AN ANALYSIS OF THE FINANCIAL AND OPERATIONAL RISKS TO CHEVRON CORPORATION FROM AGUINDA V. CHEVRONTEXACO

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EXECUTIVE SUMMARY

Key Findings:

- Chevron is facing a number of financial and operational risks with regard to litigation in Ecuador in *Aguinda v. ChevronTexaco* concerning the company's liability for alleged widespread contamination of soil and water.

- At present, Chevron is facing an $18 billion judgment that remains under appeal in the Ecuadorian courts. This is a historically high judgment that is comparable in size only to BP's promised $20 billion fund to compensate victims of the 2010 Gulf of Mexico oil spill.

- Chevron's principal legal defense to immediate enforcement of the recent $18 billion judgment from an Ecuadorian court was to obtain a preliminary injunction from U.S. District Court. Over the long term, it is not clear that such an injunction in U.S. court would protect Chevron from enforcement efforts outside the United States. The injunction is also subject to appeal.

- Chevron has also sought to defend itself though international arbitration against the government of Ecuador under the provisions of the Bilateral Investment Treaty (BIT) between the U.S. and Ecuador. At present, these arbitral proceedings are running concurrently with the Aguinda case in Ecuador. Although Chevron could conceivably obtain money damages from the Ecuadorian government from this process, the arbitral panel has no jurisdiction over the Aguinda plaintiffs or the Ecuadorian court system.

- While Chevron has admitted in sworn legal statements that the company is at risk of "irreparable injury to [its] business reputation and business relationships" from potential enforcement of the Ecuadorian court judgment, the company has failed to characterize these risks to the company in its public filings and statements to shareholders.

- These choices may lead some investors to question the adequacy of the company's public statements and disclosures and whether the board and management are fulfilling their fiduciary duties to properly manage this significant risk to the company's business and value.

1. *INTRODUCTION*

When Chevron acquired Texaco in 2001, it inherited a significant legal, financial, and reputational liability. From 1964 to 1992, Texaco had operated oil extraction facilities in the remote northern region of the Ecuadorian Amazon, known as the *Oriente,* which is home to a number of indigenous peoples. The oil fields were operated by Texaco on behalf of a business consortium that also included Ecuadorian state-owned oil company Petroecuador.

In 1993 a group of Ecuadorian citizens living around Texaco's production sites filed a class-action lawsuit against Texaco in New York, alleging that the company had knowingly used substandard environmental practices which had led to massive soil and water contamination. Over the ensuing decade, Texaco petitioned to have the case transferred to Ecuador on *forum non conveniens* grounds, a request ultimately granted by U.S. District Court Judge Jed Rakoff on the condition that the company submit to Ecuadorian jurisdiction. The case, Aguinda v. ChevronTexaco, was re-filed against Chevron in Ecuador in 2003.

After nearly two decades of litigation, on February 14, 2011, the Ecuadorian Provincial Court issued its final judgment in which it found Chevron liable for just over $18 billion in compensatory and punitive damages.[1] The judgment is now under appeal. This constitutes one of the largest court judgments for environmental damage in history. This judgment is comparable in size only to BP's promised $20 billion fund to compensate victims of the 2010 Gulf of Mexico oil spill.

Chevron has obtained a preliminary injunction from the United States Second District Court that purports to bar the plaintiffs and their lawyers from seeking enforcement of any judgment in Ecuadorian court. However, it not clear how this injunction in U.S. court would protect Chevron from enforcement efforts by the plaintiffs aimed at Chevron's assets outside the United States. Moreover, the injunction is subject to appeal.

Drawing on the unusually rich and revealing publicly available legal filings in this case, this report examines the potential damage and disruption to Chevron's operations should lawyers for the Ecuadorian plaintiffs seek to enforce the $18 billion Aguinda court judgment by attaching Chevron's assets worldwide. This report also assesses the risk that Chevron's aggressive counter-litigation and public relations campaign against the Ecuadorian plaintiffs' will backfire and prove to be a long-term barrier to the company's obtaining the legal right and social license to explore and operate in new regions.

Chevron has chosen to downplay the risk associated with the Ecuador litigation in its public filings and statements to shareholders. The company has made one-sided public statements of about the legal particulars of the case that could be misleading to some investors without additional clarification. These choices may lead investors to question the accuracy of the company's public assessments of the financial and operational risk it faces.

This report is based upon review of Chevron's public filings with the Securities and Exchange Commission, public domain legal filings in the United States and Ecuador, and interviews with legal experts.

2. CHEVRON'S FINANCIAL LIABILITY IN THE WAKE OF THE AGUINDA V. CHEVRONTEXACO COURT JUDGMENT

In this complicated, high-stakes and unprecedented legal case, it is hard to forecast Chevron's ultimate liability. However, the recent Ecuadorian court judgment provides an initial indication of what Chevron can expect from the Ecuadorian judicial system.

