contain a significant lacunae in reasoning.[66]

In any event, the Tribunal's analysis is self-contradictory. First of all, it labeled OXY's conduct as *"negligent"*, but then described it precisely in *intentional* terms, *not* as negligent.

[64] *MINE Annulment Decision*, §§ 5.08-5.09.
[65] *MINE Annulment Decision*, § 5.09; *Amco II Annulment Decision*, § 1.18; *Wena Annulment Decision*, §§ 77-80; *CDC Annulment Decision*, § 70; *Mitchell Annulment Decision*, § 21; *Soufraki Annulment Decision*, § 126; *Pey Casado Annulment Decision*, § 86; *Eduardo Vieira Annulment Decision*, § 357; Ch. Schreuer, L. Malintoppi, A. Reinisch, A. Sinclair, *The ICSID Convention, A commentary*, Cambridge University Press, 2nd Edition, Article 52, § 344 (*"No doubt frivolous, perfunctory or absurd arguments by a tribunal would not amount to reasons"*).
[66] *CMS Annulment Decision*, § 97; *Sempra Annulment Decision*, § 167.

Negligence differs from an intentional act (or an omission) by the actor's intent while committing the act.[67] Indeed, the leading English-language legal dictionary defines "*negligence*" as *"any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights."*[68] Similarly, *"intentional act"* is defined as *"An act resulting from the actor's will directed to that end. An act is intentional when it is foreseen and desired by the doer, and this foresight and desire resulted in the act through the operation of the will."*[69]

These definitions make it clear that a fundamental element of negligence is lack of intent on the actor's part. Accordingly, the presence of intent on the actor's part in committing the act (or omission) in question necessarily negates a finding of negligence.

The Tribunal failed to engage in the requisite analysis of whether or not OXY's conduct was intentional. Instead, the Tribunal focused exclusively on whether OXY's conduct was in *"bad faith."*[70] The Tribunal thus concluded that although OXY knew it was legally required to obtain prior Government approval, its failure to do so was not *"driven by bad faith,"*[71] it was *"done in bad faith"*[72] and did not *"amount [...] to bad faith."*[73] In the Tribunal's own words:

> *"[...] OEPC's failure to secure the required authorization on the part of the Ecuadorian authorities in October 2000, while not amounting to **bad faith**, was negligent [...]*[74]*.*
>
> *[...]The Tribunal has also found that this transfer required authorization on the part of the Ecuadorian authorities, that this authorization was not sought, but that OEPC's failure to secure such authorization in October 2000, while imprudent and ill advised, did not amount to **bad faith***[75]
>
> *[...]failure by OEPC to disclose the true nature of the Farm-out Agreement to Ecuador and to obtain ministerial authorization in 2000 was a 'grave mistake'; OEPC, while not acting in **bad faith**, was negligent [...]."*[76]

The Tribunal determined that OXY knew that the transaction was against the law.

Ecuador always maintained that OXY's motive or intent for violating the Hydrocarbons Law or the Participation Contract was irrelevant.[77] As discussed above, whether that violation was intentional, as is discussed below, or merely negligent, as the Tribunal found, it is a violation nonetheless that carries with it the sanction of *caducidad*.

Aware of this reality, and apparently intent on finding in favour of OXY, the Tribunal artificially created a new kind of violation of the Hydrocarbons Law: a merely negligent one, and then concluded that, given this "*lesser*" violation, Ecuador had acted disproportionately in declaring Caducidad. In so doing, the Tribunal committed three fatal errors, each of which warrants annulment of the Award:

1. First, the Tribunal entirely ignored uncontroverted evidence that Ecuadorian law does not take *intent* into consideration when evaluating or determining a violation of the HCL. That is, Ecuadorian law does not distinguish between a "*bad faith*" and a merely "*negligent*" violation of the Hydrocarbons Law. In this respect, the Tribunal's finding that OXY engaged in a negligent violation of the Hydrocarbons Law is contrary to, and therefore cannot be based on, Ecuadorian law. This

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67 Article 29 of the Ecuadorian Civil Code (*"Serious oversight, serious negligence, gross negligence, means the failure to exercise the standard of care even inattentive or thoughtless persons would exercise under all circumstances. This kind of negligence is equivalent to willful misconduct in civil matters. Minor oversight, minor negligence, petty negligence, means the failure to exercise the diligence and standard of care expected of a reasonably prudent person acting under similar circumstances. Oversight or negligence, without further description, means minor oversight or negligence. This kind of negligence is opposed to normal or medium diligence or care. [...] Slight oversight or negligence means the failure to exercise the utmost diligence and standard of care expected of a prudent person acting under similar circumstances. This kind of negligence is opposed to extreme diligence or care. Willful misconduct is the positive intention to injure a person or its property".); Comité Pro Mejoras Barrio Delfina Torres vda. de Concha v. Petroecuador, Petrocomercial and their affiliates,* published in Official Register No. 43, 19 March 2003, p. 26 (*"Fault concerns the relationship between the intent of the person and its act. Intention is considered wilful when the person wishes the act and its consequences to happen, that are usually foreseeable, and negligent when the agent causes harm without the intention to do so, but acting with oversight, negligence or incompetence, and also breaching legal or regulatory rules.").MINE Annulment Decision,* § 5.09; *Amco II Annulment Decision*, § 1.18; *Wena Annulment Decision,* §§ 77-80; *CDC Annulment Decision,* § 70; *Mitchell Annulment Decision,* § 21; *Soufraki Annulment Decision,* § 126; *Pey Casado Annulment Decision,* § 86; *Eduardo Vieira Annulment Decision,* § 357; Ch. Schreuer, L. Malintoppi, A. Reinisch, A. Sinclair, *The ICSID Convention, A commentary*, Cambridge University Press, 2nd Edition, Article 52, § 344 (*"No doubt frivolous, perfunctory or absurd arguments by a tribunal would not amount to reasons"*).

68 *Black's Law Dictionary,* 8th Edition, p. 1061 ("*negligence*").

69 *Black's Law Dictionary,* 8th Edition, p. 26 ("*intentional act*").

70 Award, § 348.

71 Award, § 348.

72 Award, § 380.

73 Award, § 380. See also, ibidem., § 383 (*"Having concluded above that OEPC's failure to secure the required authorization on the part of the Ecuadorian authorities in October 2000, while not amounting to bad faith, was negligent, the Tribunal considers that the Claimants cannot be found to have had a legitimate expectation that the Minister would not exercise his discretion and impose Caducidad"*).

74 Award, § 383.

75 Award, § 384.

76 Award, § 662.

77 *See* Ecuador's Rejoinder on Liability dated 19 September 2008, § 326 (*"Yet even if the Claimants' reasons for misstating the true nature of their arrangement with AEC were purely innocent (a proposition that is simply not credible), this would be entirely inconsequential. As Drs. Aguilar and Merlo have explained, a violation of Articles 74.11 and 74.12 in no way depends on the contractor having a deceitful motive for carrying out the transaction in question. If the contractor engages in a prohibited transaction without authorization, then it has committed a violation. It is as simple as that. The contractor cannot absolve itself of this violation by citing its own ignorance of the law or by showing that its violation was otherwise accidental or inadvertent"*).

constitutes a complete failure to apply the governing law, which equates to a manifest excess of powers warranting annulment of the Award.[78]

2. Second, in addition to entirely ignoring Ecuadorian law, the Tribunal also failed to provide any analysis or cite any legal authority supporting its artificial creation of a "negligent" violation of the Hydrocarbons Law. These failures warrant annulment of the Award because the Tribunal: (i) provided no reasons for its decision in violation of Article 52(1)(e) of the Convention; [79], and (ii) clearly acted in an impermissible ex aequo et bono manner in violation of Article 52(1)(b) of the Convention.[80]

3. Third, assuming that Ecuadorian law recognizes a "negligent" violation of the Hydrocarbons Law (and it does not), the Tribunal failed to provide the reasons for finding that OXY's violation was merely negligent. Indeed, as explained above, the Tribunal embarked on an entirely irrelevant analysis of whether OXY acted in "bad faith." Bad faith, however, has no bearing on negligence. "*Bad faith*" is defined as "*Dishonesty of belief or purpose*."[81] Whether OXY violated the Hydrocarbons Law with an ill-belief or an ill-purpose is irrelevant to the Tribunal's finding of negligence.

Notably, in this respect, the Tribunal's analysis was limited to determining whether OXY intended to "*mislead Minister Terán*" with its 25 October 2000 letter[82] or "*to mislead the Ecuadorian government*" by failing to disclose the true nature of the Farm-out Agreement in 2000[83] However, the Tribunal failed to analyze OXY's intent and failed to explain the reasons underlying its finding of mere negligence. This failure prevents the reader from fully following or understanding the Tribunal's

[78] MINE Annulment Decision, § 5.03, (*"a tribunal's disregard of the agreed rules of law would constitute a derogation from the terms of reference within which the tribunal has been authorized to function. Examples of such a derogation include the application of rules of law other that the ones agreed by the parties, or a decision not based on any law unless the parties had agreed on a decision ex aequo et bono. If the derogation is manifest, it entails a manifest excess of power");* MTD Annulment Decision, § 44, *("[...]it is established that a complete failure to apply the law to which a Tribunal is directed by Article 42(1) of the ICSID Convention can constitute a manifest excess of powers [...]"*);Sempra Annulment Decision, § 163,*(" certain ad hoc committees have [...] opined, for instance, that incorrect application of law might constitute a manifest excess of powers if 'it amounts to effective disregard of the applicable law'"*); Azurix Annulment Decision, § 136, *("the Committee accepts, that a tribunal may manifestly exceed its powers where the tribunal disregards the applicable law"*).

[79] MINE Annulment Decision, §§ 5.08-5.09.

[80] MTD Annulment Decision, § 44, *("[...]it is established that [...] a decision given ex aequo et bono – that is to say, in the exercise of a general discretion not conferred by the applicable law – which is not authorized by the parties under Article 42(3) of the Convention*" can constitute a manifest excess of powers).

[81] *Black's Law Dictionary*, 8th Edition, page 149 ("*Bad faith*").

[82] Award, § 360.

[83] Award, § 380.

reasoning and ultimate finding of negligence and renders the finding frivolous[84].

The Tribunal's finding of negligence is contradicted by the Tribunal's other findings, namely:

- That at all material times OXY had full knowledge of the Hydrocarbons Law prohibitions and sanctions as incorporated in the Participation Contract;
- That it had been advised on it by counsel;
- And that it was fully aware of the potential consequences of their actions, including the sanction of *caducidad*.

Despite being fully advised on the likely consequences, OXY proceeded with the Farm-out without first seeking Ecuador's consent. It took the cavalier approach, outlined by the Tribunal, of "*business people, seasoned oilmen, for whom legal niceties were not as important as the business realities of the deal*."[85]

Paris, Sunday 5 April 2014, offices of Dechert LLP. Stephen Anway (Squire Sanders) commences the presentation of Ecuador's arguments for the OXY annulment hearing.

[84] *Amco II* Annulment Decision, § 1.18 (*"inconsistent reasons or frivolous reasons would be tantamount to absence of reasons"*); Soufraki Annulment Decision, § 126 (*"there may be a ground for annulment in the case of: - a total absence of reasons for the award, including the giving of merely frivolous reasons");* MINE Annulment Decision, § 5.09; Ch. Schreuer, L. Malintoppi, A. Reinisch, A. Sinclair, *The ICSID Convention, A commentary,* Cambridge University Press, 2nd Edition, Article 52, § 344 (*"No doubt frivolous, perfunctory or absurd arguments by a tribunal would not amount to reasons"*).

[85] Award, § 348.

In other words, the Tribunal found that OXY knew that the transaction was against the law, and yet, it proceeded with it regardless. This proves, beyond cavil, that OXY, even if *arguendo* lacking ill-will or ill-purpose (*i.e.*, *bad faith*), did intend to violate the Hydrocarbons Law and the Participation Contract. In view of those findings, a conclusion that OXY merely acted negligently cannot stand.

In sum, the Tribunal not only contradicted itself, but deliberately refused to characterise OXY's conduct for what it was: an act to mislead through omissions and lies.

One particularly striking passage can be found at paragraph 356 of the Award, where the Tribunal notes that OXY and AEC declared to Minister Terán, on 24 October 2000, that they were contemplating an "*imminent transaction,*" while the transaction had taken place six days earlier. This, in plain English, was a lie, and a lie whose purpose was obvious: if OEPC and AEC had revealed the truth, they would have been obliged to show the agreement to the Minister and their plan was not to show it. But in the words of the Tribunal at paragraph 356 of the Award, "*while it may have been strictly correct for OEPC to refer to an 'imminent transaction', it would have been more accurate to refer to a transaction (and thus a 'transfer') which had taken place 6 days earlier.*"

One wonders how a Tribunal can affirm that to knowingly say something which is contrary to reality may be '*strictly correct*'?

As to the fact that, as a consequence of the lie, the agreement was not shown to Minister Terán, the Tribunal expresses itself in very mild terms, at paragraph 353 of the Award, "*the Tribunal has formed the view that the better course would have been to have handed a copy to the Minister*". The Tribunal feigns to believe that OXY and AEC were only imprudent, negligent, and do not see that the whole act played by those companies meant that they hid the fact that the transaction had already been entered into.

It is obvious that the Tribunal had much sympathy for the "*seasoned oilmen*" and their sense of "*business realities*", far removed from "*legal niceties*". However, the actions of the "*seasoned oilmen*"show that they understood the "*legal niceties*" that had been explained to them by their lawyers, very well, and had found a way to make *"business realities"* prevail. An ICSID Tribunal should not have tolerated that. It should have put 75% of the blame on the victim of the act.

OXY's conduct in the years that followed its meeting with Minister Terán confirms that not only did it act intentionally in violation of the Participation Contract and the Hydrocarbons Law, but that it was *actively concealing* the illegal transfer. As already explained, Ecuador only discovered the illegal transfer in 2004, during a routine audit of OXY by DNH-retained auditing firm Moores Rowland.

3.2.3 THE TRIBUNAL MANIFESTLY EXCEEDED ITS POWERS AND FAILED TO STATE THE REASONS FOR ITS DECISION ON LIABILITY PREMISED ON A "PRINCIPLE" OF PROPORTIONALITY THAT IT IS NOT ENCOMPASSED IN THE PARTICIPATION CONTRACT, ECUADORIAN LAW, THE TREATY, OR INTERNATIONAL LAW

In an unprecedented and inherently contradictory decision, the Tribunal held that *caducidad* was a disproportionate sanction and therefore contrary to Ecuadorian law, customary international law, and the BIT, despite having found that the Parties freely and expressly agreed, in the Participation Contract, that *caducidad* was the applicable sanction if OXY transferred rights to a third party (such as AEC) without prior ministerial approval.

For example, at paragraph 452 of the Award, the Tribunal held:

"It follows that ***even if OXY, as the Tribunal found earlier, breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 (or Articles 74.12 or 74.13), the 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 its Article 11.3(a) obligation to accord fair and equitable treatment to OXY's investment, and to accord it treatment no less than required by international law".*

Then, at paragraphs 453 to 455 of the Award, the Tribunal added that the disproportionate *Caducidad* Decree also amounted to a "*measure tantamount to expropriation*".

The Tribunal disregarded the explicit and unambiguous bargain struck by the Parties, and purported to apply an inexistent principle of "*proportionality*" supposedly present in Ecuadorian law, customary international law, and the BIT.

Based on this, the Tribunal proceeded to rewrite or avoid the application of Clauses 16.1, 21.1.1 and 21.1.2 of the Participation Contract and, as a consequence, failed to follow Ecuadorian law and the international law principle of "*pacta sunt servanda*."

It was undisputed amongst the Parties that both Ecuadorian law and international law encompass the "*pacta sunt servanda*" principle. OXY's legal expert specifically accepted that Article 23.18 of the 1998 Ecuadorian Constitution expressly recognized such universal legal principle.

For this reason, the Tribunal had a duty to heed and apply the principle of "*pacta sunt servanda*". However, the Tribunal neither observed nor applied this principle and, therefore, manifestly exceeded its powers by failing to apply the applicable law. Indeed, *[i]t is widely recognized in ICSID jurisprudence that failure to apply the applicable law constitutes an excess of power. The relevant provisions of the applicable law are constitutive elements of the Parties' agreement to arbitrate and constitute part of the definition of the tribunal's mandate.*"[86]

It was also undisputed that the Participation Contract was executed after extensive arms-length negotiations between two highly sophisticated parties, each of which had advice from competent and able counsel. By way of example, the Parties' lengthy negotiations to migrate from a Services Contract to the Participation Contract took place over approximately two years.

Furthermore, OXY is as an international merchant and, as such, is deemed to be a competent professional.[87] OXY is deemed by law to know what it does when trading and investing. Moreover, OXY never alleged, nor could it, that it had entered into the Participation Contract by error, duress or deceit. At paragraph 235 of its 13 February 2009 Post-Hearing Brief, Ecuador, for instance, alleged:

> *"[...] OXY have no basis to object to the nature of the sanction imposed, when they explicitly agreed in the Participation Contract to this specific sanction. Dr. Pérez-Loose acknowledged that the Participation Contract expressly includes the provisions on caducidad from the Hydrocarbons law. The Ecuadorian Constitution itself guarantees the principles of freedom of contracting ("libertad de contratar") and pacta sunt servanda. Accordingly, absent some evidence that OXY agreed to the Participation Contract under fraud or duress, there is no ground to object to the implementation of the terms of the parties' contract as written. Holding otherwise would amount to re-writing the parties' agreement."*[88]

The Participation Contract, voluntarily entered into by the Parties, contains specific provisions that govern a contractor's unlawful decision to transfer rights to third parties, and the consequences that follow if such a transfer occurs. For example, Clause 16.1 of the Participation Contract provides:

> *"16.1 Transfer of this Participation Contract or assignment to third parties of the rights under this Participation Contract, must be authorized by the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179 must be complied with."*[89]

Further, Clause 21.1 .1 of the Participation Contract provides:

> *"21.1* ***Termination:*** *This Participation Contract shall terminate:*
>
> *21.1.1 By a declaration of caducidad issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable."*[90]

Clause 21.1.1 of the Participation Contract incorporates by reference Article 74.11 of the HCL which provides:

> *"Article 74 - [Grounds for contract termination]* **The Ministry of Energy and Mines may terminate the contract 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 authorization from the Ministry****"*[91]

Finally, Clause 21.1.2 of the Participation Contract provides:

> *"21.1.2. Due to a transfer of rights and obligations of the Participation Contract without authorization from the Corresponding Ministry."*[92]

Clauses 16.1, 21.1.1 and 21.1.2 of the Participation Contract and Article 74.11 of the Hydrocarbons Law are unambiguous: termination of the Participation Contract shall occur due to a transfer

[86] Soufraki Annulment Decision, § 45. See also, for example, AES Annulment Decision, §33, *("there is 'widespread agreement that a failure to apply the proper law may amount to an excess of powers by the tribunal', the underlying basis being that the issues put to a tribunal are circumscribed by the parties' consent");* Azurix Annulment Decision, § 136, *("the Committee accepts, that a tribunal may manifestly exceed its powers where the tribunal disregards the applicable law")* and Enron Annulment Decision, § 218 (*quoting the Azurix decision*).

[87] For instance, ICC Award in Case No. 2438, 1975, reported in S. Jarvin and Y. Derains, Collection of Arbitral Awards/*Recueil des sentences arbitrales de la CCI*, 1974-1985, pp. 255-256; ICC Award in Case No. 3130, 1980, *id.*, pp. 417-422,; ICC Award in Case No. 3380, 1980, *id.*, pp. 413-417.

[88] Ecuador's Post-Hearing Brief on Liability dated 13 February 2009.

[89] Participation Contract.

[90] Participation Contract (bold in the original).

[91] Hydrocarbons Law.

[92] Participation Contract (bold in the original).

of rights without prior authorization. As a consequence, the Tribunal, when concluding that OXY transferred rights arising out of the Participation Contract to AEC without prior ministerial approval, should have also concluded that *Caducidad* was properly applied. That was the precise sanction agreed upon by the Parties in case of such a transfer of rights.

Selectively ignoring the Parties' agreement, the Tribunal applied an inexistent principle of "*proportionality*" and rewrote or avoided the application of the foregoing clear provisions incorporated into the Participation Contract, freely negotiated and agreed upon by the Parties.

As Ecuador explained at the Second Liability Hearing, OXY was asking the Tribunal to rewrite the Participation Contract as follows:[93]

	Actual Terms	OXY's Purported Reading
Clause 16.1	*Transfer of this Participation Contract or assignment to third parties of the rights under this Participation Contract, must have the authorization of the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179.*	*Transfer of this Participation Contract or assignment to third parties of the rights under this Participation Contract, must have the authorization of the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179,* ***unless the third parties have adequate administrative, technical and financial capacity and do not otherwise engage in any wrongful conduct in the exercise of the above-referenced rights that results in quantifiable harm to Ecuador.***

[93] Ecuador's Closing Presentation, Second Liability Hearing, pp. 132-135 .Participation Contract

	Actual Terms	OXY's Purported Reading
Clause 16.4	*If Contractor deems it advisable to create consortia or associations for one or several additional exploration and exploitation activities covered by this Participation Contract, Contractor may do so with the prior acceptance of PETROECUADOR and authorization from the Corresponding Ministry. [...] The integration of such consortia or associations, or the withdrawal of Contractor from same, without the authorization of the Corresponding Ministry, shall constitute legal grounds for declaring the termination of this Participation Contract.*	*If Contractor deems it advisable to create consortia or associations for one or several additional exploration and exploitation activities covered by this Participation Contract, Contractor may do so with the prior acceptance of PETROECUADOR and authorization from the Corresponding Ministry. [...] The integration of such consortia or associations, or the withdrawal of Contractor from same, without the authorization of the Corresponding Ministry, shall constitute legal grounds for declaring the termination of this Participation Contract;* ***provided, however, that the prior acceptance of PETROECUADOR and authorization from the Corresponding Ministry need not be sought and obtained if the third parties with whom consortia or associations are formed have adequate administrative, technical and financial capacity; and provided further that the Ministry may not exercise the legal grounds to declare Caducidad unless the formation of the consortia or associations causes quantifiable harm to Ecuador, and unless the sanction of Caducidad is proportionate to such harm****.*

Clause 16.5	*The integration of such consortia or associations, or the withdrawal of Contractor from the same, without the authorization of the Corresponding Ministry, shall constitute legal grounds for declaring the termination of the Participation Contract.*	*The integration of such consortia or associations, or the withdrawal of Contractor from the same, without the authorization of the Corresponding Ministry, shall constitute legal grounds for declaring the termination of the Participation Contract,* ***except that such legal grounds shall not exist if the integration of the consortium caused no quantifiable harm to Ecuador, or if the sanction of Caducidad would not be proportionate to such harm****.*
Clause 21.1	*Clause 21.1: Termination. This Contract shall terminate:* *21.1.1 By a declaration of Caducidad issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable.* *21.1.2 Due to a transfer of rights and obligations of the Participation Contract without prior authorization from the Corresponding Ministry*	*Clause 21.1: Termination. This Contract shall terminate:* *21.1.1 By a declaration of Caducidad issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable;* ***provided, however, that Caducidad may be imposed only if Ecuador suffered quantifiable harm from the violation, and if the sanction would be proportionate to such harm.***

Clause 21.1		*21.1.2 Due to a transfer of rights and obligations of the Participation Contract without prior authorization from the Corresponding Ministry;* ***provided, however, that, notwithstanding the above mandatory language, no such termination may occur if the unauthorized transferee has adequate administrative, technical and financial capacity and does not otherwise engage in any wrongful conduct in the exercise of such rights and obligations that results in quantifiable harm to Ecuador, or if the sanction of Caducidad is not proportionate to such harm****.*

In its Award, the Tribunal essentially accepted OXY's attempt to rewrite the Participation Contract, and thus failed to follow and apply the "*pacta sunt servanda*" principle encompassed in both Ecuadorian law and international law. Instead, the Tribunal rewrote the Participation Contract in two different ways:

First, the Tribunal rewrote Clause 21.1.2 of the Participation Contract when, at paragraphs 419 and 420 of the Award, it held:

> "**419.** *There is no dispute that the Caducidad Decree refers only to Article 74 of the HCL. That in itself might not be the end of the matter if the termination provisions of the Participation Contract were identical as in the HCL, but they are not. Article 74.11 of the HCL empowers the Minister to declare caducidad 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.' The Tribunal notes that the reference is to transfer of rights only. By contrast, Clause 21.1.2 of the Participation Contract refers to an unauthorized transfer of 'rights and obligations'.*
>
> **420.** *There was no suggestion by the Respondent that the 'earn-in' stage of the Farm-out Agreement somehow effected a transfer to AEC of OXY's obligations under the Participation Contract. The fact is that the only party who ever owed obligations to PetroEcuador, and the only party against whom PetroEcuador might plausibly have sought to enforce obligations owed under the Participation Contract, was OXY. It is presumably for that reason that the Respondent sought to proceed under the HCL rather than the Participation Contract."*

The Tribunal's interpretation of Clause 21.1.2 is blatantly incorrect.

The Parties' intention when drafting this Clause could not be that, if OXY transferred rights but not obligations to a third party, without prior ministerial approval, the Participation Contract should not be terminated. That interpretation of Clause 21.1.2 of the Participation Contract removes all *effet utile* from that clause,[94] and also, for that matter, from the law. What the Parties meant was that any transferred right entails a transfer of a correlative obligation. The Tribunal's erroneous interpretation of Clause 21.1.2 of the Participation Contract is no more than a sophism intended to avoid following and applying the principle of "*pacta sunt servanda*." The erroneous interpretation of Clause 21.1.2 of the Participation Contract by the Tribunal amounts to a manifest excess of powers.

[94] *Civil Code,* Official Register Supplement 46, 24 June 2005 (Book IV), Article 1578, which consecrates the principle of *effet utile* in the interpretation of contracts ("*The meaning which gives a clause some effect shall prevail over the one in which it is unable to take any effect*").

Second, the Tribunal also rewrote Clause 21.1.1 of the Participation Contract. At paragraphs 421 and 422 of the Award, the Tribunal held:

> **421.** *Nor is the position changed by reason of the fact that OEPC agreed that the contract 'shall terminate' in the event of 'a declaration of forfeiture issued by the Corresponding Ministry for the causes and following the procedure established in Article 74 […] of the [HCL] […]'. The reference to a declaration of caducidad under the HCL can only mean a declaration properly made – the contractor cannot be taken to have agreed to accept termination in circumstances where the decree is issued contrary to the requirement of proportionality in Ecuadorian law.*
>
> **422.** *The fact that a contractor agrees that caducidad may be a remedy in certain situations does not mean that the contractor has waived its right to have such a remedy imposed proportionately, or otherwise imposed in accordance with all relevant laws. That is particularly so when, as in the present case, the parties agree that the contract is to be governed by a system of law (Ecuadorian law) which expressly requires the principle of proportionality to be observed. There is nothing in the Participation Contract to indicate an intention to 'contract out' of proportionality or any other legal principles of general application".*

The Tribunal avoided the application of the Participation Contract.

As argued by Ecuador at the Second Liability Hearing, the Tribunal rewrote Clause 21.1.1 of the Participation Contract by adding the phrase "*properly made*" and "*in accordance with the requirement of proportionality in Ecuadorian law.*" There is no such language in the Participation Contract.

Without providing any reasons, the Tribunal effectively avoided the application of the Participation Contract – thereby failing to apply the "*pacta sunt servanda*" principle encompassed in Ecuadorian and international law – on the basis of two incomprehensible theories:

First theory:
In paragraphs 418 and 419 of the Award, the Tribunal held the following:

> **"418**. *To return to the Respondent's three arguments identified above, the Tribunal does not accept the submission that the ICSID authorities relied upon by the Claimants can be distinguished because of the absence of a contractual provision comparable to that found in Clause 21 of the Participation Contract. As noted earlier, the Caducidad Decree was not predicated upon breach of contract, but was instead issued pursuant to, and in reliance upon, alleged breaches of Article 74 of the HCL. This is a point of general importance given that the Respondent consistently advanced the plea that caducidad could not be a breach of the Treaty when it was a penalty freely agreed to by OEPC. Accordingly, it is an issue which deserves careful analysis.*
>
> **419**. *There is no dispute that the Caducidad Decree refers only to Article 74 of the HCL. That in itself might not be the end of the matter if the termination provisions of the Participation Contract were identical as in the HCL, but they are not. Article 74.11 of the HCL empowers the Minister to declare caducidad 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.' The Tribunal notes that the reference is to transfer of rights only. By contrast, Clause 21.1.2 of the Participation Contract refers to an unauthorized transfer of 'rights and obligations'".*

The fact that the *Caducidad* Decree did not expressly refer to a breach of Clauses 16.1, 21.1.1 or 21.1.2 of the Participation Contract is irrelevant or false for three reasons:

One, as already pointed out, the Participation Contract, especially through Clause 21.1.1, expressly incorporated, by reference, Article 74 of the Hydrocarbons Law, which was in turn expressly referred to in the *Caducidad* Decree. Accordingly, by effect of such incorporation, a breach of Article 74 of the Hydrocarbons Law automatically entails a breach of the Participation Contract.

Two, the Tribunal's suggestion that, because the *Caducidad* Decree did not expressly refer to a breach of the Participation Contract, there is no breach of the Participation Contract is unfounded and illogical. The Tribunal's finding in paragraph 418 of the Award is particularly troublesome in light of the Tribunal's finding at paragraph 452 of the Award that "*It follows that [...] OEPC [...] breached Clause 16.1 of the Participation Contract [...]".*

Three, the *Caducidad* Decree did in fact refer to the Participation Contract and to OXY's breach of it. Reference to the breach of the Participation Contract[95] is made three times in the *Caducidad* Decree. Indeed, it is stated in the very first page that:

> *"The Minister of Energy and Mines [...] requests that the Executive President of PETROECUADOR initiate the proceeding set forth in clause 21.2 and following of the CONTRACT[,) which provides for the declaration of caducity[,] deeming that the actions carried out by the CONTRACTOR., defined as offenses number 11, 12, and 13 of Art. 74 of the Hydrocarbons Law and in clauses 21.1.1 and 21.1.2 of the CONTRACT, represent grounds for such a declaration [...]."*[96]

For this reason, the Tribunal's first hollow theory, aimed at avoiding application of the Participation Contract and, hence, of the "*pacta sunt servanda*" principle is fundamentally flawed, and amounts to a failure to apply the applicable law and a manifest excess of powers.

Second theory:
At the end of paragraph 422 of the Award, the Tribunal held the following:

> *"[...]there is nothing in the Participation Contract to indicate an intention to 'contract out' of proportionality or any other legal principle of general application."*

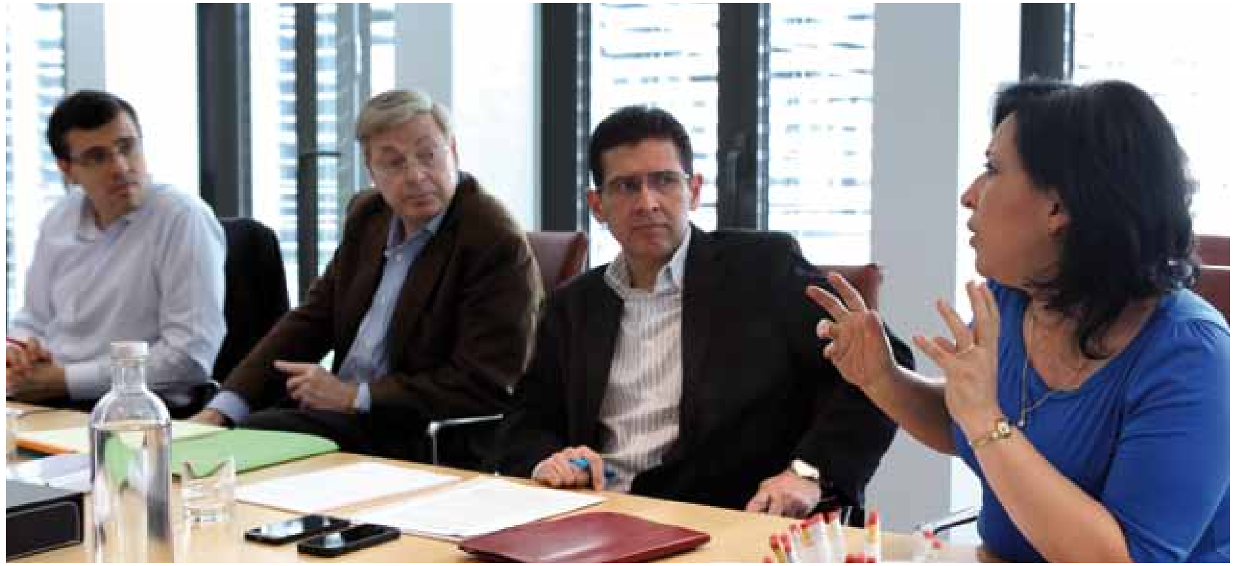
The paragraph transcribed above refers to footnote 35 of the Award, which reads:

> *"In any event, it must be doubtful whether parties could actually contract out of a principle of such central importance that it is included in the Ecuadorian Constitution.".*

The Tribunal's second theory fails for three separate reasons:

One, the Parties did not intend to subject a declaration of *caducidad* to any proportionality requirement. The Parties' intent must be gleaned from the plain language of the Participation Contract, and here, the Parties did not include any language regarding "*proportionality*." Specifically, no provision in the Participation Contract provides that *caducidad* should be applied in accordance with a proportionality principle.

95 Declaration of *Caducidad*, pages 1, 5 and 16.
96 Declaration of *Caducidad*, page 1.



Paris, Sunday 5 April 2014, offices of Dechert LLP. Preparatory meeting for the OXY Annulment hearing. Blanca Gómez de la Torre, Director of International Affairs and Arbitration of the Attorney General's Office gives her observations on the content of Ecuador's opening submission. From left to right: José Manuel García Represa, Pierre Mayer (Dechert LLP), Diego García Carrión and Blanca Gómez de la Torre (Attorney General's Office).

Two, the Tribunal did not explain how a "*proportionality principle*" would entirely avoid the application of the Participation Contract anywhere in the Award. Footnote 35 of the Award seems to suggest, without any analysis whatsoever, that because of its "*central importance*" and its inclusion in the Ecuadorian Constitution, the "*proportionality principle*" would be a mandatory rule under Ecuadorian law. This is incorrect. Ecuador explained, at the Second Liability Hearing, that proportionality under Ecuadorian law is not a mandatory rule but is, at most, a subsidiary rule (*norma supletiva*) aimed at completing the Parties' will as expressed in their Participation Contract, if needed.

OXY did not rebut Ecuador's submissions transcribed above, and the Tribunal offered no argument explaining why it ignored it. Thus, where the will of the Parties is clear – as it is with respect to the terms of the Participation Contract –the principle of proportionality has no place.

Three, assuming, *arguendo*, that the "*proportionality principle*" is a mandatory rule under Ecuadorian law, the Tribunal in any event failed to explain how that principle, under the facts of this case, could be reconciled with the "*pacta sunt servanda*" principle also included in the very same Ecuadorian Constitution.

OXY did not argue in any way that the Participation Contract should somehow be nullified by application of a purported mandatory proportionality rule contained in the Ecuadorian Constitution. As a result, by adopting such theory *sua sponte*, the Tribunal, in addition to manifestly exceeding its powers, also breached Ecuador's due process rights and committed a serious violation of a fundamental rule of procedure. Ecuador never had the procedural opportunity to discuss the Tribunal's novel application of the proportionality principle, which it ultimately adopted and employed to somehow nullify the Participation Contract.

By relying on two fundamentally flawed legal theories in order to avoid the application of the Participation Contract, the Tribunal failed to apply the applicable "*pacta sunt servanda"* principle, and thereby manifestly exceeded its powers.

3.2.4 In Its Award, The Tribunal Did Not Demonstrate How The Fair And Equitable Treatment Provision In The BIT Could Be Relied On To Avoid The Application Of The Participation Contract

At paragraph 404 of the Award, the Tribunal stated that "*[t]he obligation for fair and equitable treatment has on several occasions been interpreted to import an obligation of proportionality*".

In order to justify this assertion, the Tribunal referred to four previous ICSID cases: the *MTD, Tecmed, Azurix and LG&E*. None of these cases, however, support the existence "*in the context of international investment disputes*" of a purported "*obligation of proportionality*" under the Fair and Equitable Treatment standard such as the one that the Tribunal applied in this case.

To the contrary, those cases confirm that the *Caducidad* Decree, as the exercise of a sanction contractually agreed upon by the Parties, cannot violate the Fair and Equitable Treatment standard under the Treaty.

Of the cases cited, the Tribunal gave special consideration to the *Tecmed* case. *Tecmed,* however, does not sustain the Tribunal's position in the instant case, for the following reasons:

a. *First,* contrary to the Tribunal's assertion, the *Tecmed* tribunal did not interpret the Fair and Equitable Standard to import an "*obligation of proportionality.*" Instead, the Tecmed tribunal concluded that the Fair and Equitable Standard protects the legitimate expectations of the investor. No reference whatsoever was made to an obligation of proportionality.

