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The Damages Newsletter

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We are pleased to present the latest edition of *Quantum Quarterly*, a publication of King & Spalding's International Arbitration Group. This edition includes an interview with noted energy valuation expert Wayne R. Wilson, Jr., an "Old But Still (Very) Useful" feature on the Iran-US Claims Tribunal case of *Phillips Petroleum Co. v. Iran*, and summaries of recent damages awards, including the *Occidental v. Ecuador* award, the largest so far in ICSID history. As always, we welcome any feedback you may have.

All the best.

Table of Contents

01 An Interview with Wayne R. Wilson, Jr.

03 Recent Damages Awards — *Italia Ukraina Gas*

05 *Occidental Petroleum Corporation*

09 *EDF International*

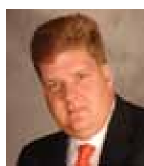
12 *M. Meerapfel Söhne AG v. Central African Republic*

14 Our "Old But Still (Very) Useful" Section — *Phillips Petroleum Co. v. Iran*

15 Who We Are

16 Contacts

An Interview with Wayne R. Wilson, Jr.



Wayne R. Wilson, Jr., Managing Director at UHY Advisors FLVS, Inc., in Houston, has provided consulting services and expert testimony to international clients in the areas of finance, organizational management, accounting, statistics, and risk management. His expertise in the petroleum industry includes, among others, crude and natural gas reserves valuations, pricing of and accounting for production, pricing of and accounting for refined & processed products, transportation pricing, transfer pricing, royalty valuations, and valuation of energy companies. Mr. Wilson has specific petroleum segment experience in exploration, production, trading, transportation, petrochemical, olefins, and refining & processing, as well as extensive expertise in the power industry.

Q: Tell us a bit about your background and practice.

A: Our practice specializes in energy and petrochemical disputes. We provide services from wellhead to Wall Street. This includes everything from operational disputes at the wellhead to valuation disputes over energy-related

continued on Page 2

Interview with Wayne R. Wilson, Jr.

continued from Page 1

derivatives. I have over 18 years of energy industry experience, and our energy dispute team at UHY is composed of practitioners with between seven and 14 years of experience in the energy industry. My practice is composed of both proactive and reactive consulting. I provide consulting services to companies from deal formation through deal arbitration. In some cases, we are asked to advise clients on the accounting and financial risks of international investments on a proactive basis in order to avoid future problems. At other times, we are asked to assist clients in responding to events that have already occurred, in order to measure the effect and assist in the correct reactions.

Q: How did you end up working as a quantum expert in international arbitration?

A: In part, it was the natural result of the global nature of the energy industry. Since I work almost exclusively in the energy industry, I have always had some international projects throughout my career. I was approached in 2005 by a client and friend about whether I would be interested in working in international arbitration. While I had participated in commercial international arbitrations prior to that point, investor-state arbitration sounded different. I have been involved nonstop as a quantum expert in international arbitration since that time.

Q: What do you consider to be the most interesting recent developments in international arbitration cases concerning damages?

A: I believe that we have seen a significant evolution occur related to the use of discounted cash flow models. This evolution has occurred in both the application of these models to the quantum questions arising in international arbitration and in the sophistication of the understanding of both counsel and panel members. This evolution has allowed for an overall elevation of the discourse related to quantum analysis, but has also allowed for the development and refinement of the models to measure the true damages.

I also see the trend toward multiple parties to a transaction pursuing disparate venues for arbitration to be a very interesting development for quantum experts and arbitration panels. The question of offset will become increasingly important, and the process for resolving these issues poses significant challenges to the process. I believe this is an issue that requires active cooperation between the legal and quantum communities in order to reach the correct solutions.

Q: As an expert, do you feel that arbitrators in investment arbitration cases approach damages differently from arbitrators in commercial cases?

A: As a quantum expert, I am often on the outside looking in at the decision or opinion of the panel. This is usually my only view of how the respective panels approach damages. However, it appears that quantum aspects of cases are given more attention in commercial cases than in the investment arbitration cases. In fact, I can think of several keynote speeches and presentation comments referring to single-paragraph discussions of quantum in multibillion-dollar investment disputes. I do not believe that quantum has any less importance in either venue, but at times it seems that damages are the last thing considered, rather than the primary motive for the investment cases. I do not believe that either set of arbitrators is better or worse at evaluating the damages.

In many cases, the short analysis and final decision often leave the impression of a Solomon compromise rather than a true legal answer. In short, I think both groups of arbitrators could benefit from panel-selected assistance of a neutral quantum expert to help them model their decisions. In many instances, disputes boil down to cash flows, discount rates, and, potentially, valuation dates. By having their own quantum expert, they could dictate their areas of agreement with the two opposing quantum experts and have their own quantum expert compile the results. This would improve the level of understanding of the opinions of arbitration panels concerning quantum and likely improve damages analysis for future disputes.

Q: Any tips for counsel advocating damages issues?

A: As the saying goes, hire experts early and often. In all seriousness though, it is very hard as an expert to come into a case later in its progression. By being involved early, we can assist counsel in identifying the documents we will need to perform the quantum analysis. Sometimes, this can save the cost of repetitive international travel and allow for an analysis of financial realities of the damages element at an early stage. Ultimately, companies pursue international arbitration as a business decision. I believe that better information yields better decisions. It can also make for happier clients that appreciate the exposure they face throughout the process. ✦

Recent Damages Awards

***Italia Ukraina Gas S.p.A. v. Naftogaz*, SCC Arbitration V 007/2008**

Date of the Award:
December 19, 2012

The Parties:
Italia Ukraina Gas S.p.A. (Claimant), Naftogaz of Ukraine (Respondent)

Sector:
Natural gas trading

Members of the Tribunal:
Staffan Magnusson (Chair), Lars Edlund, and Jan Ramberg

Background:
On December 24, 2003, Italia Ukraina Gas S.p.A. ("IUGAS"), an Italian company involved in the trading and transportation of natural gas, entered into a Natural Gas Supply Agreement from 2004 to 2013 (the "Contract") with Naftogaz, Ukraine's national oil company. Under the Contract, Naftogaz had to deliver 13 bcm of natural gas to IUGAS over 10 years. The gas was to be imported from Kazakhstan and Turkmenistan.

