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Tribunal Slams Ecuador with Largest Ever Investor-State Penalty

Ben Peachy - Public Citizen Global Trade Watch blog

We were astounded to learn earlier this month that a three-person ICSID tribunal has imposed on Ecuador a $1.8 billion judgment, **the largest investor-state award** to ever come out of the private forum. Having had a chance to look at the sovereignty-defying leaps of logic that the tribunal used to determine that Ecuador should pay the mammoth sum to U.S.-based Occidental Petroleum (Oxy), we're even more appalled.

Oxy launched the case against Ecuador under the U.S.-Ecuador Bilateral Investment Treaty (BIT). Last week, **we reported** that Chevron is attempting to use this same NAFTA-style treaty to evade an $18.2 billion ruling for decades of pollution in Ecuador's Amazon. While the **second-largest** U.S. oil corporation (Chevron) is using the BIT's extreme investor-state system to run from billions in damages inflicted upon Ecuador, the fifth-largest U.S. oil corporation has just employed the same system to extract nearly two billion from the country. It seems that Big Oil has chosen private investor-state tribunals as the preferred arena in which to attack Ecuador as its preferred punching bag.

In addition to awarding $1.8 billion of Ecuador's tax dollars to Oxy as the principal amount, the tribunal in ***Oxy v. Ecuador*** ordered Ecuador to pay $589 million in backdated compound interest, plus post-award interest and half of the costs incurred by the tribunal itself (para. 876). In sum, the tribunal handed Ecuador a penalty of at least $2.4 billion. What does $2.4 billion mean to Ecuador? That **amounts to** 16% of the country's external debt and 11% of all goods exported in one year. In more human terms, the financial drain is equivalent to the combined annual income of the poorest 20% of Ecuadoreans--nearly 3 million people. Even at the average income level, the tribunal's penalty amounts to the total income of a share of the country that's equivalent, **in U.S. terms**, to the combined populations of New York and Los Angeles. Of course, it's the Ecuadorean government who will have to figure out how to finance the $2.4 billion, which is the same amount that it spends on health care each year for over seven million Ecuadoreans-- almost half the population.

What events could have prompted such a massive judgment? In May 1999, Oxy signed a 20-year contract with Ecuador and the state oil company to explore for oil in Block 15, a segment of Ecuador's Amazon, and extract from any discovered reserves (paras. 112, 115). In exchange for taking on all expenses, Oxy was contractually entitled to 70% of the oil produced, with Ecuador maintaining a right to the rest (para. 117). The contract also stipulated that while Oxy could sell the oil, it could not sell off any portion of its rights to produce and profit from the oil without government authorization. The contract stated that transferring the rights to the oil production without authorization "shall terminate" the contract, meaning legal annulment and forfeiture of investments (para. 119). This provision explicitly enforced Ecuador's hydrocarbons law, which protected the government's ability to vet companies seeking to gain control over oil production in its territory, a particular concern in the Chevron-ravaged Amazon region (para. 121).

One year after signing the contract, Oxy sought to sell off a portion of its investment in Block 15 oil production so as to gain capital and reduce expenditure risks. In October of 2000, it signed with the Alberta Energy Company (AEC, a Canadian firm) a contract in which Oxy kept "nominal legal title" to the oil production contract with the government, but AEC purchased 40% of Oxy's oil

rights and agreed to foot 40% of ongoing costs (paras. 128, 129). The two companies formed a "Management Committee" comprised of one AEC representative and one Oxy representative with the "power and duty to authorize and supervise Joint Operations" (para 136). Oxy mentioned the deal to the government, but neither presented the contract nor sought government authorization for AEC's acquisition of a significant economic and operational stake in the Amazonian oil project (paras. 147-160).

After an audit of Oxy in 2004, Ecuador's Attorney General determined that the confidential Oxy-AEC contract in 2000 had bypassed necessary government authorization and thus violated Oxy's contract with the government, prompting him to initiate a process to annul it (para. 177). In May 2006, after a long delay filled with a presidential ouster and political tumult, the government terminated the contract with Oxy and repossessed the land and oil equipment of Block 15 (paras. 199, 200).

How did the tribunal, reviewing this evidence, determine that Ecuador should pay Oxy the largest ICSID tribunal-decided sum in history? With 326 pages of logical gymnastics. The tribunal found that Ecuador had violated its BIT obligation to provide Oxy with "fair and equitable treatment," **the single most successful investor claim** in the NAFTA-style investor-state system. To get there, the tribunal's arguments took numerous turns, often defying Ecuador's sovereignty, common sense, or both. I summarize below five of the most troubling arguments, presented in reduced arithmetic form to underscore the tribunal's "logic."

