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INTERNATIONAL ARBITRATION GROUP

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HISTORIC AWARD IN THE YUKOS MAJORITY SHAREHOLDERS ARBITRATION

In this issue:

In a historic USD 50 billion award rendered on July 18, 2014, an Arbitral Tribunal constituted pursuant to the Energy Charter Treaty held unanimously that the Russian Federation breached its international obligations under the Energy Charter Treaty by destroying Yukos Oil Company and appropriating its assets.

The Tribunal, applying the UNCITRAL Arbitration Rules and sitting in The Hague under the auspices of the Permanent Court of Arbitration ordered the Russian Federation to pay damages in excess of USD 50 billion to the majority shareholders of Yukos Oil Company. The Tribunal also ordered the Russian Federation to reimburse to the Claimants USD 60 million in legal fees, which represent 75% of the fees incurred in these proceedings, and EUR 4.2 million in arbitration costs. This is by far the largest award ever rendered by an arbitral tribunal.

The Arbitral Tribunal was composed of The Hon. L. Yves Fortier, PC, CC, OQ, QC (Chairman), Judge Stephen M. Schwebel and Dr. Charles Poncet. The Arbitral Awards are available on the website of Permanent Court of Arbitration.

Background of the Dispute

In 2003, Yukos Oil Company was the largest oil company in Russia and produced over 1 million barrels of oil a day. It was about to become the fourth largest oil company in the world. That same year, however, the Russian Federation launched coordinated attacks on Yukos Oil Company starting with the arrest of its CEO Mikhail Khodorkovsky on October 25, 2003. The Russian Federation then proceeded to destroy the Company through the enforcement of fabricated tax claims and by intimidating and harassing its employees and officials as well as other individuals related to the Company, including Yukos' auditor PwC. The expropriation of Yukos' assets was achieved gradually, starting in December 2004 with the rigged auction of Yukos' largest production unit Yuganskneftegaz ("YNG") and ending with the Company's final liquidation in November 2007.

In 2005, Hulley Enterprises Limited, Yukos Universal Limited (two subsidiaries of GML Limited), and Veteran Petroleum Limited (the pension fund established in 2001 for the benefit of former Yukos employees), which collectively owned

over 70% of the shares in Yukos Oil Company, initiated three arbitration proceedings against the Russian Federation under the Energy Charter Treaty (the "ECT"). In the arbitrations, the majority shareholders of Yukos complained of arbitrary, unfair and discriminatory treatment, and an unlawful expropriation of their investments by the Russian Federation.

THE ARBITRAL TRIBUNAL'S KEY FACTUAL FINDINGS

The "*primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its assets*"

In its Award of July 18, 2014, the Arbitral Tribunal found that:

- in imposing and enforcing the fabricated tax re-assessments against Yukos, the "*primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its assets*"; [¶ 756]
- the record of "*intimidation and harassment of Yukos' senior executives, mid-level employees, in-house counsel and external lawyers by the Russian authorities not only disrupted the operations of Yukos but also contributed to its demise and thereby damaged Claimants' investment*"; [¶ 820]
- the Russian Federation's "*total failure to engage with any of Yukos' settlement proposals raise[d] significant doubts in the Tribunal's mind as to whether Respondent's true and sole concern in its dealings with Yukos after the tax re-assessments were issued was the collection of taxes*"; [¶ 980]
- the auction of YNG was "*rigged*" [¶ 1036] and was driven "*by the desire of the State to acquire Yukos' most valuable asset and bankrupt Yukos. In short, it was in effect a devious and calculated expropriation by Respondent of YNG*"; [¶ 1037]
- the "*totality of the bankruptcy proceedings […] were not part of a process for the collection of taxes but rather, as submitted by Claimants, indeed 'the final act of destruction of the Company by the Russian Federation and the expropriation of its assets for the sole benefit of the Russian State and State-owned companies Rosneft and Gazprom'*"; [¶ 1180] and
- the pressure put on PwC to withdraw its audit of Yukos' financial statements and give evidence against Messrs. Khodorkovsky and Lebedev at their second trial, "*informs the Tribunal's view that Yukos was the object of a series of politically-motivated attacks by the Russian authorities that eventually led to its destruction, as alleged by Claimants*". [¶ 1253]

The Tax Re-Assessments against Yukos Were Fabricated

The Claimants alleged that, in order to force Yukos into bankruptcy, the Russian tax authorities fabricated and enforced against Yukos a series of tax re-assessments for the years 2000-2004 exceeding USD 24 billion. This was achieved by re-attributing the profits of Yukos' trading companies to Yukos itself and then alleging that Yukos had failed to pay tax on those profits. At the same time, the Russian tax authorities refused to re-attribute to Yukos the VAT

exemptions or refunds to which Yukos' trading companies were entitled, despite the fact that the corresponding oil had been exported. In addition, the fabricated tax liability of Yukos was significantly increased by the imposition of willful- and repeat-offender fines.