In applying the *Tecmed* tribunal's definition of the Fair and Equitable Treatment standard to the facts of this case, the only possible conclusion is that the *Caducidad* Decree, as the exercise of a contractual prerogative freely agreed to by the Parties, does not frustrate OXY's legitimate expectations and thus does not violate the Fair and Equitable Treatment standard under the Treaty.

Surprisingly, and later contradicting itself, that was the conclusion reached by the Tribunal in paragraph 383 of the Award:

"Having concluded above that [OXY]'s failure to secure the required authorization on the part of the Ecuadorian authorities in October 2000, while not amounting to bad faith, was negligent, the Tribunal considers that the Claimants cannot be found to have had a legitimate expectation that the Minister would not exercise his discretion and impose caducidad. ***The failure to secure the required authorization meant that OXY breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL which, as one option, expressly allowed the Minister to declare the caducidad*** *of the Participation Contract and the Joint Operating Agreements. For this reason, the Claimants' allegation that the Caducidad Decree frustrated their legitimate expectations is rejected."*[97]

Therefore, the *Tecmed* case cannot support the Tribunal's reliance upon the Fair and Equitable Treatment standard to avoid the application of the Participation Contract.

b. *Second,* the *Tecmed* tribunal applied a test of proportionality based on case-law of from the European Court of Human Rights with regard to expropriation (and not the Fair and Equitable Treatment standard). The test applied by the *Tecmed* tribunal in the context of expropriation is manifestly different from the so-called "*obligation of proportionality*" that the Tribunal applied in the context of the Fair and Equitable Treatment standard. Therefore, contrary to the Tribunal's proposition, the law applied by the Tribunal in this case is not the law applied by the tribunal in the *Tecmed* case.

[97] Award, § 383.Declaration of *Caducidad*, page 1.

c. *Third,* on the facts, the *Tecmed* case related to the issuance of a permit to exploit a hazardous waste landfill. No issue of performance and termination of a contract arose in that case. Therefore, the *Tecmed* case cannot sustain the Tribunal's reliance on the Fair and Equitable Treatment provision in the Treaty in the present case to avoid the application of the Participation Contract.

The Tribunal also relied on the *Azurix* and *LG&E* cases. Both the *Azurix* and *LG&E* tribunals referred to and applied the proportionality test as it was applied in the *Tecmed* case, *i.e.* (i) in the context of an expropriation and not the Fair an Equitable Treatment standar; an (ii) after establishing the existence of a deprivation of the investor's property rights by the State's measure without compensation (amounting to an expropriation in breach of the treaty), in order to determine whether such breach was justified.

In other words, the Tribunal actually applied an entirely different standard that finds no support whatsoever in investment arbitration case-law. Consequently, it has manifestly exceeded its powers.

3.2.5 The Tribunal Did Not Demonstrate That A "Proportionality Principle" Which Would Override The Principle Of *Pacta Sunt Servanda* Exists Under International Law

In support of its extraordinary claim that the Fair and Equitable standard and customary international law require avoiding the application of "disproportionate" contracts, the Tribunal mainly refers to "Europe," where one supposedly finds "*the most developed body of jurisprudence*" on proportionality.[98]

European law, however, does not even remotely support this claim. It is revealing that the Tribunal provides no specific authorities or cases.

In the European context, the principle of proportionality only applies where a breach of a fundamental right or freedom has been established, in order to determine whether the breach can be justified. For instance, the European Court of Human Rights, in the case cited in the *Tecmed* award, only triggered a proportionality review once it established that the claimant had been deprived of its property rights.[99] Likewise, the European Court of Justice only reviews whether measures *in breach of ownership rights*[100] are justified in the public interest. Thus, even if the Tribunal were to equate European law to customary international law, which Ecuador disputes, the only principle that could

[98] Award, § 403.

[99] *James and others v.The United Kingdom,* European Court of Human Rights, Decision of 21 February 1986, application No. 8793/79.

[100] For example, J.Nold, Kohlen-und Baustoff großhandlung versus The European Commission, European Court of Justice, Decision of May 14, 1974, Case 4-73, European Court Reports 1974, page. 00491.

emerge would be to the effect that breaches of fundamental rights are subject to some form of judicial review.

In the instant dispute, however, the Tribunal has done exactly the opposite, instead of establishing that OXY's rights had been breached (*quod non*), and then examining whether the breach was — proportionate to the aims pursued, the Tribunal simply considered that all of Ecuador's actions, even though legitimate and respectful of OXY's contractual rights, were subject to a general, unconstrained review of proportionality.

Ultimately, what the Tribunal presented as a principle of "*proportionality*" amounts to pure, unrestrained arbitrariness. Indeed, at paragraph 417 of the Award, the Tribunal put forward the content of the test of "*proportionality*" that it decided to apply in the following terms:

> *"The test at the end of the day will remain one of overall judgment,balancing the interests of the State against those of the individual, to assess whether the particular sanction is a proportionate response in the particular circumstance."*[101]

Thus,the Tribunal did not judge according to binding rules (and in particular those agreed upon in the Participation Contract), but simply came to its idea of justice in this case by freely and arbitrarily "*balancing*" all of the interests that it considered to be relevant.

This is not, however, the mission that the Parties entrusted the Tribunal with. In fact, the Parties did not agree anywhere that the Tribunal could act as an *amiable compositeur* or decide the dispute ex *aequo et bono*. Article 42(3) of the Convention provides that the Parties shall expressly agree to confer to the Tribunal the power to decide *ex aequo et bono* in order for it to act as *amiable compositeur* in the resolution of the dispute. Given that in this case the Parties did not grant it such power, anywhere, the Tribunal, by acting as an *amiable compositeur* in determining Ecuador's liability, manifestly exceeded its power.[102]

[101] Also in §450, the Tribunal stated that "*the overriding principle of proportionality requires that any such administrative goal must be balanced against the Claimants' own interests and against the true nature and effect of the conduct being censured.*"

[102] MTD Annulment Decision, §44, "*[…]it is established that […] a decision given ex aequo et bono – that is to say, in the exercise of a general discretion not conferred by the applicable law – which is not authorized by the parties under Article 42(3) of the Convention can constitute a manifest excess of powers*"; MINE Annulment Decision, §5.03, *("a tribunal's disregard of the agreed rules of law would constitute a derogation from the terms of reference within which the tribunal has been authorized to function. Examples of such a derogation include the application of rules of law other that the ones agreed by the parties, or a decision not based on any law unless the parties had agreed on a decision ex aequo et bono. If the derogation is manifest, it entails a manifest excess of power*").

Saturday, April 5, 2014, Offices of Dechert LLP in Paris. Preparatory meeting for the Hearing on Annulment for the OXY case. Professor Pierre Mayer (Dechert LLP) highlights the relevant points of the Annulment Application of the Award rendered in the Occidental case. From left to right: José Manuel García Represa, Pierre Mayer (Dechert LLP), Diego García Carrión, Blanca Gómez de la Torre (Attorney General's Office), Diana Moya and Juan Espinosa (Attorney General's Office).

3.2.6 THE TRIBUNAL MANIFESTLY EXCEEDED ITS POWERS BY NOT REFLECTING, IN ITS DETERMINATION OF DAMAGES, THE ALLEGED ALTERNATIVES TO *CADUCIDAD*

Ecuador maintained, during the arbitration, that the Hydrocarbons Law only authorized Ecuador to undertake two actions in response to OXY's unauthorized transfer of rights: it could either declare *caducidad* or do nothing.

Ecuador pointed out to the Tribunal that considering *caducidad* as a breach of the BIT amounted to holding that Ecuador was forced to do nothing in response to OXY's breach of the Participation Contract and the Hydrocarbons Law. Such a holding would violate State sovereignty in the most fundamental way.

In response to this argument, the Tribunal found that Ecuador had alternatives to declaring *Caducidad.*[103] This finding was in manifest excess of the Tribunal's powers, since a simple review of the Participation Contract and the Hydrocarbons Law shows no such alternative.

The Tribunal erroneously concluded that the following were lawful alternatives to declaring *caducidad*:

i. *Insistence on payment of a transfer fee in the order of USD 11.8 million; and/or*

ii. *Improvements to the economic terms of the original contract; and/or*

iii. *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.*[104]

If the Tribunal determined that these alternatives existed, logically it should have considered them when calculating the damages awarded to OXY. Otherwise, any damages award would overcompensate and unjustly enrich OXY.[105]

International law simply does not allow for such a windfall to occur.[106]

The Tribunal found that Ecuador would have acted lawfully if it had insisted on any of the three

[103] Award, §§ 428-435.

[104] Award, § 434.

[105] *Amoco International Finance v. The Islamic Republic of Iran, et al.,* 15 Iran–U.S.C.T.R. at 257, Partial Award, 14 July 1987, § 225 ; see also I. Marboe, "Compensation and Damages in International Law The Limits of 'Fair Market Value', 4(6) Transnational Dispute Management, 2007, p. 723, § 733 ("*The amount of damages must not exceed the damage actually incurred. This is necessary to avoid overcompensation*"); W. Knull et al., "Accounting for Uncertainty in Discounted Cash FlowValuation of Upstream Oil and Gas Investments," 4(6) Transnational Dispute Management, 2007, p. 22, (emphasizing that if the valuation of an expropriated property is not carried out properly it will "*result in over-compensation, allowing the investorto improve, rather than merely restore, its prior position*").

[106] *Sea-Land Services Case,* 6 Iran- U.S.C.T.R. 149, Award, 22 June 1984, pp. 164-172, (unjust enrichment is a principle that "is *codified or judicially recognised in the great majority of the municipal legal systems of the world, and is widely accepted as having been assimilated into the catalogue of general principles of law available […]*").

sanctions listed above.[107] Thus, the Award should not have compensated Claimants for an amount that Ecuador was entitled to collect from Claimants because of their unlawful transfer of rights.

Accordingly, OXY's damages should have consisted in the difference between the fair market value of Block 15 and the amount of any of those alternative sanctions to the declaration of *Caducidad*. In its Award, however, the Tribunal failed to take them into account.

Indeed, the Tribunal did not mention any of these alternatives in its discussion on damages and therefore ignored its own findings and conclusions. Its failure to consider these alternatives constitutes an excess of power[108] and, as a result, the only consequence is annulment.

3.2.7 THE TRIBUNAL COMMITTED A SERIOUS DEPARTURE FROM A FUNDAMENTAL RULE OF PROCEDURE WHEN ON 15 FEBRUARY 2011, THE PRESIDENT EMAILED THE TRIBUNAL'S UNREASONED, ULTIMATE DETERMINATION ON LIABILITY

On February 15, 2011, after the matter had been fully briefed, and more than one year since the Parties had presented closing arguments on liability, the President of the Tribunal emailed the Parties the following message:

*"The Tribunal **has reached the point in its deliberations** where it requires the assistance of both parties' experts, Mr. Joseph Kalt and Mr. Daniel Johnston, in order to help the Tribunal **assess the proper calculation of damages.***

Therefore, in accordance with Rule 34(2) of the ICSID Arbitration Rules, the Tribunal calls upon the parties to produce Messrs. Kalt and Johnston for consultation with the Tribunal at the ICSID's headquarters in Washington at 10.30 a.m. on Wednesday, 27 April 2011. If the parties agree, the Tribunal would wish to consult with the parties' experts alone without the presence of counsel."[109]

By stating that the Tribunal needed help to "*assess the proper calculation of damages*," this email made it clear that the Tribunal had reached a determination on liability against Ecuador. Only the damages to be awarded to OXY remained to be determined. And for that, the Tribunal was seeking the help of the Parties' *quantum* experts.

However, the reasoning underlying the Tribunal's determination of liability remained a secret and was not communicated to the Parties until the Award was issued twenty months later, on 5 October 2012.

Ecuador promptly objected to the Tribunal's

[107] Award §§ 431-434.

[108] MHS Annulment decision, §74 ("[©Email sent by the Tribunal to the Parties on 15 February 2011*T]he Committee finds that the failure of the Sole Arbitrator even to consider, let alone apply, the definition of investment as it is contained in the Agreement to be a gross error that gave rise to a manifest failure to exercise jurisdiction*").

[109] Email sent by the Tribunal to the Parties on 15 February 2011.

improper conduct and advised the Tribunal that it had proceeded "*in violation of Articles 48 and 49 of the ICSID Convention and 47 and 48 of the Arbitration Rules.*"[110]

Some days later, in an attempt to redress the error, President Fortier wrote to the Parties stating that "*to be clear, the Tribunal reiterates that its deliberations are continuing.*"[111] While that statement may have been accurate as it pertains to the issue of *quantum* for which the Tribunal was seeking the experts' assistance, it clearly did not (and could not) apply to the Tribunal's deliberations on liability, which, consistent with President Fortier's earlier email, had concluded.

Ecuador again raised objections to the Tribunal's continuing improper conduct and advised the Tribunal as follows:

> *"[…] [the 15 February 2011 email] is clear to the point that the Tribunal has reached a decision on liability and notified it to the Parties (i) without providing any reasons and (ii) without following the procedures set forth in the ICSID framework in violation of the ICSID Convention and the ICSID Arbitration Rules. In its 23 February emails, however, the Tribunal (i) states that, 'to be clear, the Tribunal reiterates that its deliberations are continuing' (a sentence which could only apply to the issue of quantum in order to be consistent with the Tribunal's statement in its 15 February email […]), and (ii) invites the Parties, despite the 'continuing deliberations' and the proposed 27 April meeting and the potential costs related thereto, to submit 'their respective Statement on Costs in this proceeding by Friday, March 11, 2011.' Recognizing our responsibilities as representatives of Ecuador concerned with an issue of great importance to its people, we reiterate our reservations with respect to the email of 15 February sent on behalf of the Tribunal and must express here and now our surprise at the Tribunal's 23 February emails and reserve all Ecuador's rights in this respect."*[112]

In a further attempt to rectify the procedural impropriety, President Fortier further compounded the problem by misstating his earlier statement during the third hearing on quantum, on 30 June 2011:

> *"As the Parties will recall, on 15 February 2011, the tribunal informed the parties that it has reached the point in its deliberations both as to liability and quantum where it required the assistance of both parties' respective quantum experts, Professor Joseph Kalt and Mr. Daniel Johnston.*
>
> *More specifically, the tribunal stated that, in the event after it concludes the first phase of its deliberations, it should make a positive finding on liability, it will be required to determine the fair market value of Block 15 as of May 2006."*[113]

President Fortier's statement was inaccurate since his 15 February 2011 email only stated that the Tribunal needed the quantum experts' help on issues of damages. Nowhere did the 15 February 2011 email state or imply that the Tribunal's deliberations on liability were ongoing. To the contrary, that earlier email was explicit that the "*Tribunal has reached the point in its deliberation where it requires the assistance of both parties' experts […] to help the Tribunal asses the proper calculation of damages.*"[114] Ecuador fails to see how theTribunal needed the quantum experts' assistance *on issues of liability*.

The reality is that President Fortier's statements cannot be reconciled. His 15 February 2011 email was unequivocal: the Tribunal had reached a finding on liability and needed help ascertaining damages. The problem is that the Tribunal did not communicate its reasoning on liability to the Parties before or on 15 February 2011, or with President Fortier's subsequent attempts.

In doing so, the Tribunal committed a serious departure from fundamental rules established of procedure set forth in the ICSID Convention and the Arbitration Rules. In particular, Article 48 (3) of the Convention specifically requires that the Award "*state the reasons upon which it is based*". Arbitration Rule 47 similarly provides that "*the award shall be in writing and shall contain: […] (i) the decision of the Tribunal on every question submitted to it, together with the reasons upon which the decision is based.*"

These provisions mandate, among other things, that the Tribunal communicate its decision in writing and "*state the reasons upon which it is based.*" The Tribunal failed to comply with this requirement and deprived Ecuador of the very benefit and protection which these rules of procedure were intended to provide.[115]

These rules are not merely procedural; they contain a principle of justice shared by the majority of legal systems. The *rationale* behind the rule that decisions must "*state the reasons upon which they are based*" is twofold:

110 Email sent by Ecuador to the Tribunal on 18 February 2011.
111 Email sent by the Tribunal to the Parties on 23 February 2011.
112 Email sent by Ecuador to the Tribunal on 3 March 2011.

113 Third *Quantum* Hearing, Introductory Statement from President Fortier.
114 Email sent by the Tribunal to the Parties on 15 February 2011.
115 *MINE Annulment Decision,* § 5.05, (" *[…] the departure must be substantial and be such as to deprive a party of the benefit or protection which the rule was intended to provide."*).

First,"*a statement of reasons for a judicial decision is widely regarded to be a prerequisite for an orderly administration of justice. A reasoned judgment contributes to ensuring not only that justice is done but that it is perceived to be done.*"[116] As a result, the obligation to state the reasons is mandatory.

Second, the vast majority of legal systems (including the ICSID system) also require that the reasons be provided together with the decision itself, *i.e.* simultaneously. Otherwise, the parties cannot perceive that justice has been done. Simply put, the reasons for a decision are part of the decision itself. The parties must also "*perceive*" that the reasons supporting a decision existed at the time that the decision was issued.

Even if the Tribunal had provided sufficient reasons for its finding on liability, this could not have retroactively cured the Tribunal's violation of the fundamental rule that commands that the award shall state the reasons upon which it is based.

Any reader of the Tribunal's decision on liability will immediately realize that the Tribunal first decided that Ecuador was liable and thereafter looked for reasons to support its decision.

3.3 Damages

In its Award, the Tribunal held that: (i) Ecuador acted in breach of Article II.3(a) of the Treaty by failing to accord fair and equitable treatment to OXY's investment; (ii) Ecuador acted in breach of Article III.1 of the Treaty by expropriating OXY's investment through a measure "tantamount to expropriation" by declaring *caducidad*; and (iii) OXY breached Clause 16.1 of the Participation Contract by failing to secure the required ministerial authorization for the transfer of rights under the Farm-out Agreement.

The Tribunal considered that OXY's failure to secure authorization from the Ecuadorian authorities, while not constituting bad faith, was negligent. OXY's breach of clause 16.1 of the Participation Contract entailled a violation of article 74.11 of the Hydrocarbons Law which expressly gave the relevant Minister the option to declare *caducidad* of the Participation Contract.

The Tribunal concluded that given Ecuador's breach of the BIT, by terminating the Participation Contract, and OXY's negligence in not requesting the authorization of the Ecuadorian authorities, both the State of Ecuador and OXY contributed to the damages. OXY's damages should be decreased as a result of its unlawful act. Thus, the Tribunal determined, at its own discretion, that this amount

[116] Ch. Schreuer, L. Malintoppi, A. Reinisch, A. Sinclair, *The ICSID Convention, A commentary,* Cambridge University Press, 2nd Edition, Article 52, §§ 281-282.

corresponded to 25% of the damages incurred by OXY as a result of the *caducidad* Decree.

As a consequence of these breaches, the Tribunal determined that OXY should be compensated. It awarded OXY compensation of USD 1,769,625,000 before interest.

> "The only possible effect of anassignment of rights is stipulated in the Law and in the contract: caducidad. And the direct effect of having assigned 40% of the rights is that, even if the Tribunal found Ecuador liable, it would have to deduct at the very least the percentage over which Occidental did not have ownership as a result of the assigned rights."
>
> *Dr. Diego García Carrión*
> El Comercio, April 18, 2012

In reaching its decision, the Tribunal rejected other deductions that Ecuador argued, other than contributory negligence, including:

- Law 42-2006;
- The VAT Interpretive Law;
- The taking into consideration of the Farm-out Agreement, under which OXY could only claim 60% of any amount, because AEC owns the other 40%.

Despite acknowledging OXY's breach of the Participation Contract and the Law (by assigning 40% of its rights to AEC), the Tribunal held that OXY was entitled to 100% of damages thereby allowing the offender to benefit from its own breach and thereby manifestly exceeding its power with regard to the 40% rights which belonged to a third party, unconnected with the dispute, and not protected by the BIT under which the Tribunal had jurisdiction.

Furthermore, the Tribunal rejected Ecuador's counterclaims, ordered each Party to bear its own legal costs, and ordered both Parties to split the costs and expenses related to the proceedings.

Professor Brigitte Stern issued a Dissenting Opinion in which she revealed serious violations made by the Tribunal in the application of legal principles. Professor Stern offered a different analysis on quantum.

Professor Stern's differences can be summarized in two points:

1. The consequences of OXY's unlawful actions when it violated Ecuadorian Law and the importance that each State assigns to the respect of its legal order had been overly underestimated;

2. The majority's position on the effect of the Farm-out Agreement is egregious in legal terms and full of contradictions. There is a manifest excess of power in nullifying a contract concerning a company which not only was not a party to the arbitration, but also concerned a Chinese investor which was not under the Tribunal's jurisdiction. With this decision, the Tribunal would become an accomplice to a violation of the international principle prohibiting unjust enrichment, should OXY not hand over 40% of the compensation to said investor.

Professor Stern disagrees with the reasoning concerning what the Tribunal called "preliminary matters" that should have been taken into account for the purposes of the Award, *i.e.*:

a. Law 42: rigorously fulfills the function of a tax or levy.

b. The VAT Interpretive Law: the collection of VAT should have been analyzed and the majority did not do so. Not refunding VAT does not appear to be a breach of the Participation Contract.

c. The Farm-out Agreement: i) was essentially an assignment of rights and not an imposition of contractual liabilities; and ii) the majority manifestly exceeded their powers in annulling Andes' rights; the Tribunal could only have granted 60% of the damages to OXY.

d. OXY took the risk of *caducidad* by executing the Participation Contract. It would therefore have been more reasonable to endorse a 50/50 split between OXY and Ecuador, although –according to Professor Stern– this was due to a different appreciation of the factual situations rather than an error of law.

Given the fact that, in its determination of the *quantum*, the Tribunal did not indicate its reasoning and manifestly exceeded its powers, the Award should be annulled. There are various reasons to support this view:

3.3.1 THE TRIBUNAL DID NOT GIVE ITS REASONS FOR RELYING EXCLUSIVELY ON A DISCOUNTED CASH FLOW MODEL FOR DETERMINING THE FAIR MARKET VALUE OF OXY'S INVESTMENT.

While the Parties agreed, during the arbitration, that the fair market value (**FMV**) is the standard for determining compensation should the Tribunal find Ecuador liable, they disagreed as to the method that should be used to determine such value and as to what weight should be placed on the Discounted Cash Flow (**DCF**) analyses performed by the Parties' *quantum* experts.

During the *quantum* phase of the arbitration, the Parties pleaded extensively on the reliance to be

placed on DCF models for valuation purposes. While OXY's position was that the "*DCF approach is the only reliable methodology by which to calculate their damages*,"[117] Ecuador noted that *"Claimants' DCF analysis was uncorroborated by any other methodology."*[118] Instead, Ecuador "*confirm[ed] its DCF analysis with other methods of valuation, including the use of comparable sales data.*" [119]

This methodology to calculate the FMV was also discussed by the Parties' *quantum* experts.

OXY's quantum expert contented that:

> *"[t]he standard economic approach to measuring the [FMV] today of a stream of net revenues (i.e, gross revenues minus attendant costs) that can be earned from operation of a multi-year project such as OXY's development of Block 15 is calculation of the present value (as of May 16, 2006) of the net benefits, or 'discounted cash flows'."*[120]

Ecuador's expert, on the other hand, disagreed with this position by underlining that any DCF analysis should be corroborated with other methods, stating that:

> *"109. It is widely-accepted and common to supplement one valuation approach with others if they are available or practical so as to obtain further comfort or insight into the real value of an asset. Some analysts refer to these alternate approaches as 'reality checks'. As Forrest Garb explains:70· 'I encourage the simultaneous use of all the [valuation] methods to reduce the possibility of overlooking some negative aspect of a purchase.' – p. 9· 'A single yardstick in itself is fallible and should not be considered as an adequate measure of an investment. To ensure against oversight, all the yardsticks should be reviewed, and those that seem out of line should be studied.' – p. 17· "Proper FMV determinations should consider the time element of the venue stream and the technological, economic, and political uncertainties.' – p. 17*
>
> *110. In summary, although I have employed DCF analysis in this matter, it is not the only valid valuation technique. Moreover, as described by Mr. Garb above, multiple valuation techniques must be considered and*

[117] OXY's Reply on Damages and Counter-Memorial on Counterclaim Damages dated June 12, 2009, § 46, *in fine.*

[118] OXY's Reply on Damages and Counter-Memorial on Counterclaim Damages dated June 12, 2009, § 46, *in fine.*

[119] Ecuador's Counter-Memorial on *Quantum* and Memorial on Counterclaim Damages dated March 9, 2009, § 86. See also Ecuador's Rejoinder on *Quantum* and Reply on Counterclaim Damages dated September 8, 2009, Section 70, § 233 (*"While DCF is a useful valuation tool, examining, comparable sales is also critical because it allows the evaluator to test the reasonableness of the DCF assumptions against market conditions"*); Ecuador's opening statement in the first Quantum Hearing, D2:P148:L9-22, (explaining that, in this case, comparable transactions are a *"blessing"* that allow a DCF methodology to be corroborated) and D2:P195:L20-P196:L11 (explaining that "*Claimants have no presented a [FMV] report, they have presented a seller's report, one designated to get a price rather than value the asset. It is the task of the Tribunal to calculate [FMV] as a willing buyer and willing seller would have determined it, based on the information at the time of termination*").

[120] First expert report by Joseph Kalt dated September 17, 2006, § 15.

these may even provide a more accurate figure."[121]

Ecuador's experts specifically pointed out that any DCF analysis should be corroborated with other methods, a position that was shared by Mr. Patterson, former Vice-president of AEC, who acknowledged that *"[...]I do not think you can use a DCF analysis and solely come to a market rate*"[122], because "*uncertainty is something that exists throughout*" a DCF analysis.[123]

In its Award, the Tribunal recognized that determining the appropriate method of valuation was one of the "*first and foremost*" issues for determination of *quantum*, and recalled that "*both parties have agree[d] that one method of valuation is the Discounted Cash Flow (DCF) method*."[124] Thus, the Tribunal decided on *"[u]sing a DCF model as the starting point for measuring FMV*."[125]

Saturday, April 5, 2014, in the offices of Dechert LLP, in Paris. Lawyers of the Republic of Ecuador's defense team at a preparatory meeting for the Hearing on the Annulment of the OXY Award.

121 Expert report by Daniel Johnston dated September 8, 2009.
122 First *Quantum* Hearing, D3:P152:L3-L5.
123 First *Quantum* Hearing, D3:P177:L12-L15.
124 Award, § 690.
125 Award, § 709.

However, without providing any explanation in the Award, the Tribunal relied solely on an uncorroborated DCF analysis to reach OXY's damages. As Ecuador's maintained, the *"DCF model is an overly precise snapshot of incredibly imprecise assumptions*."[126]

The award, however, contained a *"significant lacunae"* which prevents the reader from following the Tribunal's reasoning.[127]

Following the standard established by the MINE *ad hoc* Committee,[128] the Award does not allow the reader to follow how the Tribunal proceeded from Point A (when it stated that it was "*Using a DCF model as the starting point for measuring FMV*"[129]) to Point B (where it concluded that exclusively *"using the economic model agreed by Professor Kalt and Mr. Johnston, the Tribunal [...] determines that the Net Present Value of the discounted cash flows generated by Block 15 OEPC production as of 16 May, 2006 is USD $2,359,500.000 (two billion three hundred and fifty-nine million five hundred thousand dollars*)."[130]

In addition, it must be reminded that the experts Professor Kalt and Mr. Johnston did not agree on any economic model, but followed the methodology set by the Tribunal.

3.3.2 The Tribunal Manifestly Exceeded Its Powers By Raising A New Argument In Favor Of Oxy And Awarding Usd 943,000,000 On That Argument

As already mentioned, on 6 October 2011, after the oral and written submissions phase of the arbitration was over, the Tribunal wrote to the parties, raising an argument in favor of OXY that OXY had never put forward in over 5 years of proceedings.

On the date that the email was sent, the Tribunal had reached the conclusion –without providing any reasons whatsoever – that OXY had violated the Participation Contract and that the Hydrocarbons Law, by transferring, without authorization, a 40% interest in the Contract to AEC.

In arriving at this conclusion, the Tribunal was left with only two alternatives for establishing damages. The first and most obvious one was that no damages were owed to OXY. The second was to limit the damages to 60% of the value of Block 15.

126 First *Quantum* Hearing, D2:P280:L5-16.
127 CMS Annulment Decision, § 97. In that decision, the committee concluded that *"in that case, one would have excepted a discussion of the issues [submitted by the parties],"* ibidem, § 96. In the present case, the lack of discussionas to the reasons to reject the alternative methods by relying solely on - and refusing to corroborate - the DCF analysis should give lieu to annulment.
128 MINE Annulment decision, § 5.08-5.09 (*"the requirement to state reasons is satisfied as long as the award enables one to follow how the tribunal proceeded from Point A to Point B and eventually arrived at its conclusion"*).
129 Award, § 709.
130 Award, § 824.

The Farm-out Agreement was a transfer of rights in breach of the Participation Contract and the Hydrocarbons Law. Therefore, Ecuador acted legally, fairly and proportionately by issuing the Declaration of Caducidad.

Apparently wanting to give Claimants 100% of the value of the Block, but recognizing that the Parties' submissions would not allow it to do so, the Tribunal wrote to the Parties on 6 October 2011, inviting them to address a new argument, namely that OXY was entitled to 100% of the value of Block 15. Not because, as OXY had stated, the Farm-out was "indeed a contractual obligation of OEPC to AEC", but because the transfer carried out under the Farm-out Agreement was considered legally inexistent under Article 79 of the Hydrocarbons Law.

During the arbitration, OXY maintained that the Farm-out Agreement was not a transfer of rights and that, therefore, there was no breach of the Participation Contract or the Hydrocarbons Law, and, alternatively, to the extent that it was, that Ecuador's reaction in the form of the *Caducidad* Decree had been, *inter alia*, "*grossly unfair, arbitrary and discriminatory, in violation of the Treaty and Ecuadorian law.*"[131]

OXY also argued that, even if it was found to be at fault, it was entitled to the full measure of damages resulting from Ecuador's expropriating conduct[132] because: (i) OXY's harm was solely caused by Ecuador's disproportionate conduct with no contribution from[133]; and (ii) *"as the sole owners of the Participation Contract rights, Claimants are entitled to compensation reflecting the full value of those rights*".[134]

In connection with the last point, OXY's position was that, despite the Farm-out to AEC, it remained entitled to 100%, not 60%, of the rights under the Participation Contract "*since OXY continues to have an enforceable contractual liability vis-à-vis Andes under the Farm-out […].*"[135]

In turn, Ecuador argued that the Farm-out Agreement was a transfer of rights in violation of the Participation Contract and the Hydrocarbons Law,

131 OXY's Memorial on Liability dated July 23, 2007, § 368 *et seq.* See also ibidem, § 219 ("[...]*the Farm-out did not constitute a Termination Event, as defined in the HCL, either in 2000 or in 2006. However, whether it did or not ultimately matters little: both international and Ecuadorian law proscribed the unilateral termination of a government contract where, as here, the alleged breach was always known and never objected to by the State, and such termination was manifestly unfair, arbitrary, discriminatory and disproportionate*").

132 OXY's Memorial on Damages dated September 17, 2007, Sections II-III.

133 OXY's Reply on Damages and Counter-Memorial on Counterclaim Damages dated June 12, 2009, § 206 ("*In sum, none of the cases cited by Ecuador contradicts the long line of authority confirming that contributory negligence does not arise in the case of a State's disproportionate response to an investor's negligent or wrongful conduct. Moreover, all of these cases confirm that Claimants are entitled to full compensation and that their damages could only be reduced to the extent they reflect losses which they would have suffered regardless of Ecuador's breach*").

134 OXY's Reply on Damages and Counter-Memorial on Counterclaim Damages dated June 12, 2009, § 208

135 OXY's Reply on Damages and Counter-Memorial on Counterclaim Damages dated June 12, 2009, § 208.Award, § 824.

and that it therefore acted legally, fairly and proportionately in issuing the *Caducidad* Decree.[136] It argued that OXY was not entitled to any compensation[137] .

Awarding 100% of the total value of the Participation Contractin OXY's favor would result in an unexpected profit and anunjust enrichment.

Alternatively, Ecuador argued that assuming incorrectly that OXY was entitled to damages, these were limited to 60% of the value of the Participation Contract since: (i) by transferring 40% of its rights under the Participation Contract to AEC, OXY only retained a 60% interest in the Participation Contract;[138] (ii) AEC/Andes, the holder of 40% of the rights under the Participation Contract was not a protected investor under the Treaty and the Tribunal had no jurisdiction to award damages for this company's loss;[139] and (iii) awarding OXY 100% of the full value of the Participation Contract, in view of AEC's 40% ownership stake in it, would result in a windfall to Claimants and unjustly enrichment them.[140]

If the Tribunal found that the Farm-out Agreement was in the nature of a "*right of ownership of AEC in the Participation Contract*,"[141] then OXY would have been entitled to 60% of the value of the Participation Contract. Instead, the Tribunal arrogated upon itself an authority it did not have and raised the argument that the transfer made under the Farm-out Agreement was deemed legally inexistent under Article 79 of the Hydrocarbons Law. This argument had never been raised before. On October 6, 2011, during the Tribunal's deliberations, the President of the Tribunal addressed the Parties and, in the name of the Tribunal, declared:

> *"[…]The Tribunal now invites the parties to assume that an assignment of rights did occur as a result of the Farm-out Agreement and the Joint Operating Agreement. On the basis of this*

136 Ecuador's Counter-Memorial on Liability and Counterclaim dated June 16, 2008, Sections III.B.2 to III.B.6. See also Ecuador's Rejoinder on Liability dated September 19, 2008, Section III.

137 Ecuador's Counter-memorial on Liability and Counterclaim dated June 16, 2008, § 261 (*"The Claimants' expropriation claim is without merit. The Caducidad Decree can in no event be characterized as a taking of OEPC's property, because there was a proper basis to terminate the Participation Contract under its terms and governing law. The Decree was also non-compensable because it constituted a bona fide, non-discriminatory administrative sanction for OEPC's violations of the Hydrocarbons Law, and was effectuated in furtherance of a legitimate regulatory objective"*).

138 Ecuador's Post-Hearing Brief on *Quantum* and Counterclaim Damages dated December 18, 2009, §§ 133 et seq.

139 Ecuador's Counter-Memorial on *Quantum* and Memorial on Counterclaim Damages dated March 9, 2009, § 7 (*"Claimants have also misguidedly performed their damages calculations on the assumption that they had a 100% interest in Block 15, despite the fact that they irrevocably transferred 40% to AEC. Were Claimants awarded any amounts attributable to a third party's interest in the Block (even assuming, arguendo, that a breach by Ecuador had occurred), this would represent either unjust enrichment or an improper recovery on behalf of an entity not protected by the U.S.-Ecuador BIT. Both types of recovery are strictly precluded by international law, as interpreted by an unequivocal and unanimous line of cases. The same would be true under Ecuadorian law were the Tribunal to hold, par impossible, that no transfer of rights and obligations to AEC took place*").OXY's Reply on Damages and Counter-Memorial on Counterclaim Damages dated June 12, 2009, § 208.Award, § 824.

140 Ecuador's Counter-Memorial on *Quantum* and Memorial on Counterclaim Damages dated March 9, 2009, § 7.

141 Award, § 579.

> *assumption, the parties are requested to undertake a detailed analysis of the effect of an assignment of rights made under a contract governed by New York law (i.e. the Farm-out Agreement and the Joint Operating Agreement) in violation of a non-assignment clause set forth in a contract governed by Ecuadorian law (i.e. Article 16(1) of the Participation Contract) and in violation of Article 79 of the Hydrocarbons law. The parties are further requested to address both New York law and Ecuadorian law and to make submissions accordingly, even if one or both parties may consider that, for any reason, New York law and/or Ecuadorian law may not be relevant to the determination of the effect of the Farm-out Agreement and the Joint Operating Agreement."*[142]

By deciding on a matter not raised by the Parties, the Tribunal clearly exceeded its powers and, as a consequence, the decision should be annulled.

The *Soufraki ad hoc* committee explained:

> *"The ad hoc Committee must also ascertain what the concept of 'excess of power' encompasses. To exceed the scope of one's powers means to do something beyond the reach of such powers as defined by three parameters, the jurisdictional requirements, the applicable law and the* ***issues raised by the Parties.****"*[143] *(emphasis added).*

The *Soufraki ad hoc* committee added: *"as far as a question posed to the tribunal is concerned, […] a manifest excess of power would consist in answering some other question not raised by the parties, or in answering only a part of a question in fact raised by the parties."*[144]

During the whole arbitration and, fundamentally, when the Parties rested their respective cases with the filing of post-hearing reply briefs on *quantum*, both Parties had discussed, in substantial detail, the legal consequences flowing from OXY's breach of the Participation Contract and the Hydrocarbons Law. The question to be answered by the Tribunal was therefore:

> *"Whether the Farm-out Liability is in the nature of a contractual obligation of OXY vis-à-vis AEC (as opposed to a right of ownership of AEC in the Participation Contract with Ecuador or the Block 15 oil) […]."*[145]

In other words, OXY's entitlement to 100% of the value of Block 15 was the question that the Parties had submitted to the Tribunal and that the Tribunal had to answer.