Five Affronts to Sovereignty / Reason

1. Company Breaks Law + Government Enforces Law = Government Is Not "Fair"

The tribunal acknowledged that Oxy's contract with AEC effectively transferred to AEC some of the "exclusive rights to carry out the oil exploitation activities" granted to Oxy by the government contract (para. 301), giving AEC "*de facto*legal title" to the oil project (para. 331). It further stated that such a substantive transfer required "prior authorization on the part of Ecuadorian authorities," as stipulated in Oxy's government contract (para. 307). Since Oxy failed to ask permission before selling 40% of its government deal to an unappraised foreign corporation, the tribunal concluded that Oxy breached the government contract and violated Ecuadorean law (para. 381). The tribunal further notes that the government's resulting nullification of the contract was not only within its legal bounds, but is something that Oxy should have expected as a plausible response to its illegal maneuver (para. 383).

At this point, one could not be blamed for thinking that the tribunal would conclude that the government had not violated its BIT commitment to provide Oxy with "fair and equitable treatment" (FET). Indeed, even other investor-state tribunals, not generally known for their leniency on governments, would have likely stopped here, determining that it's difficult to construe contractual obedience as a contractual violation. At issue is the legal interpretation of FET, an interpretation that unaccountable tribunals have been **continuously expanding** over time to cover an increasing array of investor "rights."

Many national governments, **including the U.S. government**, and a few investor-state tribunals, have repeatedly argued for a minimum standard of treatment of investors that accords with customary international law. Under this standard definition, FET violations must be "egregious and shocking," such as "a gross denial of justice, manifest arbitrariness, blatant unfairness, a complete lack of due process…" (***Glamis Gold v. USA***, para. 627). None of those terms seem to describe a

decision to terminate a contract breached by the other party when the law plainly contemplates such termination. That's hardly "egregious," "unfair," or "a gross denial of justice." It is neither "arbitrary" nor "shocking," since, as the tribunal itself noted, Oxy should have expected contract termination as a plausible response to contract breach. And the only denial of due process came from Oxy, not Ecuador. In response to Oxy's complaints with Ecuador's decision, the Ecuadorean government had requested that Oxy pursue its case in Ecuador's courts. But Oxy rejected the request in favor of the foreign investor-state tribunal (para. 291).

Veering from the FET definition advocated by national governments, tribunals are increasingly turning to more imaginative interpretations of FET to find in investors' favor, **as we noted in July** after a tribunal ruled against Guatemala by borrowing a broad FET interpretation from yet another tribunal. The FET standard used in that case added several words to the list of descriptors that governments should avoid: "idiosyncratic" moves, "lack of transparency," or actions "in breach of representations made by the host State which were reasonably relied on by the claimant." Well, assuming that rule of law is still the norm, a government's adherence to a contract's enforcement provisions is hopefully not "idiosyncratic." And that contract, as the tribunal notes, was quite "transparent" about the consequences of failing to request authorization before involving third parties in oil extraction. Ecuador's enforcement of those consequences was thus not a "breach" of the government's statements, but a fulfillment of them. Even under this elastic interpretation of FET, which departs from customary international law, it would be difficult to find Ecuador at fault.

But that's exactly what the tribunal in this case found. To do so, they stretched the FET obligation to new lengths, requiring that "any penalty the State chooses to impose must bear a proportionate relationship to the violation which is being addressed and its consequences" (para 416). To create this standard, the tribunal took it upon itself to interpret Ecuadorean domestic law, including the Constitution, which contains a broad call for proportionality (para. 397). The tribunal also cited four investor-state cases in which the tribunals (12 people), exercising ample freedom to interpret investor protections, named proportionality as an additional obligation of States (para. 404). As with the Guatemala case, the *Oxy v. Ecuador* tribunal ignored the FET standard used by sovereign States—that FET means affording due process and adequate protection—taking instead the opinions of these twelve arbiters as cause to assert that States are also obliged to be proportionate. Who decides whether a State action has been proportionate? Once again, the tribunal.

2. Lost Investment > Lost Sovereignty

Having taken it upon itself to determine whether Ecuador responded proportionally to Oxy's contract breach, the tribunal found that it had acted out of proportion, thereby violating Oxy's right to fair and equitable treatment. One of the tribunal's key arguments was that Ecuador had not suffered materially as a result of Oxy's decision to circumvent government approval in farming out responsibility for 40% of its Amazon oil production (para. 444, 445). Even if this is true, Oxy's violation could have just as easily produced a scenario that indeed provoked significant suffering. As mentioned, Ecuador is currently seeking billions in damages from Chevron to compensate for the 26 years that Texaco (acquired by Chevron) **continuously dumped toxic sludge** in a swath of the Amazon the size of Rhode Island, poisoning the critical ecosystem and the indigenous groups who inhabit it. In the wake of such environmental calamity, Ecuador is understandably serious about vetting any corporation who seeks to extract oil from the country's Amazon region. By denying Ecuador that right, Oxy opened 40% of Block 15 to a company that could have turned out to be a second Chevron/Texaco. Who is the tribunal to say that terminating Oxy's contract was not proportional to the risk incurred?