On February 14, 2011, the Presiding Judge of the Provincial Court of Justice of Sucumbíos, Nicolas Zambrano, issued his final judgment in which he found Chevron liable for approximately $8.6 billion in damages (primarily for the remediation of contaminated soils). He also awarded 10% of the judgment ($860,000,000) to the plaintiffs. The judge also added an additional $8.6 billion in punitive damages.

This constitutes one of the largest court judgments for environmental damage in history. This judgment – if collected – would be second only to BP's promised $20 billion fund to compensate victims of the 2010 Gulf of Mexico oil spill.[2]

Chevron's ultimate financial liability resulting from the Ecuador litigation depends on many contingencies. These include how the $18 billion judgment fares on appeal in Ecuador as well as the impact of Chevron's legal attempts to prevent enforcement of the judgment in the United States and other countries where the company holds assets.

Aguinda Judgment Enforcement Timeline

The case is now moving through the appeals process in Ecuadorian Provincial Court. Chevron could take the case further to the Ecuador Supreme Court or the Constitutional Court but the company would have to post an appellate bond determined by that court to forestall the plaintiffs from seeking enforcement of the Provincial Court's judgment.

Under Ecuadorian law, the plaintiffs could seek enforcement of any judgment against Chevron following the first appellate decision. Since Chevron no longer has any assets in Ecuador, the plaintiffs would need to then pursue enforcement of any judgment in countries where Chevron still operates.

Possible Financial Effects of Enforcement

Stock analysts are beginning to incorporate Chevron's legal liability into their investment analysis. Stock research company Trefis issued a report on March 31, 2011, in which it estimated the potential impact on its estimate of Chevron's stock valuation should the company pay the penalty recently ordered by the Ecuadorian court. Assuming a payout by Chevron of only $9.5 billion (the amount of the Ecuadorian judgment excluding punitive damages), Trefis predicted a decline in its estimate of Chevron's stock valuation of approximately 5% (from $104/share to $99/share). Trefis also observed: "While this particular impact would be a one-time charge, long-term impacts could include tighter anti-pollution regulations and stricter enforcement. This would likely raise costs for oil companies, an effect that would be reflected in profit margins." [3]

Unclear Prospects for Settlement

Will Chevron settle the case and, if so, for what amount? It is uncertain based on current information and statements. According to a memo prepared by the plaintiffs' lawyers, Chevron has engaged Gregory Craig, President Obama's former White House Counsel, for the purposes of settlement negotiations in the case. In the memo, the plaintiffs' lawyers suggest that this may be a sign of genuine interest by Chevron in settling the case.[4]

However, in recent statements to the press, both legal teams seem far apart. Juan Pablo Saenz, a member of the plaintiffs' legal team in Ecuador, told the *San Francisco Chronicle* that a settlement amount of around $1 billon would be too low to provide for all necessary remediation. He further stated: "We would be open if Chevron would offer something that's legal and fair and just. And as far as I know, that hasn't happened before." Chevron spokesman Kent Robertson stated: "There certainly have been conversations from time to time….The conversations have never gone anywhere."[5]

One important factor encouraging the plaintiffs to hold out for a higher settlement is their access to funding for their legal battle. Any case with a potential payout in the billions of dollars is likely to attract the interest of investors who could invest in the continued prosecution of the case in exchange for a portion of the eventual proceeds. Even prior to the $18 billion judgment in Ecuador, the plaintiffs' legal team secured significant investment in the lawsuit from Russell DeLeon, owner of the online gaming company PartyGaming, and Burford Capital, a publicly listed fund that invests in commercial disputes.[6] The powerful and connected law firm, Patton Boggs, has also joined the plaintiffs' legal team adding significant additional capacity to the team's ability to litigate across multiple fronts and seek enforcement of the Ecuadorian judgment. Given that the plaintiffs now have an $18 billion initial judgment in their favor, their capacity to raise further funding from investors is that much greater.

3. ANALYSIS OF RISKS FROM CHEVRON'S LITIGATION STRATEGY

Chevron has chosen to spend considerable sums of money on an aggressive global litigation and public relations strategy to defend itself in the Ecuador case. In the past two years it has brought allegations of fraud and extortion against the Ecuadorian plaintiffs and their legal team to U.S. courts, seeking to preempt enforcement of the Ecuadorian judgment. Simultaneously, Chevron has sought to use international arbitration agreements to force the government of Ecuador to assume all liability from any judgment against the company. Although Chevron has won noteworthy victories in both of these arenas in recent months, some legal observers have concluded that the existing Chevron strategy may prove ineffectual in preventing enforcement of the Ecuadorian judgment against Chevron's assets in various jurisdictions around the world.

United States District Court

In the United States District Court for the Southern District of New York, Chevron has sued the Ecuadorian plaintiffs, their lawyers, and certain consultants under the RICO (Racketeer Influenced and Corrupt Organizations) Act. The RICO suit alleges that plaintiffs' lawyers colluded with Ecuadorian officials to extort a judgment from Chevron, and seeks a declaration by the court that any judgment from the Ecuadorian litigation is unenforceable in the United States. The suit is currently before Judge Lewis Kaplan.

