KING & SPALDING

Quantum Quarterly

The Damages Newsletter

A publication of King & Spalding's International Arbitration Group

Issue 07 | 2Q 2015

We are pleased to present the latest edition of *Quantum Quarterly*, a publication of King & Spalding's International Arbitration Group. This edition features an interview with Brent Kaczamarek of Navigant Consulting, together with summaries of several recent damages awards. As always, we welcome any feedback you may have.

All the best.

Table of Contents

An Interview with Brent C. Kaczmarek

Brent Kaczmarek is a Managing Director of Navigant Consulting Inc. and leads the firm's International Arbitration group from its Washington D.C., office. Brent serves as an expert and consultant on issues involving business and investment valuation, finance, accounting, and economics in industries such as financial services, manufacturing, energy, utilities, telecommunications, mining, healthcare, and business services. He has served as a financial and valuation expert in more than 60 international arbitrations, including more than 50 investor-State arbitrations. More than 15 of these disputes have involved claims exceeding US$1 billion.

The disputes Brent has helped clients and arbitral tribunals resolve have been in North, Central, and South America; Western, Central, and Eastern Europe; the Commonwealth of Independent States; Asia; the Caribbean; and Africa.

Q. How did you get started working as a damages expert?

A. I was hired in 1993 by Arthur Andersen in their litigation support group. The first case I worked on

continued on Page 2

Interview with Brent C. Kaczmarek

continued from Page 1

was an antitrust/intellectual property dispute for Xerox. Obviously I wasn't the expert on the case, but I worked with a fairly large team to conduct the work for the expert, Ken Barker, who is currently at FTI Consulting. From there, I worked on a variety of cases, both disputes and forensic investigations. I did not work on an international arbitration until 1997, right after I received the Chartered Financial Analyst (CFA) designation. That arbitration was *CSOB v. Slovak Republic*, a huge investor-State arbitration at the time. I had the pleasure of working with Judge Charles Brower (at what I recall was his last case as Counsel before focusing strictly on arbitrator appointments), and many others at White & Case whom he groomed, such as Abby Cohen Smutny. I was not the expert in that matter either. Instead, I supported my good friend who hired me in 1993 at Arthur Andersen: Tim Hart (now at Credibility Consulting). It's hard to believe that was nearly two decades ago.

Q. How long have you been working as an expert in international arbitrations in particular?

A. I started getting direct requests to serve as an expert around 2001 — before the CSOB case was completed. The CFA designation really helped me in this regard because most investor-State cases do require business valuation expertise — which is a heavy focus for the CFA designation. The first cases in which I was retained as expert were *Pey Casado v Chile, Noble Ventures v Romania*, and *GAMI v Mexico*. I'm still working on the *Pey Casado v Chile* matter today! The hearing was in April 2015.

Q. What are some of the differences you see between commercial and treaty arbitrations, from the damages perspective?

A. I like to divide commercial arbitrations between construction cases and non-construction cases—although this is often not an easy line to draw. I draw this line because Navigant has an experienced construction practice with specialists in scheduling and other disciplines germane to construction work. Most of my commercial cases involve business interruptions (which can be construction-related cases) or share purchase agreement disputes. The share purchase agreement disputes are obviously quite similar to investor-State cases on the quantum side, since the work involves business valuation. The business interruption cases can range from the mundane in terms of damages to highly complicated quantum cases. For example, I was the expert retained by Tiffany & Co. in its arbitration with Swatch over their failed watch joint venture. That was a complicated case in terms of assessing damages and, as I have read, the award was recently overturned in the Dutch courts.

Q. Do you see those differences remaining or will we see some elements of convergence?

A. I do see convergence between the two areas – but more investor-State arbitration informing commercial arbitration. That may be because investor-State arbitration is still far more transparent in terms of decisions and awards. I do see, for example, the concept of fair market value being imported into commercial cases where it might not have otherwise been imported 10 years ago. So I do think this trend will continue.

Q. You have a reputation in treaty arbitrations for acting roughly equally on the investor and State sides. Was this a conscious choice and, if so, why?

