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Yukos v. Russia: Issues and legal reasoning behind US$50 billion awards

Hulley Enterprises Limited (Cyprus) v. The Russian Federation (PCA Case No. AA 226)
Yukos Universal Limited (Isle of Man) v. The Russian Federation (PCA Case No. AA 227)
Veteran Petroleum Limited (Cyprus) v. The Russian Federation (PCA Case No. AA 228)

by Martin Dietrich Brauch

Highlights

- In addressing the two jurisdictional issues it had postponed in the 2009 interim award, the tribunal upheld its jurisdiction, finding that the claims were not barred because of the claimants' illegal conduct or because of the taxation measures carve-out of ECT Article 21.
- The arrests, tax reassessments, fines and the forced sale of the Yuganskneftegaz production facility, among other measures imposed on the claimants, amounted to an indirect expropriation of Yukos, in breach of Russia's obligations under the ECT during the country's provisional application of the treaty. The tribunal did not see a need to consider whether Russia also breached the treaty's fair and equitable treatment standard.
- Along the lines of the award in *Occidental v. Ecuador,* issued by a tribunal also chaired by Yves Fortier, a 25 per cent reduction in the amount of damages was determined, due to the claimants' contributory fault in their abuse of the low-tax regions within Russia and their misuse of the Cyprus-Russia tax treaty.
- The claimants were awarded three heads of damages: the value of their shares in Yukos, the value of lost dividends, and interest on both. The tribunal valuated the damages based on a comparable companies method advanced by the claimants' and corrected by Russia. The valuation date chosen was the award date, as the resulting amount of damages was higher.
- The tribunal granted simple pre-award interest and annually compounded post-award interest. Russia was given a 180-day grace period to pay the US$50 billion in total damages, to reimburse the claimants for the €4 million they had deposited with the PCA for costs, and to repay them about 75 per cent (US$60 million) of their legal fees.

1.0 Factual background and claims

Yukos was created as a joint stock company in 1993 and privatized in 1995, with operations across the oil and gas sector; Yuganskneftegaz (YNG) was its main production subsidiary. In 2002, Yukos was Russia's largest company in the sector and listed as one of the world's top ten oil and gas companies by market capitalization. The claimants complained that, starting in July 2003, Russia took a series of measures leading to Yukos being declared bankrupt in August 2006. Yukos was eventually struck off the registry of companies in November 2007 and its assets nationalized. Russian state-owned companies Gazprom and Rosneft acquired Yukos' remaining assets.

Among the measures alleged to have breached the ECT are the criminal prosecution of the company and its management. Mikhail Khodorkovsky (CEO of Yukos and supporter of Russian opposition parties), Platon Lebedev (Director of the claimants Hulley Enterprises and Yukos Universal) and Vasily Shakohvsky (President of Yukos-Moscow) were charged and convicted of crimes including embezzlement, fraud, forgery and tax evasion. To escape similar charges, other executives fled Russia, such as Leonid Nevzlin (Deputy Chairman of the Yukos Board of Directors).

During the arbitrations, Russia referred to Khodorkovsky, Lebedev, Nevzlin and others as the "oligarchs"—the individual owners of the

claimants—and emphasized that they were involved in several illegal activities. Russia characterized Yukos as a "criminal enterprise" that perpetrated embezzlement, tax evasion through the misuse of special low-tax zones within Russia, tax fraud and schemes to avoid the enforcement of tax liens, as well as transfer pricing schemes to divert the proceeds from the sale of oil to offshore shell companies owned by the "oligarchs."

According to the claimants, Russia also imposed tax reassessments, VAT charges, fines and asset freezes against Yukos; threatened to revoke its licenses; annulled its merger with Russian oil company Sibneft; and forced it to sell YNG, its most important production facility. They argued that, along with the harassment of Yukos' executives, these measures by Russia amounted to a breach of the fair and equitable treatment (FET) standard under the ECT Article 10(1) and to an indirect expropriation of the claimants' investment in Yukos in violation of ECT Article 13(1).