On March 7, 2011, Judge Kaplan issued a preliminary injunction in U.S. District Court that purports to bar the Ecuadorian plaintiffs and their legal representatives from pursuing enforcement of any Ecuadorian court judgment outside the country of Ecuador. Judge Kaplan issued this injunction in response to the RICO suit filed by Chevron. However, according to some legal observers, the injunction will be difficult or even impossible to enforce outside the United States, and may not survive upon appeal.

With his injunction, Judge Kaplan is attempting to protect Chevron from the "irreparable harm" that Chevron has stated that it faces should the plaintiffs seek enforcement of the Ecuadorian court judgment. According to Judge Kaplan:

> "Absent a preliminary injunction, Chevron would be forced to defend itself and litigate the enforceability of the Ecuadorian judgment in multiple proceedings. There is a significant risk that assets would be seized or attached, thus disrupting Chevron's supply chain, causing it to miss critical deliveries to business partners, damaging "Chevron's business reputation as a reliable supplier and harm the valuable customer goodwill Chevron has developed over the past 130 years," and causing injury to Chevron's "business reputation and business relationships."" [7]

According to Marco Simons, Legal Director of EarthRights International, Judge Kaplan's injunction is already limited in scope and may not hold up under appeal:

> "As a preliminary injunction, Judge Kaplan's order is subject to immediate appeal to the Second Circuit Court of Appeals, and the plaintiffs' lawyers have already filed their notice of appeal. At this stage of the case, Chevron is entitled to some presumptions in its favor, so even if they ultimately have no grounds to attack the Ecuadorian judgment, it is possible that a preliminary injunction will stand. But Chevron's entire case is premised on the notion that Judge Kaplan has jurisdiction over the Ecuadorian plaintiffs and other members of the plaintiffs' class action. That is a highly questionable position, and one that will receive considerable scrutiny from the Second Circuit. Even if Judge Kaplan can prevent the American lawyers from proceeding to enforce the judgment, if he doesn't have jurisdiction over the Ecuadorians, he cannot prevent them from going to other countries to seek enforcement (as outlined in the "Invictus" memo).
>
> The Second Circuit may also be concerned with the propriety of interfering with foreign countries' judicial processes. I'm not aware of any case where a court has ever even tried to restrain foreign plaintiffs from enforcing a foreign judgment in foreign jurisdictions. Chevron has every opportunity to challenge the judgment in the Ecuadorian courts; Chevron chose to litigate in Ecuador over the plaintiffs' objection, and the Second Circuit may

well hold them to that choice. In fact, in a recent decision in a related case, the Second Circuit said that Chevron was bound by its original promise "to satisfy any judgments in Plaintiffs' favor, reserving its right to contest their validity only in the limited circumstances permitted by New York's Recognition of Foreign Country Money Judgments Act."

Chevron argued, and Judge Kaplan accepted, that the judgment is unenforceable under that law for two reasons: because Ecuador does not provide due process, and because the judgment was obtained by fraud. But Chevron's own predecessor, Texaco, argued that the case should be sent to Ecuadorian courts in the first place, even though the plaintiffs then objected that those courts did not provide due process; Chevron may not be able to complain about that now. And what Chevron calls "fraud" was fully aired in the Ecuadorian court--all of the supposedly fraudulent evidence that Chevron is now presenting to Judge Kaplan was also presented in Ecuador, so Chevron can't really say that the plaintiffs defrauded the court.

Ultimately, even if Chevron wins the enforcement battle in the US, that doesn't end the matter, because the plaintiffs will go to other countries to enforce the judgment. The plaintiffs only need to win once or a few times, while Chevron needs to win everywhere. Even if Chevron wins twenty cases, just one loss could cost the company hundreds of millions or billions of dollars."[8]

Chevron's International Arbitration Claim

In addition to its RICO suit, Chevron has also sought to defend itself though international arbitration against the government of Ecuador under the provisions of the Bilateral Investment Treaty (BIT) between the U.S. and Ecuador. At present, these arbitral proceedings are running concurrently with the Aguinda case in Ecuador. Although Chevron could conceivably obtain money damages from the Ecuadorian government from this process, the arbitral panel has no jurisdiction over the Aguinda plaintiffs or the Ecuadorian court system.

In September 2009, Chevron initiated arbitration proceedings against the government of Ecuador at the Permanent Court of Arbitration in The Hague, under the provisions of the Bilateral Investment Treaty (BIT). Among other *requests for relief*, Chevron asked that the arbitral panel issue a "declaration that Ecuador or Petroecuador is exclusively liable for any judgment that may be issued in the Lago Agrio Litigation."[9]

The Republic of Ecuador asked a U.S. District Court to stay the arbitration, but the court refused. In March 2011, the U.S. Court of Appeals for the Second Circuit upheld the lower court's decision, and explained[10]:

> Chevron's claims are now pending in BIT arbitration precisely because they deal with allegations of Ecuador's improper behavior with respect to Texaco's investment in the region. However, Plaintiffs are not parties to the BIT, and that treaty has no application to their claims; their dispute with Chevron therefore cannot be settled through BIT arbitration. Instead Plaintiffs have exercised their right under the *forum non conveniens* dismissal to litigate their claims against Chevron in Lago Agrio. That litigation continues to this day. The existence of those parallel proceedings – one in which Chevron asserts wrongdoing on the part of Ecuador and another in which Plaintiffs assert wrongdoing on the part of Chevron – makes clear that the Lago Agrio litigation can coexist with BIT arbitration.