In the end, determining proportionality (even if it were the tribunal's place to do so), is difficult in a situation of lost sovereignty vs. lost investments. It is not at all clear what scale should be used. What is clear, however, is that Ecuador's contract annulment was no more disproportionate than the contract itself, signed by Oxy, which explicitly provided for such annulment. Oxy's contract cited Ecuador's hydrocarbon law, which states "The Minister of Energy and Mines may declare the [termination and forfeiture] of contracts, if the contractor… transfers rights or enters into a private contract or agreement for the assignment of one or more of its rights, without the Ministry's authorization" (para. 121). If Oxy considered that response to be disproportionate, it probably should not have signed the contract in the first place. Given that the company did so, it is rather beside the point to try to label Ecuador's contract enforcement as out of proportion.

3. Tax ≠ Taxation ; Hypothetical = Real

Having branded Ecuador as guilty, the tribunal then sought to estimate the penalty the country should pay to Oxy for its repossessed investments. To do so, the tribunal entertained a series of hypothetical questions. Continuing the investor-state standard of allowing companies to collect on "expected future profits," the tribunal asked how much money Oxy might have made had its contract remained in effect (para. 708). Answering that imaginative question requires not just adding up the revenues that Oxy might have seen, but subtracting the taxes that Ecuador would have imposed on those revenues. In the month prior to the cancellation of Oxy's contract, Ecuador passed a new broad-based oil tax—Law 42—that lay claim to a portion of oil profits that result from increases in the oil price (para. 465). But, peering further down the rabbit hole of "expected future profits" logic, the tribunal, in calculating Oxy's prospective earnings, asks us (and Ecuador) to imagine that the tax was never imposed. The reason, they argue, is that the new tax, if imposed on Oxy's hypothetical future profits, would have violated Oxy's contract and constituted yet another breach of the company's BIT-protected right to "fair and equitable treatment" (para. 527).

To come to this conclusion, the tribunal had to first sidestep the fact that the U.S.-Ecuador BIT actually reserves a fair amount of policy space for the governments to enact "matters of taxation," indicating their exemption from FET challenges (para. 498). How did the tribunal achieve this feat? By declaring the new tax to not be a "matter of taxation." Declining to give the measure a name, the tribunal instead described it as "a unilateral decision of the Ecuadorian Congress to allocate to the Ecuadorian State a defined percentage of the revenues earned by contractor companies" (para. 510). Let's see, what does a congressionally-mandated allocation to the government of "a defined percentage of revenues" sound like? Oh yes—a tax. The Oxford Dictionary **defines** a tax as "a compulsory contribution to state revenue, levied by the government on workers' income and business profits…" In seeking to avoid naming Law 42 as a tax, the tribunal instead offered the standard definition of…a tax. As a tax, the new measure should have been safeguarded under the BIT as a legitimate government policy not generally subject to claims of "fair and equitable treatment."

Beyond its Orwellian attempts to avoid the tax exemption, the tribunal's rationale for calling the tax a FET violation raises red flags. The tribunal argued that Law 42 violated FET because it "is in breach of the Participation Contract and flouts the Claimants' legitimate expectations" (para. 527). First, as mentioned, the idea that governments are obliged to fulfill investors' expectations is a rather inventive interpretation of "fair and equitable treatment," one that departs from customary international law and the opinions filed by the U.S. and other States in previous investor-state cases. Second, it's more than a tad ironic that when Oxy "breached" its contract and "flouted" the government's expectation to vet oil companies operating in its territory, the tribunal did not nullify Oxy's contractual claim to oil revenue. But in assessing that Ecuador's tax

law “breached” the very same contract and “flouted” Oxy’s expectation of profit, the tribunal felt perfectly comfortable nullifying the government’s legal claim to tax revenue. Such “doublethink” constitutes a second display of Orwellian tactics within six pages of the award.

Under its contradictory rationale, the tribunal chose to disregard Ecuador’s oil tax in calculating Oxy’s projected profits, substantially boosting the penalty imposed on Ecuador’s taxpayers. In so doing, the tribunal effectively converted reality into something hypothetical (i.e., let’s pretend this tax doesn’t exist) while converting the hypothetical into reality (i.e., let’s pretend unearned profits do exist).

4. 100% Ownership - 40% Sale = 100% Ownership

Then came what may be the tribunal’s most bitterly ironic reasoning in the whole award. They decided that while Oxy had sold 40% of its oil production rights to AEC, Ecuador should compensate Oxy as if it retained rights to 100% of the expected future profits. Why? Because Oxy had breached Ecuadorean law by failing to ask Ecuador’s permission for the deal with AEC. As such, the tribunal reasoned, that deal should be considered legally void, Oxy should be entitled to future profits on 100% of the contracted oil operations in Block 15, and Ecuador should increase its compensation to make it so (paras. 649-651). In other words, Ecuador should pay more for responding to Oxy’s violation of Ecuadorean law precisely *because* it was a violation. I’m not kidding. Even if we take every other aspect of the tribunal’s award as justified, this line of reasoning alone cost Ecuador’s taxpayers 40% of the judgment, or about $960 million.