[142] Decision, § 595.
[143] Soufraki Annulment Decision, § 41.
[144] Soufraki Annulment Decision, § 44.
[145] OXY's Post-Hearing Brief on Damages and Counterclaim Damages dated December 18, 2009, § 225.

In more than 5 years of proceedings, having filed countless briefs, and attended numerous hearings, OXY never once before had advanced that sophistical argument. Instead, OXY's consistent argument, as explained above, had been that it was entitled to 100% of the value of Block 15 because the Farm-out only conveyed a *beneficial interest* to AEC, it did not result in a transfer of *legal title* and merely created a contractual liability of OXY *vis-à-vis* AEC.

In an impenetrable decision, the Tribunal raised a new argument enabling OXY to justify its alleged right to 100% of the value of Block 15 under the assumption that the transfer carried out under the Farm-out Agreement was legally inexistent under Article 79 of the Hydrocarbons Law.

On that subject, Ecuador promptly objected to the Tribunal's conduct, reserving its rights, given that the Tribunal had given OXY an untimely opportunity to rectify its omission to address this argument and, thereby, violated Articles 48 and 49 of the ICSID Convention and Articles 47 and 48 of the ICSID Rules. Without prejudice to this, Ecuador argued as follows:

1. The Tribunal cannot conclude that there was an unauthorized, illegal assignment of rights by OXY and then proceed to disregard certain applicable provisions of the Participation Contract and the Hydrocarbons Law in determining the effect of this assignment.
2. Under international law, OXY's maximum entitlement to damages would, *par impossible*, only be equivalent to 60% of the fair market value of Block 15.
3. NewYork law would not render the illegal assignment void, and would not allow OXY to benefit from its misconduct.
4. Pursuant to Article 1698 of the Ecuadorian Civil Code, the nullity provided for in Article 79 of the Hydrocarbons Law is an absolute nullity.
5. Pursuant to Article 1699 of the Ecuadorian Civil Code, the absolute nullity provided for in Article 79 of the Hydrocarbons Law is not automatic and must be declared by a judge. OXY cannot request that a judge declare that the unauthorized assignment of rights is null and void (the *nemo auditur* rule under Ecuadorian Law).

On the basis of "its" new argument, the Tribunal arrived at the contradictory conclusion that:

1. The Farm-out Agreement was valid and that any obligation binding the Parties was not in dispute, nor was AEC's entitlement to seek damages from OXY in the event that it did not comply with the terms of said contract, such as not obtaining government authorization for the assignment.

2. The assignment of rights under the Farm-out Agreement is void and has no value under the both New York law and Ecuador law. According to the doctrine of inexistence, and the law of New York, a judicial declaration of nullity is not necessary for the purposes of invalidity. The Tribunal excluded nullity from its analysis for the purpose of determining the damages owed to OXY and concluded that OXY retained ownership of 100% of the rights arising from the Participation Contract. Therefore Ecuador should compensate OXY for 100% of its interest in Block 15.

3.3.3 The Tribunal Manifestly Exceeded Its Powers By Not Applying International Law (Including The BIT) In Determining The Fair Market Value Of Oxy's Investment

The Tribunal found that OXY breached Clause 16.1 of the Participation Contract. This clause reads as follows:

> *"16.1 Transfer of this Participation Contract or assignment to third parties of the rights under this Participation Contract, must be authorized by the Corresponding Ministry, in accordance with existing laws and regulations, especially the provisions contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179 must be complied with."*[146]

> *The Tribunal determined that OXY had breached Clause 16.1 of the Participation Contract.*

The Tribunal, in other words, came to the conclusion that OXY transferred 40% of its rights arising out of the Participation Contract to AEC without prior ministerial approval. The Tribunal also found that the unauthorized transfer was illegal. It is worth stressing that this very finding was foreshadowed in the Tribunal's unexpected letter dated October 6, 2011.[147] In this letter, the Tribunal established that OXY only entitled to (i) 60% of the benefits arising out of the Participation Contract, including volumes of oil, and (ii) a damages Award amounting to, at most, 60% of the fair market value of Block 15.[148]

Despite the "*real world*"[149] described earlier, the majority of the Tribunal, in another unprecedented conclusion, decided in its Award, to grant OXY damages amounting to 100% of the fair market value of Block 15.

The Tribunal's decision constitutes a clear excess of its powers. As a result, Professor Brigitte Stern wrote one of the strongest dissents in the history of investment arbitration:

[146] Participation Contract (*"16.1. La transferencia de este Contrato de Participación o la cesión a terceros de derechos provenientes del mismo deberán ser autorizadas por el Ministro del Ramo, de conformidad con las leyes y reglamentos vigentes: de manera especial se cumplirán con las disposiciones previstas en el artículo 79 de la Ley de Hidrocarburos y en los Decretos Ejecutivos Nos. 809, 2713 y 1179"*).

[147] See Section 3.3.1 supra.

[148] Email from the Tribunal to the Parties dated October 6, 2011.

[149] Dissenting Opinion, § 134.

> *"[…]there is the fundamental impossibility for me to follow the different statements in the Award relating to the effect this Tribunal should give to the Farm-out Agreement. The majority's position on the effect of the Farm-out Agreement is, in my view, so egregious in legal terms and so full of contradictions, that I could not but express my dissent. In my view, there are two major questionable aspects in the majority's approach to the question of the effectiveness of the Farm-out Agreement: the first is the analysis of the question of the effectiveness of a legal act under Ecuadorian law, which is based on a total lack of reasons, with the consequence that I was not able to follow the 'reasoning' from point A to point B, as well as gross errors of law in the purported interpretation of the content of Ecuadorian law; the second, which in my view is even a more serious matter, is the manifest excess of power of the Award nullifying a contract concerning a company which not only was not a party to the arbitration, but moreover – even if it had been a party – could not be considered, being a Chinese company, as an investor over which the Tribunal had jurisdiction under the US/Ecuador BIT."*[150]

> *Neither OXY nor the Tribunal have raised – nor can they raise— the argument that the BIT should protect the Chinese investors.*

In its decision to award damages amounting to 100% of the fair market value of Block 15 to OXY, the majority of the Tribunal, as established by Professor Stern in her dissenting opinion, also clearly exceeded its powers in two more ways: *first*, the Tribunal exercised *ratione personae* jurisdiction over a Chinese company, Andes, without any entitlement arising out of the Treaty or the Participation Contract to do so; and *second,* the Tribunal failed to apply the applicable rules of international law on damages.

3.3.4 The Tribunal Manifestly Exceeded Its Powers By Exercising *Ratione Personae* Jurisdiction Over The Chinese Company Andes

ICSID *ad hoc* annulment committees have consistently maintained that an ICSID Tribunal manifestly exceeds its powers if it exercises jurisdiction that it does not have.[151]

In particular, there will be an excess of powers if a tribunal exercises its jurisdiction over a company

[150] Dissenting Opinion, § 5.

[151] *Soufraki* Annulment Decision, § 42 *("it can be said that there is an excess of power if a tribunal acts 'too much.' There is, in principle, an excess of power if a tribunal goes beyond its jurisdiction ratione personae, or ratione materiae or ratione voluntatis. There is an exc ess of power if the tribunal: -asserts its jurisdiction over a person or a State in regard to whom it does not have jurisdiction; - asserts its jurisdiction over a subject- matter which does not fall within the ambit of the jurisdiction of the tribunal; - asserts its jurisdiction over an issue that is not encompassed in the consent of th e Parties"); Klöckner I* Annulment Decision, § 4, *("an applicant for annulment may not only invoke lack of jurisdiction ratione materiae or ratione personae under Articles 25 and 26 of the Convention, but may also contend that the award exceeded the Tribuna l's jurisdiction as it existed under the appropriate interpretation of the ICSID arbitration clause");* Vivendi I Annulment Decision, § 86 (Citing that a decision may be annulled if a Court "*exercises a jurisdiction which it does not have under the relevant agreement or treaty and the ICSID Convention, read together* ").

which is not a party to the arbitration agreement and is not an investor over which the tribunal has jurisdiction under the applicable BIT.[152]

As noted in the Request for Arbitration,[153] OXY identified, as the jurisdictional foundation of its claims, both the BIT and the Participation Contract.

The BIT does not protect Chinese nationals. The Treaty was entered into between and ratified by the Republic of Ecuador and the United States of America. The People's Republic of China is not a party to the BIT. Neither OXY nor the Tribunal has made the argument, nor could it, that the Treaty could somehow protect Chinese nationals.

The Participation Contract was entered into between the Ecuadorian State and OXY. It cannot be argued that the ICSID arbitration clause contained in this Contract could and should be extended to Andes. *Res inter alias acta.*

The Tribunal, however, by deciding that OXY was entitled to damages amounting to 100% of the FMV of Block 15, made three decisions which affect Andes without having jurisdiction over it:

First, the Tribunal effectively nullified the Farm-out Agreement without taking into account how this would affect Andes (or AEC).

Second, the Tribunal, by granting OXY damages equivalent to 100% of the FMV of Block 15, effectively granted Andes 40% of that sum, on the assumption that OXY would comply with the Letter Agreement that it had signed with Andes in 2006. According to this Letter, OXY agreed to transfer to Andes 40% of whatever proceeds of the underlying arbitration as recognized in the Award.

Third, in contrast, if OXY decided not to transfer the 40% to Andes, the Tribunal would, by virtue of its decision, have expropriated Andes of its investment up to 40% of the rights arising out of the Participation Contract for Block 15.

Professor Stern very clearly explains the Tribunal's manifest excess of powers described above in respect of the last two decisions as follows:

> *"To summarize, I conclude that the Tribunal could only have granted to the Claimants damages corresponding to 60% of their rights*

[152] *Soufraki* Annulment Decision, §§ 53-54 ("*In order to be competent in the case of Mr. Soufraki, the Tribunal had to verify compliance with the nationality requirement of Article 25 of the ICSID Convention, which is to be read alongside the pertinent jurisdictional provisions of the applicable BIT. […] Mr. Soufraki therefore had to prove to the Tribunal that he was an Italian national on the relevant dates. If he were unable to do so, it would be a manifest excess of power for the Tribunal to proceed to consider the merits*").

[153] OXY's Request for Arbitration dated May 17, 2006, §§ 51 et seq. and 61 et seq. See also OXY's Memorial on Liability, § 458 ("*By taking Claimants' investments as it did, Ecuador has breached its obligations under the Treaty and international law and under the Participation Contract and Ecuadorian law. Therefore, Claimants seek an award from this Tribunal declaring such breaches and awarding such appropriate relief as shall be set forth in their submission on remedies due September 15, 2007*").

> *and that it could not – as did de facto the majority – grant damages for 100% of the losses incurred in Block 15 resulting from Caducidad, because such a solution would be unacceptable, under the only two possible scenarios, as suggested earlier: either [OXY] will not transmit 40% of the amount received in damages to Andes, and it will then be unjustly enriched, in violation of the international principle of unjust enrichment; or [OXY] will indeed transmit 40% of the amount received in damages to Andes, and the Tribunal would therefore have compensated Andes through [OXY], in violation of the principles of its limited jurisdiction ratione personae. This would be an improper recovery on behalf of an entity not protected by the U.S.-Ecuador BIT, when Andes is not a claimant in this procedure and could only claim and receive damages from Ecuador under the China/Ecuador BIT.* ***Such investment is not protected by the Treaty because it does not belong to United States companies or nationals. It is certainly not possible for the Claimants to claim under the US/Ecuador BIT for an economic value belonging to a Chinese company.*** *As to [OXY], [it] can only claim, on [its] own behalf, the value of [its] reduced investment, and not of the investments made by another, non-American company. (i) According to the international law principles relating to the jurisdiction of the Tribunal and international law principles applicable to compensation for international illicit acts, no damages ultimately benefiting to AEC/Andes could have been awarded by the Tribunal, because, in case of split between a legal owner and a beneficial owner, it is only the beneficial owner which can be compensated."*[154]

Ecuador argued in many of its written and oral submissions[155] that the Tribunal lacked jurisdiction to make any decision in respect of Andes. In its submission dated November 22, 2011, in response to the Tribunal's letter dated October 6, 2011, Ecuador stated:

> *"Finally, the Tribunal has no jurisdiction over Andes and its 40% interest in Block 15, and could only award damages (if any) to Claimants equivalent to (maximum) 60% of the FMV of Block 15. It is worth emphasizing that the Andes agreement provides that Claimants should give 40% of the amount set forth 'in any award' rendered in their favour to Andes. Claimants cannot represent Andes in this arbitration. The Andes agreement cannot be a means to avoid the lack of jurisdiction of this Tribunal over AEC / Andes and its 40% interest in Block 15.*

[154] Dissenting Opinion, § 144.

[155] For instance, Ecuador's Counter-Memorial on *Quantum* and Memorial on Counterclaim Damages dated March 9, 2009, §§ 50 et seq; Ecuador's Brief on the Effects of Claimants' Unauthorized, Illegal Assignment of Rights Arising Out of the Participation Contract dated November 3, 2011, Section 3; Ecuador's Reply to Claimants' Brief in Response to Tribunal's Request of October 6, 2011, dated 22 November 2011, §§ 27-28.

Sunday, April 6, 2014, offices of Dechert LLP in Paris. Preparatory meeting for the hearing on annulment of the OXY case. Process of performing a full review of Ecuador's opening submission for the annulment hearing.

In sum, the best evidence that Claimants are only entitled to a maximum of 60% of the FMV of Block 15 is that they promised to pass along 40% of any recovery to Andes. That proves that they knew that their own share of damages was limited to the value of the non-transferred part of the investment. Claimants knew or should have known that they could not base their claim on Andes' loss because of the lack of jurisdiction of this Tribunal."[156]

There is not a single paragraph in the Award dealing with Ecuador's determinative argument that the Tribunal lacked jurisdiction to make any decision in respect of Andes. The Tribunal simply did not find any response to Ecuador's arguments and, instead, preferred to act as *amiable compositeur* and to follow its idea of justice instead of applying the applicable international law principles.

156 Ecuador's Reply to Claimants' Brief in Response to Tribunal's Request of October 6, 2011 dated 22 November 2011, §§ 27-28.

As Professor Stern stated,

> *"The application of international law to the question of damages should have prevented the majority to assert jurisdiction in order to take drastic decisions in relation with an investment belonging to a Chinese company under the Ecuador / US BIT.*
>
> *I consider that in declaring the rights of Andes to be inexistent, the majority has deprived an entity over which it had no jurisdiction of its rights and therefore that it has not applied the proper law, which is international law, to the assessment of damages."*[157]

3.3.5 The Tribunal Manifestly Exceeded Its Powers By Failing To Apply The Applicable International Law Principles To The Assessment Of Damages

It was common ground between the Parties in the underlying arbitration that international law, and in particular, the *"Chorzów Factory Dictum"* for the assessment of damages, applied to the assessment of damages.

The majority of the Tribunal did not do so in its decision, and, as a consequence, clearly exceeded its powers by failing to apply the willing buyer/willing seller international law standard, the "*Chorzów Factory Dictum*" and other principles of international law, and by failing to apply the rules of international law prohibiting unjust enrichment.

The Parties were in agreement in the underlying arbitration that the fair market value of Block 15 should be calculated in accordance with the willing buyer / willing seller standard.[158] Such standard is now the prevailing international law rule for the determination of compensation for expropriation.[159]

As Ecuador argued in its last submission, dated November 22, 2011, the question that the Tribunal should have clarified was: *what would a Willing Buyer have paid to a Willing Seller for the latter's economic interest in Block 15 on the day before the threat of caducidad?*

According to Ecuador, the answer to this question could vary according to two different scenarios:

157 Dissenting Opinion, §§ 130 and 131.

158 For example, Joseph Kalt's first expert report dated September 17, 2007, section 14 ("*Measurement of fair market value in a context such as at hand here properly entails consideration of market outcomes. Specifically, the fair market value today of a stream of net revenues (i.e., gross revenues minus attendant costs) that can be earned from operation of a multi-year project such as OEPC's development of Block 15 entails assessment of the amount that a willing buyer would reasonably be expected to have to pay a willing seller to induce the seller to give up its rights to those net revenues. Here, Occidental is in the position of a seller in the sense that we seek measurement of the amount Occidental would reasonably have been willing to accept to be voluntarily bought out of the instant contract and associated income-generating opportunities, as opposed to having had that contract and those opportunities involuntarily terminated by Ecuador*").

159 World Bank Guidelines on the Treatment of Foreign Direct Investment, 1992, page 41 ("*In the absence of a determination agreed by, or based on the agreement of, the parties, the fair market value will be acceptable if determined by the State according to reasonable criteria related to the market value of the investment, i.e., in an amount that a willing buyer would normally pay to a willing seller after taking into account the nature of the investment, the circumstances in which it would operate in the future and its specific characteristics, including the period in which it has been in existence, the proportion of tangible assets in the total investment and other relevant factors pertinent to the specific circumstances of each case*").

Scenario 1. The Willing Seller would hide from the Willing Buyer that the transfer of rights was not previously authorized by the Corresponding Ministry. In this case, the Willing Buyer would only accept to buy the Willing Seller's 60% economic interest in Block 15. No Willing Buyer would accept to acquire an economic interest (40%) that a Willing Seller no longer has.

Scenario 2. The Willing Seller discloses to the Willing Buyer that the assignment of rights was not authorized by the relevant ministry beforehand. No Willing Seller could convince a Willing Buyer to pay 100% of the fair market value of that Block by arguing that its transfer of a 40% economic interest in it, to a third party, would automatically or not, be null and void or inexistent. Any Willing Buyer would, under the circumstances, undertake careful due diligence and read Article 79 of the Hydrocarbons Law which stipulates that any unauthorized and illegal assignment of rights is invalid *"without prejudice to the declaration of Caducidad"*. Any Willing Buyer would also read the Participation Contract (especially Clauses 16 and 21) and Articles 74 and 75 of the Hydrocarbons Law. Lastly, any Willing Buyer would therefore understand that, because of the lack of prior authorization, there is a high risk that the entire value of the relevant participation contract could be lost because of a declaration of *Caducidad*.

The majority of the Tribunal, however, did not apply this rule, or even appropriately consider Ecuador's willing buyer/willing seller argument. In fact, the majority of the Tribunal totally missed the point and, at paragraph 658 of the Award, limited itself to holding that:

> *"Before closing its conclusions on this issue, the Tribunal notes that the Respondent has objected that the Claimants did not have the standing to claim damages beyond their 'remaining' 60% interest in Block 15, that the Claimants' interest amounts to 60% of the value of Block 15 and that no willing buyer would pay a price based on 100% of the value for Block 15.*
>
> *In view of the Tribunal's conclusion in relation to the invalidity of the assignment as set out above, this objection of the Respondent has become moot. Also moot is the Respondent's contention that there is a risk of double jeopardy as AEC has no standing to sue Ecuador directly for compensation given that it holds no rights – beneficial or otherwise – in the Participation Contract."*

[160] Civil Code, Official Register Supplement 46, June 24, 2005.

3.3.6 THE MAJORITY MANIFESTLY EXCEEDED ITS POWERS BY CHERRY PICKING ARTICLE 79 OF THE HYDROCARBONS LAW AND DISREGARDING ALL THE OTHER PROVISIONS OF THIS LAW.

The first paragraph of Article 18(4) of the Ecuadorian Civil Code states : "*the context of the law will be used to illustrate each one of its parts so that there be consistency and harmony between them.*"[160]

Article 1580 of the Ecuadorian Civil Code provides that *"[...] Each clause of a contract shall be interpreted in conjunction with each other, giving each one the meaning that best suits the contract as a whole [...]"*[161] (systematic or contextual interpretation).

Article 79 of the Hydrocarbons Law expressly refers to the other provisions of the Hydrocarbons Law that authorize and provide for *caducidad*: *"without prejudice to the declaration of caducidad as provided for in this Law"*, that is, Articles 74, 75 and 76 of the Hydrocarbons Law.

The provisions referred to in Article 79 of the HCL address the grounds for (Article 74), the effects of (Article 75) and the procedure for (Article 76) *caducidad*. In addition, Articles 74, 75 and 76 of the HCL were also incorporated into the Participation Contract.

Clause 21.1.1 of the Participation Contract provides:

> "*21.1. Termination: This Participation Contract shall terminate:*
>
> *21.1.1. By a declaration of caducidad issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable.*"

Article 75 of the Hydrocarbons Law (incorporated into Articles 21.1.1 of the Participation Contract) provides:

> *"The declaration of caducidad of a contract implies the immediate return to the State of the contracted areas, and the delivery of all equipment, machinery and other exploration or production items, industrial or transportation installations, at no cost to PETROECUADOR and, also in addition, the automatic loss of bonds and securities provided under the Law and the contract, which shall remain to the benefit of the State."*[162]

As a consequence, when construing the Participation Contract and the first paragraph of Article 79 within the system of the HCL, the majority should also

[161] Civil Code, Official Register Supplement 46, June 24, 2005 (book IV).
[162] Hydrocarbons Law, Article 75.

have taken into account that the effect of the declaration of *Caducidad* is that no compensation is due to the Contractor.

The Tribunal's conclusion was absurd. By applying Article 75 of the Hydrocarbons Law (incorporated into Clause 21.1.1 of the Participation Contract), it should have come to the conclusion that no compensation was due to OXY.

It is improper to cherry pick one provision of Ecuadorian law disregarding all the other relevant applicable legal provisions.

All of these arguments were rightly framed by Ecuador in the underlying arbitration. The majority could not simply ignore them.[163]

3.3.7 THE TRIBUNAL FAILED TO STATE THE REASONS ON WHICH IT BASED ITS DECISION TO DECLARE THE FARM-OUT AGREEMENT INEXISTENT UNDER ECUADORIAN LAW AND NEW YORK LAW

Whereas the Tribunal determined that Claimants did transfer their rights under the Participation Contract to AEC, the majority held that OXY was nonetheless entitled to 100% of the FMV of Block 15 arguing that the transfer of rights never existed, despite the fact that no judge had ever declared that assignment null and void.

Monday, April 7, 2014, Conference Room in Paris assigned to Ecuador, First Day of the Hearing. Diego García Carrión (Attorney General's Office) and Eduardo Silva Romero (Dechert LLP) comment on the development of the first day of the Hearing on Annulment.

163 Ecuador's Brief on the Effects of Claimants' Unauthorized, Illegal Assignment of Rights Arising Out of the Participation Contract dated November 3, 2011, § 62; Ecuador's Reply to Claimants' Brief in Response to Tribunal's Request of October 6, 2011, dated 22 November 2011, Section 4.3; Transcript of the hearing on questions raised by the Tribunal dated April 12, 2012, pp. 9 et seq; Ecuador's Presentation, Hearing of April 12, 2012, pp. 5-6.

The majority's determination rests on a combination of frivolous, scarce and contradictory reasons. As Professor Stern pointed out, *"the first [questionable aspect in the majority's approach to the question of the effectiveness of the Farm-out Agreement] is the analysis of the question of the effectiveness of a legal act under Ecuadorian law, which is based on a total lack of reasons, with the consequence that I was not able to follow the 'reasoning' from point A to point B."*[164]

The contradiction of the majority becomes even more serious when, on the one hand, it declared the assignment inexistent, and on the other, it maintained that OXY is "*obliged to compensate Andes to the level of 40% of any compensation it receives from action taken against Ecuador.*"[165]

These contradictions warrant the annulment of the Award.

By way of illustration, in the *Amco I* case, the *ad hoc* committee held the award to be contradictory for having accounted for a loan incurred by Amco in the calculation of the value of Amco's investment, in spite of having previously ruled that loans were not to be taken into account under the applicable law.[166]

Similarly, the *ad hoc* committee in the *Victor Pey Casado* case annulled the tribunal's determination of damages for a failure to state the reasons on which it based its decision for using the expropriation value of claimant's asset despite its earlier conclusion, in the award, that the related expropriatory acts were outside its jurisdiction.[167]

The majority attempted to avoid this contradiction by stating that the inexistence of the assignment would be, pursuant to Article 79 of the Hydrocarbons Law, "*without prejudice to the declaration of caducidad*."[168]

Ecuador, like any reasonable person, was at a loss to understand this argument. Article 79 specifies that a declaration of nullity cannot retroactively affect a declaration of *Caducidad*. Article 79 of the HCL does not (nor could it) reconcile the fact that the majority held that an assignment occurred and

164 Dissenting Opinion, § 5.

165 Award, § 654.

166 Award, § 652.

167 Victor Pey Casad Annulment Decision, § 285 ("*The Tribunal's use of the expropriation-based damage calculation is manifestly inconsistent with its decision a few paragraphs earlier that such an expropriation-based damage calculation is irrelevant and that all evidence and submissions relevant to such a calculation could not be considered*"); Continental Casualty Annulment Decision, §§ 102-103 ("*The Committee adds that for genuinely contradictory reasons to cancel each other out, they must be such as to be incapable of standing together on any reasonable reading of the decision. […] An example might be where the basis for a tribunal's decision on one question is the existence of fact A, when the basis for its decision on another question is the non-existence of fact A*"); MINE Annulment Decision, §§ 6.105, 6.107("*[…]to the extent that the Tribunal purported to state the reasons for its decision, they were inconsistent and in contradiction with its analysis of damages theories 'Y' and 'Z'. […] Having concluded that [the analysis of damages] theories 'Y' and 'Z' were unusable because of their speculative character, the Tribunal could not, without contradicting itself, adopt a 'damages theory' which disregarded the real situation and relied on hypotheses which the Tribunal itself had rejected as a basis for the calculation of damages. As the Committee stated […], the requirement that the Award must state the reasons on which it is based is in particular not satisfied by contradictory reasons*").

168 Award, § 652.

subsequently that such assignment never occurred. No doubt a contradictory finding which cannot be saved by an unintelligible excuse.

In addition, the majority's finding that (i) the assignment was inexistent, and that (ii), accordingly, *"Respondent is obliged to compensate Claimants for 100% of their interest in Block 15"*[169] is also in contradiction with its finding that OXY was not unjustly enriched.

In particular, the majority held that:

> *"In relation to unjust enrichment, there was produced to the Tribunal the letter agreement of February 22, 2006 between OEPC and Andes whereby OEPC is obliged to compensate Andes to the level of 40% of any compensation it receives from action taken against Ecuador regarding the termination of the Participation Contract. Even without this letter agreement, the Tribunal notes that the invalidity of the assignment under New York and Ecuadorian law does not mean that AEC (or Andes) may not have recourse against OEPC under the Farm-out Agreement. As mentioned earlier, the unauthorized assignment does not invalidate the Farm-out Agreement as between the assignor, OEPC and the assignee, AEC nor is the legal position affected by the fact that the assignor and the assignee actually implemented inter se parts of the legally invalid and unauthorized assignment. OEPC promised to deliver certain rights to AEC under the Farm-out Agreement, but due to its failure to secure authorisation from the Ministry it was in breach of that promise. This breach of contract may form the basis of a claim by AEC (or Andes) against OEPC. These factors weigh heavily against any unjust enrichment arguments raised in respect to OEPC's entitlement to receive compensation for 100% of the interests in the Participation Contract"*[170].

Ecuador, however, had raised several decisive arguments in the underlying arbitration against this finding:

i. Once *Caducidad* is indeed declared, the Participation Contract disappears and all reciprocal obligations under the Farm-out Agreements come to an end.

ii. The Farm-out Agreement does not contain any indemnification clause, which is logical since the parties to it were aware of the risk that *Caducidad* could be pronounced because of their joint concealment of the transfer of rights. Both suffered from *Caducidad*; OXY for its 60 % and AEC for its 40 %.

iii. Ecuador drew the Tribunal's attention to the fact that the 2006 Letter Agreement explicitly provides that Claimants have no obligation to compensate Andes in case of *Caducidad*:

> *"Neither the Company nor Occidental shall make any claim against the other for liability or fault in connection with the Caducity Proceedings or the fact that the Transfer has occurred and the Company and Occidental hereby specifically release each other from any and all such claims and liability."*[171]

Ecuador pointed out the absurdity of OXY's argument that the "*parties' sole purpose with [Point 2(g) of the 2006 Letter Agreement] was to clarify how OXY was to discharge its existing liability relating to the 40% economic interest if Caducidad were to prevent OXY from supplying oil to AEC*"[172]. The 2006 Letter Agreement did not create an obligation to compensate Andes for 40% of its economic interest. This letter establishes OXY's commitment to Andes for 40% of any monetary Award received. Such promise cannot increase the amount that OXY would be entitled to claim from Ecuador. As noted by Ecuador during the arbitration: "*What if Claimants had undertaken to pay 80 % of the amount of any award? Could they claim 140% (60% + 80 %) of the value of the Participation Contract interests?*"[173]

Even regardless of whether Ecuador's argument should have prevailed, it is impossible, in the absence of any indication from the majority, to understand how the Farm-out Agreement could be a source of liability towards AEC/Andes. The majority had to take a position on these issues and to explain why Ecuador's position was not sustained. The majority could not simply ignore Ecuador's argument.

Worse, even admitting (*quod non*) that the Farm-out Agreement was the source of a liability towards Andes, this liability should have been deemed inexistent under the majority's own scenario.

As explained above, the assignment of rights was the core of the Farm-out Agreement. The majority maintained:

> *"As explained in more detail below, based on its review of the entirety of the record, the Tribunal considers that there is ample evidence to conclude that the purpose of the Farm-out Agreement and the Joint Operating Agreement was to transfer from OEPC as Contractor to AEC certain of the Contractor's exclusive rights to carry out the oil exploitation activities under the Participation Contract, as set forth under Clause 4.2 of the Participation Contract, along with related rights and obligations."*[174]

169 Award, § 652.
170 Award, § 654.

171 2006 Letter Agreement, point 2 (a).
172 Oxy's Post-Hearing Brief on Damages and Counterclaim Damages dated September 17, 2007, § 256.
173 Ecuador's Post-Hearing Brief on *Quantum* and Counterclaim Damages dated December 18, 2009, § 161.
174 Award, § 301.

The Farm-out Agreement contains the following severability clause:

> *"If any term or provision of this Agreement is invalid, illegal or incapable of being enforced [...] all other terms and provisions of this Agreement shall nevertheless remain in full force and effect so long as the economic and legal substance of the transactions contemplated hereby are not affected in a manner that is materially adverse to either party."*[175]

Accordingly, since the purpose of the Farm-out Agreement was to transfer rights in the Participation Contract, the assignment of rights could not be severed from the Farm-out Agreement. The inexistence of the assignment necessarily entails the inexistence of the Farm-out Agreements under the majority's case.

As Professor Stern pointed out, *"I am really at a loss to understand the reasoning: - it is not contested that the sole purpose of the Farm-out Agreement was to transfer rights; - this transfer of rights is inexistent/invalid; but the Farm-out Agreement is existent/valid.*"[176]

If there is no Farm-out Agreement, OXY cannot be liable towards Andes. To that end, Professor Stern observed that the majority "*stated that the initial situation of a transfer of rights has automatically ceased to exist by application of Article 79 of the HCL, but has at the same time stated that a liability of the Claimants towards Andes remains. [...] these two aspects of the majority position are, in my view, contradictory.*"[177]

Beyond the evident lack of adequacy and persuasiveness of the majority's reasoning, no one can follow how the majority proceeded from Point A (Article 79 of the HCL) to Point B (the assignment of rights is inexistent).[178]

Professor Stern is particularly critical about this:

> ***"I will show that [Article 79 does not prescribe the inexistence of an unauthorized assignment], trying to follow step by step the different statements made by the majority, which I will treat separately as I was not able to follow the path from one statement to the other and could not understand the logic behind them."***[179]

175 Farm-out Agreement, Article 8.0.
176 Dissenting Opinion, § 127.
177 Dissenting Opinion, § 23.
178 MINE Annulment decision, §§ 5.8 to 5.9 ("*the requirement to state reasons is satisfied as long as the award enables one to follow how the tribunal proceeded from Point A. to Point B. and eventually to its conclusion*"). Ibidem, § 5.09 ("*This minimum requirement [to state reasons] is in particular not satisfied by either contradictory or frivolous reasons*".) AMCO II Annulment decision, § 1.18 ("*inconsistent reasons or frivolous reasons would be tantamount to absence of reasons"),* Ch. Schreuer, L. Malintoppi, A. Reinisch, A. Sinclair, *The ICSID Convention, A commentary,* Cambridge University Press, 2nd edition, article 52, § 344: ("*No doubt frivolous, perfunctory or absurd arguments by a tribunal would not amount to reasons*").
179 Dissenting Opinion, § 65.

Likewise, the majority analysed Article 79 of the Hydrocarbons Law and concluded that it provides for the inexistence of the assignment.[180] On this very point, Professor Stern notes that "***the majority seems to have made up its mind before any serious analysis of the Ecuadorian texts and decisions involved."***[181] In fact, Article 79 of the Hydrocarbons Law cannot be more convincing: it expressly provides for the nullity of unauthorized assignments *("serán nulas").*

The majority's heavy reliance on its purported reading of four Ecuadorian decisions does not provide the reader of the Award with more guidance as to how the majority reached its decision that the assignment was inexistent.

What further reason is needed to annul an Award?

3.3.8 THE TRIBUNAL DID NOT GIVE REASONS FOR THE DECISION WHICH LED IT NOT TO APPLY LAW 42 WHEN DETERMINING OXY'S DAMAGES.

Having characterized Ecuador's plea that the Law 42 levy should be applied to reduce the amount of OXY's damages, the majority of the Tribunal, after purporting to provide – in a summary fashion – some reasoning for its decision,[182] decided that:

> *"[...] as advocated by the Claimants, the Tribunal will not take into account Law 42 for the purpose of its valuation of the quantum of Claimants' damages."*[183]

The economic impact of the decision transcribed above must be underlined *in limine.* Ecuador's latest calculation in the underlying arbitration of the impact of the Law 42 levy on the amount of Claimants' damages amounted to USD 816 million. This figure, however, was premised on an estimated value for Block 15 of USD 1.5 billion. As a result, the impact of Law 42 on the Award's final quantification (which valued Block 15 at USD 2.3 billion), is significantly higher than USD 816 million.

In essence, in reaching its decision not to take into account Law 42 for the assessment of Oxy's damages, the majority of the Tribunal, (i) refused to characterize Law 42 under Ecuadorian law and thereby failed to apply this legal order in a manifest excess of powers; (ii) exercised jurisdiction that it did not have under the Treaty (it did "*too much*"[184]); and (iii) contradicted itself when finding, at the same time (a) that Law 42 modified the Participation Contract and (b) that Law 42 referred to revenues whereas the Participation Contract referred to volumes of oil.

180 Award, § 619.
181 Dissenting Opinion, § 64.
182 Award, §§ 484-547.
183 Award, § 536.
184 Soufraki Annulment Decision, § 42.

A procedural irregularity that took place in the underlying arbitration must be pointed out. Indeed, while OXY initially raised the issue of Law 42 as a claim in its Request for Arbitration, it subsequently indicated in its Memorial on Liability that it did not intend to make a separate claim on Law 42. OXY, however, sought to disregard the effects of Law 42 (and the VAT Interpretative Law) by belatedly claiming its illegality as part of its *quantum* case.

This volte-face prompted Ecuador to request that the Tribunal declare inadmissible OXY's last-minute Law 42 claims. After OXY advanced an entirely new case on Law 42 at the damages hearing in November 2009, the Tribunal – instead of rejecting such new submissions – gave OXY a further opportunity to advance its case by requesting that the Parties submit simultaneous briefs addressing their respective arguments on Law 42, which the Parties ultimately did.

There are at least five reasons why the majority manifestly exceeded its powers when it decided not to take the Law 42 levy into account when assessing Oxy's damages.

First, Tribunal manifestly exceeded its powers by refusing to consider whether, under international law, Law 42 was "*a matter of taxation*" (and, as such, excluded from the Tribunal's jurisdiction pursuant to article X.2 of the Treaty). Instead, the Tribunal decided to apply Ecuadorian law by concluding that Law 42 was not "*a matter of taxation*" and hence was not excluded from its jurisdiction.

The majority's refusal to consider international law was not innocent. It was a calculated attempt to bypass the Treaty's exclusion of "taxation *measures*" from the Tribunal's jurisdiction. Pursuant to Article X.2 of the Treaty, the "*provisions of this Treaty, and in particular Article VI [investor-State dispute settlement] and VII [settlement of disputes between Contracting States], shall apply to matters of taxation only with respect to the following: (a) expropriation, pursuant to Article III; (b) transfers, pursuant to Article IV; or (c) the observance and enforcement of terms of an investment agreement or authorization […].*"[185] It is undisputable that the interpretation of the Treaty is a matter of international law (and not of domestic law). However, instead of relying on international law, the Tribunal purported to base itself on Ecuadorian law, pointing to "*the plain text of Law 42*" and "*the plain text of Clause 11.9 of the Participation Contract.*"[186]

If the Tribunal had turned to the applicable

185 Treaty between the United States of America and the Republic of Ecuador on the Promotion and Reciprocal Protection of Investments dated 27 August 1993, Article X.

