

Mandatory Arbitration of International Environmental Claims

September 18, 2015

New York Law Journal

September 18, 2015 by Stephen L. Kass

In my May 2015 column on "[Regulation and Investor Protection under the Trans-Pacific Partnership](#)" (May 1, 2015), I suggested that the Obama administration should drop the controversial requirement for Trans-Pacific Partnership (TPP) parties to agree to mandatory arbitration of U.S. investors' claims against host governments. The TPP, a proposed 12-nation trade and investment convention, seeks to facilitate U.S. investments abroad. Its arbitration requirement, currently included in the latest draft of the TPP, would enable U.S. investors in TPP countries to commence private arbitration proceedings against host governments under either the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (ICSID) or the U.N. Commission on International Trade Law (UNCITRAL).

Under the TPP as currently drafted, U.S. investors could demand such arbitration against a host country's national government by alleging "regulatory takings" and other TPP violations growing out of efforts by those governments to protect their nations' environment or address global issues such as climate change or pollution of the world's oceans, whether that action was taken by the country's executive, legislative, judicial branch or a municipality.

A recent decision by the U.S. Court of Appeals for the D.C. Circuit reveals how complex that arbitration can become even under a U.S. "bilateral investment treaty" (BIT) with a single nation. It also illustrates why developing countries included in the 12-nation TPP, where the U.S. has far less bargaining leverage, may object to such a treaty requirement as a condition to TPP membership.

The D.C. Circuit's Aug. 4 decision, *Chevron Corp. v. Republic of Ecuador*, 795 F.3d 200; 2015 U.S. App. LEXIS 13528, arose in the context of a U.S.-Ecuador BIT, which became effective in 1997 and included a similar arbitration clause benefiting U.S. investors. Although nominally a dispute over the allocation of oil revenues between Chevron and Ecuador, the case was part of the 25-year battle over the environmental, legal and political issues arising over oil exploration in the Lago Agrio region among Ecuadorian villagers in that country's Amazon region, Chevron (and its subsidiary Texaco Petroleum Co.) and the Government of Ecuador. I have discussed that litigation, featuring actions in New York, Ecuador, the Hague, Canada and elsewhere, extensively in previous articles (most recently, "Foreign Environmental Claims in U.S. Federal Courts," May 1, 2013) and had resolved not to revisit it again.

However, the Chevron saga has now resurfaced in a way that sheds important light on the mandatory arbitration provisions of both existing BITs and, more importantly, the proposed TPP. While mandatory arbitration clauses are strongly favored by transnational corporate investors, they are not, in my judgment, in the long-term interest of the United States to develop the rule of law in developing countries and should be deleted from the final TPP before it is submitted to Congress for an up-or-down vote under the president's "fast-track" authority.

UNCITRAL Arbitration

On its face, the oil revenues arbitration between Chevron and Ecuador, which took place in the Hague under UNCITRAL rules, appeared to be an appropriate and desirable way to resolve a long-running commercial dispute relating to the allocation of revenues from oil exploration and development activities carried out by Chevron's subsidiary, Texaco Petroleum Co. (TexPet), over a 20-year period that ended in the early 1990s.

In 1995, TexPet and Ecuador entered into a settlement agreement that covered most of these disputed issues but permitted TexPet to continue to prosecute seven pending lawsuits in the Ecuadorian courts over sums that TexPet claimed were owed prior to the settlement. Those lawsuits, which had been commenced in the early 1990s, continued to drag on for periods of up to 15 years for procedural and other reasons that were disputed by the parties. Chevron contended that the delays in adjudicating these claims were the result of political interference by Ecuador's executive and legislative branches and continuing turmoil and corruption in its courts.

Ecuador noted that its court system had been significantly improved during this period, as both the U.S. State Department annual country reports and Chevron itself had recognized in its affidavits in the separate Lago Agrio litigation before Judge Rakoff in the Federal District Court for the Southern District of New York. Ecuador also argued that Chevron had left these commercial claims hanging as a bargaining chip in the much more significant Lago Agrio litigation then pending in Ecuadorian courts after the New York federal courts, at Chevron's request, had dismissed the Ecuadorian plaintiffs' environmental claims on forum non conveniens grounds. See, "A Most Inconvenient Forum," NYLJ, April 23, 2010.

In 1993, the U.S. and Ecuador entered into a BIT, which became effective in 1997 and provided that U.S. investors could arbitrate claims against Ecuador existing on or after the 1997 effective date. In 2006, Chevron commenced such an arbitration in the Hague claiming that the Ecuadorian courts had failed to resolve the seven pending claims in a timely fashion and had therefore violated its rights both under the BIT and customary international law. This was during the very same period that the Lago Agrio plaintiffs were making unexpected progress against Chevron in their Ecuadorian damage case, where, as the trial progressed, Chevron realized it was facing potential liability of up to \$27 billion for injury to the health and environment of villagers from Ecuador's Amazon rainforest.

Faced with this prospect, Chevron commenced a separate Lago Agrio arbitration against Ecuador (also under the BIT), this time alleging that Ecuador's President Rafael Correa and others (including the plaintiffs' lawyer Steven Donziger) had also interfered improperly with that judicial process (see, "Lessons from Lago Agrio," Sept. 15, 2011). The Lago Agrio arbitration panel in the Hague issued a "provisional order" in 2011 ordering the Ecuadorian government to direct its courts not to enforce or recognize the trial court's expected judgment against Chevron for \$18 billion. The Ecuadorian government condemned that order as an improper interference in the country's judicial process by the UNCITRAL arbitrators. Ecuador's appellate courts also ignored the arbitrators' award but ultimately reduced Chevron's liability under the Lago Agrio judgment to just over \$9 billion.