Should an arbitral panel eventually award Chevron some of the relief it seeks against the government of Ecuador, the company could seek to recoup damages from Ecuador. However, this prospect does not mitigate the potential disruption to Chevron's operations should lawyers for the Ecuadorian plaintiffs seek to enforce the $18 billion Aguinda court judgment by attaching the company's assets.

Furthermore, in upholding the lower court's ruling to allow the arbitration, the Second Circuit actually affirmed the Lago Agrio plaintiffs' arguments in some of the central and most hotly-contested issues over the course of the many years of litigation.

The court writes, "Chevron Corporation claims, without citation to relevant case law, that it is not bound by the promises made by its predecessors in interest Texaco and ChevronTexaco, Inc. … There is no indication in the record before us that shortening its name had any effect on ChevronTexaco's legal obligations." Referring to the *forum non conveniens* dismissal of the U.S. litigation, the court continues, "Chevron Corporation therefore remains accountable for the promises upon which we and the district court relied in dismissing Plaintiffs' action."[11]

The Second Circuit then recalls that in arguing to remove the case from U.S. District Court in the 1990s, "Texaco assured the district court that it would recognize the binding nature of any judgment issued in Ecuador." It goes on to conclude, "As a result, that promise, along with Texaco's more general promises to submit to Ecuadorian jurisdiction, is enforceable against Chevron in this action and any future proceedings between the parties, including enforcement actions, contempt proceedings, and attempts to confirm arbitral awards."[12]

Lastly, referring to Chevron's argument that the litigation in Ecuador is a different legal matter than the original *Aguinda v. Texaco* lawsuit, originally filed in U.S. federal court in 1993, the Second Circuit writes, "Chevron's contention that the Lago Agrio litigation is not the re-filed Aguinda action is without merit. The Lago Agrio plaintiffs are substantially the same as those who brought suit in the Southern District of New York, and the claims now being asserted in Lago Agrio are the Ecuadorian equivalent of those dismissed on forum non conveniens grounds."[13]

While Chevron has managed to take this separate matter to The Hague under the BIT, the dispute over arbitration has dealt a blow to some of Chevron's central legal arguments in its defense of the Lago Agrio litigation, affirmed that the Ecuadorian plaintiffs are not a party to the arbitration proceedings, and made clear that their claims "cannot be settled through BIT arbitration."

4. ANALYSIS OF RISKS FROM PLAINTIFFS' LITIGATION STRATEGY

In the course of the litigation and counter-litigation in this case, a key legal memo was made public during the discovery process. The memo is titled: "Invictus. Path Forward: Securing and Enforcing Judgment and Reaching Settlement." This memo has yielded significant revelations concerning the potential of the plaintiffs' lawyers to collect on the Ecuadorian judgment in countries where Chevron has significant assets.

The memo was drawn up by the law firm Patton Boggs, which has been retained by the Ecuadorian plaintiffs. Patton Boggs lays out an aggressive global strategy of obtaining enforcement of the Ecuadorian courts' judgment in the United States and other countries in which Chevron has significant operations. In the memo, Patton Boggs lays out the countries in which Chevron's assets are at most risk to attachment, appropriation, and/or impairment. Patton Boggs also reveals its extensive network of business relationships with law firms, lobbying groups, and powerful advisors in key countries that demonstrate the considerable capacity of Patton Boggs to secure enforcement worldwide of any judgment in the Ecuadorian courts.

Judge Kaplan cites the Patton Boggs memo in his opinion as evidence that Chevron's faces "significant risks" and "irreparable" damage to its assets, supply chain, business reputation, and business relationships from any enforcement of the Ecuadorian judgment.

What makes this risk to Chevron's operations particularly credible is not just the information in the Patton Boggs memo but also Chevron's own sworn testimony. Chevron Deputy Comptroller Rex Mitchell, in a sworn declaration, made clear that efforts by the plaintiffs, outlined in the Patton Boggs memo, to enforce the Ecuadorian court judgment in any one of the countries where Chevron operates would be "disruptive" and cause "irreparable" damage to Chevron.