186 Award, §§ 492-495.

international law, it would have inescapably concluded that Law 42 was excluded from its jurisdiction. In interpreting the ordinary meaning of *"taxation measures"* in the same Treaty, the *Duke Energy v. Ecuador* tribunal cited with approval, the holding in the *EnCana v. Ecuador* that "*a tax law is one which imposes a liability on classes of persons to pay money to the State for public purposes.*"[187] It was undisputed in the underlying arbitration that Law 42 "[...] *imposed a liability on classes of persons to pay money to the State for public purposes*." In addition, the majority of the Tribunal described Law 42 in the Award using terms very close to those employed in the *EnCana* Decision.[188]

Moreover, as professor Stern noted in her Dissent, in the case of *Burlington*, "*the tribunal dealing with the same BIT and the same Law 42 [as the Tribunal in this case], declared: 'The Tribunal concludes that Law 42 is a tax [...]'.*"[189] The *Burlington* tribunal fulfilled its mission and, after examining the parties' positions, decided to characterize Law 42 as a measure of taxation under international law for jurisdictional purposes.

In sum, by holding that Law 42 was "*in breach Respondent's Article II.3(a) of the Treaty to accord fair and equitable treatment to the Claimants' investment,*"[190] in the face of Article X.2's exclusion of Article II from the Tribunal's jurisdiction in relation to "*matters of taxation,*" the majority went beyond its limited jurisdiction under the Treaty and thereby manifestly exceeded its powers.

Second, the majority expressly refused to apply international law when it disregarded the international law principle according to which "*States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a nondiscriminatory manner bona fide regulations that are aimed at the general welfare,*"[191] merely on the basis of a re-written Participation Contract.

Indeed, the Tribunal itself recognized that the said principle is a "*well-known principle of international law summarized clearly by the Saluka tribunal.*"[192] However, the majority considered that it was inapplicable in the present circumstances, merely noting, in a footnote, that the Participation Contract *"fetters the State's the exercise of its regulatory*

187 *Duke Energy Electroquil Partners and Electroquil S.A. versus The Republic of Ecuador* (ICSID case No. ARB/04/19), Award, 18 August, 2008, § 174, citing *EnCana Corporation versus The Republic of Ecuador* (LCIA Case No. UN3481), Award, 3 February, 2006, § 142. See Dissenting Opinion, note 3, p. 4.

188 Award, § 510 (Law 42 is "a unilateral decision of the Ecuadorian Congress to allocate to the Ecuadorian State a defined percentage of the *revenues earned by contractor companies such as OEPC that hold participation contract*").

189 Dissenting Opinion, note 3, p. 4, citing Burlington Resources Inc. et al. versus The Republic of Ecuador (ICSID case No. ARB/08/5), Decision on Jurisdiction, June 2, 2010, § 167.

190 Award, § 527.

191 Award, footnote 65, p. 207.

192 Award, footnote 65, p. 207.

powers."[193] Such refusal to apply international law constitutes a manifest excess of powers on the part of the majority.

Third, the majority also manifestly exceeded its powers by failing to apply the international law principle according to which, absent an express and specific stabilization undertaking by the State, the fair and equitable treatment standard does not include a legitimate expectation that the State will not amend its laws and regulations.

Consistent with the principle that an investor's expectations are protected as "*long as these expectations are reasonable and legitimate and have been relied upon by the investor to make the investment*,"[194] international tribunals have held:

> *"The idea that legitimate expectations, and therefore FET, imply the stability of the legal and business framework, may not be correct if stated in an overly-broad and unqualified formulation. The FET might then mean the virtual freezing of the legal regulation of economic activities, in contrast with the State's normal regulatory power and the evolutionary character of economic life. Except where specific promises or representations are made by the State to the investor, the latter may not rely on a bilateral investment treaty as a kind of insurance policy against the risk of any changes in the host State's legal and economic framework. Such expectation would be neither legitimate nor reasonable.Further, in the Tribunal's view, the FET obligation cannot serve the same purpose as stabilization clauses specifically granted to foreign investors.*[195]

Similarly, in her dissent, Professor Stern cited the *EnCana v. Ecuador* tribunal's holding that:

> "*In the absence of a specific commitment from the host State, the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment. Of its nature all taxation reduces the economic benefits an enterprise would otherwise derive from the investment; it will only be in an extreme case that a tax which is general in its incidence could be judged as equivalent in its effect to an expropriation of the enterprise which is taxed.*"[196]

[193] Award, footnote 65, p. 207.

[194] *Biwater Gauff (Tanzania) Ltd. versus Tanzania* (ICSID case No. ARB/05/22), Award, July 24, 2008, § 602. See also, *Jan de Nul N.V. and Dredging International NV versus The Arab Republic of Egypt* (ICSID case No. ARB/04/13), Award, November 6, 2008, § 186 (*"Tribunals have considered that fair and equitable treatment was denied when the protection of the investor's expectations had not been warranted, provided that these were reasonable and legitimate"*).

[195] *EDF (Services) Limited versus Romania* (ICSID case No. ARB/05/13), Award , October 8, 2009, § 217. See also *Ulysseas, Inc. versus The Republic of Ecuador* (UNCITRAL), Award, June 12, 2012, § 249, *El Paso Energy International Company versus The Republic of Argentina* (ICSID case No. ARB/03/15), Award, October 31, 2011, § § 350-364. *Parkerings-Compagniet AS versus The Republic of Lithuania* (ICSID case No. ARB/05/8), Award, September 11, 2007, § 332 and *Sergei Paushok, CJSC Golden East Company and CJSC Vostokneftegaz Company versus Government of Mongolia* (UNCITRAL), Decision on Jurisdiction and Liability, April 28, 2011, § 302.

In the Award, the majority did not find any stabilization undertaking by Ecuador, whether in the Participation Contract, in Ecuadorian law or in any other unilateral act by Ecuador. Yet, the majority held that "*Law 42 [...] flouts the Claimant' legitimate expectations*,"[197] thereby not applying international law.

Fourth, the majority also manifestly exceeded its powers when it effectively disregarded the plain text of Law 42 (in particular its Article 2), distinguishing between "*participation in volumes*" of crude oil (guaranteed by Clause 8.1 of the Participation Contract and unaffected by Law 42)[198] and "*participation in revenues*" obtained by contractors, to conclude that Ecuador had breached the Participation Contract.

The majority could not escape from the plain text of Law 42 or the Participation Contract; both of which make the above distinction very clearly:

1. Law 42 itself indicates that it requires contractors to contribute "*at least 50% of the extraordinary revenues*" generated by high oil prices "*without prejudice to the volume of participation crude oil that corresponds to them*" under participation contracts.[199]

2. Clause 3.3.27 of the Participation Contract defines the "*Contractor Participation*" as "*the percentage of Fiscalized Production of Crude Oil which, according to clause 8.1 of this Participation Contract, corresponds to the Contractor*"[200]. *Even the majority accepted in the Award that Clauses 8.1 and 8.5 of the Participation Contract are very clear [...] OEPC would receive a participation in production of*

[196] *EnCana Corporation versus The Republic of Ecuador* (LCIA case No. UN3481), Award, February 3, 2006, § 173, cited in Dissenting Opinion, footnote 3, p. 4.

[197] Award, § 527.

[198] Clause 8.1 provides the formula for calculating the Contractor's Participation, Participation Contract (*"Calculation of the Contractor's Participation– The Contractor's Participation shall be calculated using the following formula:*

PC X.Q / 100

Where:

PC = Contractor Participation

Q = Fiscalized Production

Average factor, in percentage, rounded to the third decimal place, corresponding to the Contractor Participation, calculated according to the following formula:

x = (X1.q1 + X2.q2 + X3.q3)/q = Y

Where:

q = is the average daily Fiscalized Production for the corresponding Fiscal Year.

q1 = is the portion of q lower than L1

q2 = is the portion of q between L1 and L2.

q3 = is the portion of q greater L2").

[199] Law 42, Law Reforming the Hydrocarbons Law dated April 20, 2006, published in Official Gazette of 25 April, 2006, Article 2.

[200] Participation Contract, Clause 3.3.27.

crude oil"[201] and went as far as to affirm that Law 42 "*made the Respondent's participation in the revenues from oil directly dependent on crude oil prices, in stark contradiction with Clauses 8.1 and 8.5 of the Participation Contract, which sets the participation of the parties in the oil produced without any reference to the price of oil.*"[202]

As pointed out by Professor Stern:

> *"But, for the majority, Law 42, is not a tax or levy. This seems however in contradiction with the qualification given by the majority to the Law 42 as 'a unilateral decision of the Ecuadorian Congress to allocate to the Ecuadorian State a defined percentage of the revenues earned by contractor companies' (§510 of the Award), which in my modest understanding, describes exactly what a tax or levy does. Moreover, in order to reach the conclusion that Law 42 violated the Participation Contract,* ***the majority based such finding on a confusion between participation in volumes and participation in revenues*** *and concluded therefore that Law 42 was in violation of Clause 8.1 providing for the participation of the contractor in the volume of oil extracted, as well as in violation of Clause 5.3.2, which grants to the contractor a right of free disposal of the volumes of oil attributed under Clause 8.1.*
>
> *I would have reasoned completely differently on both counts. Firstly, I cannot admit that Law 42 is a violation of Clauses 8.1 and 5.3.2, as Law 42 is dealing with a different issue than the ones regulated by the Participation Contract. It is not because the word 'participation' is used in both expressions that participation in volumes means the same as participation in revenues!* ***Lawyers ought to be rigorous and not to use one term for the other and one concept for another.*** *Law 42 itself in its Article 2, makes the distinction: '[…] Contractor companies […] without prejudice to the volume of crude oil subject to participation that correspond to them […] will recognize in favor of the Ecuadorian State a participation of at least 50% of the extraordinary income generated by the difference in price.' "*[203]

By disregarding the plain text of the applicable law and contract, the majority also manifestly failed in its mandate and exceeded its powers.

Finally, the majority failed to apply the international law standard for determining the FMV of Block 15 (the willing buyer / willing seller standard) and thereby manifestly exceeded its powers when it refused to apply Law 42 on the basis that :

> *"The Tribunal concludes that this argument suffers from a fundamental flaw.*
>
> *It is obvious that a hypothetical third party would not pay more than would be justified by the prospective returns on an investment, and that Law 42 would have to figure in an assessment of these returns (either because of the risk of its continued application or because Ecuador would insist on this as a pre-condition to authorization). But asking what a hypothetical investor would pay under Law 42 which the Tribunal has found to be in breach of the Participation Contract is irrelevant to assessing what OEPC, whose contract protected it against things like Law 42, has actually lost. To reiterate, the test is not 'what would a hypothetical buyer pay in the circumstances as they are now'; the test is 'what have the Claimants lost.' The fair market value is a guide to answering this question, but what must be calculated is the discounted cash flow value of the Participation Contract (i.e. Block 15) excluding breaches of it (i.e. Law 42) by the Respondent."*[204]

3.3.9 The Tribunal Failed To State The Reasons On Which It Based Its Decision Not To Take Into Account The VAT Interpretative Law When Assessing OXY's Damage

At a late stage of the arbitral proceedings, OXY contended that, as an alternative argument, the VAT Interpretative Law triggered Clause 8.6(e) of the Participation Contract and should therefore not be taken into account when determining due compensation. The majority of the Tribunal upheld OXY's argument but, strikingly, failed to state *any reason whatsoever* for doing so, disposing of Ecuador's arguments to the contrary in one summary sentence.

OXY alleged that, if Ecuador did not refund VAT, a willing hypothetical buyer would be entitled to an adjustment of its participation percentages in application of Clause 8.6(e) of the Participation Contract which holds that**:**

> *"8.6 Economic Stability: In the event that, due to actions taken by the State of Ecuador or PETROECUADOR, any of the events described below occur and have an impact on the economy of this Participation Contract:*
>
> *[...] section (e). Collection of the Value Added Tax, VAT, as set forth in Official Letter No. 01044 of October 5, 1998, which appears as*

[201] Award, § 512.
[202] Award, § 520; Article 79 of the Hydrocarbons Law.
[203] Dissenting Opinion, §§ 10 and 11 (emphasis added).
[204] Award, § 539.

annex number XVI, pursuant to which the Directorate of Internal Revenue Service states that the imports made by the contractor for the operations of block 15 under the structure of the participation contract, are subject to said tax.

In the cases indicated in letters [...] e) occur, a correction factor shall be included in the participation percentages, to absorb the increase or decrease of the economic burden, in accordance with Annex No. XIV."

OXY's interest in trying to exclude the VAT Interpretative Law from the quantification was obvious, as taking it into account would reduce the size of the projected revenue stream from Block 15 and the value of OXY's interest therein, even further.

Indeed, as Ecuador argued, the application of the VAT Interpretative Law would lead to a reduction in the FMV of Block 15 amounting to between USD 25 and USD 33 million, depending on the assumptions of the valuation model. It is therefore needless to say that the VAT Interpretative Law was no minor issue.

In paragraphs 568 and 569 of its Decision, the majority maintained that:

"The Tribunal recalls that the VAT Award held that OEPC has 'a right to reimbursement (of the VAT) under the law' and that 'this reimbursement was not included in OEPC's contract'. The right of the Claimants to be reimbursed the Value Added Tax has now been legislated out of existence. There is no doubt, in the view of the Tribunal, that the VAT Interpretative Law has thereby increased the economic burden of the Claimants and thus impacted the economy of the Participation Contract.

Consequently, any hypothetical willing buyer of OEPC's rights under the Participation Contract, relying on the findings and conclusions of the VAT Tribunal, would be entitled to apply for a correction factor in the participation percentages to absorb the increase in its economic burden in accordance with Clause 8.6 and Annex No. XIV of the Participation Contract."[205]

The majority sided with OXY and excluded the application of the VAT Interpretative Law from the calculation of damages.

Pursuant to Article 52 (1) € of the ICSID Convention, Tribunals are required to state the reasons for their conclusions. Yet, the reasoning of the majority of the Tribunal fits into one summary sentence: "*There is no doubt, in the view of the Tribunal, that the VAT Interpretative Law has thereby increased the economic burden of the Claimants and thus impacted the economy of the Participation Contract*."

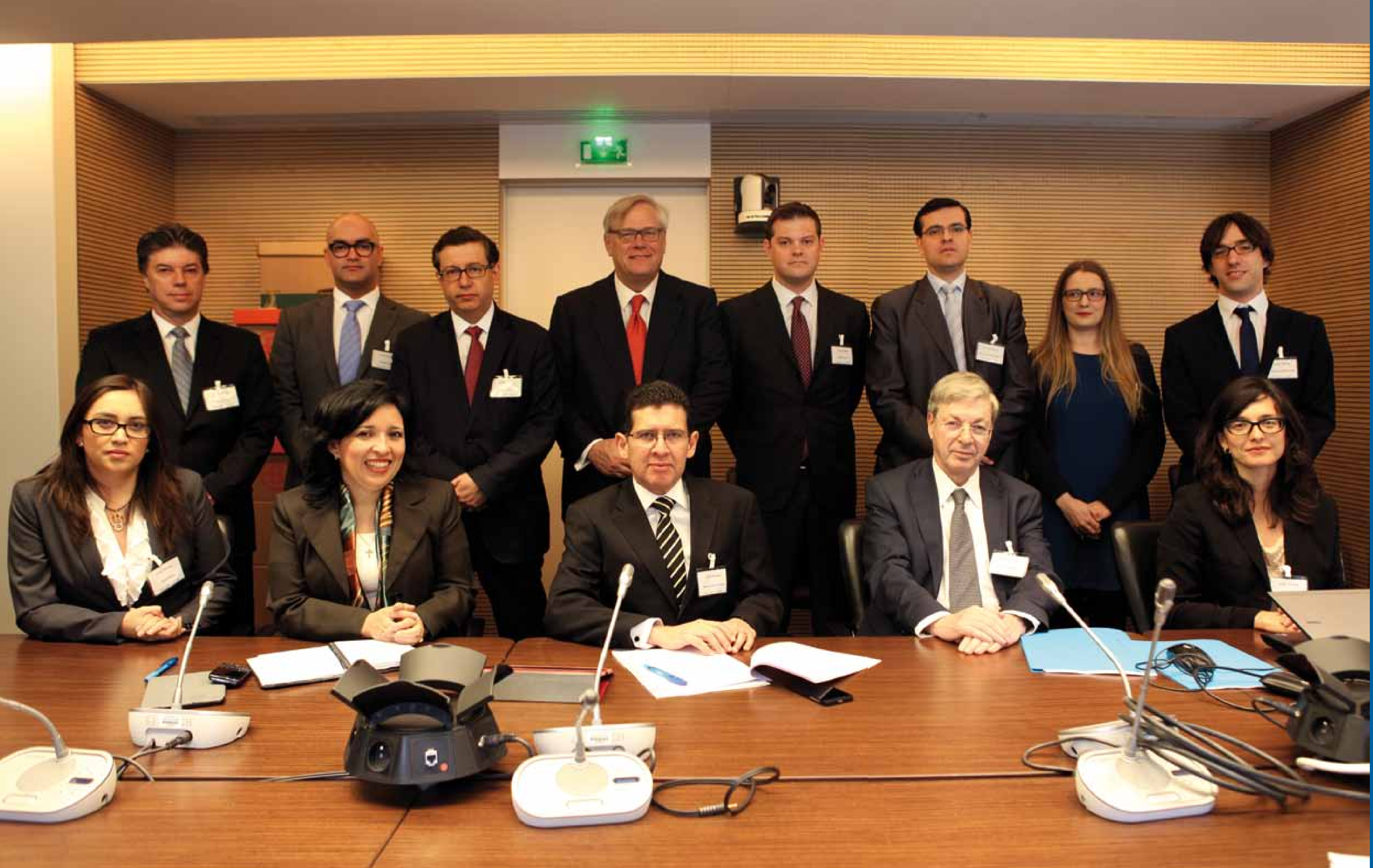
In paragraphs 14 and 15 of her Dissenting Opinion, Professor Stern analyzed this subject and highlighted the fallacies of the majority's opinion:

*"**14**. Analyzing the consequences of the VAT Interpretative Law on the Participation Contract, the Award again establishes a confusion between two different things an increase of the VAT and an impact on the economy of the contract – when stating (§ 568 of the Award) that '(t)here is no doubt, in the view of the Tribunal, that the VAT Interpretative Law has thereby increased the economic burden of the Claimants and thus impacted the economy of the Participation Contract.' (Emphasis added). I consider that it follows from a reading of Clauses 8.66 that, **contrary to what is implied by the majority's position, not every collection of VAT has ipso facto an impact on the economy of the contract. Such impact had to be analyzed, which the majority did not do**. Without entering in a lengthy discussion, it appears to me that the fact that the law did not refund VAT and that this was not compensated by a modification in the percentages of participation in the volumes does not appear to be a violation of the Participation Contract.*

***15.** As a result of the foregoing, I consider that the VAT Interpretative Law should have been taken into account in the calculation of damages. I therefore consider that the VAT Interpretative Law should have been applied in order to calculate the damages*."

Professor Stern is right and her opinion is in line with the wealth of jurisprudence from ICSID *ad hoc* committees on Article 52(1)(e) of the Convention. It is indeed simply impossible to follow the Tribunal's reasoning from Point A (the VAT Interpretative Law increased the economic burden of OXY) to Point B (thus, the VAT Interpretative Law impacted the economy of the Participation Contract).

[205] Award, § 539.



Paris, Monday, April 7, 2014. Defense team of the Republic of Ecuador which attended the Hearing on Annulment in the OXY case. Photograph taken in the Break-out Room at the headquarters of the World Bank in Paris. Standing from left to right: Dr. Juan Espinosa (Attorney General's Office), Stephan Adell (Squire Sanders), Eduardo Silva Romero (Dechert LLP), George von Mehren (Squire Sanders), Stephen Anway (Squire Sanders), José Manuel García Represa (Dechert LLP), Audrey Caminades (Dechert LLP), Antonio Marzal (Dechert LLP) Sitting: Ab. Diana Moya (Attorney General's Office), Dr. Blanca Gómez de la Torre (Attorney General's Office), Dr. Diego García Carrión (Attorney General's Office), Pierre Mayer (Dechert LLP), Ana Carolina Silva (Dechert LLP).

Legal Essays

As a corollary to the previous pages where the legal defense of the State in this emblematic case has been fully demonstrated, the following pages features essays concerning the doctrine and case law aspects which supports the main theories used to put forward said defense.

These essays have been written by prestigious lawyers who have been part of the State's defense in the OXY case, and academics and experts in international law and investment disputes.

Based on the foregoing, as appendices, we provide the reader with five essays on the different issues and facets of the case in question.

Below are the titles of the articles and their respective authors.

*- **The Award in the Occidental Case: a General Overview**, by Paul S. Reichler*

*- **Cooling-off Periods in Investment Arbitration**, by George von Mehren and Stephan Adell*

*- **The Tribunal's Finding of "Negligence",** by Stephen P. Anway and Raúl B. Mañón*

*- **The So-Called "Principle of Proportionality" as a Contractual Moderation Mechanism**, by Eduardo Silva Romero*

*- **The "60/40 Issue" in the OXY Case**, by Pierre Mayer and Audrey Caminades*

The award in the occidental case: a general overview

Paul S. Reichler[1]

The Award rendered in the arbitration proceedings initiated by Occidental Petroleum Corporation and Occidental Exploration and Production Company against Ecuador (ICSID case ARB/06/11) provides surprise after surprise for the reader. There are reasons for that. It is a decision by which the Tribunal agrees to grant to the claimant the highest compensation in the history of international arbitration, despite recognizing that Occidental violated the contract and the law of the defendant State.

Nobody should be surprised that such a decision would lead to criticism, due to the amount of compensation and the paradoxical nature of the reasoning. However, one would hardly expect to find the first criticisms in the decision itself, expressed in the extremely harsh and forceful terms used by Professor Stern when dissenting from the opinion of Messrs Fortier and Williams, the other two members of the Tribunal. This is another particularly noteworthy characteristic of the decision.

Fundamentally, as a starting point, the Award recognizes that Occidental violated the Hydrocarbons Law by transferring rights to a third party, the Canadian company Alberta Energy Corporation Ltd., AEC (subsequently sold to the Chinese company Andes Petroleum) without having received prior authorization from the competent Ecuadorian authority[2]. It also admits that this fact led to the declaration of *caducidad* of the contract, a measure considered, under Ecuadorian law, as a sanction for the unauthorized transfer of rights[3]. The Tribunal considered, however, that since the offence was not the result of willful misconduct on the part of Occidental and the transfer did not cause damage to the State, the declaration of *caducidad* was an excessive sanction, contrary to the principle of proportionality that the Tribunal considered to be incorporated into the fair and equitable treatment standard recognized by Article II.3 (a) of the BIT[4]. On this basis, the Award concluded that Occidental was entitled to compensation.

In order to determine the amount of

[1] Paul Reichler is one of the most experienced and respected litigators in the field of International Public Law. He has worked for over 25 years representing clients on matters concerning state sovereignty and disputes between States and foreign investors. He has litigated in the most important legal *fora*, such as the Court of Justice in The Hague and the International Tribunal for the Law of the Sea in Hamburg.

[2] *Occidental v. Ecuador* Award, § 383.

[3] *Ibid.* § 381.

[4] *Ibid.* § 450.

compensation, the Tribunal calculated the value of the claimants' business based on the current net value of discounted cash flows as recorded on May 16, 2006, the date of the *Caducidad* Decree[5]. The majority decided to reduce this value by 25% so as to establish the value of the compensation by considering that the claimants' "*wrongdoing*" "*significantly contributed to the damage subsequently suffered*"[6]. The majority's Award recognized 100% of this value to Occidental, thus dismissing Ecuador's allegations[7] that Occidental, pursuant to the transfer of rights, had already received payment corresponding to 40% of its investment from AEC, which then became the owner of the remaining percentage.

There are various aspects of the decision where the Tribunal in the Occidental case overlooked or incorrectly applied fundamental principles of international law. There are, however, three aspects that, in my view, are demonstrative of a dangerous tendency in investment arbitration: self-attribution of powers and authorities going much further than a State could reasonably consider being included in its consent to arbitration. I will limit my analysis to these three aspects. The first concerns jurisdiction.

THE NATURE OF THE WAITING PERIOD

The request for arbitration was submitted a mere two days after the *Caducidad* Decree was issued. Ecuador alleged that the claimants did not abide by the six-month waiting period as required by Article VI.3 of the BIT, before submitting the dispute to arbitration. In its decision on jurisdiction, which forms an integral part of the Award[8], the Tribunal recalled that "*the Caducidad procedure at issue in this arbitration*" had been initiated in 2004, and that during this lapse of 18 months, claimants had tried "*to rebut the allegations on the basis of which the Caducidad procedure was initiated, but to no avail*[9]." With this record, admitting the claimants' argument, the Tribunal considered that "*the very purpose of the waiting period requirement is to allow parties to enter into good faith negotiations before initiating arbitration*"[10] and that "*attempts at reaching a negotiated solution were futile in the circumstances*"[11]. To justify its conclusion in legal terms, the Tribunal, in a footnote, stated that "[a] *number of tribunals have confirmed that where negotiations are*

[5] *Ibid.* § 824.

[6] *Ibid.* §§ 679 to 687, 825.

[7] The Tribunal dismissed the allegations concerning the impact on the amount of two tax burdens: Law 42 and the VAT Interpretative Law.

[8] *Occidental v. Ecuador* Award, § 39.

[9] Decision on Jurisdiction, § 93.

[10] Decision on Jurisdiction, § 92.

[11] *Ibid.* § 94.

bound to be futile, there is no need for the waiting period to have fully lapsed," and cited the decisions of *Lauder v. Czech Republic*, *SGS v. Pakistan* and *Ethyl v. Canada*[12].

In the *Lauder* case, the Tribunal decided, citing *Ethyl* as an authority, that the BIT waiting period requirement of six months was not a provision related to jurisdiction restricting the Tribunal's authority to hear the dispute, but a "*procedural rule*" that had to be followed by the claimant party. *Ethyl,* however, was a case based on the North American Free Trade Agreement (NAFTA),[13] the text of which is completely different from the BIT with the United States, with regard to this requirement. In fact, Article 1118 of NAFTA provides that "*the disputing parties should first attempt to settle a claim through consultation or negotiation*". In contrast, Article VI.3 of the BIT stipulates that:

> "*At any time after six months from the date on which the dispute arose, the national or company concerned may choose to consent in writing to the submission of the dispute for settlement by conciliation or binding arbitration* [...]."

The difference is evident. The BIT clearly establishes a condition precedent for initiating arbitration. Pursuant to this provision, the investor may initiate arbitration only after six months have passed from the time the dispute arose. This is a compulsory and unavoidable period, not subject to any event or condition. Before this period has expired, the investor cannot accept the State's offer to submit the case to the compulsory arbitration established in the BIT dispute resolution clause.

In *Lauder*, a case under a treaty with an identical provision, the tribunal did not identify this difference properly. Other tribunals, however, did identify the difference in cases much closer to *Occidental*. Such cases not only involved the same BIT but also the same State. In the case of *Murphy v. Ecuador*, after criticizing the *Lauder*'s decision, the tribunal stated:

> "*This Tribunal finds the requirement that the parties should seek to resolve their dispute through consultation and negotiation for a six-month period does not constitute, as Claimant and some arbitral tribunals have stated, "a procedural rule" or a "directory and procedural" rule which can or cannot be satisfied by the concerned party. To the contrary, it constitutes a fundamental requirement that Claimant must comply with, compulsorily, before submitting a request for arbitration under the ICSID rules*"[14].

[12] *Ibid.* § 94, note 10.

[13] *Ethyl Corporation v. Canada* (NAFTA-UNCITRAL) (Bockstiegel, Brower, Lalonde), June 24, 1998.

Certainly, if the correct meaning is given to the terms of Article VI.3 of the BIT, pursuant to the rules for the interpretation of treaties of Article 31.1 of the Vienna Convention on the Law of Treaties, it must necessarily be concluded that the six-month waiting period is a requirement concerning jurisdiction, and that failure to observe it prevents the offer of consent from the State provided for in a BIT from being accepted, as this offer is subject to a condition precedent.

The authority of an international arbitration tribunal originates exclusively from the parties' consent.

If such consent was given in certain terms or with certain restrictions, the tribunal cannot exercise any authority outside such framework, simply because it has no such authority.

There is another aspect in the Occidental Decision on Jurisdiction that is open to criticism. The Tribunal assumes that the arguments submitted by the claimants during the administrative proceedings that preceded the issuance of the *Caducidad* Decree, as well as the steps taken by Occidental during said proceedings to avoid the declaration of *caducidad*, are equivalent to negotiation attempts, and that the fact that these attempts prior to the *caducidad* were not successful demonstrates that any subsequent negotiation would be "*fruitless*."[15]

It is a groundless assumption. In addition to the weak logic of the reasoning, and although it may be admitted that this equivalence is possible in factual terms, in legal terms the assumption underlying this reasoning is more critical. In fact, if there are to be attempts to resolve a dispute by any means, the dispute must first have arisen. Accordingly, in order to classify the events prior to the issuance of the *Caducidad* Decree as failed attempts to resolve the dispute, it would be necessary to first assume that the dispute had arisen before the issuance of the *Caducidad* Decree and, specifically, that it had arisen when the administrative proceedings prior to the issuance began[16].

That said, can a dispute concerning the incompatibility of the declaration of *caducidad* with the BIT standards arise before the *caducidad* has been declared? It appears that common sense

[14] *Murphy Exploration and Production Company International v. Republic of Ecuador* (ICSID case No. ARB/08/4), Decision on Jurisdiction (Oreamuno, Grigera Naón, Vinuesa) December 15, 2010, 149*Ethyl Corporation v. Canada* (NAFTA-UNCITRAL) (Bockstiegel, Brower, Lalonde), June 24, 1998.

[15] Decision on Jurisdiction, § § 90- 96.

[16] *Ibid.* § 96.

confirms a negative answer to this question.

A dispute exists when a disagreement arises regarding the facts or an issue of law, so that "*the claim by one party must be positively opposed by the other*."[17] The Tribunal in the *Burlington v. Ecuador* case therefore correctly observed that "*a dispute* […] *only arises once an allegation of Treaty breach is made*"[18]. In this case, the allegation that *caducidad* contravened the BIT could not have been made before *caducidad* was declared, since the State had not yet "*positively opposed*" Occidental's proposals.

The decisions in the *Murphy*[19] and *Burlington*[20] cases bring in another aspect that must be considered. In order for the six-month waiting period established in article VI of the BIT to be effective, it is essential that the State receives formal notice of the existence of the dispute, with specification of its terms, before the submission of the dispute to arbitration. That did not happen in this case. As in the Burlington case, "*Claimant has only informed Respondent of this dispute with the submission of the dispute to ICSID arbitration, thereby depriving Respondent of the opportunity, accorded by the Treaty, to redress the dispute before it is submitted to arbitration*"[21].

The decision on the Tribunal's jurisdiction in the Occidental case ignored or failed to apply a specific Treaty rule. Not just any rule, but precisely the one opening the door to arbitration, that is, the rule from which the Tribunal's authority ultimately comes.

However, there is an additional and extremely worrying aspect. The *Occidental* tribunal differs from two previous decisions in cases referring not only to the same rule of the same BIT, but also involving the same State. It completely contradicts *Murphy* and *Burlington* without even mentioning them. It is true that in investment arbitration other tribunals' decisions are not binding. Yet, it is also true that when it comes to decisions alluding to the same rule and the same State, the latter is likely to expect at least a reasonable explanation justifying the difference in opinion. There is no doubt that if a State body acted in a similar way and, without any explanation, adopted contradictory decisions concerning the same question, an ICSID Tribunal would rule against it for breaching the principle of fair and equitable treatment. Should the State not expect "fair and equitable" treatment from arbitral tribunals?

PROPORTIONALITY OF THE SANCTION

In the *Occidental* Award, the tribunal admits that by transferring rights to a third party without prior authorization, the claimant company not only breached the Hydrocarbons Law, but also a specific provision of the contract. It also admits that both the contract and the law provided that, in the event of such a breach, the competent administrative authority could declare the *caducidad* of the contract. The Decision states:[22]

> "*The failure to secure the required authorization meant that OEPC breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL which, as one option, expressly allowed the Minister to declare the caducidad of the Participation Contract and the Joint Operating Agreements. For this reason, the Claimants' allegation that the Caducidad Decree frustrated their legitimate expectations is rejected.*"

However, when the Minister exercised this "*option*", he applied, in the Tribunal's opinion, a disproportionate sanction. According to the Award, both Ecuadorian law and international law recognize "*the overriding principle of proportionality*" pursuant to which the goal sought by the Administration when applying a measure "*must be balanced against the Claimants' own interests and against the true nature and effect of the conduct being censured*"[23]. Based on this premise, the Award held:

> "*It follows that even if OEPC, as the Tribunal found earlier, breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 (or Articles 74.12 or 74.13), the 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 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.*

17 222.ICJ, Cases against South Africa (*Ethiopia v. South Africa*; *Liberia v. South Africa*) Preliminary Objections, Sentence of December 21, 1962; I.C.J. Reports, 1962, p. 328.

18 *Burlington Resources Inc. v The Republic of Ecuador* (ICSID case No. ARB/08/5) Decision on jurisdiction (Kaufmann-Kohler, Stern, Orrego Vicuña), June 2, 2010, § 336.

19 *Murphy Exploration and Production Company International v. The Republic of Ecuador* (ICSID case No. ARB/08/4) Decision on Jurisdiction (Oreamuno, Grigera Naón, Vinuesa), December 15, 2010, § § 101 - 109.

20 *Burlington Resources Inc. v The Republic of Ecuador* (ICSID case No. ARB/08/5), Decision on jurisdiction (Kaufmann-Kohler, Stern, Orrego Vicuña), June 2, 2010, §§ 310-312.

21 *Burlington Resources Inc. v The Republic of Ecuador* (ICSID case No. ARB/08/5), Decision on jurisdiction (Kaufmann-Kohler, Stern, Orrego Vicuña), June 2, 2010, § 312 (emphasis in original).

22 *Occidental v. Ecuador*, Award, § 383.

23 *Ibid.* § 450.

foregoing shows that even if, as previously determined by the Tribunal, OEPC had violated Clause 16.1 of the Participation Contract and was guilty of a breach subject to penalty of Article 74.11 (or Articles 74.12 or 74.13), the Declaration of Caducidad was not a proportionate response in the specific circumstances and this is the conclusion of the Tribunal. Consequently, the Declaration of Caducidad was penalized in breach of Ecuadorian law, customary international law and the Treaty. With respect to the Treaty, the Tribunal expressly considers that the Declaration of Caducidad constituted a failure by the Claimant to fulfill its obligation contained in Article II.3(a) to grant fair and equitable treatment to the Claimants' investment and not to provide them with less favorable treatment than required by international law"[24].

The central question is not whether Ecuadorian law and international law "recognize" the principle of proportionality. The question is whether they admit that an administrative authority can be called to apply it in the circumstances of this case.

I am not going to refer to the issue of proportionality in Ecuadorian law in detail. I will limit my analysis to the rules invoked and interpreted in the Award, and to the authorities by which the Award is backed.

Before doing so, however, it should be noted that the Award recognizes that a declaration of *caducidad* is a sanction under Ecuadorian law[25] for a legal and contractual breach consisting of the unauthorized transfer of rights to a third party[26].

Both Ecuadorian and international law consider that the principle of legality is inherent to the concept of sanction. This means that behavior cannot be sanctioned when it has not been previously classified as an offence and sanctions other than those stipulated by law cannot be applied.

To support its assessment concerning the principle of proportionality in Ecuadorian law, the Award first refers to the provision contained in subsection 3 of Article 24 of the 1998 Constitution, which adopts from among the rules of due process one according to which "*the laws shall establish the due proportionality between offences and penalties*".[27] As shown by the text, this is a rule for the legislator. However, to

[24] *Ibid.* § 452.
[25] *Ibid.* §§ 297, 338, 387.
[26] *Ibid.* § 383.
[27] *Ibid.* § 397.

demonstrate that the principle is not only applied in criminal law but also in all types of judicial or administrative proceedings, the Award cites a decision from the Supreme Court which recognizes this. In fact, the paragraph of the decision transcribed in the Award states that "*the measures or sanctions adopted within any legal or administrative proceeding must be proportional with the facts or acts established as violations*", which is the idea incorporated by the *Occidental* Tribunal. However, the same paragraph transcribed by the Tribunal contains, at the end, a very important specification that the Tribunal ignored. The Supreme Court decision states as follows:

"*In this sense, the mentioned principle of proportionality constitutes a requirement for the Government, since to establish a sanction between the two limits, minimum and maximum, it must consider the factual situation beforehand and attend to the end sought by the rule*."[28]

This means that, under Ecuadorian law, at least according to this decision, in order for the principle of proportionality to be applied, it is necessary that the body competent to apply this sanction have the possibility of choosing between two limits: a maximum and a minimum sanction.

The other provision on which the Award is based is Article 11 of the Ecuadorian Regulation for the Control of Discretion in the Acts of Public Administration, according to which "[t]*he measures involved in the discretionary action must be proportionally suitable to the goal*." Yet the Decision also transcribes Article 2 of the same Regulation, according to which *"[t]he discretion envisaged by law, implies choosing one among many equally valid options*"[29].