In 2006, however, escalating geopolitical tensions between Russia and Ukraine culminated in a decision by Gazprom—Russia's national gas company, which controls the main pipelines in the area—to curtail natural gas shipments from Central Asia to Ukraine in the winter of that year. Faced with this situation, Naftogaz agreed to receive supplies exclusively from Gazprom's subsidiary RosUkrEnergo. The supply agreement with RosUkrEnergo prohibited the resale of the natural gas delivered to Naftogaz. In order to conserve Ukrainian domestic gas reserves, the Ukrainian government decided to limit the export of Ukrainian natural gas by implementing a gas export license requirement. Reacting to this turn of events, Naftogaz ceased to supply IUGAS under the Contract.

IUGAS filed for arbitration before the Arbitration Institute of the Stockholm Chamber of Commerce, seeking enforcement of Naftogaz's delivery commitments, payment of contractually agreed penalties, and damages for contractual breach. The Tribunal rendered a Separate Award on October 19, 2010, upholding Naftogaz's obligation to deliver natural gas under the Contract and condemning Naftogaz to pay contractual penalties to IUGAS on the basis of the volumes of natural gas actually requested by IUGAS. The Tribunal, however, rejected IUGAS's claim for damages for breach of the Contract. Following the parties' exchange of pleadings on quantum, the Tribunal rendered a Final Award on December 19, 2012.

Damages Claim:
Under the Contract, the penalty in cases of underdelivery of gas shall amount to 20% of the cost of the amount exceeding 5% of the underdelivered gas amount. Further, under the Contract, the penalty is not linked to the Contract price. Instead, IUGAS argued that the penalty must be calculated on the basis of the market value of the gas at or in the vicinity of the delivery point. Based on these estimated values during the relevant contract period, IUGAS requested the Tribunal to order Naftogaz to pay contractuallyagreed penalties in the amount of US$168 million plus interest, plus capitalized interest in the amount of US$18 million. Naftogaz rejected this approach, citing difficulties in assessing a substitute value because of the fragmented

... IUGAS argued that the penalty must be calculated on the basis of the market value of the gas at or in the vicinity of the delivery point.

continued on Page 4

continued from Page 3

nature of the European gas market and the outsize influence exercised by Gazprom on natural gas supplies.

In the alternative, IUGAS requested the payment of contractual penalties in the amount of US$204 million plus interest, plus capitalized interest in the amount of US$20 million. IUGAS's alternative damages claim was based on an estimated Contract price, which would have had to be renegotiated to take into account the impact of Gazprom's reduction of supplies to the European market.

Naftogaz, instead, argued that the penalty should be determined on the basis of a "cost plus" mechanism, as the original Contract price had been calculated. Alternatively, the amount should be calculated on the basis of the last Contract price to which both parties had agreed, or US$110 per 1000 cubic meters of gas.

Tribunal's Analysis:
In the Separate Award dated October 19, 2010, the Tribunal found that the contractual penalty should not be reduced even if it should exceed the damages actually incurred by IUGAS and recognized in the Final Award that the contractual penalty shall amount to 20% of the cost of the amount exceeding 5% of the underdelivered gas amount.

As for the calculation of the penalty, the Tribunal rejected IUGAS's approaches, holding instead that the penalty was to be calculated on the basis of the Contract price and not on the basis of substitution costs or a renegotiated price. Instead, the Tribunal concluded that it was not competent to determine a new Contract price that might constitute the basis for the calculation of penalties. "As far as the Tribunal can find, the only remaining alternative is then to calculate the penalties on the basis of the price stipulated in the Contract, i.e. US$110 for 1000 cubic meter[s] of gas."

The Tribunal further found that Naftogaz was prevented from bringing about exports of gas to IUGAS during the years 2011 and 2012, and that Naftogaz was thus exempted from the obligation to pay penalties for non-nonperformance of the Contract as from January 1, 2011. In the Tribunal's own words: "[T]he policy of the Ukrainian government subsequent to the entering into force of the law No. 2467 is reflected by the decisions by the Minister of Energy and Coal industry. It is clear that Naftogaz had no possibility to comply with IUGAS' delivery requests as far as the years 2011 and 2012 are concerned and that the circumstances constituted an impediment as set forth in Article 79 of CISG. What has now been said implies that Naftogaz is not liable to pay penalties for non-performance during 2011 and 2012."

On the basis of the above, the Tribunal set the penalties owed by Naftogaz to IUGAS at US$12.7 million, significantly lower than the US$186 million originally sought by IUGAS.

Interest:
In the absence of Naftogaz's objections to IUGAS's claim for interest on the penalties at a rate corresponding to the Swedish official reference rate plus 8% per annum, the Tribunal ordered Naftogaz to pay interest "in accordance with IUGAS' method of calculation."