> "The seizure of Chevron assets, such as oil tankers, wells, or pipelines, in any one of these countries, would disrupt Chevron's supply chain and operations; and seizures in multiple jurisdictions would be more disruptive."
>
> "Defendants' campaign to seek seizures anywhere around the world and generate maximum publicity for such acts would cause significant, irreparable damage to Chevron. Unless it is stopped, Defendants' announced plan to cause disruption to Chevron's supply chain is likely to cause irreparable injury to Chevron's business reputation and business relationships that would not be remediable by money damages."[14]

Enforcement Strategy

The Patton Boggs memo outlines a legal strategy in the United States for picking the most favorable U.S. state or federal court for enforcement of the Ecuadorian court judgment in the United States.[15] Under the Full Faith and Credit clause of the U.S. Constitution, the plaintiffs' lawyers need only convince one state or federal court to enforce the judgment against Chevron. The Patton Boggs memo analyzes which U.S. state and federal courts would be the most favorable to both plaintiffs and the enforcement of judgments in foreign courts.[16]

Outside the United States, the memo envisions a similar "keystone nation" strategy for global enforcement of the judgment. Under this strategy, lawyers for the Ecuadorian plaintiffs will identify certain "keystone" nations that both promise the best potential for recognizing the validity of the Ecuadoran court judgment and also enjoy reciprocity or even a judgment recognition treaty with countries that serve as the locus for greater Chevron assets.[17]

The Patton Boggs memo assesses several countries as possible "keystone nations" in enforcing the judgment internationally.

Patton Boggs anticipates "serious, early consideration" of enforcement in Argentina, Brazil, Colombia, and Venezuela. All four of these countries have ratified the Organization of American States' Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards, a fact that should have the effect of significantly streamlining any enforcement process in those countries. In addition, Patton Boggs has represented the governments of Colombia and Venezuela and maintains long-standing relationships with law firms and public affairs firms in all four countries. [18]

Chevron has significant operations in all four countries. In 2010, operations in Argentina, Brazil and Colombia produced 97,000 barrels per day of production of crude oil, natural gas liquids, and natural gas.[19] The company's share of daily production in Venezuela over the same period was 58,000 barrels.[20] Chevron is investing heavily in future production in the region. For instance, in 2010, a Chevron-led consortium was selected to participate in a heavy-oil project in eastern Venezuela. Chevron also owns 10 per cent of Venezuela's first projected LNG project.[21] Brazil is the site of Chevron's majority-owned and operated Frade Field in which the company expects to add eight additional wells by the end of 2011.[22]

In its memo, Patton Boggs notes that "Chevron publicly asserts that 'Singapore plays a critical role in [its] global operations.' Singapore is home to Chevron's Asia-Pacific headquarters for downstream operations as well as seven core refineries, two chemical plants, and the largest additives manufacturing facility in Asia." Patton Boggs notes that former U.S. ambassador to Singapore, Hon. Timothy Chorba, is now one of the firm's partners. This is significant since Singapore's Reciprocal Enforcement of Foreign Judgments Act emphasizes reciprocity and gives Singapore's Minister of Law authority to determine whether the country has a reciprocal relationship with another nation. Patton Boggs concludes that the law firm's "uniquely strong ties to this potentially important nation increase the likelihood that our arguments in this regard will be heard." [23]

Patton Boggs also notes that one of its foreign affairs advisors, Ambassador Frank Wisner, is the former US ambassador to the Philippines, a country that Patton Boggs has represented and in which the firm has relationships with law firms and public affairs practices. [24] Chevron's operations in the Philippines include 25,000 barrels of oil-equivalent production per day. In November 2010, the company signed agreements to explore, develop and operate the Kalinga geothermal prospect and it expects to sign a new 25-year contract by the end of 2011 to operate steam fields supplying a 637 megawatt geothermal power facility.[25]

Although the preliminary injunction may have blocked the US-based attorneys from pursuing these seizures in the near-term, the injunction is subject to appeal, and all of these strategies could be reopened if the injunction is lifted.

What is the Risk to Chevron's Future Operations?

Chevron's core oil and gas production business faces two risks from the Aguinda case. Firstly, Chevron's legal strategy of suing the Ecuadorian plaintiffs in a RICO suit and taking the government of Ecuador to trade arbitration risks building resistance among governments and local communities worldwide to doing business with the company in the future. Secondly, the legal strategy outlined by Patton Boggs for enforcement of any judgment includes extensive public policy and press work that would further publicize Chevron's connection to environmental damage in the Amazon and thus heighten Chevron's notoriety worldwide.

Chevron's core business is production of oil and natural gas, known in the industry as "upstream business." According to Trefis, over half of Chevron's value derives from its oil and gas production operations, which enjoy much higher profit margins compared to "downstream" businesses such as refined product sales.[26]

To succeed and grow in this business, Chevron has to win access to a steady stream of new projects around the world in competition with other oil and gas companies. In its most recent 10K report, Chevron notes:

> "To sustain its long-term competitive position in the upstream business, the company must develop and replenish an inventory of projects that offer attractive financial returns for the investment required. Identifying promising areas for exploration, acquiring the necessary rights to explore for and to produce crude oil and natural gas, drilling successfully, and handling the many technical and operational details in a safe and cost-effective manner are all important factors in this effort. Projects often require long lead times and large capital commitments."[27]