The Award cites no rule or authority on the basis of which it can be concluded that, when concerning sanctions, the principle of proportionality authorizes the application of measures not provided for in the rules instead of the single authorized penalty. Thus, according to the authorities of Ecuadorian law cited in the Award, the principle of proportionality referring to the application of a sanction is operational only when it is legally possible to choose between various equally valid sanctions, that is, sanctions contained in the law for the same breach, pursuant to the principle of legality.

Does this happen with *caducidad*? Certainly not. Neither the Hydrocarbons Law nor the Contract provide for a maximum and minimum sanction for the case of an offence consisting of unauthorized transfer of rights.

The Award cites the contractual provision

[28] *Ibid.* § 399. (emphasis added).
[29] *Ibid.* § 400. (emphasis added).

according to which for *"a transfer of rights and obligations of the Participation Contract without prior authorization from the Corresponding Ministry,"*[30] the applicable sanction is the termination of the contract, and also transcribes Article 74 of the Hydrocarbons Law, according to which the *caducidad* of the contract may be officially declared if the contractor "[t]*ransfers rights or enters into a private contract or agreement for the assignment of one or more of its rights, without the Ministry's authorization*"[31]. In the same paragraph of the Award, Article 77 of the Hydrocarbons Law, which makes a clear distinction between offences which give rise to termination of the contract and those which deserve a lesser sanction, is also quoted. The Article states:

> *"Art.77. A breach of contract that does not cause caducidad effects or a violation of the Law or Regulations shall be punished with a fine imposed by the National Hydrocarbons Director, of two hundred to three thousand United States Dollars, depending on the seriousness of the violation, in addition to compensation for the damages caused.*"

Therefore, there is no maximum and minimum sanction for the offence consisting of unauthorized transfer of rights, in Ecuadorian law. Thus when the Award attempts to present the "*alternatives to caducidad*", it includes four options, none of which is a sanction[32]. The options suggested by the Decision are: "*insistence on payment of a transfer fee in the order of USD 11.8 million*"; "*improvements to the economic terms of the original contract*"; and a negotiated settlement which could cover an "*additional compensation*". In addition to the fact that legally they are not sanctions, these three "*options*" imply the voluntary acceptance by the other party. The fourth option is classified by the Tribunal itself as not very realistic: to do nothing more than give a public warning. The Tribunal's reasoning can be summarized as follows: in view of the fact that the only sanction provided for by the law for this breach seems disproportionate to us, contrary to the thoughts of the Ecuadorian legislator, the Minister should not have imposed any sanction, but another kind of contractual measure. Indeed, it is difficult to reconcile this solution with the Award's emphasis that *caducidad* was declared as a response to a breach of the law, not of the contract[33].

The serious problem is that the Award itself attempts to justify the legal weakness of its arbitrary reasoning with an explanation, as a footnote, the content of which, far from reducing it, aggravates the fault. The Award clarifies that these alternative options to termination do "*not arise from Article 77 of the* [Hydrocarbons Law]," with the justification that *"[t]his s provision is not relevant to the Tribunal's analysis regarding alternatives to caducidad since its operation is confined to instances of breach of the Participation Contract which do not cause caducidad effects nor a violation of the Law or Regulations*"[34]. Is this not relevant? Is this not precisely one of the cases of breach of contract to which the rule refers? Is it not precisely demonstrated in this article that in Ecuadorian law there is no alternative sanction to *caducidad*?

We certainly do not see here, the scenario described by the Supreme Court decision transcribed in the Award: the possibility of choosing between a maximum and a minimum sanction within a scale provided for by the law. In this sense, the Tribunal reached a conclusion that does not flow from the authority it cites, contradicting the principle that when an international Tribunal must apply national law, it shall do so in such a way that it is faithful to the application that would be made by a local Tribunal, being guided by existing decisions in this respect, especially if made by the highest judicial bodies[35]. The Award has extended the application of the principle of proportionality to a situation that is completely different from that which was carefully stated by the Ecuadorian Supreme Court, without basing its reasoning on any authority.

Although the Award asserts that it is not judging the law, but the administrative act by which *caducidad* was declared[36], in the end what the Tribunal did was to apply the principle of proportionality to Ecuadorian law, not to the administrative act that simply applied it. The Tribunal is saying that this provision of the Hydrocarbons Law, in the circumstances of the case (absence of fraud or economic prejudice), would contradict the principle of proportionality established in the Constitution. It would, in such case, firstly be a matter of the constitutionality of a legal standard, not of the administrative act that applied it.

This raises some questions on this matter. Does an arbitral tribunal have the power to make this determination? And, then, would any State give its consent to arbitration if it knew that a tribunal was going to judge the constitutionality of its own laws?

What the Hydrocarbons Law has done in article 77 is precisely to assess the seriousness of the breaches and to attribute to those it considers to be the most serious, the most serious sanction, *caducidad*, leaving for all other breaches the sanction of a fine in amounts proportional to the seriousness of the offence. In other words, the Ecuadorian legislator has already assessed the correlation between

30 *Ibid.* § 120.
31 *Ibid.* § 121.
32 *Ibid.* § § 428-436.
33 *Ibid.* §

34 *Ibid.* § 434, footnote 44.
35 James Crawford, *Brownlie's Principles of Public International Law*, 8th Edition Oxford, p.53.
36 "*The application of proportionality to an act of administration (as opposed to the promulgation of legislation or regulations) was what was at issue in Tecmed, and it is similarly at issue in the present case*" *Occidental v. Ecuador*, Award § 408.

breaches and sanctions, and has established a scale. What authority does an arbitral tribunal have to dissent from this assessment made by the legislator?

The Tribunal itself appears to have had doubts about its conclusion, and to have attempted to overcome the obstacle by saying that "[e]*ven if the Tribunal is wrong on that question of domestic Ecuadorian law, the Tribunal has no doubt that the principle of proportionality is applicable as a matter of general international law, and has been applied in many ICSID arbitrations in the past, in particular in the Tecmed case.*"[37]

International law does not authorize an arbitral tribunal to cite the principle of proportionality to "*correct*" a proportionality judgment already made by the national legislator as a result of which, within a scale of breaches and sanctions, the latter has determined that this specific breach deserves a more serious sanction, without other consideration.

In fact, none of the authorities cited in the Decision support the position of the Tribunal in the *Occidental* case.

In the *Tecmed* case, proportionality was applied to a non-punitive discretional administrative act: renovation of an operating permit. What the Tribunal assessed in this case was not the proportionality of a sanction already provided for by local law, but whether or not the reasons cited for the issuance of the act corresponded to the seriousness of the discretional measure, even more so when the violations of the license stated in the reasoning had previously been penalized with less serious sanctions.[38] The non-renewal of the permit was not conceived or applied as a sanction for a specific breach of the law, but the existence of various offences in the past was the justification cited as the reason for adopting a completely discretional measure. The other cases cited in the Award do not concern a situation even remotely similar to that of *Occidental,* either. In the *MTD v. Chile case*, the Tribunal itself took care of the refusal to approve a property project[39]. The other cases, *LGE v. Argentina* and *Azurix v. Argentina* do not concern the application of sanctions for breaches of the law either. In fact, the Award does not cite a single authority admitting, as a principle of international law, the possibility to demand a state authority to apply, instead of the sanction provided for by the law, contractual measures that are not sanctions.

If the Tribunal had been entrusted with the power to resolve the dispute *ex aequo et bono,* maybe such a solution would have been admissible. It is in no way admissible when, as in this case, the Tribunal

[37] *Occidental v. Ecuador*, Award, § 427.

[38] *Técnicas Medioambientales Tecmed, S.A. v. The United States of Mexico*, ICSID case No. ARB (AF)/00/2 § § 99-102.

[39] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID case No. ARB/01/7.

is called to resolve the matter in accordance with the law.

From a legal perspective, the absence of fraud and financial loss was not considered by the Ecuadorian legislator when establishing the sanction of *caducidad*. The State's authority to decide on the use of its resources, and therefore, the *intuitu personae* nature of hydrocarbon exploitation contracts, are the values which the rule has tried to protect. Damage to such values, for the legislator, occurs regardless of the intention or the harmful result. The observation made by Professor Stern that "*the consequence of the fault committed by the Claimants, when they violated the Ecuadorian law, is overly underestimated and insufficiently taking into account the importance that each and every State assigns to the respect of its legal order by foreign companies*"[40] is fully applicable to the determination of liability and not only to the amount of compensation.

CALCULATION OF COMPENSATION

The calculation of compensation and its full allocation to Occidental, despite the fact that said company had transferred some of its rights to a third party, are undoubtedly the most alarming aspects of the Award. In her dissenting opinion, Professor Stern meticulously analyses the majority position and unveils its errors and contradictions with indisputable forcefulness.

The first point of discrepancy refers to the effect that the illegal actions of the claimants may have had on calculation of the compensation. The majority attributes to the claimants' behavior, a share of 25% of the result, and reduces by this percentage the value of the compensation to which they would be entitled. Professor Stern considers that this percentage is insufficient and advocates for an equitable distribution of the blame, as the *MTD* tribunal did, when it stated: "*both the tribunal and the ad hoc committee have endorsed a 50/50 split on the sole ground that the claimant had acted imprudently from a business point of view though not illegally. Here the split 50/50 would have been even more justified, as the Claimants have acted both very imprudently and illegally*"[41].

Once again, given that Professor Stern's discernment is much more reasonable, it seems to me that this discussion would be appropriate only if the Tribunal was one of equity and not one of law. From a legal perspective, if the claimants acted illegally and their breach gave rise to the only possible sanction according to the law, *Caducidad*, then the declaration of the *Caducidad* by a competent body of the State would not be an international illegal action.

[40] Dissenting Opinion, § 4.

[41] *Ibid.*, § 7.

The second issue that merits special mention is the attribution to Occidental of 100% of the compensation, when it held only 60% of the rights in the Participation Contract. As Professor Stern says, the majority position on this point is egregious[42].

In order to conclude that Occidental is entitled to receive the entire compensation, the majority considered that the agreement between Occidental and AEC was "*non-existent*", supposedly based on Ecuadorian law, despite the facts that (i) the contract was subject to the laws of New York; (ii) Ecuadorian law requires a court declaration in case of nullity; and (iii) the company AEC, whose rights remained unknown with the declaration of the Award, was not a party to the arbitration.

These aspects, particularly the latter, led Professor Stern to maintain that the Award demonstrates a "*manifest excess of power*" by "*nullifying a contract concerning a company which not only was not a party to the arbitration, but moreover – even if it had been a party – could not be considered, being a Chinese company, as an investor over which the Tribunal had jurisdiction under the US/Ecuador BIT*"[43].

There are so many flaws in the Award that they do not pass an impartial scrutiny. The Tribunal ignored a basic rule of the Treaty by determining it had jurisdiction. It exceeded its powers by attempting to rewrite Ecuadorian law, without the real support of any authority whatsoever. It has transgressed fundamental principles of international law and basic rules of due process.

It is precisely this accumulation of flaws in such a well-known case which, to a certain extent, also makes this Decision in the Occidental case a symbol. As an embodiment of the typical flaws in international investment arbitration, the Decision puts the system, and particularly the ad hoc committees as a control mechanism, to the test.

If the control mechanism does not prove to be effective against such glaring flaws and cannot correct them, the system itself has demonstrated its own failure. The crisis of States' confidence in the investment arbitration system that is currently being experienced can be fully justified.

42 *Ibid.*, § 5.
43 *Ibid.*

Cooling-off periods in investment arbitrationas a Contractual Moderation Mechanism

George von Mehren and Stephan Adell, Squire Sanders Llp[1]

The inclusion of "waiting" or "cooling-off" periods in bilateral investment treaties ("BITs") is quite common. Their purpose appears straightforward: to appraise the host State of a potential dispute with a foreign investor and encourage amicable settlement prior to engaging costly and time-consuming adversarial dispute resolution methods, such as arbitration.

In practice, however, the question has turned out to be point of contention itself. The issue arises in part from the wording of the provisions themselves, which sometimes do not make clear whether these cooling-off periods are mandatory or not. This is aggravated by inconsistent arbitral decisions – sometimes even when faced with similar wording in the applicable BITs – addressing the purpose of these provisions and the consequences of their breach. Ultimately, the issue may give rise to legal uncertainty for both claimants and respondents – the first in need of bringing their claims promptly before a neutral forum and the second in knowing what legal options they have when facing a disregard of such provisions.

This article is part of the book dedicated to the *Occidental v Ecuador* case, where Ecuador challenged jurisdiction on this very point. Because Ecuador's position on this question has already been explained at length in other sections of this book, we simply recall here that Occidental initiated arbitral proceedings (*i.e.* 17 May 2006) just two days after *caducidad* had been declared (*i.e.* 15 May 2006), without ever formally notifying Ecuador of a dispute under the US-Ecuador BIT. The declaration of *caducidad* was the central point of Occidental's case (and not the events leading to it). On the basis of the facts in this particular case, it should have led to the dismissal of jurisdiction.

This article first provides a background analysis of cooling-off provisions in BITs (**A**), followed by their history in investment case law (**B**), concluding with our observations on the *Occidental v. Ecuador* case and for the future of the requirement (**C**).

A. COOLING - OFF PERIODS IN INVESTMENT LAW

It is undisputed that States may condition their consent to arbitration with foreign investors. The International Court of Justice has held that "*jurisdiction is based on the consent of the parties*

1 The authors and their law firm represented the Republic of Ecuador in the underlying arbitral proceedings *Occidental Petroleum Corp. and Occidental Exploration and Production Co. v. The Republic of Ecuador*, ICSID Case No. ARB. 06/11 as well as in the subsequent ongoing annulment proceedings against the Award.

and is confined to the extent accepted by them. When that consent is expressed in a compromissory clause in an international agreement, any conditions to which such consent is subject must be regarded as constituting the limits thereon".[2]

The same view was ascribed to by the Wintershall v. Argentina ICSID tribunal, when it held that "it is a general principle of the law of treaties that a third beneficiary of a right under it must comply with the conditions for the exercise of the right provided for in the treaty"[3]. The issue is important because--in the words of Professor Schreuer—"[a]n arbitral tribunal derives its power from the parties' agreement"[4].

Many investment treaties contain a provision providing that an investor notify the host State of a dispute and attempt negotiations for determined period of time prior to submitting the dispute to arbitration. For example, Article 8 of the Dutch-Czech BIT provides for a six-month waiting period:

> "*1) All disputes between one Contracting Party and an investor of the other Contracting Party concerning an investment of the latter shall if possible, be settled amicably.*
>
> *"2) Each Contracting Party hereby consents to submit a dispute referred to in paragraph (1) of this Article, to an arbitral tribunal,* ***if the dispute has not been settled amicably within a period of six months from the date either party to the dispute requested amicable settlement.*"**

Article VI(3) of the US-Ecuador Bit contains a similar provision:

> "***Provided that*** *the national or company concerned has not submitted the dispute for resolution under paragraph 2 (a) or (b)* [to the national courts or in accordance with any previously agreed dispute settlement procedures] ***and that six months have elapsed from the date on which the dispute arose, the national or company concerned may choose to consent in writing to the submission of the dispute for settlement by binding arbitration.*"**

Both provide (as do most BITs containing cooling-off periods) a two-fold test for an investor to proceed arbitration. First, a dispute must arise. Second, the investor must *inform* the host State of the existence of the dispute, and *attempt* amicable settlement.

With regard to the definition of a "dispute," the International Court of Justice has observed that "*a mere assertion is not sufficient to prove the existence of a dispute any more than a mere denial of the existence of the dispute proves its nonexistence. Nor is it adequate to show that the interests of the two parties to such a case are in conflict. It must be shown that the claim of one party is positively opposed by the other*"[5].

The *Helnan v. Egypt* ICSID tribunal linked the definition to the investor's decision to have the dispute solved and framed it as follows: "*different views of parties in respect of certain facts and situations become a 'divergence' when they are mutually aware of their disagreement.* ***It crystallizes as a 'dispute' as soon as one of the parties decides to have it solved, whether or not by a third party*"**[6]. Whereas the tribunal in Lauder v. Czech Republic linked the definition to the notice obligation under the treaty, and concluded that a treaty dispute only arises when notice is given by the investor[7].

It would appear from the above findings that, regardless of the specific definition, a dispute requires contact of opposing views between the parties. It would not suffice for one party to deem by itself that a dispute has arisen. As Professor Schreuer explains "*[i]t follows that normally a dispute will be characterized by a certain amount of communication demonstrating opposing demands and denials*"[8]. Ultimately, the question is a factual one and each tribunal will have to reach a conclusion upon weighing the evidence submitted in the proceedings.

While the second leg of the above test appears simple, and while it is undisputed that States can condition their consent to arbitration, the analysis and application of cooling-off periods has hardly been consistent in investment case law. The main divide surrounds the nature of this requirement: is it procedural or is it jurisdictional?

B. COOLING-OFF PERIODS IN CASE LAW

As shown in the following paragraphs, the early trend of decisions addressing the issue pointed to giving cooling-off provisions a procedural nature, rather than a mandatory jurisdictional one.

In *Lauder v. The Czech Republic* in 2001, a case brought under the US-Czech BIT (which provided a six-month cooling-off period), the claimant filed for arbitration after only 17-days of having notified the Czech Republic of a dispute. The tribunal allowed the claim on the basis that it found no evidence that the respondent would have been willing to negotiate. It further observed that dismissal of the claim would be an "*overly formalistic approach which would not serve to protect any legitimate interests of the Parties*"[9].

2 *Armed Activities on the Territory of the Congo (New Application: 2002) (Democratic Republic of the Congo v. Rwanda),* Jurisdiction and Admissibility, Judgment, I.C.J. Reports 2006, 3 February 2006,§ 88.

3 *Wintershall Aktiengesellschaft v. The Argentine Republic* (ICSID Case No. ARB/04/14), Award, 8 December 2008,§ 114.

4 Ch. Schreuer, L. Malintoppi, A. Reinisch, A. Sinclair, *The ICSID Convention, A Commentary*, Cambridge University Press, 2nd Edition, Article 52,§ 132.

5 See also *South West Africa Cases (Ethiopia v. South Africa; Liberia v. South Africa)*, Preliminary Objections, Judgment of 21 December 1962, I.C.J. Reports 1962, pp. 319-328. See also *Mavrommatis Palestine Concessions*, Judgment No. 2, 30 August 1924, P.C.I.J., Series A, No. 2, p. 11.

6 *Helnan Int'l Hotels A/S v. Egypt* (ICSID Case No. ARB/05/19), Award, 3 July 2008,§ 162.

7 *Lauder v. The Czech Republic* (UNCITRAL), Final Award, 3 September 2001,§ 185.

8 Christoph Schreuer, "What is a legal dispute?", Transnational Dispute Management, Vol 6 –Issue No. 1, March 2009, p 7.

9 *Ronald S. Lauder v. Czech Republic*, UNCITRAL, Award (Final), 3 September 2001,§ 190.

The *SGS v. Pakistan* award rendered in 2003, under the Switzerland-Pakistan BIT (which a consultation obligation of 12-months), reached a similar conclusion. In that case the claimant had filed for arbitration only two days after having notified Pakistan of a dispute under the treaty. The tribunal held that the 12 months cooling-off period was "*directory and procedural rather than mandatory and jurisdictional in nature*"[10] and not a condition for arbitration, and that neither party had shown willingness to negotiate. The tribunal further held that suspension of the arbitration in order to allow the parties to negotiate would not be an "*orderly and cost-effective procedure*"[11].

In *Ethyl v. Canada* in 2004[12], under NAFTA, the tribunal was faced with a claimant that purposely submitted its claim for arbitration before the expiration of the cooling-off period. Despite this, the tribunal did not dismiss the claim because by the time it rendered its decision the cooling-off period would have lapsed, thus resulting in higher costs and time loss. Interestingly, the tribunal ordered Ethyl to bear the costs of the proceedings related to this question. The tribunal in *Bayindir v. Pakistan* in 2005 interpreted the waiting period in the German-Pakistan BIT (which contained a six-month waiting period), to be procedural and a formalistic barrier that did not prevent access to the tribunal's jurisdiction. It concluded that "*the Tribunal is prepared to find that preventing the commencement of the arbitration proceedings until six months after the 4 April 2002 notification would, in the circumstances of this case, amount to an unnecessary, overly formalistic approach which would not serve to protect any legitimate interests of the Parties and hold "that the six-month waiting period in* [the BIT] *does not preclude it from having jurisdiction in the present proceedings*"[13].

In *Biwater Gauff v. Tanzania* in 2008[14], under the UK-Tanzania BIT, the claimant filed for arbitration just three months after the dispute arose and despite a 6-month cooling-off period. The tribunal found the requirement procedural in nature, holding that the purpose of the clause was to facilitate settlement and

10 *See SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13, Award on Jurisdiction, 6 August 2003,§ 184.

11 *I.d*

12 *Ethyl Corporation v. Canada*, UNCITRAL Arbitration, Decision on Jurisdiction of 24 June 1998, 7 ICSID Rep.12 (2004),§ 84.

13 *See Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/03/29, Decision on Jurisdiction, 14 November 2005,§ 102: *"(...) As far as possible, the investor and the concerned party shall endeavour to settle these disputes by consultations and negotiations in good faith. If these disputes* ***cannot be settled in this way within six months following the date of the written notification*** *mentioned in paragraph 1, the dispute can be submitted (...).*"

14 *Biwater Gauff (Tanzania) Limited v. United Republic of Tanzania,* ICSID Case No. ARB/05/22, Award, 24 July 2008.

not bar access to arbitration. It appears that the parties in that case had previously engaged in negotiations [15].

Similar decisions were reached in other cases, including *Link-Trading v. Moldova*, *Sedelmeyer v. Russia*, and *Wena Hotels v. Egypt*.

As shown above, early decisions on the nature of cooling-off periods consistently found the requirement to be procedural in nature and not a bar to jurisdiction. The main driver for this conclusion appears to be the tribunals' desire to ensure procedural efficiency.

Later decisions, however, changed course. A series of investment cases, including the most recent ones, began to hold that the cooling-off periods were in fact not merely procedural requirements but, rather, were a condition to the respondent State's consent to arbitration and thus jurisdictional in nature.

The tribunal in *Enron v. Argentina* in 2004 was one of the first tribunals to express the view that waiting periods are of jurisdictional nature holding that "*such requirement is in the view of the Tribunal very much a jurisdictional one. A failure to comply with that requirement would result in a determination of lack of jurisdiction.* (...)"[16.]

The tribunal in *Burlington v. Ecuador* in 2010 also found that the investor's non-compliance with the waiting period defeats jurisdiction. Burlington argued that it had provided multiple notices throughout the years, including an official notice of dispute sent six months prior to filing its request for arbitration. Ecuador argued that certain of Burlington's claims were not covered by its official notice of dispute and thus in breach of the cooling-off period. The tribunal dismissed jurisdiction over these claims on the basis that they had not been sufficiently described in the official notice[17]. It found that "*the purpose of this right is to grant the host State an opportunity to redress the problem before the investor submits the dispute to arbitration. In this case, Claimant has deprived the host State of that opportunity. That suffices to defeat jurisdiction*"[18].

15 *Ib.*,§ 343: "*The Republic's objection depends upon the characterisation of the six-month period in Article 8(3) of the BIT as a condition precedent to the Arbitral Tribunal's jurisdiction, or the admissibility of BGT's claims.* ***In the Arbitral Tribunal's view, however, properly construed, this six-month period is procedural and directory in nature, rather than jurisdictional and mandatory.*** *Its underlying purpose is to facilitate opportunities for amicable settlement. Its purpose is not to impede or obstruct six month period, therefore, does not preclude this Arbitral Tribunal from proceeding.*" *Helnan Int'l Hotels A/S v. Egypt* (ICSID Case No. ARB/05/19), Award, 3 July 2008,§ 162.

16 *Enron Creditors Recovery Corporation (formerly Enron Corporation) and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3, Decision on Jurisdiction, 14 January 2004, §88. On 30 July 2010, the Enron Award was annulled for unrelated reasons to the matter discussed in this article and its reasoning thereon thus remains useful.

17 *Burlington Resources Inc., v. Republic of Ecuador* (ICSID Case No. ARB/08/5), Decision on Jurisdiction, 2 June 2010, §§306-308.

18 *Ib.*, § 315.

The tribunal in *Murphy v. Ecuador* in 2010 endorsed the reasoning of *Burlington v. Ecuador*[19].

In that case, two subsidiaries of Murphy International, the claimant, were part of a consortium involved in a service contract with Ecuador for the exploration and exploitation of hydrocarbons in the Ecuadorian Amazon. A dispute arose in 2006. Repsol, leading the consortium, entered into negotiations with Ecuador. In November 2007, Repsol notified Ecuador of a dispute under the Spain-Ecuador BIT. On 29 February 2008, Murphy notified Ecuador of a dispute under the US-Ecuador BIT, referring to the earlier negotiations led by Repsol, and filed its claim before ICSID two days later on 3 March 2009.

Ecuador objected to the jurisdiction of the tribunal, arguing that Murphy had not complied with the six month negotiation period in Article VI of the US-Ecuador BIT. Murphy argued that it had complied with the negotiation requirement through its indirect involvement in the negotiations led by the consortium. The tribunal, however, was not persuaded. It held that Murphy could not rely on those negotiations as they had been carried on behalf of different legal persons (*i.e*., Murphy's subsidiaries in the consortium) and under a different treaty (*i.e.*, the Spain-Ecuador BIT). Murphy further argued that the cooling-off requirement was procedural in nature and thus did not bar the tribunal's jurisdiction. The tribunal was equally unpersuaded. It found that it was not possible to ignore the obligation set forth in the BIT for the parties to attempt negotiations in order to resolve their disputes, which it considered an essential mechanism to engage in genuine negotiation efforts before resorting to arbitration.

In 2012 the tribunal in *ICS v. Argentina* also found that the 18-month local remedies requirement in the UK-Argentina's BIT was jurisdictional in nature. It held that "*the failure to respect the pre-condition to the Respondent's consent to arbitrate cannot but lead to the conclusion that the Tribunal lacks jurisdiction over the present dispute. Not only has the Respondent specifically conditioned its consent to arbitration on a requirement not yet fulfilled, but the Contracting Parties to the Treaty have expressly required the prior submission of a dispute to the Argentine courts for at least 18 months, before a recourse to international arbitration is initiated. The Tribunal is simply not empowered to disregard these limits on its jurisdiction*"[20].

The tribunal in *Tulip v. Turkey in* 2013, under the Dutch-Turkey BIT which contained a one-year cooling off period, emphasized the jurisdictional nature of waiting periods (making reference to Enron and Murphy cited above) "(...) *The Tribunal finds compliance is an essential element of Turkey's prospective consent to qualify its sovereignty to permit unknown future investors of the other contracting State to claim relief under the terms of the BIT against it in an international forum. The Tribunal finds that the fulfilment of the requirements in Article 8(2) is a pre-condition to the jurisdiction of this Tribunal*"[21].

Most recently, the tribunal in *Rurelec v. Bolivia* in January 2014, under the US-Bolivia BIT which imposed a six-month cooling-off period, held that both the requirement of written notification of a claim and the requirement to abide with a waiting period are mandatory pre-requisites for the tribunal's jurisdiction: *"The explicit wording requiring a written notification and the expiry of a period of six months from that notification leads the Tribunal to consider that the "cooling off period" narrows the consent given by the Contracting Parties to international arbitration. It is not up to the Tribunal to evaluate the importance or effect of such a condition, but simply to acknowledge that it was agreed by the two Contracting Parties as a condition precedent to the availability of an arbitral tribunal which is, and must be, based on consent.* ***The truth is that the Contracting Parties only gave their consent to arbitration subject to the existence of a written notification of a claim and subject to the passing of six months' time between such notification and any request of arbitration***"[22].

Despite the recent trend affirming the jurisdictional nature of cooling-off periods, they are not strictly and formalistically enforced in every case. Investors often argue that cooling-off periods can be waived when settlement negotiations with the host State are manifestly futile. Several investment tribunals have addressed the issue. For example, the tribunal in *Ambiente v. Argentina* held that "*mandatory waiting periods for consultations (let alone a simple duty to consult, as in the present case) do not pose an obstacle for a claim to proceed to the merits phase if there is no realistic chance for meaningful consultations because they have become futile or deadlocked*"[23]. Tribunals have reached a "futility" finding where the investor can prove that it genuinely attempted settlement negotiations and the host State was not sufficiently responsive. In this respect, the tribunal in *Al-Bahloul v. Tajikistani,* based on the facts of the case, held that *"[i]t seems clear that Respondent was not interested in settling the dispute amicably. Insisting on compliance with*

[19] *Murphy Exploration and Production Company International v. Republic of Ecuador*, ICSID Case No. ARB/08/4, Award on Jurisdiction, 15 December 2010, 147-157.

[20] *ICS Inspection and Control Services Ltd v. Argentine Republic* (PCA Case No. 2010-9), Award on Jurisdiction, 10 February 2012, §262.

[21] *Tulip Real Estate and Development Netherlands B.V. v. Republic of Turkey*, ICSID Case No. ARB/11/28, Decision on Bifurcated Jurisdictional Issue, 5 March 2013, §72.

[22] *Guaracachi America, Inc. and Rurelec PLC v. The Plurinational State of Bolivia*, UNCITRAL, PCA Case No. 2011-17, §§388-389 (emphasis added).

[23] *Ambiente Ufficio S.P.A. and Others v. Argentine Republic*, ICSID Case No. ARB/08/9, Decision on Jurisdiction and Admissibility, 8 February 2013, §582. *Mohammad Ammar Al-Bahloul v. Republic of Tajikistan*, SCC Case No. V064/2008, Partial Award on Jurisdiction and Liability, 2 September 2009, §155.

the three- month period thus would be an unnecessary formality"[24].

C. OBSERVATIONS ON THE OCCIDENTAL V. ECUADOR CASE AND THE FUTURE OF COOLING-OFF PERIODS

The current line of cases dealing with cooling-off periods shows a reversal in the trend. Whereas early decisions treated the requirement as procedural, the most recent trend of decisions appears to consistently treat it as jurisdictional. This line of analysis is more consistent with the interpretation of conditions to consent held by the ICJ. While the success of this argument for States will depend on the specific wording of the relevant arbitration clause and the facts of the case, it is hoped that consistency in the treatment of such requirements will lead to more legal certainty for both claimants and respondents. In light of recent case law, it is also possible that the question may appear less and less, as it can be presumed that counsel for claimants will advise clients on these requirements when deciding on strategy at the early stages of a case. The *Occidental v. Ecuador* case was a lost opportunity to further clarify the issue.

The tribunal in *Occidental v. Ecuador* addressed the cooling-off defense in its Decision on Jurisdiction of 9 September of 2008, which was subsequently incorporated into its Award of 5 October 2012. Ecuador had challenged the arbitral tribunal's jurisdiction in the underlying arbitration on the basis that Occidental had failed to provide notice of the dispute and, instead, commenced arbitration just 2 days after *Caducidad* had been declared (*Caducidad* being the basis for its claims). The tribunal rejected the challenge and asserted jurisdiction.

The facts of this particular case should have led to the dismissal of jurisdiction, or at the very least, the tribunal should have provided a meaningful discussion on its reasons for dismissing it. By the time the Decision on Jurisdiction was rendered, the *Enron v. Argentina* ICSID tribunal had taken the view that such requirements were jurisdictional in nature. It is unfortunate that the tribunal did not pay due attention to the question.

It was undisputed that the applicable US-Ecuador BIT contained a mandatory cooling-off period. While Occidental had argued that the requirement was procedural in nature, the tribunal did not address this point.

It was equally undisputed that Occidental had failed to provide notice of any kind, having filed for arbitration just two days after *Caducidad* had been declared. As set forth above, tribunals have dismissed specific claims when they were not sufficiently detailed in a notice of dispute, even in

[24] *Mohammad Ammar Al-Bahloul v. Republic of Tajikistan*, SCC Case No. V064/2008, Partial Award on Jurisdiction and Liability, 2 September 2009, §155.

cases where other claims had been formally and properly notified. Moreover, in the factual context of this case in which *Caducidad* proceedings (but not its declaration) had been initiated months before, the definition of a "dispute" under international law became very relevant. This question was completely ignored by the tribunal.

The case law cited above, however, supports the view that "dispute" as defined under international law had not arisen. There could not have been "positive" opposition by Occidental against *Caducidad* before it was declared, as provided in the *West Africa Cases*. Nor could Occidental have "decided" to solve the dispute via arbitration, thus "crystalizing" the dispute, as provided by the *Helnan v. Egypt* ICSID tribunal. Occidental's approach would have equally run afoul of the standard under the *Lauder v. Czech Republic*, which directly links the conception of a dispute to its *notice* by the investor to the host State.

The tribunal's finding that negotiations would have been futile is equally troublesome from a legal standpoint. It is extremely short, thus making its analysis difficult or impossible. The tribunal did not clearly identify which standard it was applying to the facts of the case. The question was clearly relevant because investment tribunals have held that "obvious futility"[25] must be demonstrated, as opposed to the tribunal's (apparent) lower simple "futility" standard. Moreover, the finding that negotiations would have futile was largely unexplained and appears to be in contradiction of findings by other tribunals at the time that Ecuador was indeed negotiating with oil companies[26]. The question therefore merited far closer scrutiny than what it received.

In these circumstances, the tribunal's light-handed approach to the above issues left more questions than answers.

In the annulment proceedings, Ecuador argued that the tribunal did not address the definition of "dispute" under international law — which is pertinent to the issue of whether a "dispute" existed before *Caducidad* was declared — or whether it regarded the cooling-off period as procedural or jurisdictional in nature. Ecuador also argued that,

[25] See e.g. *Consorzio Groupement L.E.S.I – Dipenta v. Republic of Algeria* (ICSID Case No. ARB/03/08), Award, 10 January 2005, 32(iv) : "[l]*e Tribunal arbitral relève, en outre, que la condition examinée n'a pas un caractère absolu et que l'on devrait pouvoir en faire abstraction dans des cas où il apparaîtrait à l'évidence qu'une tentative de conciliation serait d'emblée vouée à l'échec, en raison de l'attitude manifestée de manière définitive par l'autre partie*" (Unofficial translation: "[t]*he Tribunal also notes that this condition is not absolute, and that it should be waived when it is obvious that any conciliation attempt would be doomed given the clearly demonstrated attitude of the other party*") (emphasis added) and *ICS Inspection and Control Services Ltd v. Argentine Republic* (PCA Case No. 2010-9), Award on Jurisdiction, 10 February 2012, §269: explaining that because it was not a case of "obvious futility" "*the Tribunal simply cannot conclude that recourse would have been completely ineffective at resolving the dispute*."

[26] For example, the tribunal in *Murphy v. Ecuador* held that Ecuador was negotiating with oil companies at the time (*Murphy Exploration and Production Co. Int'l v. Republic of Ecuador* (ICSID Case No. ARB/08/4), Award on Jurisdiction, 15 December 2010, §136).

while the tribunal found that negotiations would have been futile, it did not address the applicable standard for this finding — namely, that the negotiations must have been "*obviously* futile." The *ad hoc* Committee's decision is still pending as of the date this article.

Occidental v. Ecuador (ii): The Tribunal's Finding of "Negligence"

Stephen P. Anway, Raúl B. Mañón, Squire Sanders (US) Llp[1]

I. INTRODUCTION

The award in Occidental Petroleum Corp. and Occidental Exploration and Production Co. v. The Republic of Ecuador, ICSID Case No. ARB. 06/11 (the "Award"), is among the most controversial decisions in investment-treaty jurisprudence. While the Award continues to be debated in the academic literature and international law circles, one aspect of the Award has been largely overlooked: the tribunal's conclusion that Occidental Exploration and Production Company ("**OEPC**") was merely "negligent" in breaching its Participation Contract with Ecuador's State-owned oil company, PETROECUADOR, and Ecuador's Ley de Hidrocarburos (the "**Hydrocarbons Law**" or "HCL"). This article examines that conclusion, the analysis used by the tribunal to reach it, and its profound implications on the ultimate outcome of the arbitration.

The Participation Contract and the HCL—whose operative articles were quoted and cited in the Participation Contract—prohibited OEPC from transferring any part of its interest in the Participation Contract to a third party without prior approval from Ecuador. It also expressly authorized Ecuador to declare *Caducidad* if such an unauthorized transfer occurred. In the Award, the tribunal found that OEPC had done precisely that—it had transferred its interest in the Participation Contract without prior approval from Ecuador. Despite that finding, the tribunal went on to conclude that Ecuador's exercise of its express contractual right to declare *Caducidad* was "*disproportionate*" and, therefore, unlawful. That single, controversial conclusion was the basis for an award of USD 1.7 billion.

For their part, OEPC and its parent company, Occidental Petroleum Corporation ("**OPC**") (collectively the "*Claimants*"), argued for more than eight years (from mid-2004, when Ecuador first became aware of the transfer, through October 2012, when the Award was issued) that an unauthorized transfer had never taken place and that, even

[1] The authors and their law firm represent the Republic of Ecuador in the arbitral proceedings (the "**Arbitration**") in this matter, including the now-concluded investment arbitration styled *Occidental Petroleum Corp. and Occidental Exploration and Production Co. v. The Republic of Ecuador*, ICSID Case No. ARB. 06/11 and the related, ongoing annulment proceeding. The authors would like to thank Rafael Langer-Osuna of Squire Sanders (US) LLP, who assisted in the preparation of this article.

assuming it had, Ecuador had consented to it. The tribunal rejected both of Claimants' arguments, finding that OEPC (*i*) had indeed transferred its rights and obligations to a third party when, on October 19, 2000, OEPC transferred to a third party 40% of OEPC's rights and obligations under the Participation Contract, and (*ii*) had not obtained Ecuador's authorization to do so.