Costs:
The Tribunal noted that IUGAS had prevailed with respect to Naftogaz's objections to jurisdiction and Naftogaz's liability to pay penalties for the September 1, 2008 - December 31, 2010, period but that Naftogaz was not liable for penalties for the years 2011 and 2012, nor for damages on the grounds alleged by IUGAS. The Tribunal also based the calculation of penalties on the price stipulated in the Contract instead of on the value claimed by IUGAS. On the basis of that contrasted outcome, the Tribunal found "it reasonable that each of the parties shall bear its own total costs." The Tribunal further held the parties jointly and severally liable to pay the Arbitrators' fees and arbitration costs and that each Party shall finally bear half of these arbitration costs.

Occidental Petroleum Corporation, Occidental Exploration and Production Company v. Ecuador (ICSID Case No. ARB/06/11)

Claimants:
Occidental Petroleum Corporation, Occidental Exploration and Production Company v. Ecuador

Respondent:
Republic of Ecuador

Date of Award:
October 5, 2012

Tribunal:
L. Yves Fortier, C.C., Q.C. (President); David A.R. Williams, Q.C.; Brigitte Stern

BIT:
US-Ecuador BIT

Background:
The Claimants, Occidental Petroleum Corporation ("OPC") and Occidental Exploration and Production Company ("OEPC"), were two U.S. companies incorporated in the states of Delaware and California, respectively. OPC is OEPC's parent company. The Respondent was the Republic of Ecuador.

The parties' dispute arose out of a termination—*caducidad*—of a participation contract dated May 21, 1999, between OEPC and Petroecuador for the exploration and exploitation of hydrocarbons in Block 15 of the Ecuadorian Amazon region (the "Participation Contract"). The *caducidad* of the Participation Contract was declared by a decree of the Ecuadorian Minister of Energy and Mines on May 15, 2006.

> It concluded that it was a unilateral decision by the Ecuadorian Congress to allocate to the Ecuadorian State a defined percentage of the revenues earned by contractor companies such as OEPC that held participation contracts.

The Claimants alleged several breaches of domestic and international law by Ecuador on the basis of the US-Ecuador BIT and the Participation Contract and sought compensation for the loss of the contract. Ecuador for its part alleged that in declaring *caducidad* it had acted in accordance with the Participation Contract in reaction to OEPC's unauthorized transfer of rights to a third party.

After careful analysis of the Claimants' transfer of rights to a third party and the provisions of the Participation Contract, the Tribunal concluded that the Claimants had indeed breached the Participation Contract but that the *caducidad* decree was not a proportionate response in the circumstances. Ecuador's actions in breach of Ecuadorian law, customary international law, and the BIT made the measure "tantamount to expropriation." The Tribunal did not find it necessary to address the remaining allegations of breach under the Treaty and Ecuadorian law.

The damage analysis in the award is lengthy and complex, and the Tribunal took the time to request additional information from the damages experts at various points. The result is a fairly thorough damages analysis, arising out of a complicated factual matrix.[1]

Threshold Issues
The Claimants requested full Fair Market Value ("FMV") of the Participation Contract as of the day after the *caducidad* decree (May 16, 2006). The Respondent objected to this claim by raising four issues, which the Tribunal determined it would deal with as threshold issues before addressing the standard of compensation. The four issues were (i) the Impact of Law 42; (ii) the VAT Interpretative Law; (iii) the Farmout Agreement; and (iv) the Claimants' alleged fault prior to the *caducidad*.

(i) Impact of Law 42
The Respondent argued that any valuation of Claimants' interest in the oil block would have to take account of Law 42 (a type of windfall profits tax enacted in April 2006) because a hypothetical buyer

continued on Page 6

[1] Professor Stern issued a dissenting opinion regarding the majority's damages findings.

continued from Page 5

on May 16, 2006, would have taken Law 42's effects into account. To support its argument, the Respondent submitted that Law 42 was a general fiscal measure that did not fall within the ambit of Clause 8.6 of the Participation Contract—a clause which triggered re-negotiation in the event of enactment of tax measures affecting the economics of the Contract. In the alternative, the Respondent argued that even if Law 42 fell within the ambit of Clause 8.6, the latter was merely a re-negotiation clause and not a stabilization clause.

The Claimants for their part argued that Law 42 should not be taken into account in quantifying loss, as it violated both the Treaty and the Ecuadorian Constitution. The Respondent had its opportunity to include the content of Law 42 in the Participation Contract during negotiations in 1999 and again when the parties attempted to re-negotiate the contract in 2005, but it was unable to do so and could not do so unilaterally by legislation. Further, Law 42 was not a generally applicable modification to Ecuador's tax or legal framework.

The Tribunal determined that in order for it to analyze the impact of Law 42, it had to first characterize the nature of Law 42. The Tribunal agreed with the Respondent that Law 42 was not a royalty, tax, levy, or any other measure of taxation under the Participation Contract. It concluded that it was a unilateral decision by the Ecuadorian Congress to allocate to the Ecuadorian State a defined percentage of the revenues earned by contractor companies such as OEPC that held participation contracts.

The Tribunal noted that under the Participation Contract, the Claimants bore the risk of low oil prices and stood to benefit from an increase in oil prices. As such, Law 42 struck at the very heart of OEPC's acquired rights under the Participation Contract by changing the participation formula such that it reduced OEPC's agreed-upon share of production. Law 42 also took away OEPC's contractual right to "freely dispose" of its participation.

The Tribunal found that the introduction of Law 42 modified unilaterally, and in a substantial way, the contractual and legal framework that existed at the time the parties negotiated and agreed upon the Participation Contract and, as such, breached the Participation Contract. Also, OEPC was justified in expecting that the contractual framework would be respected and certainly not modified unilaterally by the Respondent.