Chevron needs both legal permission from governments and "social license to operate" from local communities where the company is bidding to exploit new oil and gas fields. In the course of the Aguinda case, the plaintiffs and their legal team have been successful in painting a picture in the courts and the media worldwide of a company responsible for pollution and lack of mitigation in the Ecuadorian Amazon. Chevron has reinforced its own reputation as a company that does not deal fairly with governments and local communities with its trade case against the government of Ecuador and the company's inclusion of the Ecuadorian plaintiffs in its RICO suit. In its memo, Patton Boggs outlines an enforcement strategy involving the vigorous use of the media and public policy work that would continue to underscore these themes.[28] All of these factors can be reasonably expected to contribute to the notoriety of Chevron as an irresponsible operator and thereby increase opposition by governments and local communities to granting Chevron legal and social license to operate in new areas.

5. HOW HAS CHEVRON DISCLOSED AND MANAGED ITS RISK?

Given the issues discussed above, it should be of growing concern to the company's shareholders how Chevron's board of directors and management are managing and disclosing risks related to the Ecuadorian case. In its most recent annual report and 10-K, Chevron neglects to disclose one of its own assessments of the severity of risk to its operations, specifically the sworn testimony of Deputy Comptroller Rex Mitchell to the U.S. District Court. Chevron also makes statements in its annual report about the Ecuadorian litigation that are a one-sided interpretation of the case and which could be misleading to some investors in the absence of additional disclosures. In addition, shareholders may reasonably question whether Chevron's board of directors is failing in its fiduciary duties to oversee this material issue facing the company.

Shareholder Concerns About Management And Disclosure of Ecuador Risk

Concerned shareholders have long questioned Chevron's management and disclosure of the risks to the company from the Ecuadorian case. As early as 2003, shareholders led by Trillium Asset Management filed the first in a series of shareholder resolutions on the issue. In the resolution, the shareholders asked the company to remediate the damage from its pollution in Ecuador in order to reduce the risk to Chevron's reputation and business.

> "In our view, Texaco's cleanup efforts were inadequate and our company has a continuing ethical obligation to redress the outstanding environment and health consequences of its activities in Ecuador. Negative publicity generated by this situation damages our credibility as an environmentally responsible corporate citizen and jeopardizes our ability to compete in the global marketplace."[29]

Shareholders continued to question Chevron's disclosure and management by filing resolutions each year. In May 2009, the then New York State Attorney General Andrew Cuomo joined concerned shareholders by writing Chevron on two issues. One was that the company had not disclosed its assessment of the probable outcome of the Ecuadorian litigation or its estimated financial liability. The other was that in public filings with the SEC, Chevron had asserted its belief that the Ecuadorian court lacked jurisdiction over Chevron, which appeared to be contradicted by the Company's own filings from *Aguinda v. ChevronTexaco* in which Chevron consented to be subject to any duly obtained judgments of that court as a condition of the case's removal to Ecuador.

More recently, in April 2010, Trillium Asset Management, Amnesty International USA, and the Commonwealth of Pennsylvania Treasury Department in a letter to Chevron shareholders cited concerns over Chevron's liability in Ecuador as one reason why shareholders should support their resolution asking the board of directors to nominate one board candidate with "a high level of expertise and experience in environmental matters relevant to hydrocarbon exploration and production." That resolution received the votes of over 25% of Chevron outstanding shares. The shareholders have subsequently re-filed the shareholder resolution for a vote at Chevron's annual shareholder meeting in May 2011.

Has Chevron Disclosed Fully to Shareholders the Financial And Operational Risk From the Ecuador Judgment?

Chevron did not disclose any risk of its liability from the Ecuador litigation in its Annual Report until as late as February 2009. In its most recent Annual Report and 10-K, Chevron discloses the February 2011 Ecuadorian Provincial Court judgment but continues to assert uncertainty as to its ultimate probable financial liability, stating:

> "The ultimate outcome of the foregoing matters, including any financial effect on Chevron, remains uncertain. Management does not believe an estimate of a reasonably possible loss (or a range of loss) can be made in this case. …Moreover, the highly uncertain legal environment surrounding the case provides no basis for management to estimate a reasonably possible loss (or a range of loss)."[30]

One of the most notable omissions from Chevron's recent filings is the analysis of the significance, severity and implications of the risks to its operations from any enforcement of the Ecuadorian court judgment. In this regard, it is instructive to contrast what Chevron's Deputy Comptroller stated in his recent sworn testimony to Judge

Kaplan and what Chevron publicly disclosed at around the same time to its shareholders in its latest annual report.

In its most recent annual report dated February 24, 2011, Chevron does disclose that it expects the Ecuadorian plaintiffs to seek enforcement of any judgment outside Ecuador.

> "Because Chevron has no substantial assets in Ecuador, Chevron would expect enforcement actions as a result of this judgment to be brought in other jurisdictions. Chevron expects to contest any such actions."

