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Case summary

Sapphire International Petroleums Ltd.
v
National Iranian Oil Company

Year of the award: 1963
Forum: Ad hoc Tribunal
Applicable Law: General principles of law

Arbitrator	**Timeline of the dispute**
Pierre Cavin, Federal Judge, Lausanne, Switzerland	28 September 1960 - request for arbitration 12 January 1961 - arbitrator appointed 15 March 1963 - arbitral award

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I. Executive Summary

In 1958, the National Iranian Oil Company (NIOC) and Sapphire Petroleums Ltd (Sapphire), a Canadian company, entered into a contract to expand the production and exportation of Iranian oil. The parties set up the Iranian Canada Oil Company (IRCAN) to carry out the terms of the contract on behalf of the parties.

Sapphire International, Sapphire's subsidiary to which the Sapphire assigned the contract shortly after its conclusion, started works in the concession area and subsequently claimed the reimbursement of it expenses through IRCAN, as agreed in the contract. However, NIOC refused to reimburse the expenses arguing that Sapphire International had not consulted NIOC before carrying out its operations. As a result, Sapphire International did not start drilling in the concession area as planned, and NIOC subsequently repudiated the contract on the basis that Sapphire International had not fulfilled its drilling obligations.

In September 1960, Sapphire initiated arbitration proceedings pursuant to the contract, claiming the breach of contract and requesting compensation for expenses (incurred before and after the conclusion of the contract), loss of profit and the refund the US$350,000 indemnity, provided by Sapphire as a guarantee at the time of the contract conclusion, later cashed by NIOC.

The Tribunal found that NIOC was in breach of contract and was liable to pay damages to Sapphire International. The arbitrator held that the object of damages was to put the party to whom they were awarded in the position they would have been if the contract had been performed. He ruled that the plaintiff should be given full compensation on the basis of '*damnum emergens'* and '*lucrum cessans'*. He ordered compensation for the expenses incurred by the plaintiff after the conclusion of the contract, and the refund of the indemnity. However, the claim for expenses incurred *before* the conclusion of the contract was denied on the basis that this would have put the plaintiff in the position it would have been had it not concluded the agreement.

The arbitrator found that the claimant was entitled to an award for loss of profits due to a loss of opportunity to make profit. He held that even where the amount of profit could not be determined precisely, showing *sufficient probability* of making a profit was enough to show entitlement to compensation. The arbitrator resorted to the principle of '*ex aequo et bono*' (in this context, judicial discretion) to determine the amount of the compensation for the loss of opportunity on the basis of available evidence. The defendant was also ordered to pay the amount of indemnity as well as compound interest at the rate of 5% and plaintiff's costs.

II. Factual Background and Claims

On 16 June 1958, the National Iranian Oil Company (NIOC) and Sapphire Petroleums Ltd (Sapphire), a Canadian company, entered into a contract to expand the production and exportation of Iranian oil. Sapphire had the technical competence, financial ability and the organisation necessary to accomplish the operations laid out in the contract. It was obliged to make a minimum investment of $8 million in four years.

The parties set up the Iranian Canada Oil Company (IRCAN), a "joint stock company and non-profit corporation", to carry out the operations under the contract on behalf of the two parties (with respect to prospecting it would act as Sapphire's agent only). Both parties subscribed to half the share capital of IRCAN at a cost of US$5,000 each.

In August 1958, Sapphire Petroleums Ltd. assigned its rights and obligations to Sapphire International Petroleums Limited (Sapphire International), a company wholly owned by Sapphire. Sapphire paid NIOC $3,500 for registration of Sapphire and Sapphire International in Tehran.

The contract distinguished two periods in the venture: first, the prospecting period in which Sapphire would act through IRCAN. During this period all expenses would be automatically reimbursed to Sapphire through IRCAN on the basis of accounts submitted by Sapphire. The second period included the working, extraction and sale of the oil in which IRCAN would act for both parties. The parties were to be jointly responsible for any expenses incurred during this period.