The Tribunal also dismissed other arguments by the Respondent with respect to Law 42, holding that a State's sovereignty is not unfettered, that Law 42 was not a royalty, tax, or levy so the question of the Claimants not being indemnified by a change in Ecuadorian law was irrelevant, and that since re-negotiation did not occur, the Respondent could not belatedly offer this as a potential remedy.

The Tribunal summarized its basic task as answering the question of what was the Claimants' actual loss, not what might have been lost had things been different, and concluded that it would not take into account the effects of Law 42 in its valuation.

The Tribunal also invoked the principle that a State could not reduce its liability for a wrongful act on the basis of another wrongful act. In this case, Ecuador could not reduce its liability for expropriation on the basis of Law 42, which breached Ecuadorian and international law.

Quoting Professor Irmgard Marboe, the Tribunal noted that to relegate a wrongful act to the category of "background" change or "business risk" would be to allow the Respondent to profit from its own wrongdoing, contrary to general principles of international law explicitly prohibiting this. So, if a measure is not lawful, it must be discounted for valuation purposes. Accordingly, the Tribunal disregarded the effects of Law 42 in its valuation.

Further, the Tribunal noted that when a willing buyer establishes the FMV of the investment, he steps into OEPC's shoes and is entitled to claim, invoke, and weigh all the provisions of the Participation Contract.

(ii) Ecuadorian VAT Interpretive Law

A previous tribunal had issued an award in OEPC's favor that found that Ecuador had an obligation to make VAT refunds to OEPC and that its refusal to do so was unfair, arbitrary, and discriminatory. A month after the VAT Award was issued, the Ecuadorian Congress adopted the VAT Interpretive Law, which stipulated that reimbursement of VAT was not applicable to petroleum activities.

Ecuador argued that the Tribunal should consider the VAT Interpretive Law in assessing damages because a hypothetical buyer would have acquired its interest after the enactment of the law and would have had no legitimate expectation to the VAT refunds as contained in the VAT Award. The Claimants countered that the VAT Interpretive Law violated the terms of the VAT Award, the Treaty and the Andean Community Law.

The Tribunal found that the VAT Interpretive Law unfairly and arbitrarily frustrated the legitimate expectations of the Claimants in precisely the same way as the decrees that had denied the VAT refunds. The VAT Interpretive Law was therefore a breach of the Treaty, had no legal effect between the parties, and should therefore not be taken into account as a factor that would impact the FMV of the Claimant's investment.

The Tribunal also dismissed the Respondent's argument about the expectations of a hypothetical buyer and reiterated its position that the appropriate question was the value of what the Claimants had lost, not what the investment would have yielded had it been sold to a third party after the government's measures. Further, the Tribunal noted that when a willing buyer establishes the FMV of the investment, he steps into OEPC's shoes and is entitled to claim, invoke, and weigh all the provisions of the Participation Contract. The Tribunal again noted that the State could not take advantage of its own wrongful acts. Therefore, the Tribunal had to disregard the VAT Interpretive Law in determining the FMV of the Claimants' investment.

In the alternative, if the Tribunal took the VAT Interpretive Law into consideration, it would trigger the application of the correction factor in the Participation Contract, which in any event would neutralize the effect of the VAT Interpretive Law.

(iii) The Farmout Agreement

The Respondent submitted that the Claimants' claim was limited to 60% of the interest in Block 15 because it had farmed out 40% of its interest under the Participation Contract to a third party. Accordingly, the Claimants were entitled to only 60% of the profits, and granting the Claimants damages on the basis of a 100% interest risked double jeopardy.

The Claimants countered that OEPC was the sole owner of the Participation Contract rights and had the necessary standing to claim 100% of the damages. The Claimants also noted that even though OEPC now had to meet its contractual obligations vis-à-vis the third party, that did not confer any ownership of the Participation Contract rights on the third party. The Claimants also argued that there was no risk of unjust enrichment, because OEPC had a contractual obligation to pay the third party an amount equal to 40% of any compensation awarded in the arbitration. In addition, there was no risk of double jeopardy, as the third party had no rights under the Participation Contract so could not make a claim against Ecuador. In any event, a clear award by the Tribunal for 100% of the Participation Contract would preclude any future claims by the third party.

Both parties relied on dictum of the *Chorzów Factory* case to support their respective positions on the Farmout Agreement. The Respondent argued that the Claimants' damages are limited to the personal and actual loss of revenue arising from the loss of their investment, while the Claimants argued that, according to the dictum, contractual obligations and liabilities for which the injured party remained liable should not be excluded from the compensable damage.

The Tribunal invited the parties to make additional submissions on the validity of the Farmout Agreement under both Ecuadorian law and New York law. The

continued on Page 8

continued from Page 7

Tribunal's finding was that the purported assignment of rights under the Participation Contract was not authorized by the Ministry of Energy and thus was in breach of the Ecuadorian Hydrocarbon Law ("HCL"). The assignment was therefore null and void, of no validity whatsoever, and of no legal effect. The Tribunal would therefore disregard it for the purposes of determining the compensation due to the Claimants.

According to the Tribunal's holding, at the date of the *caducidad* the Claimants continued to own 100% of the rights to the Participation Contract and the Respondent was obliged to compensate the Claimants for 100% of their interest. It followed that it is Ecuador which would be unjustly enriched if it were obliged to compensate only 60% of the value of unlawful taking. Under international law, the Tribunal continued, any obligation that the Claimants had to a third party did not affect their right to receive compensation from Ecuador. This was clearly recognized in the *Chorzów Factory* dictum.