In striking contrast to this low key reference, over a week before the publication of the annual report, Chevron Deputy Comptroller Rex Mitchell stated in sworn testimony in Chevron's RICO suit that the company faces "irreparable damages" if the Ecuadorian plaintiffs are able to seize or attach Chevron assets in the course of the enforcement of the Ecuadorian judgment. Citing the Ecuadorian plaintiffs' lawyers enforcement plan outlined in the Patton Boggs memo, Mitchell stated:

> "The seizure of Chevron assets, such as oil tankers, wells, or pipelines, in any one of these countries, would disrupt Chevron's supply chain and operations; and seizures in multiple jurisdictions would be more disruptive."

> "Defendants' campaign to seek seizures anywhere around the world and generate maximum publicity for such acts would cause significant, irreparable damage to Chevron. Unless it is stopped, Defendants' announced plan to cause disruption to Chevron's supply chain is likely to cause **irreparable injury to Chevron's business reputation and business relationships that would not be remediable by money damages.**" [emphasis added][31]

Rex Mitchell's sworn testimony is dated on February 15, 2011, more than a week prior to the February 24, 2011, publication date of Chevron's 2010 Annual Report. It seems likely that Mitchell's testimony was prepared much earlier than that date making it available to be disclosed in the Annual Report. The fact that Chevron did not disclose its own alarming assessment of the risk to its operations in its 2010 Annual Report poses the question of whether the company is being fully transparent to its shareholders. Shareholders reading the annual report disclosure could reasonably want to know the Deputy Comptroller's assessment of the potential for irreparable harm to reputation and relationships that would not even be remedied by monetary damages. For those wanting to know how severe the downside risk of recent adverse rulings in Ecuador is, a clarification that "enforcement actions in other jurisdictions" could mean seizure of oil tankers, wells or pipelines, and "irreparable injury to the company's business reputation and relationships" could be the kind of information that is viewed as "material" to determining the value of stock and prospects for the company.

In analyzing whether these omissions in the company's disclosures are material within the meaning of the securities laws the courts would consider several factors, including the importance of the information to investor decision-making. A core inquiry involves whether there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the `total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed. 2d 757 (1976); *Basic Incorporated v. Levinson*, 485 U.S. 224. 108 S.Ct. 978, 99 L.Ed. 2d. 194 (1988).

The company has disclosed that enforcement actions may be anticipated regarding the Ecuador judgment, and that it intends to contest such enforcement actions. However, the company neglected to disclose management's concern about the potential for severe damage to the company's operations, relationships and reputation indicated in the comptroller's testimony. Many investors might have reasonably expected the company to have disclosed more regarding these risks. Although the company has held the immediacy of these impacts at bay through a preliminary injunction, the appeal process for the injunction could threaten to reopen such potential risks and impacts.

Have Chevron's Statements to Shareholders About the Court Case Been Accurate?

Chevron's most recent annual report and 10-K include a number of questionable statements about the court case in Ecuador.

> "As to matters of law, the company believes first, that the court lacks jurisdiction over Chevron"[32]

While this may be a true statement of the company's opinion, Chevron's statement is misleading since it omits the fact that Texaco agreed to the binding nature of any judgment issued in Ecuador in 2002 before a U.S. federal court as a condition of the case being transferred to Ecuador.[33]

Moreover, in a recent opinion on Chevron's BIT arbitration, the United States Second Circuit noted that in arguing to remove the case from U.S. District Court in the 1990s, "Texaco assured the district court that it would recognize the binding nature of any judgment issued in Ecuador." It goes on to conclude, "As a result, that promise, along with Texaco's more general promises to submit to Ecuadorian jurisdiction, is enforceable against Chevron in this action and any future proceedings between the parties, including enforcement actions, contempt proceedings, and attempts to confirm arbitral awards."[34]

> "the claims are barred by the statute of limitations in Ecuador" [35]

This statement fails to mention that Chevron waived its defenses under the statute of limitations when company voluntarily submitted itself to jurisdiction in Ecuador in 2002 before a U.S. federal court as a condition of the case being transferred to Ecuador.[36]

> "the lawsuit is also barred by the releases from liability previously given to Texpet by the Republic of Ecuador and Petroecuador and by the pertinent provincial and municipal governments." [37]

This statement is misleading. Chevron neglects to mention that the company was released from *government* claims. Their attempt to apply this release to citizens, in addition to the government, has been met by legal assertions that the citizens never signed off on the release and are therefore not bound by it. Notably, Chevron fails to mention that the recent court ruling in Ecuador did not accept Chevron's broad interpretation of the scope of this release.[38]

> With regard to the facts, the company believes that the evidence confirms that Texpet's remediation was properly conducted and that the remaining environmental damage reflects Petroecuador's failure to timely fulfill its legal obligations and Petroecuador's further conduct since assuming full control over the operations."[39]

It is true that Texaco negotiated an agreement in the 1990s with the Ecuadorian government under the terms of which the company conducted a three-year remediation at a cost of $40 million of specific sites in proportion to Texaco's ownership share of the consortium.