While considering that "*Yukos was vulnerable in respect of certain facets of its tax optimization scheme*" [¶ 494], the Arbitral Tribunal acknowledged the grave irregularities in Yukos' treatment by the Russian tax authorities and courts. With regard to revenue-based taxes, it found that "*there was no precedent for re-attribution at the time that the tax assessments and related decisions were issued in respect of Yukos*" [¶ 625]. Regarding VAT liability, the Tribunal held that "*the Russian Federation was determined to impose the VAT liability on Yukos, and would have done whatever was necessary to ensure that the VAT liability was imposed on Yukos. […] [I]t was Respondent's intent to impose VAT liability on Yukos no matter what Yukos did*" [¶ 694]. As to the fines, the Tribunal took the view that "*the willful offender fines were clearly improper insofar as they related to VAT*" [¶ 728] and that "*the willful offender fines as they related to the revenue-based taxes were improperly assessed against Yukos*". [¶ 729]

On that basis the Arbitral Tribunal concluded that "*the primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its valuable assets*". [¶ 756]

The Harassment of Yukos and Yukos-related Individuals

Russia conducted a "*ruthless campaign*" of harassment and intimidation

The Claimants maintained that, in addition to imposing a massive tax liability on Yukos, the Russian Federation severely disrupted the operations of the Company by pursuing a campaign of intimidation and harassment against the Company and numerous individuals related to it, including Yukos-related individuals executives, employees and external advisers, and legal counsel. The campaign also included numerous searches and seizures at the premises of the Company.

The Arbitral Tribunal was unequivocal in condemning the Russian Federation's campaign of harassment and intimidation: "*[t]he treatment of Yukos senior executives, mid-level employees, in-house counsel, external lawyers and related entities […] support Claimants' central submission that the Russian authorities were conducting a 'ruthless campaign to destroy Yukos, appropriate its assets and eliminate Mr. Khodorkovsky as a political opponent.'*" [¶ 811]

The "Blanket Rejection" of Yukos' Settlement Offers

Yukos sought to comply with the fabricated tax re-assessments while continuing to contest their legality before the Russian courts. The Claimants argued that Yukos reached out to the Russian authorities with several settlement offers, all of which were ignored, with the exception of one which was rejected without consideration. This was confirmed by the Arbitral Tribunal, which ruled that "*Respondent's total failure to engage with any of Yukos' settlement proposals raises significant doubts in the Tribunal's mind as to whether Respondent's true*

and sole concern in its dealings with Yukos after the tax assessments were issued was the collection of taxes". [¶ 980]

The "Rigged" Auction of YNG

The auction of YNG was "*a devious and calculated expropriation*"

The Claimants argued that after issuing that tax re-assessment, the Russian Federation proceeded to seize and hastily auction Yukos' largest production unit, YNG, at a knock-down price of USD 9.35 billion. YNG was acquired by Baikalfinancegroup, a previously unknown company established at the address of a local bar in Tver two weeks before the auction. With only USD 359 in capital, it managed to pay a cash deposit in the amount of USD 1.77 billion to register for the auction. State-owned Rosneft acquired Baikalfinancegroup shortly after the auction.

The Arbitral Tribunal described the auction as "*one of the most striking episodes in the saga of Yukos' demise*". [¶ 981] It held that "*the Russian authorities deliberately ignored the advice of Dresdner [their valuation expert] that haste in carrying out the auction could decrease the price*" [¶ 1022] and that the final price paid by Baikalfinancegroup was "*far below the fair value*" of YNG [¶ 1020]. As to the identity of Baikalfinancegroup, the Tribunal characterized it as "*one of the most opaque facets of the YNG auction […] [which] was obviously created solely for the purpose of bidding for YNG at the auction*" [¶ 1024]. On that basis the Tribunal concluded that the auction was "*rigged*" [¶ 1036] and that it was driven "*by the desire of the State to acquire Yukos' most valuable asset and bankrupt Yukos. In short, it was in effect a devious and calculated expropriation*". [¶ 1037]

In reaching its conclusions, the Arbitral Tribunal also took account of the statements of President Putin made during the February 2003 meeting of the Russian Union of Industrialists and Entrepreneurs at the Kremlin. During that meeting, Mr. Khodorkovsky and President Putin had a chilling exchange concerning various issues, including corruption. The Tribunal noted that during this meeting

"*President Putin made this seemingly prescient observation:*

> *[C]ertain things are obviously clear. [Rosneft] is a State-owned company. It has insufficient reserves and should increase them. Some other oil companies, such as Yukos, have a surplus of reserves.*