These were crucial findings that should have been dispositive. After all, the tribunal found that OEPC did what it was contractually and statutorily prohibited from doing, which entitled the State to impose the precise sanction (*caducidad*) that OEPC had expressly agreed in the Participation Contract would apply under these exact circumstances. Instead of following these findings to their logical conclusion, however, the tribunal avoided that conclusion by making two additional findings:

First, the tribunal determined that, although OEPC transferred its rights without Ecuador's prior authorization, it did so merely "*negligently*;" and

Second, based on that "*negligence*" finding, the tribunal held that the imposition of *Caducidad* was "*disproportionate*" under both Ecuadorian law and public international law.

While the second finding has received much attention and remains the subject of intense debate, it is the first finding that is the subject of this article. As analyzed in this article, the tribunal based that first finding on the sole factual proposition that OEPC allegedly meant no harm to Ecuador and did not act in bad faith. Rather, the tribunal concluded, OEPC merely acted in an "*imprudent*" and "*ill-advised*" manner because, while it was aware of its contractual and legal duty and had been so advised by its lawyers, its decision was taken by "*business people, seasoned oilmen, for whom legal niceties were not as important as the business realities of the deal.*"

II. THE FINDING OF NEGLIGENCE

A. Factual Context

The Participation Contract—executed on May 21, 1999—granted OEPC the right to develop and exploit certain oil fields within Block 15 and to receive as compensation a share—a *participation*—of the crude produced. Four provisions of the Participation Contract were relevant in the Arbitration:

Section 16.1, which prohibited OEPC from transferring or assigning to third parties its rights under the Participation Contract without Ecuador's prior written approval obtained in accordance with the HCL[2];

[2] This limitation also applied to the formation of any consortium or association with non-parties.

Section 21.1.2, which provided that the Participation Contract "*shall terminate*" if, among other things, OEPC transferred or assigned to third parties its rights under the Participation Contract without Ecuador's prior written approval;

Section 21.3 pursuant to which Chapter IX of the HCL, which governed *Caducidad* proceedings and sanctions for illegal transfers, was made applicable in case OEPC illegally transferred or assigned its rights to a third party; and

Section 22.1.1, in which OEPC explicitly acknowledged that it had actual knowledge of Ecuador's legislation governing hydrocarbon participation contracts, including the HCL.

These provisions made clear that OEPC and Ecuador agreed that OEPC could not transfer or assign its rights under the Participation Contract to any third party without Ecuador's prior written consent, and that if such a transfer took place, the Participation Contract was to automatically terminate and Ecuador was to impose the sanction of *Caducidad*.

Shortly after the Participation Contract was executed and unbeknownst to Ecuador, OEPC began negotiating with a third party, AEC[3], the sale of 40% of OEPC's rights and obligations under the Participation Contract. The transaction was consummated in October 2000 with the execution of the Farm-out Agreement and the accompanying Joint Operating Agreement (the "**Farm-out Documents**").

During the Arbitration, OEPC argued that the Farm-out Documents envisioned two phases: "**Phase One**" in which OEPC transferred to AEC a 40% "*economic interest*" in Block 15, which, according to OEPC, simply consisted of AEC paying OEPC money in exchange for oil; and "**Phase Two**," in which OEPC would formally transfer to AEC "*legal title*" over 40% of OEPC's rights in the Participation Contract. OEPC alleged that the transfer of an "*economic interest*" in "phase one" was not a transfer for which prior approval from Ecuador was required under the Participation Contract because, OEPC alleged, it was a mere swap of oil for money. Any "*transfer of rights*," OEPC argued, would occur in "phase two," which never materialized.

The tribunal rejected Claimants' argument. Based on the Farm-out Documents' language, the tribunal concluded that they "*intended to effectuate a transfer of rights and obligations held under the Participation Contract to the benefit of AEC*"[4]. The tribunal also rejected Claimants' argument that the

[3] The negotiations originally were between OEPC and City Investing Company Limited (" **City Investing**"). Subsequently, City Investing changed ownership several times and with that changed its name first to AEC Ecuador, Ltd. and then to EnCana International, Ltd. Unless otherwise specified, City Investing, AEC Ecuador, Ltd., and EnCana International are collectively and interchangeably referred to herein as " **AEC**." In 2005, during the pendency of the Arbitration, EnCana International, Ltd. sold its interests in the Farmout Agreement and Joint Operating Agreement to Andes Petroleum Co. ("**Andes**"), a Chinese-controlled entity.

[4] Award§ 302 (emphasis added). That conclusion is reiterated in§§ 301, 305, 305, and 307, among others, of the Award.

transfer of a 40% "*economic interest*"[5] was functionally different from a transfer of "*legal title*", and held that the Farm-out Documents effectuated a transfer of OEPC's rights and obligations under the Participation Contract[6]. Finally, the tribunal concluded that, because OEPC had not sought prior approval from Ecuador, OEPC's unauthorized transfer constituted a breach of the Participation Contract and a violation of the HCL[7].

B. The Tribunal's "Negligence" Analysis

Upon determining that OEPC had acted wrongfully and illegally by proceeding with the unauthorized transfer, the tribunal proceeded to assess the gravity of OEPC's conduct. That was an unnecessary exercise because, as Ecuador argued during the arbitration, OEPC's motive or intent for breaching the Participation Contract and violating the HCL was irrelevant. The issue before the tribunal was simply whether OEPC's transfer of 40% of its rights under the Participation Contract was done with or without Ecuador's approval. If it was done with approval, then Ecuador was not permitted to declare *Caducidad* and it owed OEPC damages; but if it was done without approval, then Ecuador was expressly permitted to declare *Caducidad* under both the Participation Contract and the HCL, and Ecuador was liable for no damages. The tribunal concluded that it was done without Ecuador's approval. If follows, therefore, that Ecuador was entitled to declare *caducidad* and owed OEPC no damages.

The tribunal, however, found that although OEPC was aware of the risk of not obtaining prior approval for the Farm-out, its failure to do so was not "*driven by bad faith*"[8],was not "*done in bad faith*"[9], and did not "*amount[] to bad faith*"[10], Rather, the tribunal held, OEPC was merely "*negligent*." In the tribunal's words:

> *"OEPC's failure to secure the required authorization on the part of the Ecuadorian authorities in October 2000, while not amounting to bad faith, was negligent*[11].

[5] Award§ 306: Although the Farmout was sometimes characterized by the Claimants as "merely" transferring to AEC, in 2000, a 40% economic interest in Block 15, as opposed to legal title to an interest in Block 15, the Tribunal does not accept that the transaction, whatever may have been the parties' intention, did not serve to effectuate a transfer of rights and obligations requiring authorization on the part of the Ecuadorian authorities.

[6] Award§ 307: The reality is that by entering into the Joint Operating Agreement, OEPC agreed to share with AEC some of the rights and obligations it had under the Participation Contract and, in so doing, it agreed to a transfer of these rights and obligations. As such, prior authorization on the part of the Ecuadorian authorities was required.

[7] Award§ 381 ("*In conclusion, the Tribunal finds, based on the above, that OEPC, by failing to secure the required ministerial authorization, breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL*.") (emphasis added).

[8] Award§ 348 (emphasis added).

[9] Award§ 380 (emphasis added).

[10] Award§ 380 (emphasis added). *See also id.* at§ 383 ("*Having concluded above that OEPC's failure to secure the required authorization on the part of the Ecuadorian authorities in October 2000, while not amounting to bad faith, was negligent . . .*") (emphasis added).

[11] Award§ 383 (emphasis added).

> *The Tribunal has also found that this transfer required authorization on the part of the Ecuadorian authorities, that this authorization was not sought, but that OEPC's failure to secure such authorization in October 2000, while imprudent and ill advised, did not amount to bad faith*[12].

> *[F]ailure by OEPC to disclose the true nature of the Farm-out Agreement to Ecuador and to obtain ministerial authorization in 2000 was a 'grave mistake'; OEPC, while not acting in bad faith, was negligent"*[13].

In the annulment proceeding that followed the Award, Ecuador argued that the tribunal effectively created a new, "*lesser*" kind of contractual breach and violation of the HCL: a merely "*negligent*" one. That conclusion is problematic for three reasons:

- *First*, Ecuadorian law does not take into consideration *intent* when evaluating or determining a breach of contract or a violation of the HCL.
- *Second*, the tribunal failed to provide any analysis or cite to any legal authority supporting its creation of a "*negligent*" contractual breach or violation of the HCL.
- *Third*, even assuming that Ecuadorian law recognizes a "*negligent*" contractual breach or violation of the HCL, the tribunal failed to provide the reasons for finding that OEPC's violation was merely negligent.

Moreover, as Ecuador argued in the annulment proceeding, the analysis employed by the tribunal to reach its "*negligence*" conclusion was, in effect, an inquiry into whether OEPC had acted in "*bad faith*." But the lack of "*bad faith*" does not equate to "*negligence*." "*Bad faith*" is "*dishonesty of belief or purpose*"[14]. Whether OEPC breached the Participation Contract or violated the HCL with an ill-belief or an ill-purpose, however, does not lead to a conclusion of negligence.

Rather, negligence is defined as "any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights"[15]. Negligence thus has two components: (i) the assessment of a party's conduct under a certain standard of care mandated by positive law; and (ii) a determination that the conduct at issue is not intentional, wanton, or willful.

[12] Award§ 384 (emphasis added).

[13] Award§ 662 (emphasis added).

[14] *Black's Law Dictionary*, 8th Edition, p. 149 ("*Bad faith*") (emphasis added).

[15] *Black's Law Dictionary*, p. 1061 ("*negligence*") (emphasis added).

This is true in virtually every legal system around the world[16], including in Ecuador.

Under Ecuadorian law, conduct can be "*dolosa*" (*i.e.*, intentional conduct) or "*culposa*" (*i.e.*, non-intentional conduct)[17]. Ecuadorian law further distinguishes between three types of conduct deemed "*culposa*" based on the standard of care imposed by the law and the nature of the actor's conduct, in an increasing level of gravity: "*culpa o descuido levísimo*," "*culpa leve*," and "*culpa grave*"[18].

The tribunal never mentioned, much less applied, any standard of care that governed OEPC's conduct

[16] This is the case under: (***i***) French law. *See* G. Cornu, *Vocabulaire Juridique*, 8th Edition, 2007, p. 610 ("*négligence*") ("*faute non intentionnelle consistant à ne pas accomplir un acte qu'on aurait dû accomplir, quasi-délit source de responsabilité civile [...] ou parfois pénale* "); (***ii***) English law. *See* Clerk & Lindsell on Torts, 20th Edition, 2010, p. 415 ("*[r]equirements of the tort of negligence. There are four requirements, namely: (1) the existence in law of a duty of care situation, i.e. one in which the law attaches liability to carelessness . . .; (2) breach of the duty of care by the defendant, i.e. that he failed to measure-up to the standard set by law . . .* "); and (***iii***) United States law. *See* Second Restatement of Torts, The American Law Institute, 1965, 282 (negligence is conduct " *which falls below the standard established by law for the protection of others against unreasonable risk of harm*"); Prosser and Keeton on the Law of Torts, West Publishing Co., 5 th Edition, 1984, p. 169 ("*[a] failure to conform to the standard [of conduct imposed by the law] is negligence, therefore, even it if is due to clumsiness, stupidity, forgetfulness, an excitable temperament, or even sheer ignorance*").

[17] *Comité Pro Mejoras Barrio Delfina Torres vda. de Concha v. Petroecuador, Petrocomercial and their affiliates* , published in Official Register No. 43, March 19, 2003, p. 26: *La responsabilidad civil extracontractual, en nuestra legislación, es en esencia subjetiva; es decir, requiere la presencia de la culpabilidad como elemento indispensable para su configuración. La culpabilidad investiga la relación existente entre la voluntad del sujeto y su acto. Dicha voluntad es calificada de dolosa cuando el sujeto desea el acto y sus consecuencias, que son normalmente previsibles, y es culposa cuando el agente causa un daño sin el propósito de hacerlo, pero obrando con imprudencia, negligencia o impericia, y puede añadirse con infracción de normas legales o reglamentarias.*

[18] *See* Ecuador Civil Code, Art. 29: "*La ley distingue tres especies de culpa o descuido: Culpa grave, negligencia grave, culpa lata, es la que consiste en no manejar los negocios ajenos con aquel cuidado que aún las personas negligentes y de poca prudencia suelen emplear en sus negocios propios. Esta culpa, en materias civiles, equivale al dolo. Culpa leve, descuido leve, descuido ligero, es la falta de aquella diligencia y cuidado que los hombres emplean ordinariamente en sus negocios propios. Culpa o descuido, sin otra calificación, significa culpa o descuido leve. Esta especie de culpa se opone a la diligencia o cuidado ordinario o mediano . . . Culpa o descuido levísimo, es la falta de aquella esmerada diligencia que un hombre juicioso emplea en la administración de sus negocios importantes. Esta especie de culpa se opone a la suma diligencia o cuidado. El dolo consiste en la intención positiva de irrogar injuria a la persona o propiedad de otro.* " *See also Comité Pro Mejoras Barrio Delfina Torres vda. de* Concha, p. 26: *Las tres formas clásicas en que se presenta la culpa son: negligencia, imprudencia e impericia. La negligencia aparece cuando el sujeto omite la realización de un acto que habría evitado el resultado dañoso. Es aquella omisión más o menos voluntaria pero consciente de la diligencia que hubiere correspondido hacer de modo tal que no llegara a producir el efecto perjudicial. En suma, la negligencia manifestada del autor del hecho lesivo se produce cuando habiendo motivos para prever el perjuicio que acontecería, no actúa con suficiente diligencia para evitarlo. La imprudencia aparece en el supuesto del sujeto que al obrar precipitadamente no prevé las circunstancias perjudiciales a las que arriba con posterioridad. Se caracteriza por la falta de atención o cautela en el actuar del individuo, incurriendo en ella ya sea por acción o ya sea por omisión. El imprudente es aquel sujeto que actúa con audacia y por impulso sin detenerse a percibir los efectos que su accionar haya podido acarrear. En la práctica no resulta cosa fácil determinar la verdadera noción de la negligencia y de la imprudencia, porque no es sencillo delimitar sus alcances, por lo cual comúnmente ambos términos son utilizados de manera similar. La impericia aparece cuando existe incapacidad técnica para el ejercicio de una función, profesión o arte determinado. Estas tres diferentes maneras de representación que adopta la conducta culposa, no suelen darse de un modo claro e independiente a la hora de la práctica forense.*

under Ecuadorian law. Rather, the tribunal summarily concluded that OEPC was negligent solely because it did not act in bad faith. The operative inquiry pertaining to negligence, however, is whether OEPC acted with *intent*, not *bad faith*.

When we speak of "intent," we must clarify what we mean—intent *to do what?* We are not referring to the intent *to mislead*. That is another way of asking whether there was intent *to act in bad faith*. And the tribunal answered that question in Paragraph 360 of the Award, concluding that "*[t]he Tribunal does not believe that OEPC intended to* ***mislead*** *Minister Terán.*" (Emphasis added). Put differently, the tribunal concluded that OEPC did not act in bad faith. But, again, that does not lead to a finding of negligence.

To the extent that a negligence analysis was relevant at all, however (which Ecuador denied), the question is whether OPEC acted *intentionally* when it transferred its rights to a third party without governmental approval in breach of the Participation Contract and in violation of the HLC. The tribunal, however, did not address that question.

C. Did OEPC Act in the Face of a Known Risk?

If a "negligence" analysis was relevant at all (and it was not), the operative inquiry was whether OEPC acted in the face of a known risk. The tribunal did not engage in such an inquiry, however, only reasoning in terms of the lack of bad faith. But in other places in the Award, the tribunal reached the factual finding that—prior to closing the transfer deal—OEPC *did* have knowledge of the HCL prohibitions and sanctions as incorporated in the Participation Contract, was advised by legal counsel on it, and was aware of the potential consequences of its actions, including the sanction of *Caducidad*.

Indeed, the tribunal found that, although OEPC may not have been 100% certain that Ecuador's prior authorization was required for the Farm-out,[19] there were "two schools of thought" within OEPC: one which "saw the Farm-out for what it truly was for oilmen, *i.e.* an 'oil for money' deal which allowed OEPC to finance and leverage its continued exploration of Block 15"[20];and another composed of "*probably the lawyers, [who] advocated that it was prudent to ask for 'prior approval' for the 'earn-in'*

[19] This is explained, *inter alia*, in paragraph 342 of the Award where the tribunal analyzed the OEPC-AEC August 9, 2000 Letter of Intent (which preceded the Farmout Documents). There, the tribunal notes that the document expressly conditioned the "Farmin Transaction" on obtaining the "necessary government approvals, if any, including without limitation, the approval of the Ministry of Energy and Mines in Ecuador." (Award§ 342). The tribunal then recognizes that, at a minimum, that language meant that there was "*no consensus between AEC and OEPC that ministerial authorization was necessary*." *Id.* In other words, OEPC was apprised of the fact that Ecuador's prior approval could be required, although it arguably was not 100% certain of it, yet chose not to confirm that fact. Regardless of whether it had reached the full realization that Ecuador's prior consent was indeed required, OEPC, as a party to the Participation Contract (which explicitly stated that prior consent was required), had actual knowledge of that statutory and contractual requirement.

[20] Award§ 345.

phase". They had obviously carried out a cursory examination of the agreements at issue.[21]

Faced with those competing views, the tribunal reasoned, OEPC chose not to follow the "*lawyers … [who] had obviously carried out a cursory examination of the agreements at issue*." They did so, the tribunal further reasoned, because they were driven by the cavalier approach of "*business people, seasoned oilmen, for whom legal niceties were not as important as the business realities of the deal*"[22].

As argued by Ecuador, those conclusions reflect that OEPC had actual awareness of the risk associated with its conduct and that it knowingly took that risk. That conduct squarely fits the definition of an intentional[23] or, at a minimum, a reckless act[24]. And when a person acts "*intentionally, wantonly, willfully disregardful of other's rights*"[25], or recklessly, one is by definition not acting merely "*negligently*." Thus, even if one accepts the tribunal's finding that OEPC did not act with ill-will or ill-purpose (*i.e.*, bad faith), the tribunal's other findings show *intent* or *recklessness* in breaching the Participation Contract and in violating the HCL.

D. The Impact of the Negligence Finding

The finding of negligence had a case-determinative effect in two respects: (*i*) whether the *Caducidad* Decree was a proportionate response to OEPC's conduct; and (*ii*) what was OEPC's appropriate percentage of fault in bringing about the loss of its investment.

As to the first issue, the tribunal weighed OEPC's alleged "*negligent*" conduct in determining the proportionality of the declaration of *Caducidad*. After analyzing both Ecuadorian law and public international law, the tribunal summarized its understanding of the doctrine of proportionality as follows:

> "*In cases where the administration wishes to impose a severe penalty, then it appears to the Tribunal that the State must be able to demonstrate (i) that sufficiently serious harm was caused by the offender; and/or (ii)* that there had been a flagrant or persistent breach of the relevant contract/law, sufficient to warrant the sanction imposed; *and/or (iii) that for reasons of deterrence and good governance it is appropriate that a significant penalty be imposed, even though the harm suffered in the particular instance may not have been serious*"[26].

21 Award§ 347 (emphasis added).

22 Award§ 348 (emphasis added)

23 *Black's Law Dictionary*, p. 26 ("*intentional act*" is "*[a]n act resulting from the actor's will directed to that end. An act is* ***intentional when it is foreseen and desired by the doer****, and this foresight and desire resulted in the act through the operation of the will*") (emphasis added).

24 *Black's Law Dictionary*, p. 1298 ("*reckless*" is "*[c]haracterized by the creation of a substantial and unjustifiable risk of harm to others and* ***by a conscious (and sometimes deliberate) disregard for or indifference to that risk . . . [r]eckless conduct is much more than mere negligence****: it is gross deviation from what a reasonable person would do*") (emphasis added).

25 *Black's Law Dictionary*, p. 1061 ("*negligence*" consists of "*any conduct that falls below the legal standard established to protect others against unreasonable risk of harm,* ***except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights***") (emphasis added).

The second element—"*that there had been a flagrant or persistent breach of the relevant contract/law, sufficient to warrant the sanction imposed*"—makes clear that a simple breach of a legal duty will not do. Something more, according to the tribunal, was required. The breach must be "*flagrant or persistent*." Flagrant conduct is defined as conduct that is "*conspicuously offensive… so obviously inconsistent with what is right or proper as to appear to be a flouting of law or morality*."[27]. The tribunal did not find OEPC's conduct to be so egregious. It instead found that OEPC had acted negligently, imprudently, in an ill-advised manner, but not in bad faith, and based on *that* finding determined that Ecuador acted disproportionately.

The critical consideration given to OEPC's allegedly "*negligent*" conduct is confirmed elsewhere in the Award. When articulating its ultimate conclusion on proportionality, for example, the tribunal considered "*the true nature and effect of the conduct being censured*" and measured *Caducidad* against the "*wrongdoing alleged against OEPC*"[28]. Both refer to the *nature* and *gravity* of OEPC's conduct. Likewise, in another part of the Award, the tribunal restates the requisite proportionality test as not requiring "*that the State… prove harm, but that any penalty the State chooses to impose must bear a proportionate relationship to the violation which is being addressed and its consequences*"[29]. Again, the tribunal's focus is on the *nature* and *gravity* of OEPC's conduct.

Similarly, in determining OEPC's contributory fault, the tribunal expressly recognized that it "*consider[ed] the extent of the contribution of the Claimants' negligence to their injury…*"[30].

Logically, if a finding of mere "*negligence*" in violating the Participation Contract and the HCL rendered OEPC 25% at fault for its injury, then a finding that OEPC was *more* than negligent—a finding, for example, that OEPC acted intentionally or recklessly—would only have increased OEPC's

26 Award§ 416 (emphasis added).

27 *Merriam-Webster Dictionary* ("*flagrant*") (emphasis added).

28 Award§ 450 ("*But the overriding principle of proportionality requires that any such administrative goal must be balanced against the Claimants' own interests and against* ***the true nature and effect of the conduct being censured****. The Tribunal finds that the price paid by the Claimants – total loss of an investment worth many hundreds of millions of dollars – was out of proportion to the* ***wrongdoing alleged against*** *OEPC . . .*") (emphasis added).

29 Award§ 416 (emphasis added).

30 Award§ 681 (emphasis added).

percentage of fault (and hence would have reduced its damages further)[31].

In sum, the tribunal's findings on the issues of proportionality and contributory fault were in significant part anchored on the tribunal's earlier conclusion that OEPC's conduct was merely "*negligent*." These two key issues were of crucial importance in the case because the first issue entailed the possibility of entirely absolving Ecuador of liability for the *Caducidad* Decree and the second—depending on what is considered an appropriate percentage of fault on OEPC's part—could have reduced the amount of Ecuador's liability under the Award by more than USD 1 billion.

III. CONCLUSION

Negligence is a legal concept whose defining elements are provided by the law applicable to the conduct being adjudicated. In this case, Ecuadorian law governed the issue because the conduct at issue was OEPC's breach of the Participation Contract, which was governed by Ecuadorian law, and OEPC's violation of the Ecuadorian HCL. A cursory review of the Award establishes that the tribunal did not base its "*negligence*" finding on Ecuadorian law or any other law. It reached that finding citing no law and providing no legal analysis.

More fundamentally, the tribunal's holding amounts to a finding that OEPC committed a negligent breach of the Participation Agreement and a *negligent* violation of the HCL—despite the fact that no such thing exists and that OEPC's lawyers had specifically advised the company of the risk of *Caducidad* prior to the transfer of rights. And that inexorably leads to the question that the tribunal did not ask: When a party bound by contract proceeds in breach of that contract and in the face of a known risk, can it be said to have acted merely "negligently?" The importance of this unasked question cannot be overstated; for the tribunal's "negligence" conclusion lies at the very heart of the tribunal's multi-billion dollar Award.

[31] Notably in this respect, Professor Stern believed that the tribunal underestimated Claimants' contribution to their injury, stating that Claimants were 50% responsible for bringing about the *Caducidad* Decree. (*See* Dissenting Opinion§ 7). Logically, but for the tribunal's finding of negligence, Claimants would have been found to have violated the HCL knowingly and intentionally, thereby rendering them solely responsible for their injury or, at a minimum, significantly increasing their percentage of fault.

The So-Called "Principle of Proportionality" as a Contractual Moderation Mechanism

Eduardo Silva Romero[1] *, Dechert (Paris) LLP*

The "*case law*"[2] concerning investments is unsettled and thus oscillates as to the value to be attributed to contracts executed, for most investments, between the investor (or one of its subsidiaries) and the State host of the investment (or one of its entities or agencies) *at the time* the investment is made.

Said doubts and oscillations are particularly surprising as many international investments – not to say all international investments – are made either because the host State imposes it or because of the international investors' practice, through a contract. This practice leads, among other things, to the legal notions of "*investment contract*" and "*State contract*."[3] We will use, in particular, the first to designate contracts by means of which the investment is conducted.

In the **early stages of development of investment "*case law*,"** perhaps marked by the desire of certain arbitrators to win the trust of investors so that the frequency, some investment tribunals, in particular in the cases arising out of the 2000 and 2001 Argentine crisis, used bilateral investment promotion and protection treaties ("BIT" and "BITs", in plural) to rewrite and amend contracts signed by the investor (or its subsidiary) and the host State (or its body or agency).

This first group of decisions originates, in our opinion, from the subjective notion of justice held by the arbitrators issuing them, rather than from a reasoned application of legal rules. In this regard, the tribunals which made this first group of decisions, manifestly exceeding their powers, acted more as *amiable compositeurs* than arbitrators of law. The objective justice of positive law is, however, in most of the cases, superior to the subjectivity of two or three mortals.

It would appear that those who created this "*case law*" consider, without providing further reasons, that the BIT prevails over the relevant contract.

[1] Head of Dechert LLP's International Arbitration Practice. The author must reveal, *in limine,* that he formed part of the team of lawyers representing the Republic of Ecuador ("**Ecuador**") in the arbitration between OPC and OEPC (separately and jointly, "**OXY**") and Ecuador ("**OXY 2**" case). The opinions expressed by the author in this article are personal and are not intended to represent the position of Ecuador or of Dechert LLP.

[2] There is no real "*arbitration case law*" in the strict sense, thus the inverted commas.

[3] Both concepts were developed by the French academics Prosper Weil, Charles Leben and Pierre Mayer.

"*case law*," of the *pacta sunt servanda* principle?

Decisions in the cases *CMS v. Argentina*, *Sempra v. Argentina* and *Enron v. Argentina* were the first to forget – not to say "*disregard*–" the importance of a contract within the investor-State relationship and the principle of *pacta sunt servanda* underlying it. This omission is observed in said cases in two different ways:

First, the decisions in the *CMS*, *Sempra* and *Enron* cases used the Fair and Equitable Treatment standard ("**FET**") to rewrite the relevant contract, that is, to modify its *ratione materiae* scope. In said decisions, the rewriting of the investment contract followed three stages:

One, following what had been held by the tribunal in the *Tecmed v. México* case on this point, the tribunals in said cases maintained that FET is to be understood as the respect of "*investor's legitimate expectations*."

Two, said tribunals added that *CMS*, *Sempra* and *Enron* had the legitimate expectation that the Argentine legal system in force at the time in which the investment was made would remain unchanged. Given that the relevant contracts did not contain a stabilization clause for the applicable law, by maintaining the foregoing, said tribunals rewrote them and added an equivalent provision to them, on the basis of the FET.

Three, said tribunals concluded that any change to the Argentine legal system in force at the time the investment was made led to a violation of the FET standard of the applicable BIT. In other words, said Tribunals promoted the FET standard of the BIT to an "*agreement for stabilization of the applicable law*."

Second, tribunals such as the one in the *CMS* case did not hesitate to use the so-called *"umbrella clause"* of the BIT to extend the relevant investment contract to parties that did not sign it. In other words, said tribunals simply disregarded the principle of the privity of contracts *(res inter alios acta)*, which is well-rooted in civil law.

In investment *"case law",* it seems that there is no action without a reaction. At a **second phase of said "*case law*"**, in effect, certain tribunals maintained (i) that a BIT and its FET standard cannot be used to include in investment contracts stabilization clauses that were not negotiated or introduced by the parties and, (ii) that the "*umbrella clause*" of a BIT cannot be used to extend the relevant investment contract to parties that did not sign it.

First, today there is a line of investment *"case law"* in which it is fairly clearly determined that the FET standard of a BIT, together with its alleged content of *"protection of legitimate expectations,"* cannot be used to insert into the investment contract of the case in question, a stabilization clause that the parties did not introduce or discuss while negotiating such contract. The decisions in the *Parkerings v. Lithuania* and *El Paso v. Argentina* cases constitute good examples of this line of "*case law*." For example, in the *El Paso* case, the tribunal maintained the following:

> "*The Tribunal cannot follow the line of cases in which fair and equitable treatment was viewed as implying the stability of the legal and business framework. Economic and legal life is by nature evolutionary* […].
>
> *It is inconceivable that any State would accept that, because it has entered into BITs, it can no longer modify pieces of legislation which might have a negative impact on foreign investors, in order to deal with modified economic conditions and must guarantee absolute legal stability. In the Tribunal's understanding, FET cannot be designed to ensure the immutability of the legal order, the economic world and the social universe and play the role assumed by stabilization clauses specifically granted to foreign investors with whom the State has signed investment agreements*."[4]

We do not find this line of decisions to be correct. In effect, almost all the investors are, in the sense of the *lex mercatoria*, "*international traders*." In this capacity, investors are presumed to be competent professionals. Thus, if an investor did not negotiate the inclusion of a stabilization clause with the host State or with its respective agency, it should not be able to use the FET standard of a BIT to obtain, through an international investment arbitration, what it was not able to obtain during the negotiations for the investment contract. In short, investors should not be treated as if they were legally incapable by investment tribunals.

This is why, in our opinion, it is necessary to carry out a reintegration of international law pursuant to which investment law will not be applied in isolation. That is, without taking into consideration other branches of international law such as, for example, international commercial law (including the principle that international traders are presumed to be competent professionals) and the law on fundamental guarantees.

Second, the same line of "*case law*" has reclaimed privity of contracts *(res inter alios acta)* by not applying "*umbrella clauses*" when said

[4] *El Paso Energy International Company v. The Republic of Argentina* (ICSID case No. ARB/03/15), Award of October 31, 2011, paras. 352, §§367-368.

application implies the extension of the contract to parties that did not sign it. In the Decision by the Annulment Committee in the *CMS* case, the privity principle was asserted. In fact, the *CMS* committee annulled the CMS tribunal's decision to extend the investment contract to parties that did not sign it.

The best example of reinforcement of the investment contract with respect to *"umbrella clauses,"* among the Ecuadorian cases, is the Decision on liability in the *Burlington v. Ecuador* case. In said Decision, the tribunal said the following:

The Gustav Hamester tribunal observed that the CMS annulment decision '*made it clear that [...] a contractual obligation between a public entity distinct from the State and a foreign investor cannot be transformed by the magic of the so-called 'umbrella clause' into a treaty obligation of the State towards a protected investor[.]*' By the same token, the umbrella clause cannot transform a contract obligation of the State towards an investor's subsidiary into an obligation to the investor itself.[5]

As we will see, the OXY 2 Award marks a disappointing step back towards the "*case law*" era of decisions made in investment arbitrations in which tribunals, guided more by a subjective notion of justice than by the rule of law, have forgotten – not to say "*disregarded*–" the importance of the contract signed by the investor (or its subsidiary) and the host State (or its body or agency) and, therefore, have failed to apply one of the cornerstones of law, that is, the *pacta sunt servanda* principle.

In short, the OXY 2 Award invents a principle – named "*proportionality* –" which would allow the private contractor to request the revision of the investment contract when one or more clauses in said agreement are considered "*disproportionate*" (without knowing how or why). In sum, it is sort of a contractual moderation by operation of a so-called "*principle of proportionality*." Before proceeding with the critique of said so-called "*principle of proportionality*" in the OXY 2 Award (Section 2), it is necessary to briefly describe the OXY 2 Tribunal's decision based on said principle (Section 1).

[5] *Burlington Resources Inc. v. Ecuador*, ICSID (ICSID case No. ARB/08/5), Decision on Liability, December 14, 2012, § 231.

1. The so-called "principle of proportionality" in the OXY 2 Award

In an unprecedented and inherently contradictory decision, the Arbitral Tribunal in the OXY 2 case ("**Tribunal**") maintained that *caducidad* was a disproportionate sanction and, therefore, contrary to Ecuadorian law, customary international law and the Ecuador – USA BIT ("**Treaty**"), despite having previously determined that the parties freely and expressly agreed in the Participation Contract that *caducidad* was the applicable sanction should OXY transfer rights to a third party (such as AEC) without the prior approval of the relevant Ministry.

At paragraph 452 of the Award, the Tribunal maintained the following:

"It follows that even if OEPC, as the Tribunal found earlier, breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 (or Articles 74.12 or 74.13), the 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 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."

Later, at paragraphs 453 to 455 of the Award, the Tribunal added that the *Caducidad* Decree, supposedly "*disproportionate*," amounts to a "*measure tantamount to expropriation*."

In the decisions summarized in the previous paragraphs, the Tribunal did n*ot apply the explicit terms of the Participation Contract and, as a consequence, it did not observe Ecuadorian law or the principle of international law, pacta sunt servanda. To the contrary, the Tribunal ignored the explicit and unequivocal agreement of the parties and applied a non-existent principle: the principle of "proportionality*," supposedly present in Ecuadorian law, customary international law and the Treaty.

As a result of this, by means of said principle of "*proportionality*," the Tribunal ignored the parties' agreement and rewrote or avoided the application of Clauses 16.1, 21.1.1 and 21.1.2 of the Participation Contract. Nevertheless, the proposal that "*a contract is disproportionate*," above all, when, as in this case, the contract was freely negotiated between two equally sophisticated parties that were advised by equally sophisticated legal advisers, has no legal grounds or common sense. As a matter of law and fact, a sanction expressly stipulated in a contract cannot be "*proportionate*" or "*disproportionate*." As a matter of fact, a freely agreed upon sanction "*is applied*" or "*is not applied*." This is why the Tribunal's decision, based on a so-called "*principle of proportionality*" must be criticized.

2. Critique of the decision based on a so-called "principle of proportionality" in the OXY 2 Award

In sum, the Tribunal either rewrote or avoided the application of the Participation Contract and thereby failed to apply the principle of *pacta sunt servanda*, recognized under Ecuadorian law and international law (**Section 2.1**), and, rather than enforcing a valid contract, purported to apply a principle of "*proportionality*" that does not exist in Ecuadorian law, customary international law, and the Treaty (**Section 2.2**).

2.1. The Tribunal rewrote or avoided the application of the Participation Contract and thereby failed to apply Ecuadorian law and the international law "*pacta sunt servanda*" principle

There is no doubt that both Ecuadorian law and international law encompass the *pacta sunt servanda* principle. The 1998 Ecuadorian Constitution, for instance, expressly recognizes, in its Article 23.18, such universal legal principle. As a consequence, the Tribunal had the duty to follow and apply the *pacta sunt servanda* principle in this case. However, as will be further demonstrated below, the Tribunal did not follow or apply such principle and, hence, manifestly exceeded its powers by failing to apply the applicable law. Indeed, "*it is widely recognized in ICSID jurisprudence that failure to apply applicable law constitutes an excess of power. The relevant provisions of the applicable law are constitutive elements of the Parties' agreement to arbitrate and constitute part of the definition of the tribunal's mandate*"[6].

It must be emphasized that the Participation Contract for Block 15 was executed after extensive arms-length negotiations held in a context of free will and equality between two highly sophisticated parties, each of which had received advice from competent and able counsel. By way of example, the parties' lengthy negotiations to migrate from a Services Contract to a Participation Contract took place over approximately two years.

In addition, OXY is an international merchant and,

[6] *Soufraki* Annulment Decision, § 45. See also, for example, *AES* Annulment Decision, §33 ("*there is a 'widespread agreement that a failure to apply the proper law may amount to an excess of powers by the tribunal', the underlying basis being that the issues put to a tribunal are circumscribed by the parties' consent;*") *Azurix* Annulment Decision §136, ("*the Committee accepts, that a tribunal may manifestly exceed its power where the tribunal disregards the applicable law*") and *Enron* Annulment Ruling, § 218 (quoting the *Azurix* Decision).

as such, is deemed to be a competent professional.[7] OXY is deemed by law to know what it does when trading and investing. Moreover, OXY never alleged, nor could it, that it had entered into the Participation Contract by error, duress or deceit.