Under the contract, the first period would start 6 months after the date of the contract and drilling was to start a maximum of two years after the date of the contract. The contract also specified that if Sapphire failed to carry out its obligations within the periods set out, NIOC would have the right to cancel the contract six months after the said period had expired. In that event, Sapphire would be liable to pay NIOC an indemnity of $350,000 (a bank guarantee was provided to NIOC), except in the case of *force majeure.* The payment of this indemnity was guaranteed by a bank guarantee in accordance with a letter sent by Sapphire to NIOC on 16 June 1958.

In the subsequent months, Sapphire International started work in the designated concession area and in May 1959, sent two reports on the expenses incurred from the date of the contract until 31 March 1959. The total amount of the expenses was $302,545.25. NIOC refused to refund the expenses on the basis that it had not been consulted before the operations as required by the contract.

In July 1959, Sapphire International sent a letter to the Shah of Iran requesting a refund of their losses. On 5 September 1959, the Prime Minister of Iran replied that Sapphire International had not fulfilled its obligations and as a result NIOC were entitled to refuse the refund. He referred Sapphire International to NIOC for the settlement of the dispute.

In the circumstances, Sapphire International decided that they could not risk signing a drilling contract in light of their dispute with NIOC. On 24 July 1960 NIOC sent a letter to Sapphire International noting that the latter had not carried out their drilling

obligations. Six months later on 24 January 1961 NIOC repudiated the contract on this basis. NIOC also cashed the $350,000 indemnity despite formal opposition by Sapphire International.

On 28 September 1960, Sapphire notified NIOC of their request for arbitration and appointed an arbitrator. NIOC refused to appoint an arbitrator. Pursuant to Article 41 of the Contract, Sapphire International asked the President of the Swiss Federal Court to appoint a sole arbitrator, who appointed Federal Judge Pierre Cavin of Lausanne as sole arbitrator. The defendants did not appear at the arbitral hearing.

The plaintiff claimed that the defendant breached the contract and requested the following items as damages:

- Compensation for expenses incurred before the contract plus interest;
- Compensation for expenses incurred after the contract plus interest;
- Loss of profit;
- Refund of the $350,000 indemnity.

III Findings on Merits

A. Applicable Law

Procedural Law

The Tribunal held that arbitration was subject to the Code of Civil Procedure of Vaud.

Substantive Law

The arbitrator held that based on the intention of the parties and evidence found in the contract, he would apply **general principles of law**. The arbitrator also declared that he would not decide the cases according to 'equity', like an '*amiable compositeur'* but would instead disentangle the *rules of positive law*, common to civilised nations, such as are formulated in their statutes or are generally recognised in practice. With regard to each rule of law applied, he would first show its character as a rule of positive law and then its generality. He limited his analysis to Continental law and Anglo-Saxon law.

The choice of applicable law was not explicit in the contract, so the arbitrator used the reasoning below in deciding on the applicable law:

- The characteristics of the contract were such that they excluded the application of the traditional rules of private international law and reduced the likelihood that Iranian law would be applied to the interpretation and performance of the contract. (35 ILR 171)

- The contract contained an arbitral clause which entrusted the task of arbitrating any possible dispute to an arbitrator chosen by the President of the Supreme Court of Switzerland, Denmark, Sweden or Brazil. No positive implication could be drawn from the clause but a negative intention could be

drawn, specifically that the clause rejected the exclusive application of Iranian law. (35 ILR 172)

- Article 38 of the contract expressed an intention to carry out the provisions of the contract according to the principles of good faith and good will, and to respect the spirit as well as the letter of the contract. It has been held in several arbitral awards[1] concerning similar legal relations that such a clause is scarcely compatible with the strict application of the internal law of a particular country and it much more often calls for an application of the general principles of law based upon reason and upon the common practice of civilised countries. (35 ILR 172-3)

- Article 37 of the contract provided that *force majeure* as used in the contract would be defined according to the principles of international law. If Article 37 is read with Article 38 then it could reasonably be held to have a wider application and to extend to the entire contract. (35 ILR 173-4)