2.0 A recap of the interim award on jurisdiction

On 30 November 2009 the arbitral tribunal issued an interim award on jurisdiction. While the tribunal upheld its jurisdiction to hear the three cases, it postponed two jurisdictional issues to the merits phase: a) whether the claimants' illegal conduct deprived them of protection under the ECT (the "unclean hands" objection); and b) whether the tribunal had jurisdiction over claims with respect to "Taxation Measures" other than those based on expropriatory "taxes" (the objection under ECT Article 21).

While leaving those two jurisdictional objections to be addressed in the analysis of the final award, the following issues were dealt with in the interim award.

Provisional application. ECT signatories are obligated to provisionally apply the treaty pending ratification, in accordance with Article 45(1). Russia signed the ECT on 17 December 1994, but never ratified it. On 20 August 2009, during the arbitration proceedings, it notified the depository of the treaty of its intention not to ratify it. The tribunal held that the ECT provisionally applied to Russia from the date of its signature until 18 October 2009 (60 days after the notification). It also held that investments made in Russia during provisional application would benefit from the ECT's protections for 20 years, that is, until 19 October 2029. Therefore, Russia's notification of its intention not to ratify the treaty did not affect the tribunal's jurisdiction.

Russia argued that it could only apply provisionally those treaty provisions that were consistent with Russian law, and that the ECT provisions on dispute settlement were not. This argument was not accepted by the tribunal, which held that provisional application of the ECT is a matter of "all-or-nothing": "either the entire Treaty is applied provisionally, or it is not applied provisionally at all" (para. 311). In addition, it concluded that provisional application did not depend on an analysis of consistency of each provision with the state's domestic law, but on whether the principle of provisional application itself was consistent with that law. The tribunal found that to be the case under Russian law, and upheld its jurisdiction.

Claimants as "investors." Russia argued that the claimants did not qualify as "investors," given that they were shell companies owned and controlled by nationals of Russia, the host state. The tribunal referred to ECT case *Plama v. Bulgaria* which, taking a plain language reading of the ECT, found that the only requirement for a company to qualify as a protected investor is that it be organized under the laws of a Contracting Party. The tribunal held that, as the claimants were organized under the laws of Cyprus, they were protected investors, irrespective of the nationality of their owners or controllers.

Denial of benefits. ECT Article 17(1) reserves the right of a state to deny the substantive protections under the treaty to an entity that has no substantial business where it is organized. Russia argued that it exercised its right of denial by means of its 1994 Agreement with the European Union on Partnership and Cooperation, which considers that companies with a registered office in a state may only be considered companies of that state if they possess real and continuous links with its economy. The tribunal disagreed. It found that Russia had not exercised its right of denial because under the ECT because the 1994 Agreement and the ECT did not refer to each other. Therefore, the 1994 Agreement could not be seen as Russia's act to deny benefits.

Fork-in-the-road. ECT Article 26(3)(b)(i) contains a fork-in-the-road provision: states listed in Annex ID (including Russia) do not grant consent to international arbitration if the investor previously submitted the dispute for resolution under other listed means. Pointing to the other proceedings

initiated by the "oligarchs" in Russian courts and their applications to the European Court of Human Rights (ECtHR), Russia stated that the arbitral tribunal had no jurisdiction. The tribunal aligned with the claimants, however, indicating that Russia's objection did not pass the "triple identity" test: "identity of parties, cause of action and object of the dispute" (para. 592).

3.0 Jurisdictional objections addressed in the final award

Russia attempted to raise the 'fork-in-the-road' objection again during the merits phase, claiming that the damages sought by the claimants before the ECtHR were the same as those sought under the UNCITRAL arbitrations, giving rise to a potential double recovery. In the final award, the tribunal saw no reason to change its view on the objection, and went on to decide on the two jurisdictional issues it had postponed to the merits phase, once it had a fuller understanding of the facts: the "unclean hands" objection, and the one relating to the taxation measures carve-out.

3.1 Unclean hands

According to Russia, the claimants had "unclean hands" and ran a "criminal enterprise," leading to the tribunal's lack of jurisdiction, to the inadmissibility of the claims, or to the deprivation of the substantive protections of the ECT. Russia listed 28 instances of the claimants' "illegal and bad faith conduct," which the tribunal grouped in four categories: illegal conduct in the acquisition of Yukos; the misuse of the tax treaty between Cyprus and Russia; the use of Russia's low-tax regions to mitigate tax burdens; and actions to obstruct the enforcement of tax claims.