The Claimants' Alleged Fault Prior to the *Caducidad* Decree (Contributory Negligence)

Ecuador claimed that any recovery by the Claimants should be reduced in order to reflect the Claimants' reckless conduct in unlawfully assigning its contractual rights to a third party. This conduct had violated the laws of Ecuador and provoked Ecuador's decision to declare *caducidad*. According to Ecuador, damages should be "substantially reduced" on account of the Claimants' contributory fault. The Claimants countered that even if they were found negligent in not obtaining prior ministerial authorization, the damages should not be reduced, as such negligence did not cause their losses—this was an issue of causality.

In its analysis, the Tribunal observed that it is not just "any" contribution by the injured party to the damage that it has suffered that will trigger a finding of contributory negligence; the contribution has to be material and significant. In this regard, the Tribunal had a wide margin of discretion in apportioning fault. The Tribunal noted that the contractual framework between OEPC and Ecuador explicitly authorized *caducidad* and by signing the Participation Contract and failing imprudently and negligently to obtain ministerial authorization for the transfer of rights as required, OEPC exposed itself to a risk of *caducidad* being declared. Invoking Article 39 of the ILC Articles on State Responsibility, the Tribunal said it had to determine whether OEPC's unlawful act contributed to its injury in a material and significant way or whether it was only a minor contributory factor that, based on subsequent events such as the VAT Award, could not be considered a link in the causative chain in legal terms.

The Tribunal concluded that the Claimants should pay a price for committing an unlawful act that contributed in a material way to the prejudice which they subsequently suffered when the *caducidad* decree was issued. The Tribunal also noted that the issuance of the *caducidad* decree was a disproportionate sanction to the Claimants' unlawful behavior and tantamount to expropriation. Indeed, the Claimants' behavior was not the only cause of the *caducidad*, and the Tribunal had the difficult task of weighting the relative causal links. In the end, it concluded that the Claimants had contributed 25% to the prejudice that they suffered.

Valuation

The Claimants submitted that under international law, the appropriate standard of reparation was compensation for the losses suffered by the victim and that FMV was the proper measure of damages. The Claimants contended that FMV was the price "a willing buyer would pay to a willing seller in circumstances in which each had good information, each desired to maximize his financial gains, and neither was under duress or threat." The Respondent did not disagree with the Claimants that FMV was the proper measure in the event that the Tribunal found there had been an expropriation.

The Tribunal agreed with the parties and proceeded to determine the FMV of the Claimants' investment. It held that the FMV could be calculated by the present value of the cash flows that OEPC would have expected "but for" the scenario where there was a contract termination. The difference between the "but for" and actual scenarios was the economically appropriate and reliable measure of the cumulative economic harm suffered by the Claimants as a consequence of the contract termination.

Discount Rate

The Claimants said they were prepared to accept a 10% discount rate that Petroecuador (the state-owned oil company) had frequently used in related contexts or the 12% that both parties had used after the exchange of briefs and rebuttal expert reports. In accepting 12%, the Tribunal noted that Petroecuador had used that rate in its 2007-2011 and 2008-2012 Five Year Plans, which reflected the financial, country, and industry risks.

Calculation of Damages

The Tribunal determined that the Net Present Value of the discounted cash flows generated by Block 15 OEPC production as of May 16, 2005, was US$2.3 billion. This was reduced by a factor of 25% to an amount of US$1.7 billion, which the Respondent was ordered to pay.

Interest

The Claimants sought compound interest at the monthly interest rate paid on U.S. Government Treasury Bills compounded on a monthly basis from the day after the expropriation. The Respondent challenged the award of compound interest, stating that Ecuadorian law, which prohibits compound interest, should apply, not international law. As to the rate, the Respondent requested 5%.

The Tribunal reviewed arbitral practice and concluded that compound interest is the norm in recent expropriation cases under ICSID and saw no reason to depart from the norm. The Tribunal chose a rate of 4.188%—the U.S. Treasury Bill rate at the time the Claimants' expert filed his report.

With respect to compounding intervals, the Tribunal noted that there were no general rules. It noted that monthly compounding would be unduly favorable to the Claimants and settled on annual compounding.

The Tribunal chose a rate of 4.188%—the U.S. Treasury Bill rate at the time the Claimants' expert filed his report.

As to the period during which interest must accrue, the Tribunal settled on a start of May 16, 2006, and held that it should run until the payment of the award, as requested by the Claimants and in accordance with established arbitral practice.

The Tribunal thus applied pre-award interest of 4.188% until the date of the Award, and post-Award interest from date of the Award until the date of payment at the U.S. six-month LIBOR rate compounded monthly.

Taxes

The Claimants sought damages on an after-tax basis and asked the Tribunal to confirm that the Respondent would not seek a tax payment due on any award granted. The Tribunal agreed with the Respondent that such a request was speculative and premature and denied it.

Costs

The Tribunal ruled that each party would bear its own legal costs and that the fees and expenses of the Tribunal and the administrative charges of ICSID should be borne equally between the parties.