- The contract with Sapphire was the last of several contracts made by NIOC which had the same object. In the contract of October 1954 with the International Oil Consortium, Article 41 of that contract was identical to Article 38 of the Sapphire Petroleum contract with the difference that the contract with the Consortium pointed to the general principles of law as applicable law. (35 ILR 174-5)

B. Breach of Contract

The validity of the contract was not contested; the dispute between the parties concerned the interpretation and performance of the contract. The arbitrator was satisfied that the plaintiff had fulfilled its obligations under the contract regarding the prospecting works at least until February 1960. He also found that the defendant deliberately refused to carry out certain of its obligations and that this failure was a breach of contract. He further noted that the rule *pacta sunt servanda* was the basis of every contractual relationship. (35 ILR 176-181)

The arbitrator also observed that there was a general rule of private law that said the failure of one party to a synallagmatic contract to perform its obligations releases the other party from its obligations and gives rise to a right to pecuniary compensation in the form of damages. He further noted that this rule could not be set aside even in the case where the contract contained elements which had their origin in administrative law, such as the present case which concerned a territorial concession:

> Rules of public law, which might possibly differ from civil law, could only be taken into consideration if the Iranian State had relied upon its sovereign rights and had taken steps of a public law nature likely to endanger the performance of the contract.(35 ILR 183)

[1] *Petroleum Developments Limited v Ruler of Abu Dhabi*, ICLQ (1952), p.247; *Ruler of Qatar v International Marine Oil Company Limited*, 18 ILR (1951), p.144

The arbitrator held that the deliberate failure of the defendant to carry out its obligations in breach of contract, and having particular regard to the circumstances in which the refusal was made, justified the plaintiff's non-performance of the contract. The plaintiff did not make an explicit notice of intention to repudiate the contract but given the circumstances, the arbitrator found that a notice would have been superfluous. (35 ILR 184-5)

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

The law applicable to the determination of damages was the general principles of law. However, the arbitrator also used the principle of '*ex aequo et bono'* to quantify the compensation for loss of profit.

B. Standard of Compensation

The arbitrator applied the general rule that the object of damages is to place the party to whom they are awarded in the same pecuniary position that they would have been in if the contract had been performed in the manner provided for by the parties at the time of its conclusion. He observed that the rule is simply a direct deduction from the principle *pacta sunt servanda*, since its only effect is to substitute a pecuniary obligation for the obligation which was promised but not performed. (35 ILR 186) He continued to state:

> This compensation includes the loss suffered (d*amnum emergens*), for example the expenses incurred in performing the contract, and the profit lost (*lucrum cessans),* for example the net profit which the contract would have produced. (35 ILR 186)

The arbitrator examined the plaintiff's claims on the basis of this principle. In determining the amount of compensation for loss of profit, the arbitrator relied on the '*ex aequo et bono*' approach.

B. Claims

1. **Expenses incurred before the conclusion of contract** (US$165,175).

2. **Expenses incurred after the conclusion of the contract:**
   - cost of prospecting work (US$1,018,932);
   - registration fees for the Canadian companies in Tehran (US$3,500);
   - share in the capital of IRCAN (US$5,000).

3. **Loss of profit** (US$5,000,000)

4. **Refund of the indemnity under the bank guarantee unlawfully cashed by NIOC** (US$350,000)

C. Quantification of Damages

1. Expenses incurred before the conclusion of the contract

The arbitrator held that the claim could not be allowed by way of positive damages as claimed by the plaintiff. The claim would have put the plaintiff in the position they would have been if the contract had never been completed (negative damages) and not the position they would have been in if the contract had been performed. The arbitrator reasoned that "[a]s opposed to the expenses incurred in performing the contract, the expenses of concluding it do not result from the contract, which they have preceded". (35 ILR 186)

The arbitrator further noted that the plaintiff was justified in hoping to recover the expenses of making the contract out of the profit they were expecting, but this element was included in the compensation for loss of profit. He stated that "[a]dding positive and negative damages together is a contradiction and cannot be allowed". (35 ILR 187)

2. Expenses incurred after the conclusion of the contract

On the basis of his examination of the statement of expenses provided by the plaintiff, the arbitrator was satisfied that total amount which should be awarded to the plaintiff was US$650,874.[2] The arbitrator did not discuss the large discrepancy between the amount claimed and the amount awarded. (35 ILR 187)