However, plaintiffs have argued in response that the remediation was grossly inadequate, and that soil and water samples collected by the court nearly a decade later found essentially equal levels of contamination at "remediated" and non-remediated sites. Judge Zambrano's verdict contains a lengthy analysis that includes the statement that: "the environmental conditions are similar in all sites even though in these the aforementioned remediation labors have taken place."[40]

Plaintiffs also argue that Chevron, as the operator of the concession and designer of all production infrastructure, can be held liable for 100% of the damage, not the 37.5% that Chevron claims (Texaco's ownership share in the consortium).

Furthermore, recent evidence suggests that Texaco may have knowingly deceived the Government of Ecuador about the results of its remediation of the pollution that is the subject of the Aguinda case. In September 2008, the Ecuadorian government indicted two Chevron attorneys who worked for Texaco at the time of the remediation along with five former government ministers.

The cleanup was not properly performed and certificates releasing the company from liability were not properly obtained, according to a translated version of the Aug. 26 indictment provided by Chevron and reported by Bloomberg. "The certificates set forth statements as true facts when they actually are not true, which suggests the possibility of a punishable act," according to the indictment quoted by Bloomberg.[41] An analysis of the oil wells cited in the indictment "found that they indicate work as having been performed when in fact it was not performed or not completed."

Chevron is entitled to disagreements with the plaintiffs about points of contention in the lawsuit; indeed, that is why a lawsuit exists. However, some of the preceding statements, taken in aggregate, could create the misleading perception that the Ecuadorian lawsuit is fraudulent and without legal merit. The reality is that these are disputed issues on which Chevron holds a position, which is not the same as the position held by the plaintiffs or that held by the court.

Has Chevron's Board of Directors Provided Adequate Oversight of Management?

The Chevron board of directors has fiduciary duties to exercise care in its oversight, such as undertaking appropriate inquiries into potentially material issues facing the company, and to avoid conflicts of interest. Failure to exercise these and other duties in good faith could lead to individual board member liabilities.

When shareholders have approached the board to discuss concerns regarding management and quantification of the Ecuador litigation's risks and liabilities, the board has been unresponsive. Last year in a memorandum to Chevron shareholders, the filers of the shareholder resolution asking for the appointment of an independent director with a high level of environmental expertise, expressed their frustration concerning the board's lack of attention to this issue.

> "In 2007, former US Senator Sam Nunn, the chair of Chevron's Public Policy Committee, also rejected an overture from the Carter Center to convene a dialogue with some of the proponents of this proposal to discuss the concerns regarding environmental and legal risk. The shareholder group included a number of institutional investors, including public pension funds, labor and religious shareholders, who had sponsored or otherwise supported shareholder resolutions addressing this matter."[42]

Of particular concern and interest is whether the Board of Directors of Chevron provided proper oversight of the acquisition of Texaco. There has been little if any disclosure of the extent to which the Board of Directors vetted Texaco's representations prior to the acquisition about its potential environmental liability in Ecuador or the limitations of the company's purported "release" by the Ecuadorian government.

6. CONCLUSION

When Chevron acquired Texaco in 2001, it inherited a significant legal, financial, and reputational liability. This liability became more apparent in February 2011 when, after nearly 18 years of litigation over responsibility for alleged widespread oil contamination resulting from operations by Texaco, Chevron was found liable by an Ecuadorian court for over $18 billion in compensatory and punitive damages. The judgment is now under appeal. This constitutes one of the largest court judgments for environmental damage in history. This judgment is comparable in size only to BP's promised $20 billion fund to compensate victims of the 2010 Gulf of Mexico oil spill.

In late March, stock research company Trefis estimated the potential impact on its estimate of Chevron's stock valuation should the company pay $9.5 billion in damages (the amount of the Ecuadorian judgment, excluding punitive damages). Trefis predicted a decline in its estimate of Chevron's stock valuation of approximately 5% (from $104/share to $99/share).

Chevron's principal legal defense to immediate enforcement of a recent $18 billion judgment in an Ecuadorian court was to obtain a preliminary injunction from U.S. District Court. Over the long term, it is not clear that an injunction in U.S. court would protect Chevron from enforcement efforts outside the United States. The injunction is also subject to appeal.

Chevron has also sought to defend itself though international arbitration against the government of Ecuador under the provisions of the Bilateral Investment Treaty (BIT) between the U.S. and Ecuador. At present, these arbitral proceedings are running concurrently with the Aguinda case in Ecuador. Although Chevron could conceivably obtain money damages from the Ecuadorian government from this process, the arbitral panel has no jurisdiction over the Aguinda plaintiffs or the Ecuadorian court system.

While Chevron has admitted in sworn legal statements that the company is at risk of "irreparable injury to [its] business reputation and business relationships" from potential enforcement of the Ecuadorian court judgment, the company has failed to characterize these risks to the company in its public filings and statements to shareholders. These choices may lead some investors to question the adequacy of the company's public statements and disclosures and whether the board and management are fulfilling their fiduciary duties to properly manage this significant risk to the company's business and value.

ENDNOTES

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