According to the claimants, Russia's allegations of their misconduct, even if proven, could not impact the arbitrations for three reasons: the "unclean hands" principle is not included in the ECT; neither is it recognized as a general principle of law; and the claimants' misconduct would amount to mere "collateral illegalities." The tribunal guided its analysis by considering each of those reasons.

Invoking ECT case *Plama v. Bulgaria*, the tribunal supported the view that the substantive provisions of the treaty did not apply to investments made illegally, even in the absence of language to that effect. As the treaty seeks to encourage legal investments made in good faith, investments made otherwise should not benefit from it.

Russia argued that not only illegalities in the *making* of the investment, but also in its *performance*, would lead to barring the claimants from invoking ECT protections. However, the tribunal was not persuaded, reasoning that, even if the claimants breached Russian law in the course of their investment, the object and purpose of the ECT would be undermined if the tribunal denied them the right to make a case against Russia's measures before an arbitral tribunal.

Neither was the tribunal persuaded that the "clean hands" doctrine constituted a "general principle of law recognized by civilized nations," agreeing with the claimants that Russia failed to cite a majority decision in which the principle was applied and operated to bar a claim.

In analyzing the instances of "bad faith and illegal conduct" alleged by Russia, the tribunal looked only to those related to the *making* of the investment, which it considered could bar the claimants from seeking relief under the ECT. It considered that the misuse of the tax treaty between Cyprus and Russia, the use of Russia's low-tax regions to mitigate tax burdens, and the actions to obstruct the enforcement of tax claims, all of which are conduct in the *performance* of the investment, did not impact the availability of ECT protections to the claimants. As to the other category of illegalities indicated by Russia—those instances of illegal actions in the acquisition of Yukos—the tribunal indicated that the actions were taken not by the claimants themselves, but by the "oligarchs" and other actors, before the claimants became shareholders of Yukos. In the tribunal's view, Russia could not demonstrate that those actions were sufficiently connected with the transactions that consolidated the making of the investment by the claimants. While the tribunal did not find that the claimants' alleged illegalities could give Russia a successful preliminary objection to jurisdiction, it recognized that they could impact liability and damages.

3.2 The taxation measures carve-out and the taxes claw-back

Russia submitted that, under ECT Article 21, "taxation measures" broadly were "carved out" of the tribunal's jurisdiction, while the same article provided for a narrow "claw-back" with respect to expropriatory "taxes," but not with respect to other expropriatory taxation measures. Accordingly, Russia argued that the tribunal only had jurisdiction over claims with respect to expropriatory taxes.

Since the measures complained of by the claimants were not taxes, but, more broadly, taxation matters, the tribunal would be devoid of jurisdiction.

The tribunal disagreed that the "taxation measures" carve-out was broad and that the expropriatory "taxes" claw-back was narrow: assuming the taxation measures carve-out applied, the tribunal concluded that any measures carved out would be within the scope of the expropriation claw-back.

Furthermore, the tribunal agreed with claimants that Russia's actions consisted not in taxation measures made in good faith, but in measures "under the guise of taxation," aimed at bankrupting Yukos, appropriating its assets and politically harming its CEO. The tribunal referred to similar conclusions in the *RosInvestCo v. Russia and Quasar v. Russia* cases, and held that the carve-out did not apply, thus upholding its jurisdiction.

4.0 Reasonable expectations and indirect expropriation

In the tribunal's view, the claimants should have expected that their tax avoidance operations could prompt adverse reactions from Russia, but not that Russia's actions would be as extreme as the arrests, tax reassessments, fines, the forced sale of YNG and other measures imposed on them. The tribunal considered that, while Russia did not explicitly expropriate Yukos, its measures had an effect equivalent to expropriation, and set out to analyze the elements of an illegal expropriation under ECT Article 10.

First, the tribunal found it questionable whether the expropriation of Yukos, "Russia's leading oil company and largest taxpayer," was in the public interest, and pointed out that it was in the interest of state-owned oil company Rosneft, which is not the same (para. 1581).

Second, the tribunal considered that the treatment of Yukos might have been discriminatory in comparison with the treatment of other oil companies, but did not see a reason to delve into the matter.