Arbitration Award

It was against this backdrop that the commercial arbitral panel dealt with Chevron's seven oil revenue claims against Ecuador. After first addressing Ecuador's jurisdictional objections that these pre-1997 claims were not subject to the BIT at all (and that, even if they were, the panel could not entertain them while they were pending in Ecuadorian courts), the panel issued an "interim award" on the merits in December, 2008. In that award the panel found that Ecuador had improperly delayed and interfered with TexPet's judicial claims and was presumptively liable for approximately \$700 million in cumulative damages, subject to the panel's final assessment of damages and costs of the arbitration itself.

In August, 2011, after further briefing and argument, the panel reduced this amount to \$96 million after finding that some 85 percent of the original \$700 million award would have been payable back to the government as taxes. Because Chevron had prevailed on the jurisdictional issues and on the merits but Ecuador had largely prevailed on the amount of damages, the panel declined to impose costs on either party.

Ecuador nevertheless appealed the arbitrators' award through three levels of the Dutch courts, which affirmed the award on the ground that the arbitrators were authorized to determine both jurisdictional and substantive questions and that their decision was in any case reasonable. Armed with this final judgment, Chevron then sought enforcement against Ecuador in the United States, where the D.C. District Court held that the UNCITRAL award was enforceable under the Convention on the Recognition of Foreign Arbitration Awards (commonly known as the "New York Convention"). Ecuador's appeal then brought the case to the D.C. Circuit.

The D.C. Circuit treated this case as an ordinary commercial dispute that happened to involve a foreign nation operating in the commercial sphere. It therefore afforded considerable deference to the arbitrators' determination that they had jurisdiction to decide the case, that Ecuador had interfered improperly in the judicial process to TexPet's detriment and that that interference amounted to a violation of both the BIT and customary international law. To remove any doubt, however, the circuit court added that it agreed with the arbitrators on these issues and therefore affirmed the judgment of the district court dismissing Ecuador's challenge to U.S. recognition and enforcement of the UNCITRAL award.

Broader Context

But this was not an ordinary commercial dispute over oil revenues. The entire arbitration was integrally related to the far broader and more important Lago Agrio litigation in the U.S. and Ecuador and to the concurrent arbitration (before a separate UNCITRAL panel) of Chevron's claim that Ecuador's politically motivated president and corrupt local judges, with help from the plaintiffs' lawyer Donziger, had conspired to issue a fraudulent multibillion-dollar judgment against Chevron. The status and role of Ecuador's courts and the relationship of the Ecuadorian government to those courts, even more than Ecuador's environmental policies, were at the heart of the Lago Agrio arbitration, just as they were to the Chevron oil revenues arbitration.

There were therefore important reasons for Ecuador to urge that both arbitrations were outside the intended scope of the BIT's mandatory arbitration provisions and that Ecuador had never agreed to endow an UNCITRAL arbitration panel with authority to order the nation's president to direct its courts to issue (or not to issue) a particular judgment in litigation affecting the nation's environmental and public policies. The oil revenues arbitration award finding that Ecuador's judicial process was so flawed that it violated Chevron's rights under international law therefore bore directly on Chevron's Lago Agrio claim that the plaintiffs' multibillion-dollar award in that case was equally flawed.

I am not arguing that arbitration of Chevron's claims in either the oil revenues or Lago Agrio case was not appropriate. (On the contrary, arbitration of the entire Chevron-Ecuador-Lago Agrio controversy would likely have resulted in more justice at less cost and in less time.) What I do suggest is that this case illustrates why the TPP should not require nations to agree to mandatory arbitration as a condition of improved trade with the U.S. If Ecuador or any TPP nation wishes to attract foreign investment by agreeing to arbitrate any claim of discriminatory treatment or illegal governmental conduct, it should be free to do so. However, if TPP nations believe they have a competent and independent judicial system—or are simply working to develop one—they should be free to insist that foreign investors be subject to the same body of law and procedure as others in their country. If investors are not satisfied with that prospect, they will take their business elsewhere. The business community has hardly voted with its feet against doing business in China because its courts are corrupt or subject to political control; nor did TexPet avoid Ecuador for that reason in the 1970s.

The breakdown of law in developing countries should be of grave concern to the U.S. and other developed countries, affecting not only commercial transactions but protection of the environment, fundamental human rights, regional security, cross-border migration and the growing success of radical terrorism. The development of functioning court systems able to vindicate individual and constitutional rights is essential if developing countries are to confront those challenges successfully. Encouraging or, worse, requiring TPP and other trading partners to agree to private supra-national arbitration rather than using a nation's courts makes it less likely that such courts will be able to perform their essential functions in a law-abiding society. When the disputes involve the validity of important public policies or initiatives, the removal of such

claims from the host nation's judicial system is worse. There is no valid reason for the TPP to impose such a requirement simply to advance the interest of U.S. and other transnational corporations already capable of defending their own interests. Rather than slowing the development of critically needed independent courts among our trading partners, the U.S. should consider assisting TPP countries in developing their judicial systems and should make judicial independence, rather than private arbitration, the price of TPP trade benefits.

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