3. Loss of profit

The arbitrator held that there are two steps in dealing with a claim for loss of profit. The first step is to determine whether compensation for the loss of opportunity is recognized in law. If the principle is recognized, then the determination of the amount of compensation is a question of fact to be determined by the arbitrator. (35 ILR 187)

- **Does a loss of opportunity give the right to compensation?**
  It was not possible to affirm positively that the venture would be profitable but no one could deny it. The opportunity to discover oil was recognised by both parties. Did this loss of opportunity give the right to compensation?

  > It is not necessary to prove the exact damage in order to award damages. On the contrary, when such proof is impossible, particularly as a result of the behaviour of the author of the damage, it is enough for the judge to be able to admit with sufficient probability the existence and extent of the damage. (35 ILR 188)

  In the arbitrator's judgment, the plaintiff had satisfied the legal requirement of proof by showing a *sufficient probability* of the success of the prospecting undertaken if they had completed the process. The plaintiff could therefore claim compensation for 'loss of profit'. It was not necessary to have full

[2] This amount was derived as follows: US$651,474.82 from the statement of expenses, including the cost of registering companies, plus US$5,000 for the share capital in IRCAN, less $5,600 from the sale of installations.

certainty that there were deposits of commercially workable oil in the concession area.

On the facts of the case, the arbitrator decided that the loss of profits had been shown with sufficient probability on the basis of the testimony of the plaintiff's expert witness and the observation that NIOC would not have made a concession to the area if they did not think there was a serious chance of discovering oil. (35 ILR 188-189)

- **Amount for the loss of profit**

  The expert witness estimated that if everything went well for the plaintiff, they would receive a net income of US$ 46,000,000. In case of failure, the minimum loss would be the investment of $8,000,000 required by the contract.

  The amount of the compensation could not be established precisely because the extent and existence of the damage were not certain. It was therefore the arbitrator's task to decide on an amount '*ex aequo et bono*' by considering all the circumstances. In the arbitrator's judgment, it was reasonable and equitable to fix the amount of compensation for loss of profit at $2,000,000.

4. Refund of the indemnity

The arbitrator ruled that as the plaintiff had been released from their obligations as a result of the failure of their partner to carry out the contract, the plaintiff was also freed from the obligation to start drilling. Therefore the defendant could not claim the indemnity in the event that the drilling obligation was not met and was ordered to refund US$350,000. (35 ILR 186)

D. Interest

Sapphire claimed compound interest at a rate of 5% on the restoration of US$350,000 from 24 January 1961 (date when the indemnity was cashed by NIOC) and 5% on damages and expenses from 28 September 1960 (date of request for arbitration). The arbitrator awarded interest as claimed by the plaintiff.

E. Costs

The arbitrator ruled that the costs were to be borne entirely by the defendant.

V. Implications / Initial Analysis

- **Contract damages** should aim at putting the aggrieved party in the position that it would have been in if the contract had been performed. This rule is a consequence of the principle *pacta sunt servanda.*

- Full compensation in a dispute of this nature comprises of ***damnum emergens*** (expenses incurred pursuant to the contract) and ***lucrum cessans*** (profit lost).

- If an investor suffers a **loss of opportunity** to make a profit because of the conduct of the other contracting party, the investor is entitled to compensation for loss of profit. Where a claimant cannot show with certainty that an operation would have been profitable, it is enough to show a **sufficient probability** of the success of the venture. The negative consequences of the objective impossibility to show the precise amount of lost profits should be borne by the party in breach.

- If the **amount** of the lost profit cannot be established with precision, the arbitrator can determine it *ex aequo et bono*. In this case the arbitrator used the term '*ex aequo et bono*' to refer to judicial discretion, rather than in the sense this term is used in Article 38(2) of the ICJ Statute (deciding a case on the principles of fairness, rather than under the rules of positive law). Here, the arbitrator did not depart from the rules of positive law but simply exercised its discretion within the boundaries afforded by those rules to fix the amount of lost profit.