Third, while Yukos was subjected to processes of law, the tribunal did not find that the expropriation was "carried out under due process of law," in view of the harsh treatment accorded to the executives and counsel of Yukos. The tribunal went so far as to state that the Russian courts, in sentencing Khodorkovsky and Lebedev, "bent to the will of Russian executive authorities to bankrupt Yukos, assign its assets to a State-controlled company, and incarcerate a man who gave signs of becoming a political competitor" (para. 1583).

Finally, given that Yukos was expropriated without compensation, Russia was found to be in breach of its obligations under ECT Article 13, and therefore liable under international law, without a need to consider whether it breached ECT Article 10 on fair and equitable treatment.

5.0 Contributory fault

Having established that the claimants were entitled to compensation for expropriation, the tribunal went on to determine whether and to what extent that compensation should be reduced in view of the claimants' wrongdoing, based on the legal principle of contributory fault invoked by Russia. To reach that determination, the tribunal evaluated whether any wilful or negligent act or omission of the claimants had a material and significant contribution to the damage they suffered.

Most instances of the claimants' "illegal and bad faith conduct" were found not to contribute materially to their damage. However, the tribunal did find that the claimants' abuse of the low-tax regions and their misuse of the Cyprus-Russia tax treaty lessened Russia's responsibility, contributed to the prejudice they suffered, and should lead to a reduction in the damages award.

Noting the difficulty in determining the extent and proportion of the fault of each disputing party, the tribunal referred to two earlier arbitral decisions. The annulment committee in *MTD v. Chile* found that the claimants were 50 per cent responsible for the damage they suffered. The *Occidental v. Ecuador* tribunal (which, like the Yukos arbitrations, was chaired by Yves Fortier) determined that the claimants' contributory fault led to a 25 per cent reduction in the damages. The Yukos tribunal, "having considered and weighed all the arguments" presented by the parties and "in the exercise of its wide discretion," agreed to a 25 per cent reduction, which it saw as a "fair and reasonable" apportionment of responsibility between the claimants and Russia (para. 1637).

6.0 Interest

Interest may be factored into the calculation of damages under ECT Article 26(8). The claimants had proposed three rates: LIBOR plus two or four percent; the yield on Russian sovereign bonds issued in U.S. dollars; and the U.S. prime rate plus two percent. All of them were rejected: LIBOR, as the tribunal found it had been "discredited"; the yield on Russian sovereign bonds, as it would lead to "excessive compensation" (para. 1679); and the U.S. prime rate, as there was no evidence that the claimants had to borrow money because of the expropriation.

The tribunal looked for guidance in the *Santa Elena v. Costa Rica* decision (chaired, as the Yukos tribunal, by Yves Fortier). Santa Elena, along with other cases, supported the use of an interest rate that the amount of compensation, had it been paid right after the expropriation, would have earned if reinvested at that time—the "investment alternatives approach." A rate based on ten-year U.S. Treasury bond rates was seen as appropriate by the tribunal, "in the exercise of its discretion" (para. 1685). While recognizing that compounded interest has become more frequent in investor-state arbitrations, it regarded as "just and reasonable" to grant simple pre-award interest and annually compounded post-award interest, if Russia does not fully pay the damages and costs within the 180-day grace period following the date of the award (para. 1689).

7.0 Quantification of damages

Two issues were considered with respect to the date of valuation: the date in which the expropriation took place, and whether the claimants could choose between valuations based on that date or on the award date. The claimants argued that the expropriation had occurred on 21 November 2007, when Yukos was struck off the registry of legal entities, but the tribunal found that the threshold of expropriation had been crossed earlier. As to the first issue, it fixed the date of expropriation as 19 December 2004, the date of the forced auction of YNG, after which Yukos could no longer properly operate. As to the second issue, finding support in *Kardassopoulous and Fuchs v. Georgia* and other decisions, the tribunal held that the claimants, having suffered an unlawful expropriation, could select the date of valuation. With respect to causation, the tribunal considered that, but for the tax assessments and other enforcement measures imposed by Russia, the claimants would not have suffered the damage. Russia suggested that the claimants could have mitigated their damages by paying the taxes and filing tax returns, but the tribunal concluded that, even if the claimants had done so, Russia would have still taken the enforcement measures aimed at bankrupting Yukos.