[…] [A]fter having reviewed the totality of the circumstances leading to the YNG auction and the auction itself, the Tribunal concludes that this episode provides yet more compelling evidence that the Russian Federation was not engaged in a true, good faith tax collection exercise but rather was intent on confiscating the most valuable asset of Yukos and effectively transferring it to the Russian State." [¶ 985]

PwC Was Pressured into Withdrawing Yukos' Audits

The Claimants further maintained that the Russian Federation exerted pressure on PwC to withdraw its Yukos audits in order to bolster the legitimacy of the destruction of Yukos. The harassment of PwC took the form of searches, seizures, interrogations, criminal charges, two tax lawsuits, and the potential loss of clients and its license to do business in Russia. In this context, rather than risk its business and employees for the sake of a client that was no longer a going concern, PwC chose the only viable option, namely to cooperate with the Russian authorities by finding pretexts to withdraw its audits of Yukos' financial statements.

"Yukos was the object of a series of politically-motivated attacks"

The Arbitral Tribunal agreed and held that "*PwC was clearly pressed by the Russian authorities to find grounds for withdrawing its audits of Yukos*". [¶ 1247] It added that "*the pressure mounted by the Russian authorities against Yukos' auditors, which led to PwC's eventual withdrawal of its audits and even to a PwC auditor testifying against Messrs. Khodorkovsky and Lebedev at their second trial, informs the Tribunal's view that Yukos was the object of a series of politically-motivated attacks by the Russian authorities that eventually led to its destruction, as alleged by Claimants.*" [¶ 1253]

Bankruptcy Was "The Final Act of Destruction" of Yukos

The Claimants explained that, being deprived of the cash-flows generated by YNG, Yukos struggled to remain afloat for about a year. Rosneft entered into a confidential agreement with a syndicate of Western banks that were Yukos' creditors. According to the agreement, Rosneft would satisfy the outstanding debt owed by Yukos to the syndicate, in exchange for the assignment to Rosneft of the banks' claims against Yukos. Pursuant to the agreement, the banks would also initiate bankruptcy proceedings against Yukos in Russia. Following these arrangements, once the banks initiated the bankruptcy proceedings, a temporary receiver was appointed by the Russian courts. In the course of the bankruptcy proceedings, a plan to rehabilitate the Company was rejected and its assets were auctioned off piece by piece. State-owned Rosneft acquired the majority of Yukos' assets in the liquidation auctions. In the end, Yukos was struck off the register of companies on November 21, 2007.

In relation to the bankruptcy proceedings, the Arbitral Tribunal did not "*accept that it was in any sense proper or fair for the creditors' committee to reject the Rehabilitation Plan, for the court to declare Yukos bankrupt, or for Yukos to have been deprived of all of its remaining assets through a hasty and questionable liquidation process. On the contrary, it is evident to the Tribunal that the totality of the bankruptcy proceedings […] were not part of a process for the collection of taxes but rather, as submitted by Claimants, indeed the 'final act of the destruction of the Company by the Russian Federation and the expropriation of its assets for the sole benefit of the Russian State and State-owned companies Rosneft and Gazprom.'*" [¶ 1180]

THE ARBITRAL TRIBUNAL'S LEGAL FINDINGS

The Arbitral Tribunal Rejected the Russian Federation's Remaining Preliminary Objections that Had Been Joined to the Merits

Article 21 applies only to bona fide taxation measures

In its Interim Awards on Jurisdiction and Admissibility, the Arbitral Tribunal dismissed all of the Russian Federation's preliminary objections on jurisdiction and admissibility, except for two which the Tribunal deferred to the merits phase: the Respondent's contention that the Claimants had not allegedly come to the Tribunal with "clean hands" and that the claims were precluded by the ECT's taxation carve-out, Article 21. In its Final Awards, the Arbitral Tribunal rejected both of these objections.

As regards the "clean hands" objection and the scope of such objection, the Arbitral Tribunal first ruled that an investor who obtained an investment solely by acting in bad faith or in contravention of the host State's laws would not be able to benefit from the ECT [*see* ¶ 1352]. The Tribunal added that an investor who has breached the law of the host State in the course of the performance of its investment would not be denied the right to invoke the ECT [*see* ¶ 1355]. The Tribunal also considered that the so-called "clean hands" doctrine did not exist as a general principle of international law which would bar a claim by an investor [*see* ¶ 1363]. In this case, the Tribunal rejected the Respondent's allegations concerning the manner in which the Claimants acquired their investments [*see* ¶ 1370].