The Participation Contract, voluntarily entered into by the parties, contains specific provisions that govern a contractor's unlawful decision to transfer rights to third parties, and the consequences that follow if such a transfer occurs. For example, Clause 16.1 of the Participation Contract provides that:

> "*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 contained in Art. 79 of the Hydrocarbons Law and Executive Decrees No. 809, 2713 and 1179.*"

In addition, Clause 21.1.1 of the Participation Contract provides that:

> "*21.1 **Termination**: This Participation Contract shall terminate:*
>
> *21.1.1 By a declaration of forfeiture* [caducidad] *issued by the Corresponding Ministry for the causes and following the procedure established in Articles seventy four (74), seventy five (75) and seventy six (76) of the Hydrocarbons Law, insofar as applicable.*"

Clause 21.1.1 of the Participation Contract incorporates by reference Article 74.11 of the Hydrocarbons Law, which provides as follows:

> "*Article 74* - [Grounds for termination of the contract] *The Ministry of Energy and Mines may terminate the contract 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*."

Furthermore, Clause 21.1.2 of the Participation Contract provides that:

> "21.1 ***Termination****: This Participation Contract shall terminate:*
>
> *[…] 21.1.2. Due to a transfer of rights and obligations of the Participation Contract without prior authorization from the Corresponding Ministry*."

[7] For instance, ICC Award in Case No. 2438, 1975, reported in S. Jarvin and Y. Derains, Collection of Arbitral Awards/*Recueil des sentences arbitrales de la CCI,* 1974-1985, pp. 255-256; ICC Award in Case No. 3130, 1980, *id.*, pp. 417-422; ICC Award in Case No. 3380, 1980, *id.*, pp. 413-417.

Clauses 16.1, 21.1.1 and 21.1.2 of the Participation Contract and Article 74.11 of the Hydrocarbons Law are unambiguous: termination of the Participation Contract shall occur due to a transfer of rights without prior authorization. As a consequence, the Tribunal, when concluding that OXY transferred rights arising out of the Participation Contract to AEC without prior ministerial approval, should have also concluded that *caducidad* was properly applied. That was the **precise** sanction agreed upon by the parties in case of such a transfer of rights. *Pacta sunt servanda.*

However, in its Award, the Tribunal rewrote the Participation Contract in two different ways:

First, the Tribunal rewrote Clause 21.1.2 of the Participation Contract when, at paragraphs 419 and 420 of the Award, it held:

"There is no dispute that the Caducidad Decree refers only to Article 74 of the [Hydrocarbons Law]. That in itself might not be the end of the matter if the termination provisions of the Participation Contract were identical as in the [Hydrocarbons Law], but they are not. Article 74.11 of the [Hydrocarbons Law] empowers the Minister to declare caducidad of the contract 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.'* The Tribunal notes that the reference is to transfer of rights only. By contrast, Clause 21.1.2 of the Participation Contract refers to an unauthorized transfer of '*rights and obligations.*'

There was no suggestion by the Respondent that the 'earn-in' stage of the Farm-out Agreement somehow effected a transfer to AEC of OEPC's obligations under the Participation Contract. The fact is that the only party who ever owed obligations to PETROECUADOR might plausibly have sought to enforce obligations owed under the Participation Contract, was OEPC. It is presumably for that reason that the Respondent sought to proceed under the [Hydrocarbons Law] rather than the Participation Contract."

The Tribunal's interpretation of Clause 21.1.2 is blatantly incorrect. The parties' intention when drafting this clause could not be that, if OXY transferred rights but not obligations to a third party without prior ministerial approval, the Participation Contract should not be terminated by *caducidad*. This reading of Clause 21.1.2 of the Participation Contract removes the whole purpose of that clause[8]. What the parties meant was that any transferred right entails a transfer of a correlative obligation. To be clear, in this case, OXY's transfer of its ownership, operational, managerial and voting rights to AEC also entailed the transfer to AEC of OXY's obligation to finance 40% of Block 15 operations. The Tribunal itself admits as much in paragraph 301 of the Award, where it indicates that OXY transferred "*rights and obligations*" under the Participation Contract to AEC[9]. The Tribunal's erroneous interpretation of Clause 21.1.2 of the Participation Contract is no more than a sophism intended to avoid following and applying the principle of *pacta sunt servanda.*

Second, the Tribunal also rewrote Clause 21.1.1 of the Participation Contract. At paragraphs 421 and 422 of the Award, the Tribunal held:

Nor is the position changed by reason of the fact that OEPC agreed that the contract *"shall terminate"* in the event of *'a declaration of forfeiture issued by the Corresponding Ministry for the causes and following the procedure established in Article 74 ... of the [Hydrocarbons Law] ....'* The reference to a declaration of Caducidad under the [Hydrocarbons Law] can only mean a declaration properly made – the contractor cannot be taken to have agreed to accept termination in circumstances where the decree is issued contrary to the requirement of proportionality in Ecuadorian law.

The fact that a contractor agrees that Caducidad may be a remedy in certain situations does not mean that the contractor has waived its right to have such a remedy imposed proportionately, or otherwise imposed in accordance with all relevant laws. That is particularly so when, as in the present case, the parties agree that the contract is to be governed by a system of law (Ecuadorian law) which expressly requires the principle of proportionality to be observed. There is nothing in the Participation Contract to indicate an intention to "contract out" of proportionality or any other legal principles of general application."

In this regard, the Tribunal rewrote Clause 21.1.1 of the Participation Contract by adding the phrases "*properly made*" and "*in accordance with the requirement of proportionality in Ecuadorian law*." **There is no such language in the Participation Contract.** Given this undisputed fact, the Tribunal in fact suggested that the application of the Participation Contract should somehow be avoided by operation of Ecuadorian Law.

Without making any reference to the reasons that, under any civil law system such as Ecuador's, could be invoked to avoid performance of a contract (nullity of the contract for any of the grounds provided for, for example, in the Ecuadorian Civil Code), the Tribunal effectively

[8] *Código Civil, Registro Oficial Suplemento* 46, 24 June 2005 (Book IV), Article 1578, which consecrates the principle of effet utile in the interpretation of contracts ("*The meaning which gives a clause some effect shall prevail over the one in which it is unable to take any effect*").

[9] Award, § 301.

avoided the application of the Participation Contract – thereby failing to apply the "*pacta sunt servanda*" principle encompassed in Ecuadorian and international law – on the basis of two incomprehensible theories:

First theory. The Tribunal, at paragraphs 418 and 419 of the Award, held:

To return to the Respondent's three arguments identified above, the Tribunal does not accept the submission that the ICSID authorities relied upon by the Claimants can be distinguished because of the absence of a contractual provision comparable to that found in Clause 21 of the Participation Contract. As noted earlier, the Caducidad Decree was not predicated upon breach of contract, but was instead issued pursuant to, and in reliance upon, alleged breaches of Article 74 of the [Hydrocarbons Law]. This is a point of general importance given that the Respondent has consistently advanced the plea that caducidad could not be a breach of the Treaty when it was a penalty freely agreed to by OEPC. Accordingly, it is an issue which deserves careful analysis.

There is no dispute that the Caducidad Decree refers only to Article 74 of the [Hydrocarbons Law]. That in itself might not be the end of the matter if the termination provisions of the Participation Contract were identical as in the [Hydrocarbons Law], but they are not. Article 74.11 of the [Hydrocarbons Law] empowers the Minister to declare caducidad 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.*'. The Tribunal notes that the reference is to transfer of rights only. By contrast, Clause 21.1.2 of the Participation Contract refers to the unauthorized transfer of "*rights and obligations.*"

The fact that the *Caducidad* Decree did not expressly refer to a breach of Clauses 16.1, 21.1.1 or 21.1.2 of the Participation Contract is irrelevant or false for three reasons:

One, as already pointed out, the Participation Contract, especially through Clause 21.1.1, expressly incorporated by reference Article 74 of the Hydrocarbons Law, which was in turn expressly referred to in the *Caducidad* Decree. Accordingly, by effect of such incorporation, a breach of Article 74 of the Hydrocarbons Law automatically entails a breach of the Participation Contract.

Two, the Tribunal's suggestion that, because the *Caducidad* Decree did not expressly refer to a breach of the Participation Contract, there is no breach of the Participation Contract is unfounded and illogical. The Tribunal's finding at paragraph 418 of the Award is particularly troublesome in light of the Tribunal's finding at paragraph 452 of the Award that "[i]*t follows that* [...] *OEPC* [...] *breached Clause 16.1 of the Participation Contract* [...]."

Three, the *Caducidad* Decree did in fact refer to the Participation Contract and to OXY's breach of it. Reference is made to the breach of the Participation Contract three times in the *Caducidad* Decree[10]. Indeed, it is stated in the very first page that:

"*The Minister of Energy and Mines* [...] *requests that the Executive President of PETROECUADOR initiate the proceeding set forth in clause 21.2 and following of the CONTRACT which provides for the Declaration of caducidad*[,] *deeming that the actions carried out by the CONTRACTOR, defined as offenses number 11, 12 and 13 of Art. 74 of the Hydrocarbons Law and in clauses 21.1.1 and 21.1.2 of the CONTRACT, represent grounds for such a declaration* […]"[11].

As a consequence, the Tribunal's first hollow theory aimed at avoiding application of the Participation Contract and, hence, of the *pacta sunt servanda* principle is fundamentally flawed, and amounts to a failure to apply the applicable law in this case.

Second theory. At the end of Clause 422 of the Award, the Tribunal held:

"[...] *There is nothing in the Participation Contract to indicate an intention to 'contract out' of proportionality or any other legal principles of general application*."

The paragraph transcribed above refers to footnote 35 of the Award, which reads:

"*In any event, it must be doubtful whether parties could actually contract out of a principle of such central importance that it is included in the Ecuadorian Constitution*."

The Tribunal's second theory fails for three separate reasons. As a matter of contractual interpretation:

One, the parties did not intend to subject a declaration of *caducidad* to any proportionality requirement. The parties' intent must be gleaned from the plain language of the Participation Contract, and here, the parties did not include any language regarding "*proportionality*." Specifically, no provision in the Participation

[10] *Caducidad* Decree, pp. 1, 5 and 16.

[11] *Caducidad* Decree, p. 1.

Contract provides that *Caducidad* should be applied in accordance with a "*principle of proportionality*".

Two, the Tribunal did not explain, anywhere in the Award, how a "*principle of proportionality*" would entirely avoid the application of the Participation Contract. Footnote 35 of the Award seems to suggest, without any analysis whatsoever, that, because of its "*central importance*" and its inclusion in the Ecuadorian Constitution, the "*principle of proportionality*" would be a mandatory rule under Ecuadorian law. This is incorrect. Under Ecuadorian law, proportionality is not a mandatory rule but is, at most, a subsidiary rule aimed at completing the parties' will as expressed in their Participation Contract, if needed. In this last respect, where the will of the parties is clear - as it is with respect to the terms of the Participation Contract - the principle of proportionality has no place.

Three, assuming hypothetically that the "*principle of proportionality*" is a mandatory rule under Ecuadorian law, the Tribunal in any event failed to explain how that principle, under the facts of the case, could be reconciled with the *pacta sunt servanda* principle also included in the very same Ecuadorian Constitution.

It is worth noting that the OXY 2 Award makes no mention anywhere that Claimants have argued in any way that the Participation Contract should somehow be nullified by application of a purported mandatory proportionality rule contained in the Ecuadorian Constitution.

By relying on two fundamentally flawed legal theories in order to avoid the application of the Participation Contract, the Tribunal failed to apply the applicable *pacta sunt servanda* principle, and thereby manifestly exceeded its powers. Furthermore, the Tribunal also manifestly exceeded its powers by purporting to apply a "*principle of proportionality*" that, in fact, is inexistent.

2.2. The Tribunal applied a purported principle of "proportionality" that is not encompassed in the Participation Contract, Ecuadorian law, the Treaty, or customary international law

Not only did the Tribunal manifestly exceed its power by failing to apply the *pacta sunt servanda* principle, it also did so by purporting to apply a "*proportionality principle*" which does not exist in the Participation Contract, Ecuadorian law, the Treaty, or customary international law.

2.2.1. No "*proportionality principle*" is referred to in the Participation Contract

Nowhere does the Participation Contract mention that *caducidad* should be declared in accordance with a "*proportionality principle*."

At paragraphs 396 and 422 of the Award, however, the Tribunal suggests that the Participation Contract would refer indirectly to a "*proportionality principle*" contained in the Ecuadorian legal order by way of the applicable law clause which designates Ecuadorian law as the proper law of the Participation Contract. In particular, paragraph 422 of the Award held:

> The fact that a contractor agrees that caducidad may be a remedy in certain situations does not mean that the contractor has waived its right to have such a remedy imposed proportionately, or otherwise imposed in accordance with all relevant laws. That is particularly so when, as in the present case, the parties agree that the contract is to be governed by a system of law (Ecuadorian law) which expressly requires the principle of proportionality to be observed. There is nothing in the Participation Contract to indicate an intention to 'contract out' of proportionality or any other legal principles of general application.

As demonstrated above, the Tribunal, however, does not explain anywhere in its Award how this "*proportionality principle*" could lead to avoiding the application of the Participation Contract and therefore to a failure to apply the *pacta sunt servanda* principle recognized in Ecuadorian law and international law. By purporting to apply a "*proportionality principle*" over the principle of *pacta sunt servanda* with no legal justification whatsoever, the Tribunal manifestly exceeded its power.

The Tribunal's disregard of the *pacta sunt servanda* principle goes even further.

2.2.2. The Tribunal does not demonstrate that a "proportionality principle," which would override the *pacta sunt servanda* principle, exists under Ecuadorian law

There is no demonstration whatsoever in the OXY 2 Award as to how a "*proportionality principle*" should prevail over the *pacta sunt servanda principle* under Ecuadorian law in general and, even less, in the circumstances of this case.

The reasons provided by the Tribunal at paragraphs 396 to 401 of the Award to assert the existence of a "*principle of proportionality*" under Ecuadorian law are incomprehensible and frivolous.

The Tribunal seems to import the proportionality rule from Article 24 (3) of the 1998 Ecuadorian Constitution, according to which criminal laws may only impose sanctions proportionate to the crimes. The Tribunal's decision to extend the applicability of this constitutional rule is wrong.

Moreover, it should be noted that the Tribunal does not cite (nor could it) a single authority that supports its finding that contracts are subject to a proportionality requirement under Ecuadorian law.

The Tribunal's lack of application of Ecuadorian law went even further. At paragraphs 428 to 436 of the Award, the Tribunal relied on an imaginary set of rules purportedly belonging to Ecuadorian law which would provide for alternatives to *caducidad* such as a settlement agreement or a statement by Ecuador asking investors not to replicate the reprehensible behavior deployed by OXY.

There is, however, no such set of rules under Ecuadorian law.

A mere reading of Chapter IX of the Hydrocarbons Law ("*Caducidad, Sanctions and Transfers*"), comprising of Articles 74 to 80, confirms that the majority invented alternatives not provided for under Ecuadorian law. Put simply, Ecuadorian law does not, in the circumstances of this case, provide for an alternative sanction to *caducidad*. Ecuador, in short, had no choice but to declare *caducidad* or do nothing following the reprehensible conduct of OXY.

2.2.3. The Tribunal does not demonstrate how the FET provision in the Treaty could be relied on to avoid the application of the Participation Contract

At paragraph 404 of the Award, the Tribunal stated that "T*he obligation for fair and equitable treatment has on several occasions been interpreted to import an obligation of proportionality*."

In order to justify this assertion, the Tribunal refers to four previous ICSID cases: *MTD*, *Tecmed*, *Azurix* and *LG&E.* None of these cases, however, support the existence "*in the context of international investment disputes*" of a purported "*obligation of proportionality*" under the FET standard as the one that the Tribunal applied in this case. To the contrary, the referred cases confirm that the *Caducidad* Decree, as the exercise of a sanction contractually agreed by the parties, cannot violate the FET standard under the Treaty. In purporting to apply the proper law (*i.e.*, the FET standard in accordance with four previous ICSID

cases), but actually applying something that is not the applicable law, the Tribunal manifestly exceeded its powers.[12]

From the cases cited, the Tribunal gave special consideration to the *Tecmed* case. *Tecmed*, however, does not sustain the Tribunal's position in this case for the following reasons:

First, contrary to the Tribunal's assertion, the *Tecmed* tribunal did not interpret the FET standard to import an "*obligation of proportionality*". Instead, the *Tecmed* tribunal concluded that the FET standard protects the legitimate expectations of the investor. According to the *Tecmed* tribunal:

> "*The Arbitral Tribunal considers that the* [the FET] *provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all the rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the State that were relied upon by the investor to assume its commitment as well as to plan and launch its commercial and business activities. The investor also expects the State to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments, and not to deprive the investor of its investment without the required compensation.*"[13].

In applying the *Tecmed* tribunal's definition of the FET standard to the facts of this case, the only possible conclusion is that the *Caducidad* Decree, as the exercise of a contractual prerogative freely agreed to by the parties, does not frustrate OXY's legitimate expectations and thus does not violate the FET standard under the Treaty. Indeed, that was the conclusion reached by the Tribunal at paragraph 383 of the Award:

[12] *MTD Annulment Decision*, § 47 ("*the notion of endeavouring to apply the law is not a merely subjective matter. An award will not escape annulment if the tribunal while purporting to apply the relevant law actually applies another, quite different law*").

[13] *Tecmed S.A. versus The United States of Mexico (ICSID case No. ARB (AF)/00/2), Award, May 29, 2003, § 154.*

"*Having concluded above that OEPC's failure to secure the required authorization on the part of the Ecuadorian authorities in October 2000, while not amounting to bad faith, was negligent, the Tribunal considers that the Claimants cannot be found to have had a legitimate expectation that the Minister would not exercise his discretion and impose caducidad. The failure to secure the required authorization meant that OEPC breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the HCL which, as one option, expressly allowed the Minister to declare the caducidad of the Participation Contract and the Joint Operating Agreements. For this reason, the Claimants' allegation that the Caducidad Decree frustrated their legitimate expectations is rejected*."[14]

Therefore, the *Tecmed* case cannot support the Tribunal's reliance upon the FET standard to avoid the application of the Participation Contract. In particular, the *Tecmed* case's interpretation of the FET standard, as protecting investors' legitimate expectations, directly contradicts the Tribunal's conclusion in this dispute that the *Caducidad* Decree violated the FET standard under the Treaty despite the fact that it did not frustrate OXY's legitimate expectations.

Second, the *Tecmed* tribunal applied a test of proportionality based on case-law from the European Court of Human Rights with regard to expropriation (and not the FET standard). The test applied by the *Tecmed* tribunal in the context of expropriation is manifestly different from the so-called "*obligation of proportionality*" that the Tribunal applied in the context of the FET standard. Therefore, contrary to the Tribunal's proposition, the law applied by the Tribunal in this case was not the law applied by the *Tecmed* tribunal.

In *Tecmed*, the Tribunal first determined that the claimant, due to the resolution denying the renewal of its license, "*was deprived of the economical use and enjoyment of its investments, as if the rights thereto* […] *had ceased to exist*"[15]. Having determined that the claimant was permanently deprived of its economic rights by the resolution that was a measure which effects amounted to an expropriation, the tribunal then applied a test of proportionality to determine whether such a deprivation of rights without compensation (and thus in breach of the relevant treaty) could be justified. According to the tribunal, such tests was "[t]*o determine whether* [the actions of the State in light of the expropriation provision of the Agreement] *are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation*"[16].

The Tribunal concluded at paragraph 383 of the Award that (i) "*OEPC breached Clause 16.1 of the Participation Contract and was guilty of an actionable violation of Article 74.11 of the Hydrocarbons Law, which […] allowed the Minister to declare the Caducidad of the Participation Contract and the Joint Operating Agreements*;" and (ii) the *Caducidad* Decree did not frustrate OXY's legitimate expectations. Under such circumstances (*i.e.*, the straightforward application of a contractual agreement and the preservation of OXY's legitimate expectations), there cannot be a breach of the FET standard. In the absence of a previous breach of OXY's rights, the "*principle of proportionality*" in order to assess whether such breach was justified, as it was applied by the *Tecmed* tribunal in the context of expropriation, is simply not applicable here.

Third, on the facts, the *Tecmed* case related to the issuance of a permit to exploit a hazardous waste landfill. No issue of performance and termination of a contract arose in that case. Therefore, *Tecmed* cannot sustain the Tribunal's reliance on the FET provision in the Treaty in the present case to avoid the application of the Participation Contract.

The same conclusions apply to the Tribunal's reliance on the *Azurix* and *LG&E* cases. Indeed, as noted by the Tribunal at paragraph 409 of the Award, the *Azurix* tribunal "*endorsed the reliance in Tecmed on case law from the European Court of Human Rights*." Both the *Azurix* and *LG&E* tribunals referred to and applied the proportionality test as it was applied in the *Tecmed* case, *i.e.*, (i) in the context of an expropriation and not the FET standard and (ii) after establishing the existence of a deprivation of the investor's property rights by the State's measure without compensation (amounting to an expropriation in breach of the treaty), in order to determine whether such breach was justified. As demonstrated above, it is simply not the legal standard that the Tribunal applied in OXY 2.

Finally, the Tribunal also cited the *MTD* case. However, in *MTD*, the tribunal did not apply the FET standard as requiring a so-called "*obligation of proportionality*" nor even presented a definition of proportionality under the FET standard. The tribunal simply noted in a single paragraph (quoted by the Tribunal at paragraph 405 of the Award) that **the parties** agreed to a general definition of the FET standard proposed by the claimant's expert witness as encompassing, *inter alia*, "*proportionality*." Nevertheless, the definition of the FET standard agreed by the parties was not the

14 Award, § 383 (emphasis added).

15 *Tecmed S.A. v. The United Mexican States* (ICSID Case No. ARB (AF)/00/2), Award, 29 May 2003, § 115.

16 *Tecmed S.A. v. The United Mexican States* (ICSID Case No. ARB (AF)/00/2), Award, 29 May 2003, § 122.

definition that the tribunal applied in that case. The tribunal indeed relied upon the *Tecmed* definition of the FET standard which, as demonstrated above, refers to the preservation of legitimate expectations and not to proportionality.

In sum, to avoid the application of the Participation Contract, the Tribunal enforced an "*obligation of proportionality*" which purportedly derives from the FET standard, as determined in the *Tecmed*, *Azurix*, *LG&E* and *MTD* cases. In reality, however, the Tribunal applied an entirely different standard that finds no support whatsoever in investment arbitration "case law".

2.2.4. The Tribunal does not demonstrate that a "proportionality principle," which would override the pacta sunt servanda principle, exists under international law

In support of its extraordinary claim that the FET standard and customary international law require avoiding the application of "*disproportionate*" contracts, the Tribunal mainly refers to "*Europe*", where one supposedly finds "*the most developed body of jurisprudence*" on proportionality[17].

European law, however, does not even remotely support this claim. It is revealing that the Tribunal provides no specific authorities or cases. In the European context, the principle of proportionality only applies where a breach of a fundamental right or freedom has been established, in order to determine whether the breach can be justified. For instance, the European Court of Human Rights, in the case cited in the *Tecmed* award, only triggered a proportionality review once it established that the claimant had been deprived of its property rights[18]. Likewise, the European Court of Justice only reviews whether measures in breach **of ownership** rights are justified in the public interest[19]. Thus, even if we were to equate European law to customary international law, which Ecuador disputes, the only principle that could emerge would be to the effect that breaches of fundamental rights are subject to some form of judicial review. In the OXY 2 case, however, the Tribunal has done *exactly the opposite*: instead of establishing that OXY's rights were breached (*quod non*), and then examining whether the breach was proportionate to the aims pursued, the Tribunal simply considered that all of Ecuador's actions, even though legitimate and respectful of OXY's contractual rights, are subject to a general, unconstrained review of proportionality.

Ultimately, what the Tribunal presents as a principle of "*proportionality*" amounts to pure, unrestrained arbitrariness. Instead of applying applicable rules or paying appropriate deference to

17 Award, § 403.

18 *James and others v The United Kingdom,* European Court of Human Rights, Judgment of 21 February 1986, app. no. 8793/79.

19 For instance, *J. Nold, Kohlen- und Baustoffgroßhandlung v Commission of the European Communities,* European Court of Justice, Judgment of 14 May 1974, Case 4-73, *European Court Reports* 1974, p. 00491.

Ecuadorian authorities, the Tribunal used the principle of proportionality to justify deciding *ex aequo et bono*, *i.e.*, in accordance with its subjective notion of justice. Indeed, at paragraph 417 of the Award, the Tribunal puts forward the content of the test of "*proportionality*" that it decided to apply in the following terms:

> "*The test at the end of the day will remain one of overall judgment, balancing the interests of the State against those of the individual, to assess whether the particular sanction is a proportionate response in the particular circumstances*"[20].

Thus, the Tribunal did not judge according to binding rules (and in particular those agreed to in the Participation Contract) but simply came to its idea of justice in this case by freely and arbitrarily "*balancing*" all interests that it considered relevant. This is not, however, the mission that the parties entrusted it with. In fact, the parties did not agree that the Tribunal could act as an *amiable compositeur* or decide the dispute *ex aequo et bono,* anywhere. Article 42 (3) of the ICSID Convention provides that the Parties shall expressly agree to confer the Tribunal the power to decide *ex aequo et bono*, in order to act as *amiable compositeur* in the resolution of the dispute. Given that, in this case, the parties did not grant it such power anywhere, the Tribunal, by acting as an *amiable compositeur* in determining liability, manifestly exceeded its powers[21].

****

In conclusion, it remains only for us to hope that the OXY 2 Award simply be an unfortunate exception to the new general rule of respect of investment contracts as conceived by the investment tribunals' of the second line of "*case law*" described above. After all, the contract is, in almost all cases, the only objective reality that arbitrators can, and must, apply in order to ensure the principle of "*legal certainty*" for the peace of mind of both investors and investment-hosting States. *Pacta sunt servanda.*

20 Also, at § 450, the Tribunal stated that "*the overriding principle of proportionality requires that any such administrative goal must be balanced against the Claimants' own interests and against the true nature and effect of the conduct being censured*."

21 *MTD Annulment Decision, § 44, ("[…] it is established that […] a decision given ex aequo et bono – that is to say, in the exercise of a general discretion not conferred by the applicable law – which is not authorized by the parties under Article 42(3) of the Convention' can constitute a manifest excess of powers") : MINE Annulment Decision, § 5.03, ("a tribunal's disregard of the agreed rules of law would constitute a derogation from the terms of reference within which the tribunal has been authorized to function. Examples of such a derogation include the application of rules of law other that the ones agreed by the parties, or a decision not based on any law unless the parties had agreed on a decision ex aequo et bono. If the derogation is manifest, it entails a manifest excess of power").*

The "60/40 issue" in the OXY case

Professor Pierre Mayer, partner at Dechert (Paris) LLP
And Audrey Caminades, associate at Dechert (Paris) LLP[1]

INTRODUCTION

The Final Award dated 5 October 2012 (the "Award") is unprecedented not only in the amount of damages awarded, but also in the dubious reasoning on which it rests and the vigour of the dissent that accompanied it, and which openly calls for the annulment of the Award.

The Republic of Ecuador approached this arbitration with a very simple and just position: Ecuador was entitled to declare Caducidad because Occidental Exploration and Production Company ("**OEPC**") and Occidental Petroleum Corporation ("**OPC**") (together, "**Claimants**") expressly agreed in the Participation Contract for Block 15 (the "Participation Contract") that Ecuador could do so if OEPC transferred any rights thereunder to a third-party without Government approval. The same is true under the Hydrocarbons Law (the "HCL") to which Claimants and Ecuador expressly submitted the Participation Contract. The Tribunal unanimously found that Claimants transferred such rights without Government approval to a third party (Alberta Energy Company Ltd., "AEC") with the Farm-out Agreement of 19 October 2000 and the Joint Operating Agreement between Claimants and AEC (together the "Farm-out Agreements"). Therefore, Ecuador applied the exact sanction that OEPC had agreed Ecuador could apply in that exact circumstance.

The Tribunal, however, refused to hold OEPC to its agreement. The basis for that refusal was that, in the Tribunal's view, the sanction to which OEPC voluntarily agreed in the Participation Contract was "*disproportionate*." As Professor Silva Romero described in a preceding article of this volume, the Tribunal arrogated upon itself the power to act as an *amiable compositeur* and decided the case *ex aequo et bono*. Even that, however, could not prepare Ecuador for what happened next.

After the Parties had completed their written submissions and hearings on quantum, they were left to wait until the Tribunal rendered its Award. While waiting for the Award, the Parties received an email from the Tribunal on 6 October 2011.

[1] The views expressed in this article are those of the authors alone.

The Tribunal's 6 October 2011 eleventh-hour email, however, raised a proposition found nowhere in the Parties' submissions: that even if the Tribunal concluded that OEPC had unlawfully transferred 40% of its rights in violation of the Participation Contract and Ecuadorian law, Claimants *would still be entitled to 100% of the value of Block 15.* Forced to conclude, as it later did in the Award, that Claimants had indeed transferred 40% of their rights under the Participation Contract in violation of Ecuadorian law, the Tribunal wanted to award Claimants not only 60% of the value of Block 15, but in fact 100%.

And that is precisely what happened.

After instructing the Parties to brief the issue, the Tribunal immediately acted on its own newly-raised argument to declare inexistent the transfer of rights effected by Farm-out Agreements between OEPC and AEC. This was an alarming conclusion, as AEC was not a party to the arbitration and – even if it had been – was not a US national that could qualify as a protected investor under the Treaty between the United States of America and the Republic of Ecuador concerning the Encouragement and Reciprocal Protection of Investment of 27 August 1993 (the "**Treaty**"). Having purported to nullify the third-party transfer of rights, the majority found the 40% interest always belonged to OEPC and thus awarded Claimants 100% of the value of Block 15, i.e. an additional USD 943 million[2].

In a now famous dissenting opinion (the "Dissenting Opinion"), Professor Stern openly called for the annulment of the Award on this specific basis:

> "*[…] there is the* ***fundamental impossibility*** *for me to follow the different statements in the Award relating to the effect this Tribunal should give to the Farm-out Agreement. The majority's position on the effect of the Farm-out Agreement is, in my view,* ***so egregious in legal terms and so full of contradictions****, that I could not but express my dissent. In my view, there are two major questionable aspects in the majority's approach to the question of the effectiveness of the Farm-out Agreement: the first is the analysis of the question of the effectiveness of a legal act under Ecuadorian law, which is based on* ***a total lack of reasons, with the consequence that I was not able to follow the 'reasoning' from point A to point B, as well as gross errors of law*** *in the purported interpretation of the content of Ecuadorian law; the second, which in my view is* ***even a more serious matter, is the manifest excess of power*** *of the Award nullifying a contract concerning a company which not only was not a party to the arbitration, but moreover – even if it had been a*

[2] According to the Tribunal's damages calculation, which are here challenged, Block 15's fair market value was USD 2,359,500,000.00. See Award § 824 *et seq*. Based on these numbers, Claimants' 60% ownership interest in Block 15 amounted to USD 1,415,700,000.00 and AEC's 40% ownership stake amounted to USD 943,800,000.00.

party – could not be considered, being a Chinese company, as an investor over which the Tribunal had jurisdiction under the US/Ecuador BIT".[3]

In order to fully apprehend the majority's decision to nullify the Farm-out Agreements (**the "60/40 issue**"), the present article will summarize the background of that decision **(Section I**) prior to detailing the strong criticisms to which it gives rise (**Section II**).

I. THE CONTEXT OF THE MAJORITY'S DECISION TO NULLIFY THE TRANSFER OF RIGHTS EFFECTED BY THE FARM-OUT AGREEMENTS

Both the factual (**Section A**) and the procedural (**Section B**) background of the case will enlighten the readers on the extraordinary nature of the majority's decision.

A. The Factual Background : Claimants concealed from Ecuador that the Farm-out Agreement and the Joint Operating Agreement operated a transfer of rights

In Ecuador, Claimants' investment related to four major oil fields, then known as Yanaquincha, the Indillana Complex, Limoncocha, and Edén Yuturi. These four fields were located in Ecuador's Oriente Basin. The four oil fields were partly located within what was known as Block 15.

On 25 January 1985, OEPC and Ecuador's State oil company at that time, CEPE, entered into a services contract for the exploration and exploitation of hydrocarbons in Block 15 ("**the Services Contract")**[4]. Pursuant to the Services Contract, OEPC undertook and financed all activities required to explore and produce crude oil from Block 15.

On 21 May 1999, OEPC and Ecuador's State oil company at that time, PETROECUADOR, entered into an agreement modifying the Services Contract, and converting it into a Participation Contract (the "**Participation Contract**"). Under the Participation Contract, OEPC had the right to develop and exploit certain fields within Block 15 and to receive as compensation a share – a "*participation*" – of the crude produced, which was to be calculated pursuant to a contract formula. OEPC's contractual rights with regard to Block 15 were to terminate on 22 July 2012 for areas designated as being in the "*production base*," and on 22 July 2019 for "additional exploration areas", unless they were terminated earlier. Several key provisions of the Participation Contract were at issue in the proceedings.

In particular, OEPC was precluded from transferring or assigning its rights and obligations under the Participation Contract to any third party without Ecuador's prior authorization in accordance with

[3] Dissenting Opinion, § 5, (emphasis added).

[4] *Modificación al Contrato de Prestación de Servicios para la Explotación de Hidrocarburos del Bloque 15 en Contrato de Participación para la Exploración y Explotación de Hidrocarburos (Petróleo Crudo) en el Bloque 15*.

Article 79 of the HCL and Executive Decrees 809, 2713, and 1179[5]. Similarly, OEPC was precluded from entering into or creating a consortium or association pertaining to the activities covered under the Participation Contract without Ecuador's prior authorization[6]. Failure to obtain such authorization was grounds for termination of the Participation Contract through a Caducidad proceeding[7].

In addition, the Participation Contract was governed by Ecuadorian law[8] and was to be interpreted in accordance with Title XIII, Book Four of the Ecuadorian Civil Code[9].

In 1999, the same year the Participation Contract was entered into, OEPC and AEC began negotiations originally for the sale of Block 15 to AEC and subsequently for the "Farm-in" of AEC into Block 15. If OEPC's Farm-in of AEC is at the heart of the proceedings, it is worth highlighting that AEC was not a party to the proceedings.

Pursuant to the "*Farm-in*" mechanism, OEPC would convey and transfer to AEC a 40% stake in Block 15 with all attendant rights and obligations under the Participation Contract. The "Farm-in" mechanism consisted of two phases: a first phase ("**Phase One**") in which OEPC transferred to AEC a 40% "economic interest" in Block 15, which Claimants said was simply AEC paying OEPC money for oil; and a second phase ("**Phase Two**"), which OEPC would formally transfer to AEC "legal title" over 40% of its rights in the Participation Contract.

To enable AEC to direct and instruct OEPC during Phase One, the Parties agreed to execute a joint operating agreement (the "**Joint Operating Agreement**")[10]. The Joint Operating Agreement was *"to govern exploration, exploitation, development, maintenance, operation and production of Block 15"*[11]. In the Joint Operating Agreement, OEPC and AEC sought to "define their respective rights and obligations with respect to their operations under the Participating Agreements"[12]. Significantly, the Joint Operating Agreement went a step beyond the Farm-out Agreement in accurately depicting the parties' relationship.

As found by the Tribunal[13] – Claimants' description of Phase One of as transferring a mere "economic interest" – i.e., money for oil – was a farce. Rather, the Farm-out Agreements immediately conveyed to

[5] Participation Contract, § 16.1.

[6] Participation Contract, § 16.4.

[7] Participation Contract, § 16.5. See also, Participation Contract, § 21.1.

[8] Participation Contract, § 3.1.

[9] Participation Contract, § 22.1.

[10] Farm-out Agreement, § 2.02.

[11] Farm-out Agreement, § 2.02.

[12] Joint Operating Agreement, last "*whereas*," §§ 1.51 and 3.1.1.

[13] Award, §§ 302-303 and 305-307.

AEC an interest in the Participation Contract, which gave AEC everything associated with the 40% interest in the Participation Contract except bare legal title.

Claimants, however, never told Ecuador any of this. Through a series of purposefully and carefully orchestrated acts, Claimants prevented disclosure of the Farm-out Agreements to Ecuador until 2004. Cognizant that full disclosure of the consummated transaction would have raised intense Government scrutiny and potentially triggered Caducidad proceedings, Claimants instead misrepresented to Ecuadorian Government officials the full extent of their agreement with AEC.

It was only when independent auditors (Moores Rowland) discovered the Farm-out Agreements through an audit of OEPC in 2004 that they came to light. Despite the importance of that discovery, OEPC never informed AEC of it. Instead, on 15 July 2004, OEPC *unilaterally* wrote to the Government requesting approval for the transfer of *"legal title"*. On 27 August 2004, *more than over five months* since Moores Rowland made its initial request, the Government for the first time received copies of the executed agreements.

Following OEPC's disclosure of the Farm-out, on 15 May 2006, Ecuador promptly and properly declared Caducidad, as permitted by Ecuadorian law and agreed to by Claimants in the Participation Contract.

In parallel, on 30 August 2005, AEC executed a Share Sale Agreement with Andes Petroleum Co ("**Andes**"), a Chinese entity, whereby AEC sold AEC Ecuador to Andes and thereby transferred its 40% interest under the Participation Contract to Andes. It is worth highlighting that Andes was not a party to the proceedings.