***EDF International S.A., SAUR International S.A., and Leon Participaciones Argentinas S.A. v. Argentine Republic* (ICSID Case No. ARB/03/23)**

Date of the Award:
June 11, 2012

The Parties:
EDF International S.A., SAUR International S.A., and Leon Participaciones Argentinas S.A. (Claimants), Argentine Republic (Respondent)

Sector:
Electricity distribution

continued on Page 10

continued from Page 9

Applicable Treaty:
France-Argentina Bilateral Investment Treaty, signed on July 3, 1991 ("France-Argentina BIT" or "BIT")

Members of the Tribunal:
Professor William W. Park (Chair), Professor Gabrielle Kaufmann-Kohler, and Professor Jesus Remon

Background:
The Claimants acquired for US$238 million a 51% interest in Empresa Distribuidora de Energia de Mendoza S.A. ("EDEMSA"), which had entered into a Concession Agreement with the Argentinean Province of Mendoza for the transmission and distribution of electricity. The Claimants alleged that the government of the Province of Mendoza subsequently passed a number of regulatory measures (the "Pre-Emergency Measures") that adversely affected the Concession Agreement. During Argentina's economic turmoil of late 2001 and early 2002, national and provincial emergency laws were enacted (the "Emergency Measures") that according to the Claimants further crippled EDEMSA's financial stability and ultimately destroyed its enterprise value. These measures included the repeal of the convertibility system (i.e., the fixed foreign exchange rate of one Argentine peso to one U.S. dollar), which significantly devalued the Argentine currency; the abrogation of tariff terms involving foreign currencies contained in public utility contracts (these tariff terms were replaced by emergency tariff measures that froze tariff rates while imposing pesification, i.e., a fixed parity rate between the peso and the dollar); the mandatory renegotiation of all public utility contracts; and the obligation for all public utility concessionaires, such as EDEMSA, to continue performing their contractual obligations during the renegotiation process.

The Claimants initiated an ICSID arbitration against Argentina in August 2003, arguing that the Pre-Emergency and Emergency Measures had breached a number of provisions of the France-Argentina BIT. In 2004, EDF International S.A. acquired the interests in EDEMSA of its fellow Claimants Leon Participaciones Argentinas S.A. and SAUR International S.A. EDF International S.A. subsequently entered into a share-purchase agreement with IADESA, a local Mendoza-based investment firm, in which it agreed to sell its 51% interest in EDEMSA for US$2 million. The deal closed in March 2005.

The Arbitral Tribunal ultimately held that Argentina had breached its obligations under the BIT to respect specific commitments undertaken in connection with the Claimants' investment and to afford the Claimants fair and equitable treatment with respect to their investment.

The Arbitral Tribunal ultimately held that Argentina had breached its obligations under the BIT to respect specific commitments undertaken in connection with the Claimants' investment and to afford the Claimants fair and equitable treatment with respect to their investment.

Damages:
The parties agreed that the use of the DCF method to calculate EDEMSA's value was the best way to determine the Claimants' damages. But the parties submitted very different DCF models to the Tribunal.

The Claimants' proposed DCF model assumed that the proper asset base for determining their investment returns should be the actual price paid for their EDEMSA shares. The Claimants then calculated their damages by taking the difference in the value of their stake in EDEMSA under "but for" and "actual" scenarios. The Claimants applied the same discount rate (a WACC rate of 11.34%) to the "but for" and "actual" scenarios, arguing that the only difference between the two was the Emergency Measures that adversely affected EDEMSA.

The Respondent's DCF model posited that the value of EDEMSA's equity should be calculated as the difference between the value of the business and its

financial debt. The model concluded that EDEMSA's value during the November-December 2001 period was zero, allowing the Respondent to argue that EDEMSA had actually benefited from the Emergency Measures. Importantly, the Respondent during the quantum phase an amended model that departed significantly from the model that it had put forward during the merits phase, including a 77% decrease in firm value, an increase in the country risk premium from 7% to 10%, and the addition of a 25% EBITDA/sales cap.

The Tribunal concluded that the fairest measure of damages for Argentina's breaches was the genuine value of the Claimants' investment. It held in this respect that the Claimants' DCF model presented the most realistic and reliable set of calculations. In particular, the Tribunal agreed with the Claimants that the proper asset base for the purposes of DCF calculations was the actual price paid for the EDEMSA shares (it noted in this connection that the Claimants had not overpaid for their EDEMSA shares, since the closeness of the first two bids established the commercially realistic and reasonable nature of the Claimants' purchase price). The Tribunal also adopted the Claimants' cost of equity and cost of debt calculations verbatim, endorsing the Claimants' findings in relation to the risk-free rate, the market risk premium, the beta, and the country-risk premium. The Tribunal ultimately held that the appropriate WACC rate (applicable to both the "actual" and "but for" scenarios) was the Claimants' proposed 11.34%. Finally, the Tribunal agreed with the Claimants that the proper valuation date was December 31, 2001.

In turn, the Tribunal rejected the Respondent's approach to calculating damages, finding that its DCF model contained unreasonable assumptions. The Tribunal was not persuaded by the zero value attributed to EDEMSA during the November - December 2001 period and thus by the Respondent's argument that EDEMSA had benefited from the Emergency Measures. The Tribunal was also unsettled by the Respondent's amended model. In particular, it held that the 25% EBITDA/sales cap was unjustified, finding that it was inconsistent with EDEMSA's right to obtain a reasonable rate of return on its investment.

However, the Tribunal did not completely dismiss the Respondent's damages allegations. It agreed with the Respondent that the Claimants had failed to mitigate their damages when EDF International S.A. sold its 51% interest in EDEMSA during the mandatory renegotiation process, thus "getting off the horse in the middle of the river." The Tribunal reasoned that EDF International S.A. should have incorporated a provision in its share purchase agreement with IADESA that considered the possibility that EDEMSA may have successfully renegotiated the Concession Agreement with the Province of Mendoza or obtained some form of reparation. As a consequence of the Claimants' failure to mitigate damages, the Tribunal subtracted from the total damages awarded an amount equivalent to 50% of the value of the Claimants' participation in EDEMSA. The Tribunal ultimately granted the Claimants US$133.6 million as total damages in relation to the Emergency Measures (having subtracted US$14.1 million as a result of their failure to mitigate damages). The Tribunal also awarded the Claimants US$2.5 million in damages as a result of the Pre-Emergency Measures' adverse impact, for a grand total of US$136.1 million.