According to the tribunal, the claimants were entitled to three heads of damages: the value of their shares, the value of the dividends that they would have received in the absence of expropriation, and pre-award simple interest on both. The claimants wanted the tribunal to take into account the potential listing of Yukos in the New York Stock Exchange and the potential effects of a merger between Yukos and Sibneft. However, the tribunal disregarded those two potential scenarios, as it saw them as too uncertain.

The tribunal's method to valuate the shares. The claimants had advanced eight different methods to valuate Yukos on their suggested date of valuation (21 November 2007), resulting in amounts ranging between US$74 billion and US$129 billion. These methods included the discounted cash flow (DCF), comparable companies, comparable transactions and market capitalization methods.

The tribunal regarded the DCF method as being influenced by the claimants' notion of what would be an appropriate result. It also questioned the comparable transactions method since the parties agreed that there were no comparable transactions that could serve as a reliable basis for comparison. Ultimately, the tribunal adopted the figure that resulted from the comparable companies method, with a few corrections proposed by Russia, as the starting point for the valuation of Yukos. To adjust the value calculated by the claimants to the two possible valuation dates (date of expropriation and date of award), the tribunal chose the RTS Oil and Gas index, reasoning that it reflected the prices of trade in securities on the Moscow Stock Exchange, and included the shares of important Russian oil and gas companies.

The tribunal's method to valuate the dividends. Turning to the valuation of the dividends, the tribunal once again exercised its discretion to fix the amounts of dividends as rough averages between the figures put forward by the claimants' expert, on the one hand, and the corrected figures presented

by Russia's expert, on the other. It thus arrived at round figures of dividends at US$2.5 billion in 2004, and of US$45 billion from 2004 through the first half of 2014.

Applying its valuation methods, the tribunal found total damages (estimated value of shares plus estimated value of lost dividends) of US$21.988 billion for the 19 December 2004 valuation date, and of US$66.694 billion for the award date (fixed as 30 June 2014 for calculation purposes). Considering the higher amount only, and reducing it in 25 percent to account for the claimants' contributory fault, the tribunal estimated total damages at US$50,020,867,798, and determined that this amount should be distributed between the claimants according to their participation in Yukos: 56.3 per cent for Hulley Limited, 11.6 per cent for Veteran Petroleum and 2.6 for Yukos Universal.

8.0 Costs

The costs of the arbitration, including the arbitrators' fees, the fees of the assistant to the tribunal, the PCA's fees and costs including court reporters, interpreters, hearing rooms, meeting facilities and all other expenses amounted to €8,440,000. Given that the claimants prevailed, Russia, which had deposited €4,200,000 with the PCA for costs, was ordered to reimburse the claimants' deposited contributions, in the amount of €4,240,000.

The claimants indicated that their costs for legal representation and assistance amounted to US$79,628,055.56 in the jurisdictional phase plus £1,066,462.10 in the merits phase. Taking into account factors such as the excessive nature of some of the fees of the claimants' experts, the limited assistance they offered in determining damages, the reduction of the award due to the claimants' contributory fault, and the egregious nature of the expropriatory measures, the tribunal, "in the exercise of its discretion," thought it "fair and reasonable" for Russia to reimburse US$60 million of the claimants' costs for legal representation and assistance, noting that this amounted to approximately 75 per cent of their schedule of costs (para. 1887).

9.0 Russia will fight to set aside the award; the claimants, to enforce it

Russian Deputy Foreign Minister Vasily Nebenzya characterized the award as biased and "politically motivated." He also argued that the amount of damages was derived arbitrarily, and that the case was a display of "abuse by internal investors registering themselves as foreign residents with the help of offshore schemes for the purpose of tax evasion" (ITAR-TASS, 2014b).

In a statement, the Russian Finance Ministry affirmed that Russia will seek to set aside the award under the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). According to Deputy Minister Sergei Storchak, the tribunal had no jurisdiction, as Russia had not ratified the ECT, and had not given consent to investment arbitration under any treaty before its ratification, as this would be against Russian law (ITAR-TASS, 2014a).