With respect to the Article 21 objection, the Tribunal held that the Russian Federation's arguments were not availing for two reasons. First, the Tribunal considered that any measures excluded by the taxation exception in Article 21(1) of the ECT would be brought back within the Tribunal's jurisdiction through Article 21(5) of the ECT (which, in turn, provides that the ECT's provisions on expropriation apply to taxes) [*see* ¶ 1416]. Second, the Tribunal found that Article 21 applies solely to *bona fide* taxation actions. It does not apply to actions taken only under the guise of taxation and which in reality aim to achieve an entirely unrelated purpose, "*such as the destruction of a company and the elimination of a political opponent*" [¶ 1407]. Given that the Russian Federation's tax assessments levied against Yukos "*were essentially aimed at paralyzing Yukos rather than collecting taxes*", Article 21(1) of the ECT did not apply in this case [¶ 1444].

It should also be noted that the Russian Federation re-raised in the merits phase an objection which had already been rejected by the Tribunal in the jurisdiction phase, namely that the Claimants' claims were barred by the ECT's fork-in-the-road mechanism in Article 26 in relation to a number of other outstanding legal proceedings, including the ECHR proceeding brought by former Yukos Oil Company against the Russian Federation. The Tribunal summarily dismissed this objection, noting that it saw "*no reason to reopen the issue and change its decision*" [¶ 1271].

Rosneft conduct is attributable to the Russian Federation

The Actions of Rosneft Were Attributable to the Russian Federation

The Russian Federation also argued that, under international law, it could not be liable for any of the actions of the interim receiver in the bankruptcy proceeding of Yukos and of Rosneft. While the Arbitral Tribunal agreed that the receiver's actions could not be attributed to the Russian Federation, it considered that Rosneft's conduct in the context of the YNG auction was attributable to the Russian State. In this connection, the Tribunal placed special emphasis on President Putin's statement at the time of the auction that "*[t]oday, the state, resorting to absolutely legal market mechanisms, is looking after its own interests*" [¶ 1470]. The Tribunal considered that this statement constituted "*public acceptance*" that Rosneft's acquisition of YNG through Baikalfinancegroup "*was an action in the State's interest, the inference being that the State, then 100 percent shareholder of Rosneft, the most senior officers of which were members of President Putin's entourage, directed that purchase in the interest of the State*" [¶ 1472]. While Mr. Putin had not made such an "*inculpatory admission*" [¶ 1474] concerning Rosneft's conduct in the bankruptcy proceedings, the Tribunal considered that, in that context too, "*it may be reasonably held that the highest officers of Rosneft who at the same time served as officials of the Russian Federation in close association with President Putin acted in implementation of the policy of the Russian Federation*" [¶ 1480].

The Russian Federation Expropriated the Claimants' Investments and Breached Article 13(1) of the ECT

In deciding on the Claimants' claim of expropriation, the Tribunal recalled that it had previously found that "*the primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its valuable assets*" [¶ 1579]. It then decided that, while Yukos may not have been "*explicitly expropriated*", the Russian Federation's actions "*have had an effect 'equivalent to nationalization or expropriation'*" [¶ 1580]. Moreover, the Tribunal held that the cumulative conditions under Article 13(1) of the ECT for an expropriation to be lawful had not been met:

(a) the expropriation was not in the public interest, but "*in the interest of the largest State-owned oil company, Rosneft, which took over the principal assets of Yukos virtually cost-free*" [¶ 1581];

(b) the expropriation "*may well have been discriminatory*" [¶ 1582];

(c) the expropriation was not carried out under due process of law, given "*that Russian courts 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*" [¶ 1583];

(d) the expropriation was not accompanied by the payment of prompt, adequate and effective compensation: there was no compensation "*whatsoever*" [¶ 1584].

The expropriation of Yukos was not in the public interest but in the interest of Rosneft

Having thus found that the Russian Federation's actions amounted to an illegal expropriation, the Arbitral Tribunal considered it unnecessary to decide whether or not the Russian Federation also breached its obligations under Article 10(1) of the ECT on fair and equitable treatment.

Calculation of damages

In determining the damages owed to the Claimants for the expropriation of their investment in Yukos, the Tribunal took into account the objection raised by the Respondent that certain actions of Yukos or the Claimants had contributed to the Claimants' injury [¶ 1634]. The Tribunal considered that in two instances (Yukos' conduct in certain low-tax regions in Russia, and its utilization of the Cyprus-Russia Double Taxation Agreement) the Claimants had contributed to the prejudice that they suffered. On this basis, the amount of damages due to the Claimants was reduced by 25% – from approximately USD 66.7 billion to USD 50 billion.

Key Points

- Largest award ever
- USD 50 billion in damages
- USD 60 million in legal fees
- EUR 4.24 million in arbitration costs

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