Concurrently with the Share Sale Agreement, AEC and Andes also executed a Supplemental Indemnity Agreement, which made clear that AEC and Andes were fully aware of the Caducidad proceedings and of the fact that Ecuador had not approved the earlier Farm-out Agreements between AEC and OEPC.

In February 2006, however, Claimants undertook new and additional obligations, not contained in the Farm-out Agreements, vis-à-vis Andes. On 22 February 2006, OEPC entered into a letter agreement (the "**2006 Letter Agreement**") with Andes forming a unified front to fight the anticipated declaration of Caducidad. Two provisions of the 2006 Letter Agreement are particularly relevant. *First*, under Clause 2(a), Andes released OEPC of any liability arising out of the *Caducidad* proceedings and acknowledged that OEPC had no obligation to compensate Andes in case of

Caducidad. Second, under Clause 2(g), OEPC agreed to share with Andes 40% of whatever monetary award OEPC received as a result of the Caducidad proceedings. This new, additional obligation to share on the amount of any monetary award has no basis anywhere in the Farm-out Agreements.

While this factual background calls for the conclusion that Ecuador was entitled to declare Caducidad, the Tribunal refused to hold so on the untenable basis that the sanction to which OEPC voluntarily agreed in the Participation Contract would be "*disproportionate*." Worse, the Tribunal sua sponte created and raised an argument so that Claimants be awarded 100% of the fair market value of Block 15, despite the transfer of 40 % of their rights under the Participation Contract to AEC/Andes.

B. Procedural Background: the Tribunal, after the submission phase of the arbitration had concluded, raised a new argument for Claimants to award it more damages than they sustained

During the quantum phase of the arbitration, which overlapped with the liability phase, the Parties submitted their respective briefs and evidence on *quantum*. On 15 February 2011, the Tribunal wrote to the parties informing them that the Tribunal had reached a decision on liability against Ecuador, but without disclosing its reasoning. While both Parties raised concerns about the Tribunal's approach, it gave rise to an additional hearing on 30 June 2011. After the Parties had completed their written submissions and hearings on quantum, they were left to wait until the Tribunal rendered its Award. No one could have predicted what happened next.

While waiting for the Award, the Parties received an email from the Tribunal on 6 October 2011. The email arrived without prior notification and *more than five years* after the commencement of this case, after countless written submissions, and after numerous in-person hearings and provided as follows:

> *"Members of the Tribunal continue their intense deliberations. The Tribunal regrets that its decision has taken longer to finalize than it would have wished. However, the parties have submitted to the Tribunal, in their extensive written and oral submissions, a myriad of factual and legal issues which all need to be analyzed and determined. The Tribunal is confident that its deliberations will end soon and a decision issued shortly thereafter.*
>
> *In recent days, the Tribunal has been addressing an issue which, in its view, neither party has dealt with comprehensively in its prior*

submissions. The issue concerns the interpretation of the Farm-out Agreement and the Joint Operating Agreement.

The Respondent submits […] that the calculation of damages (if any) to be awarded to the Claimants in the circumstances must be limited to a 60% interest in Block 15 because of the transfer by the Claimants to AEC under the terms of the Farm-out Agreement of 40% of their interest under the Participation Contract. The Claimants do not accept the Respondent's contention […]"

The governing law clause of the Farm-out Agreement provides:

"This Agreement shall be governed by and construed, interpreted and applied in accordance with the laws of the State of New York, United States of America, excluding any choice of law rules or conflict of law principles which would refer the matter to the laws of another jurisdiction, except to the extent that the laws of Ecuador require application of the laws of Ecuador to the Participating Agreements and Block 15 or other property situated in or operations or activities conducted in Ecuador.

The Tribunal notes that the Claimants argued that the transfer of the 'economic interest' to AEC would not be considered an assignment under New York law and that, as a result, the non-assignment clause in Article 16(1) of the Participation Contract was not breached […] . Accordingly, the Claimants did not analyze the effect and validity of an assignment, (assuming an assignment had indeed occurred as a result of the Farm-out Agreement and the Joint Operating Agreement), in breach of Article 16(1) of the Participation Contract and Article 79 of the Hydrocarbons Law. In addition, the Claimants did not analyze Ecuadorian and New York law in this regard. The Tribunal further notes that the Respondent argued that New York law is irrelevant to the issue of whether an assignment under the Farm-out Agreement and the Joint Operating Agreement (if any) is in breach of Ecuadorian law (Counter-Memorial on Liability, para 185).

In sum, neither party, in their quantum submissions, referred to the effect of Article 79 of the Hydrocarbons Law or Article 16(1) of the Participation Contract on the assumption that an assignment of rights occurred as a result of the Farm-out Agreement and the Joint Operating Agreement.

The Tribunal now invites the parties to assume that an assignment of rights did occur as a result of the Farm-out Agreement and the Joint Operating Agreement. On the basis of this assumption, the parties are requested to undertake a detailed analysis of the effect of an assignment of rights made under a contract governed by New York law (i.e. the Farm-out Agreement and the Joint Operating Agreement) in violation of a non-assignment clause set forth in a contract governed by Ecuadorian law (i.e. Article 16(1) of the Participation Contract) and in violation of Article 79 of the Hydrocarbons Law. The parties are further requested to address both New York law and Ecuadorian law and to make submissions accordingly, even if one or both parties may consider that, for any reason, New York law and/or Ecuadorian law may not be relevant to the determination of the effect of the Farm-out Agreement and the Joint Operating Agreement. […]."

In this eleventh-hour email, the Tribunal asked the Parties to comment on the possibility that, if the Tribunal agreed with Ecuador that OEPC had unlawfully transferred 40% of its rights in the Participation Contract, then the Tribunal could nullify the transfer and OEPC would always have possessed 100% of the rights in Block 15. It would be entitled to 100% of the fair market value of Block 15 as damages. The Tribunal had reached the conclusion that OEPC violated the Participation Contract and the HCL by transferring without authorization a 40% interest to AEC, which, based on the Parties' submissions to the Tribunal, would have meant that no damages were owed (Caducidad being the sanction expressly agreed for such violation), or at the very least would have limited Claimants' damages to 60% of the value of Block 15.

Apparently wanting to give Claimants *100%* of the value of the Block, but recognizing that the Parties submissions would not allow it to do so – the Tribunal wrote to the Parties on 6 October 2011 inviting them to address a new argument, *which could only benefit Claimants, and which Claimants had never argued before.*

The Parties' positions in the case, however, had been extensively briefed and were the subject of extensive testimony. During the submission phase of the arbitration, Claimants' position was that the Farm-out was not a transfer of rights in violation of the Participation Contract and the HCL, and, alternatively, to the extent that it was, Ecuador's reaction in the form of the Caducidad Decree had been, inter alia, unfair, arbitrary and discriminatory, in violation of the Treaty and Ecuadorian law. Claimants also argued that, even if they were found to be at fault, they were entitled to the full measure of damages resulting from Ecuador's expropriating conduct because: (i) Claimants' harm was solely caused by Ecuador's disproportionate conduct with no contribution from the Claimants; and (ii), as the sole owners of the Participation Contract rights, Claimants are entitled to compensation reflecting the full value of those rights.

In connection with the last point, Claimants' position was that, despite the Farm-out to AEC, they remained entitled to 100% of the fair market value of Block 15. In short, Claimants accepted that the Farm-out did effectuate a transfer of a 40% but added that, since it was OEPC's fault that no approval from the Government was obtained, which triggered Caducidad that deprived AEC/Andes of its 40% interest, OEPC had a contractual liability vis-à-vis AEC and, as a result, Claimants were entitled to seek compensation for 100% (60%+ 40%) of the value of the Participation Contract.

In turn, Ecuador argued during the liability phase that the Farm-out Agreements effected a transfer of rights in violation of the Participation Contract and the HCL and that it had acted legally, fairly, and proportionately in issuing the Caducidad Decree. As a result, Claimants were not entitled to any compensation.

Alternatively, Ecuador argued, inter alia, that assuming incorrectly that Claimants were entitled to damages, Claimants' damages were limited to 60% of the value of the Participation Contract because: (i) by transferring 40% of its rights under the Participation Contract to AEC, Claimants only retained a 60% interest in the Participation Contract; (ii) AEC/Andes, the holder of 40% of the rights under the Participation Contract, was not a protected investor under the Treaty and the Tribunal had no jurisdiction to award damages for AEC/Andes' loss; and (iii) awarding Claimants 100% of the full value of the Participation Contract, in view of AEC's 40% ownership stake in it, would result in a windfall to and unjustly enrichment of Claimants.

Thus, at the conclusion of the submission phase of the arbitration, both Parties had filed briefs with and presented argument to the Tribunal analyzing in detail the legal consequences under Ecuadorian law and international law of Claimants' transfer of rights and obligations to AEC. The issue the Parties squarely put to the Tribunal concerning Claimants' entitlement to 100% of the damages was whether the Farm-out Liability is in the nature of a contractual obligation of OEPC vis-à-vis AEC (as opposed to a right of ownership of AEC in the Participation Contract with Ecuador or the Block 15 oil). In other words, the principal issue submitted to its determination by the Parties was whether Claimants'

transfer of an *"economic interest"* to AEC was, in effect, a transfer of rights to Block 15 (as opposed to constituting, as Claimants posited, a contractual obligation of Claimants vis-à-vis AEC).

The Tribunal's answer to this fundamental proposition would have dictated Claimants' recovery percentage for its alleged loss. If the Tribunal found for the Claimants that the Farm-out was in the *"nature of a contractual obligation of OEPC vis-à-vis AEC"*[14], then Claimants would have been entitled to 100% of the value of the Participation Contract. Conversely, if the Tribunal (as it did) found for Ecuador that the Farm-out was in the nature of a *"right of ownership of AEC in the Participation Contract"*[15], then Claimants would have been entitled to 60% of the value of the Participation Contract.

That was the full scope of the Parties' mandate to the Tribunal on this issue. However, the Tribunal refused to comply with that mandate and instead arrogated upon itself an authority it did not have: *on its own initiative, it raised a new argument for the Claimants that neither Party had raised in 5 years of intensely-contested arbitral proceedings.*

As instructed by the Tribunal, the Parties submitted their respective principal briefs on this issue on 3 November 2011 and their reply briefs on 22 November 2011. Ecuador filed its briefs with a full reservation of rights. On 12 April 2012, the Tribunal – after expressing its reluctance to hear Ecuador on the matter – held a one-day hearing on its newfound argument.

On 5 October 2012, a sharply-divided Tribunal issued the Award. The majority of the Tribunal, composed of President Fortier and Arbitrator Williams *increased* the damages by another USD 943 million when it adopted the argument that the Tribunal had itself raised, and thereafter let Claimants advance for the first time, in their eleventh-hour email of 6 October 2011. The majority held that the transfer was unlawful and thus should be nullified, which the majority concluded meant that the 40% interest reverted back to OEPC which then was entitled to 100% of the damages.

II. THE STRONG CRITICISMS AGAINST THE MAJORITY'S DECISION TO DECLARE THE TRANSFER OF RIGHTS EFFECTED BY THE FARM - OUT AGREEMENTS INEXISTENT

The majority's decision entails strong criticisms. While Ecuador requested the annulment of the decision on the basis that the majority exceeded the scope of its powers and seriously departed from a fundamental rule of procedure when deciding an issue not raised by the Parties, the most stringent

14 Award, § 579.
15 Award, § 579.

criticisms pertains to the majority's decision in itself.

On the one hand, the decision was rendered in blatant disregard of international law. First, the majority exercised *ratione personae* jurisdiction over a Chinese company, Andes, without any entitlement arising out of the Treaty or the Participation Contract to do so (pursuant to Article 2(g) of the 2006 Letter Agreement, Claimants is to transfer 40% of the damages awarded, thereby providing to Andes the compensation for its loss in spite of the fact that Andes was not a party to the proceedings and – even if it had been – was not a US national that could qualify as a protected investor under the Treaty); and second, the Tribunal failed to apply the applicable rules of international law on damages. In particular, the majority failed to apply the willing buyer / willing seller international law standard to the assessment of damages; failed to apply the "Chorzów Factory Dictum" and other principles of international law to the assessment of damages; and failed to apply the international law rule prohibiting unjust enrichment. The readers of this article are invited to read Prof. Stern's Dissenting Opinion in this respect.

On the other hand, and most strikingly, the majority's decision to declare inexistent under Ecuadorian law, the illegal, unauthorized assignment between Claimants and AEC/Andes is replete with fundamental flaws. That decision gave rise to one of the strongest dissents in ICSID history. On this specific issue, Professor Stern explains that *"[t]he majority's decision on the effect of the Farm-out Agreement is, in my view,* ***so egregious in legal terms and so full of contradictions****, that I could not but express my dissent,"*[16] *adding that "the question of the effectiveness of a legal act under Ecuadorian law […] is based on a total lack of reasons, with the consequence that I was not able to follow the 'reasoning' from point A to point B, as well as* ***gross errors of law*** *in the purported interpretation of the content of Ecuadorian law"*[17]. The present article will focus on both the egregious application of Ecuadorian law (Section A) and the inherent flaw of the contradictory reasoning of the majority's decision (Section B).

A. The majority's extraordinary decision to declare the transfer of rights inexistent was not rendered in accordance with Ecuadorian law

At paragraphs 650 and 651 of the Award, the majority found:

> *"It follows that, pursuant to New York and Ecuadorian law, the purported assignment by OEPC to AEC of rights under the Participation Contract pursuant to the Farm-out Agreement and the Joint Operating Agreement is null and void and has no validity whatsoever and the Tribunal so finds. Under the doctrine of inexistence and under New York law, there is no requirement that the Court must first declare the assignment to be invalid. Indeed, even under the doctrine of absolute nullity, any purported assignment is not considered 'valid' prior to a declaration of nullity – there is only the 'appearance' of an act. As such, the purported assignment of rights under the Farm-out Agreement and the Joint Operating Agreement was not valid and produced no legal effect. It must therefore be disregarded by the Tribunal for purposes of determining the compensation to which the Claimants are entitled. Consequently, the Tribunal finds that OEPC continued to own, as of the date of the Caducidad Decree, 100% of the rights under the Participation Contract.*
>
> *The Tribunal accordingly concludes that the Respondent is obliged to compensate the Claimants for 100% of their interest in Block 15 which it acquired upon the issuance of the Caducidad Decree."*

The majority applied to the assignment a doctrinal concept that is not recognized under Ecuadorian law, save for specific contracts for which the law expressly requires a solemn form for their existence (**Section 1**). In any event, the majority could not nullify the unauthorized, illegal assignment of rights between Claimants and AEC/Andes (**Section 2**).

1. The illegal, unauthorized assignment of rights between Claimants and AEC/Andes is not inexistent under Ecuadorian law

In order to reach the conclusion that Ecuadorian law provided for the inexistence of the unauthorized, illegal assignment of rights, the majority undertook an intricate demonstration. For the purpose of this article, the alleged demonstration will be summarized as follows: (i) Article 79 of the HCL would "on its face" provide for the inexistence of an unauthorized, illegal assignment of rights; (ii) the notion of inexistence would have been introduced in Ecuadorian law by four Ecuadorian Supreme Court decisions; and (iii) absolute nullities, in any event, need not be declared.

As a first step, the majority undertook to examine Article 79 of the HCL and concluded that, "[o]n its face," Article 79 of the HCL renders the assignment of rights inexistent under Ecuadorian law[18]. On this very point, Professor Stern cautions that *"the majority seems to have made up its mind before any serious analysis of the Ecuadorian texts […] involved"*[19].

[16] Dissenting Opinion, § 5 (emphasis added).
[17] Dissenting Opinion, § 5 (emphasis added).
[18] Award, § 619.
[19] Dissenting Opinion, § 64 (emphasis added).

Article 79 of the HCL provides:

> *"La transferencia de un contrato o la cesión a terceros de derechos provenientes de un contrato***, serán nulas y no tendrán valor alguno** *si no precede autorización del Ministerio del Ramo, sin perjuicio de la declaración de caducidad según lo previsto en la presente Ley."*

Article 79 of the HCL prescribes the nullity (serán nulas) of an unauthorized assignment. Further, Article 79's nullity is governed by the Título XX of the Libro IV of the Ecuadorian Civil Code (De la Nulidad, Articles 1697 to 1714). These legal texts indisputably confirm that Article 79 of the HCL prescribes the nullity (serán nulas) of an unauthorized assignment.

Article 1698 of the Ecuadorian Civil Code provides:

> *"La nulidad producida por un objeto o causa ilícita, y* **la nulidad producida por la omisión de algún requisito o formalidad que las leyes prescriben para el valor de ciertos actos o contratos,** *en consideración a la naturaleza de ellos, y no a la calidad o estado de las personas que los ejecutan o acuerdan,* **son nulidades absolutas.***"*

In turn, Article 1699 of the Ecuadorian Civil Code expressly provides in this respect that:

> **La nulidad absoluta** *puede y* **debe ser declarada por el juez***, aún sin petición de parte, cuando aparece de manifiesto en el acto o contrato […].*

As for all nullities, Article 79's nullity is not automatic and must be declared by a judge.

As Professor Stern observed in her Dissent, on the basis of the above mentioned legal texts, "*it appears with the utmost clarity, that the absence of a requirement necessary for the validity of the transfer entails absolute nullity and that such absolute nullity has to be declared by a judge"*[20].

No judge ever declared the assignment of rights to AEC/Andes null and void prior to the majority's decision. Simply put, under Ecuadorian law, an assignment of rights remains valid until declared null and void. Where legal texts are clear, there is no room for interpretation.

Tellingly, even though the majority knew of the existence of these legal norms, it did not devote a single line or reference in its Award to the provisions of the Título XX of the Libro IV of the Ecuadorian Civil Code on *Nulidad*.

20 Dissenting Opinion, § 60 (emphasis added).

As a second step, the majority purported to ground its conclusion on the basis of four Ecuadorian decisions that supposedly introduced a general concept of inexistence into Ecuadorian law. These decisions are dated 16 May 2001[21], 7 June 2001[22], 29 August 2001[23], and 20 February 2002[24]. The tortured reading of those four decisions by the majority deserves to be detailed.

On the one hand, the majority decided, without the slightest support in said decisions, to extend their scope of application to an unauthorized assignment of rights.

These four isolated decisions on which the majority purported to rely all relate to sales of real property or promises to sell real property that were executed without the required solemn form of a public deed. None of these decisions relate to an assignment of rights.

On the other hand, the majority also deliberately disregarded the criteria of inexistence set by those same Ecuadorian decisions.

In particular, the majority, relying on the **academic** definition of inexistence mentioned in the decision of 16 May 2001, namely *"cuando el acto carece de los requisitos esenciales para que tenga vida"*[25] concluded that *"it is the Tribunal's view that the intended assignment that occurred under the Farm-out Agreement and the Joint Operating Agreement undoubtedly meets the criteria expressed in the above quotations for 'inexistence'"*[26].

The majority did not define these *"essential elements for a contract or a legal act to have life."* The majority simply invented a rule according to which a ministerial authorization was an "*essential element […] for the assignment to have life"*[27]. It is not. This is all the more surprising given that the definition of an "*essential requirement for the act to have life"* is provided later in that same decision as "*la voluntad manifestada, el consentimiento, el objeto y la forma solemne"*[28].

With regards to elements of form, said decision also mentioned that:

> *"En casos excepcionales, la ley prescribe la observancia de ciertas solemnidades para el perfeccionamiento de los actos jurídicos, lo que equivale a exigir que la voluntad se exprese en forma predeterminada para que se tenga por*

21 *Corte Suprema de Justicia*, Decision of 16 May 2001, *Gaceta Judicial*, *Año* CII, Serie XVII, No. 6.
22 *Corte Suprema de Justicia*, Decision of 7 June 2001, *Registro Oficial* No. 378,.
23 *Corte Suprema de Justicia*, Decision of 29 August 2001, *Registro Oficial* No. 420.
24 *Corte Suprema de Justicia*, Decision of 20 February 2002, *Registro Oficial* No. 616.
25 *Corte Suprema de Justicia*, Decision of 16 May 2001, *Gaceta Judicial*, *Año* CII, Serie XVII, No. 6, p. 1528.
26 Award, § 626.
27 Award, § 627.
28 Award, § 627, quoting *Corte Suprema de Justicia*, Decision of 16 May 2001, *Gaceta Judicial*, *Año* CII, Serie XVII, No. 6, p. 1528.

> *emitida. La falta de dichas solemnidades obstaculiza la formación o perfeccionamiento de tales actos jurídicos y conduce a que estos se reputen inexistentes.”*[29].

As confirmed by Professor Stern, these cases “*stand for the principle that inexistence does not result from the absence of other formalities than the solemnity of a legal deed”*[30]. Article 79’s prior ministerial authorization is in no way (i) a solemn form (ii) in/by which Claimants and AEC/Andes should have expressed their will to enter into the Farm-out Agreement.

The majority deliberately ignored this definition of an “*essential requirement for the act to have life,”* pretending that the issue was not the Farm-out Agreement but the assignment and that “*therefore applying a contractual analysis is inappropriate”*[31]. That conclusion is at best striking given that the majority did apply said contractual analysis in relying on those same decisions to uphold that the assignment was inexistent and that the Ecuadorian Supreme Court decision of 16 May 2001, on which it relies specifically, refers to “legal acts” (‘actos jurídicos’) (as opposed to contracts only) when defining “*the essential element for an act to have life”*[32].

As observed by Professor Stern, “[t]he majority’s approach can be described as a *proprio motu* determination of what the majority considered to be an essential element, a determination completely disconnected from the legal order in which these essential elements have been precisely and restrictively defined”[33].

As a third step, the majority purported to confirm its finding that the assignment was inexistent by arguing that, in any event, even if Article 79’s nullity were to be an absolute nullity, no declaration of nullity would be necessary to consider that the assignment of rights has no validity[34]. The majority goes so far as to contend that under Ecuadorian law “*a null act produces no legal effects, even before a judicial declaration is obtained”*[35].

It has already been noted that, under Ecuadorian law, any nullity, even absolute, has to be declared.

As a final remark, it is worth stressing that the majority’s heavy reliance on the terms “*y no tendrán valor alguno*”[36] in Article 79 of the HCL is puzzling. That expression also exists under the French law (“*nul et de nul effet”*) and no author ever professed that the notion of inexistence is de *lege lata* recognized under French law.

[29] *Corte Suprema de Justicia*, Decision of 16 May 2001, *Gaceta Judicial*, *Año* CII, Serie XVII, No. 6, p. 1529 (emphasis added).

[30] Dissenting Opinion, § 105.

[31] Award, § 627.

[32] *Corte Suprema de Justicia*, Decision of 16 May 2001, *Gaceta Judicial*, *Año* CII, Serie XVII, No. 6 (“*[e]n casos excepcionales, la ley prescribe la observancia de ciertas solemnidades para el perfeccionamiento de los actos jurídicos, lo que equivale a exigir que la voluntad se exprese en forma predeterminada para que se tenga por emitida.”*).

[33] Dissenting Opinion, § 70.

[34] Award, §§ 629-633.

[35] Award, § 632.

[36] See, for instance, Award, § 626.

2. The majority could not, in any event, nullify the assignment of rights between Claimants and AEC/Andes

Even if the notion of inexistence had been recognized under Ecuadorian law, the majority could not declare the assignment null and void without exceeding its jurisdiction.

To properly “give effect,” the first question the majority had to decide was whether it had jurisdiction. The second question was whether the claim was admissible. The third question was whether the claim had any merit.

First, the majority had no jurisdiction to declare either the Farm-out Agreements or even the assignment null and void.

Clause 7.01 of the Farm-out Agreement provides that:

> *“If OEPC and AECI or their respective successors, assigns or legal representatives are unable to amicably resolve any dispute or difference arising under or out of, in relation to or in any way connected with (i) this Agreement, the JOA, the Participating Agreements, or any of them, or (ii) any operations, transactions, actions or inactions conducted, arising under or out of, in relation to or in any way connected with this Agreement, the JOA, the Participating Agreements, or any of them (whether contractual, tortious, equitable, statutory or otherwise), including, without limitation, the negotiation, execution, existence, amendment, validity, enforceability, performance, non-performance, breach, termination, interpretation or construction thereof, such matter shall be finally and exclusively referred to and settled by arbitration under the Commercial Arbitration Rules of the American Arbitration Association pursuant and subject to the arbitration procedures set forth in Exhibit H attached hereto and incorporated herein; provided that, to the extent permitted by the law of arbitration the scope of application of the Commercial Arbitration Rules of the American Arbitration Association shall be modified as may be necessary to include all of the above referenced matters within the scope of the application of such rules. In the event of any conflict between the Commercial Arbitration Rules of the American Arbitration Association and the arbitration procedures set forth in*

Exhibit H, the arbitration procedures set forth in Exhibit H shall govern and control[37].

The arbitration clause contained in the Farm-out Agreement extends to the issue of the existence or validity of the assignment of rights. Therefore, the majority had no jurisdiction to rule upon the inexistence of the transfer of rights.

Second, a claim brought before the Tribunal for the nullity of the Farm-out Agreements or even the assignment was inadmissible.

It is a general principle of law that the nullity (or inexistence) of a contract or legal act may be declared if, and only if, all the parties to the act or contract are parties to the judicial process.

This is a legal principle enshrined in the Ecuadorian Constitution. As the Ecuadorian Supreme Court observed:

*"**La acción de nulidad** en un **contrato es un caso típico de indivisibilidad jurídica,** porque no puede dividirse o fragmentarse, en otras palabras un contrato **no puede ser válido para uno de los contratantes y nulo para el otro, la declaración judicial de nulidad no puede ser hecha por ende sino cuando las dos partes del contrato han sido oídas mediante la respectiva citación de la demanda**.- De otro modo faltaría uno de los elementos esenciales del proceso, los legitimados pasivos con derecho a ejercer su acción de contradicción, y se está infringiendo **el principio jurídico consagrado en la Constitución Política de la República del Ecuador de que nadie puede ser condenado en un juicio sin ser oído**"*[38].

The Farm-out Agreements were executed between Claimants and AEC which, in turn, transferred rights in the Participation Contract to Andes. Ecuador was not a party to those agreements. Therefore, given that AEC (or its successor Andes) was not a party to the underlying arbitration, the majority lacked the authority to declare that the Farm-out Agreements had no validity.

Third, any claim towards declaring either the Farm-out Agreements or the assignment null and void had no merit.

Article 1699 of the Ecuadorian Civil Code provides:

*"La nulidad absoluta puede y debe ser declarada por el juez, aún sin petición de parte, cuando aparece de manifiesto en el acto o contrato; puede alegarse por todo el que tenga interés en ello**, excepto el que ha ejecutado el acto o celebrado el contrato, sabiendo o debiendo saber el vicio que lo invalidaba […]**"*[39].

[37] Farm-out Agreement, Clause 7.01 (emphasis added).

[38] *Corte Suprema de Justicia*, Decision of 24 February 2003, *Registro Oficial* No. 66, 22 April 2003, p. 27 *et seq*. (emphasis added). See also 1998 Political Constitution of the Republic of Ecuador, Article 24.

In other words, those who have performed the act or contract knowing, or under the duty to know, the vice invalidating it are not entitled to request that the absolute nullity, such as the one contained in Article 79 of the HCL, be declared by a judge. Neither could that judge do so sua sponte without violating the rationale of Article 1699 of the Ecuadorian Civil Code and AEC's constitutional due process rights. This second effect of the absolute nullity provided for in Article 79 of the HCL is an application of the *nemo auditur* principle recognized under Ecuadorian law. As the majority emphasized, "*nullus commodum capere de sua injuria propria*: a State cannot be allowed to take advantage of its own wrongful act"[40].

***

In sum, the majority's decision to declare inexistent the Farm-out Agreement under Ecuadorian law was rendered in complete disregard of Ecuadorian law.

B. The Tribunal's extraordinary decision to declare the transfer of rights inexistent is inherently flawed

Whereas the Tribunal determined that Claimants did transfer its rights under the Participation Contract to AEC, the majority held that Claimants were nonetheless entitled to 100% of the fair market value of Block 15 arguing that the transfer of rights never existed, despite the fact that no judge ever declared that assignment null and void.

The majority's determination rests on a combination of frivolous and contradictory reasons. As Professor Stern asserts, *"the first [questionable aspect in the majority's approach to the question of the effectiveness of the Farm-out Agreement] is the analysis of the question of the effectiveness of a legal act under Ecuadorian law, which is based on a total lack of reasons, with the consequence that I was not able to follow the 'reasoning' from point A to point B"*[41].

Above all, the majority's finding that the assignment is inexistent is in contradiction with both a prior

[39] See also *Corte Suprema de Justicia*, Decision of 22 August 1991, *Gaceta Judicial*, *Año* XCI, Serie XV, No. 12, pp. 3529 *et seq*., ("*[…] [l]a nulidad absoluta puede alegarse por todo el que tenga interés en ello, excepto el que ha ejecutado el acto o celebrado el contrato, sabiendo o debiendo saber el vicio que lo invalidaba […]*"); *Corte Suprema de Justicia*, Decision of 31 March 2009, *Gaceta Judicial*, *Año* CIX-CX, Serie XVIII, No. 6, pp. 2130 *et seq*. ("*[…] [a]simismo, de conformidad con lo previsto en el Art. 1699 del Código Civil, la nulidad absoluta puede y debe ser declarada por el juez, aun sin petición de parte, cuando aparece de manifiesto en el acto o contrato (como en el caso subjudice); puede alegarse por todo el que tenga interés en ello, excepto el que ha ejecutado el acto o celebrado el contrato, sabiendo o debiendo saber el vicio que lo invalidaba […]*").

[40] Award, § 564.

[41] Dissenting Opinion, § 5 (emphasis added).

finding of the Tribunal (that Claimants effected a transfer of rights in the Participation Contract to AEC through the Farm-out Agreements) and a subsequent finding of the majority that Claimants are *"obliged to compensate Andes to the level of 40% of any compensation it receives from action taken against Ecuador"*[42].

On the one hand, it is impossible to reconcile (i) the Tribunal's finding that, since "*the Farm-out Agreement and the Joint Operating Agreement operated to effect a transfer of rights under the Participation Contract from OEPC to AEC,*"[43] Claimants, *"by failing to secure the required ministerial authorization, breached Clause 16.1 of the Participation Contract and were guilty of an actionable violation of Article 74.11 of the HCL"*[44], with (ii) the majority's finding that, since the transfer of rights was automatically "*inexistent*" pursuant to Article 79 of the HCL, Claimants must be awarded 100% of the fair market value of Block 15.

One cannot, at the same time, hold, for liability purposes, that a transfer of rights in the Participation Contract was effected and, for quantum purposes, hold that such transfer was inexistent.

A diligent reader of the Award will notice the majority's addition of the term "purported" before the term assignment in some parts of the decision of liability as perhaps an attempt to save the contradiction. That addition, however, was to no avail. Article 74.11 of the HCL specifically provides that Caducidad may be declared if the contractor "*traspasare derechos*." It does not mention a "*purported*" assignment of rights. In addition, the alleged alternatives to Caducidad invented by the Tribunal confirm that the Farm-out Agreements operated a transfer of rights. As the Tribunal put it:

> *[…] the foregoing options existed as an alternative to Caducidad , namely: i) insistence on payment of a transfer fee in the order of USD 11.8 million; and/or[…]*[45].

If the Farm-out Agreements did not effect a transfer of rights or if the transfer of rights automatically never existed, the payment of a transfer fee would be nonsensical. The request for the payment of a transfer fee if the assignment was automatically inexistent would even be a breach of Ecuadorian law under the majority's scenario.

On the other hand, the majority's finding that, since the assignment is inexistent, "*Respondent is obliged to compensate the Claimants for 100 % of their interest in Block 15*"[46] is also in contradiction with its finding that Claimants remained obligated under the Farm-out Agreements to compensate Andes (and hence would not be unjustly enriched).

[42] Award, § 654.
[43] Award, § 384.
[44] Award, § 381.
[45] Award, § 434 (emphasis added).
[46] Award, § 651.

In particular, the majority held that:

> *"In relation to unjust enrichment, there was produced to the Tribunal the letter agreement of February 22, 2006 between OEPC and Andes whereby OEPC is obliged to compensate Andes to the level of 40% of any compensation it receives from action taken against Ecuador regarding the termination of the Participation Contract. Even without this letter agreement, the Tribunal notes that the invalidity of the assignment under New York and Ecuadorian law does not mean that AEC (or Andes) may not have recourse against OEPC under the Farm-out Agreement. As mentioned earlier, the unauthorized assignment does not invalidate the Farm-out Agreement as between the assignor, OEPC and the assignee, AEC nor is the legal position affected by the fact that the assignor and the assignee actually implemented inter se parts of the legally invalid and unauthorized assignment. OEPC promised to deliver certain rights to AEC under the Farm-out Agreement, but due to its failure to secure authorization from the Ministry it was in breach of that promise. This breach of contract may form the basis of a claim by AEC (or Andes) against OEPC. These factors weigh heavily against any unjust enrichment arguments raised in respect to OEPC's entitlement to receive compensation for 100% of the interests in the Participation Contract"*[47].

This single paragraph is supposed to settle one of the most debated issues of the underlying arbitration, both prior to and after the extraordinary invitation of the Tribunal to comment on the effect of Article 79 of the HCL on the unauthorized, illegal assignment of rights.

Point 2(g) of the 2006 Letter Agreement provides as follows:

> "*If Occidental receives any monetary award from the Government of Ecuador as a result of the Government's actions to enforce caducity and terminate Occidental's contract with respect to Block 15, Occidental agrees that [Andes] is entitled to a 40% share in the net amount received, after all costs and expenses of the Caducity Proceedings have been reimbursed or paid (in calculating such amount there shall be no double counting).*"

In short, while it was common ground between the Parties and the Tribunal that any continuing debt must not be deducted from the damages[48], the Parties disagreed as to whether Claimants' alleged liability

[47] Award, § 654 (emphasis added).
[48] For instance, *The Factory at Chorzów (Claim for Indemnity) (The Merits)*, PCIJ, Judgment No. 13, 13 September 1928, p. 31.

toward Andes was a pre-existing liability (that should be included in the amount of damages) or not (and hence should not be included in the amount of damages).

In the single and obscure above-mentioned paragraph, the majority rejected Ecuador's argument that the 2006 Letter Agreement does not confirm any pre-existing liability under the Farm-out Agreement, thereby adopting one of Claimant's numerous theses without providing any reasons at all in support of its decision.

Even regardless of whether Ecuador's argument should have prevailed, it is impossible in the absence of any indication from the majority to understand how the Farm-out Agreement could be a source of liability towards AEC/Andes. The majority had to take a position on these issues and to explain why Ecuador's position was not sustained. The majority could not simply ignore Ecuador's argument.

Worse, even admitting *(quod non)* that the Farm-out Agreement was the source of a liability towards Andes, this liability should have been considered inexistent under the majority's own scenario.

The majority merely added in this respect that the inexistence of the assignment did not affect the Farm-out Agreements:

> *"As noted further below, Article 79 of the HCL serves to invalidate the assignment, not the Farm-out Agreement itself which remains a valid contract as between OEPC and AEC*[49].
>
> *[...]Article 79 of the HCL is concerned with the legal effect of the assignment itself; it does not purport to invalidate either the Farm-out Agreement under which OEPC had an obligation to obtain any necessary government approvals for the assignment or the Joint Operating Agreement."*[50].

However, the majority never provided any reasons at all for its decision to sever the assignment from the Farm-out Agreements. The assignment of rights was recognized as the core of the Farm-out Agreement. The majority itself held that *"the purpose of the Farm-out Agreement and the Joint Operating Agreement was to transfer from OEPC as Contractor to AEC certain of the Contractor's exclusive rights to carry out the oil exploitation activities under the Participation Contract along with related rights and obligations"*[51].

The Farm-out Agreement contains the following severability clause:

> *"If any term or provision of this Agreement is invalid, illegal or incapable of being enforced [...] all other terms and provisions of this Agreement shall nevertheless remain in full force and effect so long as the economic and legal substance of the transactions contemplated hereby are not affected in a manner that is materially adverse to either party"*[52].

[49] Award, § 619.
[50] Award, § 619(bis).
[51] Award, § 301.

Accordingly, since the purpose of the Farm-out Agreement was to transfer rights in the Participation Contract, the assignment of rights could not be severed from the Farm-out Agreement. The inexistence of the assignment necessarily entails the inexistence of the Farm-out Agreements under the majority's case.

As Professor Stern noted, *"**I am really at a loss to understand the reasoning**: - it is not contested that the sole purpose of the Farm-out Agreement was to transfer rights; - this transfer of rights is inexistent/invalid; but the Farm-out Agreement is existent/valid"*[53]. If there is no Farm-out Agreement, there cannot be a liability of OEPC towards Andes.

Conclusion

The majority's decision to hold the transfer of rights effected under the Farm-out Agreements inexistent under Ecuadorian law warrants strong criticisms, such as those exposed by Professor Stern in her Dissenting Opinion and summarized in the present article. For the sake of arbitration, one may hope that arbitral tribunals will apply the proper law to the specific facts of a case without resorting to inexistent concepts to fit their preconceived idea of justice, especially where, such as in the present case, the applicable law was agreed upon between the Parties.

[52] Farm-out Agreement, Article 8.0.
[53] Dissenting Opinion, § 127 (emphasis added).

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