Deputy Minister Storchak said the award runs against the decision of the ECtHR, which "concluded twice that Yukos committed large-scale tax evasion and its management was aware of violations, that all extra tax payments required from Yukos were lawful and legitimate and that Yukos was not discriminated against and the actions by the Russian authorities were not politically motivated." The statement of the Finance Ministry complained of many other flaws in the arbitration, including biased investigations and use of evidence, inadmissible reviews of Russian court judgments, and a "senseless and completely speculative attempt to give a hypothetical appraisal" of Yukos (ITAR-TASS, 2014a).

Group Menatep Limited (GML) was established in 1997 by Khodorkovsky, the former CEO of Yukos, to serve as majority shareholder of Yukos through subsidiaries, including two of the claimants, Hulley Enterprises and Yukos Universal. Nevzlin, former Deputy Chairman of the Yukos Board of Directors, is currently a beneficiary of 70% in GML. Satisfied with the award, he expressed hopes that Russia would honour it, as well as GML's readiness to search for and freeze Russia's assets around the world (Alpert, 2014; Cave, 2014).

The decision also pleased Tim Osborne, executive director of GML. He emphasized that Russia has 90 days to apply for a set-aside and expects this to go through Dutch courts of all levels. In the meantime, he already has a team committed to locating commercial assets belonging to Russia in the 150 countries party to the New York Convention. His idea is to "have assets earmarked and attached ready for when any set-aside applications are dealt with" (Cave, 2014). He envisions pursuing museum

collections exhibited by Russia around the world, planes owned by Russia and sent to air shows, and even assets of Russia's Central Bank that are used for commercial purposes (Podervyansky, 2014).

Osborne foresees that collecting US$50 billion will require hard work and could take another ten years, but is not ready to give up: "We've stuck at this for ten years. We've got to a point now with this award which nobody ever thought we would get to, and we're not going to stop now" (Cave, 2014).

In line with Osborne's estimate, Loukas Mistelis of the School of International Arbitration at Queen Mary University of London said that it could take 10 to 12 years for the claimants to collect most of the award, but maybe not the entire amount (RFE/RL, 2014).

Maria Tsarova (2014), a Ph.D. candidate at the Legislative Institute of the Verkhovna Rada of Ukraine, said that trying to enforce the award in Russia would be a waste of time and money. In her view, much of the state's property is shielded under Russian law, Russia tends to reject enforcement on public policy grounds, and Russian courts lack impartiality and independence.

Successful against Russia in a1998 investment arbitration, German investor Franz Sedelmayer, while optimistic about the chances of enforcement outside Russia, emphasized that it's a "rocky road," which he's been on for 20 years. He mentioned that he has managed to obtain satisfaction from Russia before German and Swedish courts, and suggested that shareholders try to seize the assets of Russia-controlled companies (Buckley and Hille, 2014).

In that sense, Emmanuel Gaillard, counsel for the claimants, recommends targeting the assets of Rosneft and Gazprom, Russia's state companies in the oil and gas sector (Buckley and Hille, 2014). Gus Van Harten of York University's Osgoode Hall Law School agrees that they have a better chance of seizing the assets of those companies than property covered by sovereign immunity. However, courts might be reluctant to seize assets of companies that have thousands of shareholders other than Russia, as pointed out by Kyle Davis of the Russian branch of the law firm Berwin Leighton Paisner (Meyer and Bierman, 2014).

Tsarova stated that, even in pursuing the assets of state-owned companies, the Yukos' shareholders tend to find difficulties in courts that may sympathize with a claim of sovereign immunity that Russia could bring through the public policy exception to enforcement under the New York Convention (Tsarova, 2014). Mistelis, in turn, expressed confidence that most European jurisdictions will be ready to seize Russia-owned commercial assets (RFE/RL, 2014).

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Notes

The tribunal was composed of Yves Fortier (chair), Charles Poncet (claimants' nominee) and Stephen Schwebel (respondent's nominee). The claimants were represented by Shearman & Sterling LLP, and Russia, by Cleary Gottlieb Steen & Hamilton LLP and Baker Botts LLP. The three final awards, as well as the three awards of 30 November 2009 on jurisdiction and admissibility, are available at http://www.pca-cpa.org/showpage.asp?pag_id=1599.

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