Interest:
The parties agreed that the applicable interest rate after the 2005 sale of EDEMSA and until the date of the Award should be the U.S. risk-free rate, namely 10-year U.S. Treasury Bonds. The Tribunal saw no reason to depart from the parties' agreement and granted the rate for that period. However, the parties disagreed on the appropriate interest rate to be applied prior to the 2005 sale (running from the Tribunal's valuation date of December 31, 2001). The Claimants alleged that the applicable interest rate should be the WACC (of 11.34%), since it corresponded to their opportunity costs for their invested amount during their operation of the concession. The Respondent, on the other hand, claimed that the interest on U.S. Treasury Bills, or the LIBOR, should be applied. The Tribunal ultimately

continued on Page 12

continued from Page 11

held that the Claimants had not established that they would have earned the high-risk WACC rate and decided instead to apply the U.S. risk-free rate to the 2001-2005 period as well. The Tribunal found that pre-award interest should be compounded annually. The Tribunal also awarded post-award interest on the same terms (it rejected the Claimants' request that post-award interest be compounded monthly, noting that monthly compounding could be seen as a punitive element, which it could not endorse).

Costs:
The Tribunal held that each party should bear its own costs and that the costs of the arbitration should be equally divided, considering that both sides had presented meritorious arguments, each side winning on some issues while losing on others.

***M. Meerapfel Söhne AG v. Central African Republic* (ICSID Case No. ARB/07/10)**

Date of the Award:
May 12, 2011 (Original in French)

Date of Public Release:
December 28, 2012

The Parties:
M. Meerapfel Söhne Ag Group ("MMS", a Swiss corporation) (Claimant) and Central African Republic (Respondent)

Sector:
Agriculture

Members of the Tribunal:
Azzedine Kettani (Chair), François T'Kint, Judge Marie-Madeleine Mborantsuo

Background:
Pursuant to Rule 48(4) of its current Arbitration Rules, ICSID recently published excerpts of the final award in *Söhne v. Central African Republic.*

The Claimant, a Swiss company, was the majority shareholder in a joint venture ("la société A") created as a tobacco-farming business in the Central African Republic ("CAR"). CAR shareholders held the remaining minority shares. From the outset, la société A faced various problems involving CAR customs, tax authorities, and even the local shareholders themselves. The latter filed a civil proceeding in local courts, requesting damages along with the liquidation of la société A. In an attempt to continue operations, the Claimant entered into a Protocol of Agreement with the CAR on April 12, 2006, which contained an ICSID arbitration clause. The assets of la société A were later requisitioned during the 2006 harvest, and the CAR repudiated the Protocol of Agreement. The Claimant alleged that the CAR had expropriated its investment without compensation, in violation of the Protocol of Agreement (the 1973 Switzerland-CAR BIT was not applicable to the case). On the merits, the Tribunal found that the CAR had indirectly expropriated Claimant's investment through the adoption of a series of measures, and it proceeded to determine damages.

Calculation of Damages
Although the damages portion of the final award is heavily redacted (including the final amount in euros awarded to the Claimant), certain important findings emerge regarding standards for indirect expropriation, expenses, interest, and moral damages.

In deciding the material damage caused to the Claimant, the Tribunal first noted that the Protocol of Agreement obligated the CAR to provide rapid and adequate compensation for any expropriation, through indemnity or otherwise. Because the CAR failed to indemnify the Claimant, the Tribunal considered it "evident" that the CAR had failed to fulfill its contractual obligations. Next, the Tribunal considered the value of the tobacco harvest actually lost to the CAR's expropriation, by determining the average price of tobacco on the date of expropriation (the exact amount in euros is redacted).

After awarding the value of the expropriated tobacco, the Tribunal stated that it was "unable to follow" the Claimant's positions on lost profits and loss of chance. Stating that an investor must necessarily take into account the possibility of losing future profits in exchange for an indemnification guarantee, the Tribunal declined to award lost profits and instead opted to compensate the Claimant only for the amount of its actual investment in the form of the lost harvest.

The Tribunal observed that the damage resulting from these failures was mainly financial, not moral, and that the Tribunal considered these same acts as part of the basis for the Claimant's successful expropriation claim.

Likewise, the Tribunal rejected Claimant's other requests for expenses. First, although the Claimant sought expenses that it had incurred to maintain production after the date of expropriation, the Tribunal found that the Claimant had no obligation to incur these expenses and therefore did so at its own risk. Second, the Tribunal rejected the Claimant's request for reimbursement of its expenses in attempting to reach a settlement, considering that those expenses should be independently borne by each party.

With respect to interest, the Tribunal found that the Claimant's request for interest compounded at a rate of 12% was "without basis" and instead imposed simple interest at EURIBOR +2 points, running from July 11, 2007 (the date that the CAR repudiated the Protocol of Agreement).