The tribunal’s “whereas” here is correct—their “therefore” is what needs work. As the tribunal acknowledged throughout the award, Oxy indeed violated the hydrocarbons law in not seeking authorization for farming out oil production to a third party. Now, some analysts might see Oxy’s breaking of the law as the very reason to rule that it was within Ecuador’s bounds to respond by annulling Ecuador’s contract. Instead, the tribunal maintained its disproportionate response theory and saw Oxy’s legal violation as profit entitlement. They seem to miss that while Oxy’s illegal maneuver may have nullified its contract with AEC, it certainly provided the grounds for Ecuador to nullify Oxy’s contract with the government.

To her credit, one of the tribunal members, French professor Brigitte Stern, **strongly dissented** from this and all of the tribunal’s decisions regarding damages. She called the reasoning that converted a 60% investment into a 100% profit entitlement “so egregious in legal terms and so full of contradictions, that I could not but express my dissent” (para. 5). Taking particular issue with the majority’s finding that Oxy’s contract with AEC was automatically null, she argued it was still in effect, meaning that Oxy could only lay claim to the 60% share. In assessing her counterparts’ arguments, she concluded that they were based on “an inexistent and inchoate body of law” (para. 44). That’s right—even a tribunal member has said the tribunal was making stuff up.

5. Total Share of Blame = 0.25(Illegal Action) + 0.75(Legal Response)

In its near-final act, the tribunal turned to the question of how much blame each party held for the cessation of the contract between Oxy and the government, under the notion that Oxy’s allotment should be deducted by its portion of the blame. Recounting the evidence, the tribunal reiterated that Oxy “acted negligently and committed an unlawful act. The Claimants’ [Oxy’s] fault prevented the Respondent [Ecuador] from exercising, in a formal way, its sovereign right to vet and approve AEC” (para. 679). They further acknowledged that Oxy’s mistake “exposed itself to a serious risk that [termination and forfeiture] could be declared,” which seems self-evident, given

that Oxy's contract plainly stated so (para. 672). Most importantly for determining fault for the contract annulment, the tribunal found Oxy blameworthy in a counterfactual test: "If [Oxy] had sought the Minister's consent in October 2000, in all likelihood it would have obtained it and it is probable that the Respondent [Ecuador] would not have declared [termination and forfeiture] in 2006. In other words, without the violation of the law by [Oxy], [termination and forfeiture] may not have happened" (para. 683).

But then the tribunal also assigned some blame to the government. Citing a bout of anti-Oxy "social unrest" that preceded the government's declaration of annulment (para. 684—a reference to unions and social movements that called for Oxy's departure), the tribunal suggested that the government's motivations may have included forces beyond Oxy's breach (e.g., democracy).

To what ratio of blame might this analysis lead the tribunal? 75% to 25%. No, not 75% for Oxy. Oxy, according to the tribunal, only shares 25% of the blame for prompting the cessation of its contract, while the government is responsible for three-quarters of the fault. What blame algorithm did the tribunal use to arrive at this conclusion? They don't say. In fact, they don't give any explanation whatsoever. After spending 25 paragraphs discussing possible blame on both sides, with the lion's share of the analysis devoted to acknowledging Oxy's fault, the tribunal spends one solitary paragraph plucking the 75:25 ratio from the range of possibilities (para. 687). The only substantiation provided is that the tribunal enjoys "a wide margin of discretion in apportioning fault" (para. 670). Wide, indeed.

It's rather baffling how the tribunal could make such an apportionment shortly after acknowledging that "it is probable" that the contract annulment would not have happened if Oxy had acted in a legal manner. "Probable" seems to indicate something more than a 50% chance, and thus, more than 50% of the blame for Oxy. A reverse blame ratio (75% for Oxy) would thus have been more in line with the tribunal's own reasoning. The difference between the two ratios amounts to an $800 million burden for Ecuador's taxpayers.

In sum, this ruling is, in the words of the dissenting tribunal member, "egregious." It earns this adjective not just because of the staggering penalty inflicted on Ecuadoreans, but the staggering logic used to get there. In the end, the tribunal's runaway interpretation of FET, disregard for the rule of law, defiance of basic English, selective weighing of evidence, and arbitrary blame game have not only saddled Ecuador with a cost tantamount to health care for half the country. They have saddled all Parties to NAFTA-style treaties with a precedent of twisted reason. Let's hope it isn't followed.