Finally, the Tribunal considered the Claimant's separate application for moral damages, which flowed from the CAR's refusal to comply with its own judicial decisions and certain pressure tactics by its authorities to impede the Claimant from resuming tobacco production after the expropriation date. Citing *Benvenuti & Bonfant v. Congo* and *Desert Line v. Yemen,* among other cases, the Tribunal confirmed the authority of an ICSID tribunal to award moral damages. In considering the merits of the Claimant's primary basis for moral damages—defamation—the Tribunal allowed that although the CAR made "excessive" and "exaggerated" statements, these statements were made in the context of an adversarial proceeding and did not cause injury justifying compensation. Next, the Tribunal rejected the Claimant's request for moral damages due to harm arising from its physical eviction from the joint venture's farmland. Noting that a company cannot recover for emotional harm due to eviction from property, the Tribunal pointed out that the Claimant was not able to prove stress or harm caused to individual employees (as was the case in *Desert Line*). Finally, the Tribunal considered the Claimant's allegation that the CAR's refusal to follow its own courts' judgments led to a denial of justice entitling it to moral damages. The Tribunal observed that the damage resulting from these failures was mainly financial, not moral, and that the Tribunal considered these same acts as part of the basis for the Claimant's successful expropriation claim. Therefore, citing *Pey Casado v. Chile*, the Tribunal found that the damages it had awarded for expropriation were sufficient to cover moral damage, especially considering the lack of evidence of any non-pecuniary harm. ✦

Our "Old But Still (Very) Useful" Section

Phillips Petroleum Co. v. Iran, Award No. ITL-32-24-1, 4 IRAN-USA C.T.R. 122, 157 (Dec. 19, 1983)

Phillips is famous as one of the first investor-State cases to use the discounted cash flow ("DCF") method to value an expropriated asset. The DCF method has become the main tool used internationally to assess the fair market value of companies.[1] The World Bank has defined the DCF method in the following terms:

> "[D]iscounted cash flow value" means the cash receipts realistically expected from the enterprise in each future year of its economic life as reasonably projected minus that year's expected cash expenditure, after discounting this net cash flow for each year by a factor which reflects the time value of money, expected inflation, and the risk associated with such cash flow under realistic circumstances. Such discount rate may be measured by examining the rate of return available in the same market on alternative investments of comparable risk on the basis of their present value.

In essence, to use the DCF is to view the fair market value of a company or other income-generating asset (e.g., a concession contract) as being equal to the discounted present value of its expected future net cash flows (i.e., gross cash flows minus expenses). Expected future cash flows must be discounted at a rate that reflects the facts that (1) people generally prefer present cash to future cash; (2) when there is inflation, the value of future cash flows decreases faster; and (3) the higher the risk of realizing the future cash flows, the more inclined a stakeholder will be to receive a quicker (albeit discounted) return on his risk capital.[2]

In *Phillips*, the claimant was a participant in a 1965 Joint Structure Agreement (JSA) with Iran, which provided for the exploration and exploitation of petroleum resources in an offshore area in the Persian Gulf. In 1979, Iran terminated the agreement. Phillips sought compensation and based its claim on a DCF valuation of its interest in the JSA, which it calculated to be US$159.1 million.[3] The Tribunal agreed that "the DCF method by the Claimant [is] a relevant contribution to the evidence of the value of the Claimant's contract rights which have been taken by the Respondents," but "that it is not an exclusive method of analysis and that all relevant considerations must be taken into account."[4] The Tribunal decided not "to make its own DCF analysis with revised components, but rather to determine and identify the extent to which it agrees or disagrees with the estimates of both parties and their experts concerning all of these elements of valuation."[5] Ultimately, the Tribunal disagreed with several of the claimant's assumptions and awarded substantially less damages than the amount sought.

First, the Tribunal lowered *Phillips's* assumption about the number of barrels of oil that could be produced from the field. Next, the Tribunal thought that Phillips's assumptions about the price of oil were too high and its assumptions regarding costs were too low.[6]

Third, and most significantly, the Tribunal thought that *Phillips's* discount rate of 4.5% was far too low. *Phillips's* discount rate assumed that the WACC for large oil companies in general was 4.5%, and that this project was no riskier than those associated with interests in oil reserves elsewhere.[7] The Tribunal disagreed and held that the following risks needed to be taken into account: "first, the risk that not all recoverable oil might, as a practical matter and for various reasons, be produced during the remaining years of the JSA; second, the risk that world oil prices during the remaining term of the JSA might prove lower than during the range foreseen; and third, the risk of coerced revisions of the JSA in the future that would reduce its economic benefits."[8] Although the Tribunal did not select its own discount rate, it held that the real risk was "substantially" higher, and it awarded only US$55 million in damages, which was only about 1/3 of the damages that *Phillips* sought.[9]

The *Phillips* case is an interesting read in light of more recent investment cases where Tribunals have analyzed DCF models in great detail, often enlisting the use of a tribunal-appointed expert to assist in the process. These Tribunals have often addressed a dozen or more key assumptions in the DCF model, weighing the opinions of both sides' experts (and that of the tribunal-appointed expert when there has been one) before reaching their own conclusions as to the appropriate input to the model. These analyses have been quite thorough and have generated ultimate damages figures that are precise and detailed. This contrasts with the approach of the *Phillips* Tribunal, which expressly declined to offer its own DCF valuation but instead "tinkered" with the Claimant's DCF model and ultimately derived at only a very general estimate of loss. Nonetheless, the *Phillips* case is noteworthy for its early acceptance of a methodology that has now become widespread in both investment and commercial cases. ✦

[1] See Robert F. Brunner, et al., *Best Practices in Estimating the Cost of Capital: Survey and Synthesis*, 8 J. FIN. PRAC. & EDUCATION 13-28 (1998).
[2] *Legal Framework for the Treatment of Foreign Investments: Volume II: Guidelines* (Washington, DC: The International Bank for Reconstruction and Development/The World Bank) (1992).
[3] Phillips ¶ 154.
[4] Id. ¶ 113.
[5] Id. ¶ 114.
[6] Id. ¶¶ 125-34.
[7] Id. ¶ 136.
[8] Id. ¶ 138.
[9] Id. ¶ 158.

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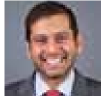
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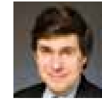
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