A. It very much was a conscious decision from the beginning. My first four cases were split: two cases for States, two cases for investors. Today, I have been appointed more than 40 times by States and more than 60 times by investors. I am continuously conscious of keeping this ratio close to 50:50. When I began work in this area, it was immediately apparent to me that experts were willing (or could be coaxed) into taking positions that are very advantageous for the party that appointed them. If you are such a malleable expert, you have to pick one side or the other (investors or States). I think our practice is quite unique because we have maintained a balance between investors and States for nearly two decades. I'd say the job is quite a bit harder to take appointments by both sides. It means telling your client and their counsel "no" quite often! Anyone who has worked with me or my team would testify to this. I often tell people the story of an investor client who cursed at me and my colleagues when they saw our initial damages calculations. The client obviously thought the calculations were derisory. We didn't change them. After the hearing, the same client said we were worth every penny and more than what he had paid to us. Those experiences have probably emboldened me to maintain a very neutral approach to our work.

Q. What advice do you have for counsel in advocating damages issues?

A. That is a difficult question to answer! And my answer would likely have been different in the past. I can say two things in response to this question. First, my philosophy has always been to make neutral calculations. I tell clients and counsel all the time that fair market value is the price agreed between a willing buyer and willing seller. Conservative calculations favor the buyer, while aggressive calculations favor the seller. So, when calculating fair market value, the calculation should be neutral. I have also always proceeded under the theory that if you present a reasonable calculation to a tribunal, they would likely accept it in full because, at the end of the day, arbitrators are lawyers, and doing complex damages calculations is something they don't enjoy or feel capable of doing on their own. I never subscribed to the theory that you should put up a high damages calculation for a claimant, because arbitrators are likely to reduce it anyway. I think that is a self-fulfilling prophesy (if you are advancing highly aggressive damages calculations, they are likely being reduced because arbitrators recognize they are highly aggressive). Second, I think counsel need to remind themselves that the tail should not wag the dog — meaning that counsel are supposed to make their case based upon the expert's opinions rather than telling experts the opinion they would like to have. This is a slippery slope because damages calculations also involve legal principles that lawyers must discuss with the expert. Unfortunately, I think this slope is often too slippery, and claimants and respondents are often successful in getting their experts to take extreme positions. I think it is often overlooked that if a respondent loses liability, but if the valuation or damages claim is really low (particularly with respect to an expropriation), it is really a win for the respondent.

Q. What advice do you have for arbitrators in deciding damages issues?

A. I think arbitrators are generally far too conservative with damages calculations and valuations. If a State causes damage to an investment (but the investor still keeps the investment), perhaps this conservative view is acceptable. However, when a State expropriates an investment, being conservative favors the State, as I said before. I think arbitrators are too prone to put themselves in the shoes of a buyer and not the seller. And when they are wearing the shoes of the buyer, they are too prone to use the State's own influence on the value of the investment (which is exceptional), to the detriment of the investor. Fair market value represents a mutually agreeable price in a transaction. Expropriations are forced sales with a buyer that is unwilling to pay a fair price. I think tribunals need to identify this litigation position more often. I am also not encouraged by recent decisions that have discounted damages or valuation awards by accepting that newly elected governments can attack investments rather than "promote and protect investments" as agreed in previously executed BITs. If a newly elected government can adopt general policies against investments, and then expropriate them for pennies on the dollar because of the risk created by those policies, I wonder whether investors or governments will find BITs to be worth the paper they are written on in the future.

Q. What "hot" issues in damages do you see currently, or foresee emerging in the near future?

A. The biggest issue is the one I just mentioned above. We are at crossroads in dealing with States that elect rogue politicians, such as President Chávez, who actively chose to reverse the State's promises to promote and protect investments. He went after the "capitalists" and some tribunals are saying that the valuation of investments expropriated after these policies were implemented must be taken into account. I frankly don't understand the logic. I feel the just approach is that the value of any investment covered by a BIT should assume that the State fulfills the promise it made — to promote and protect investments (just like any commercial award between parties to a contract would assume each party honors the contract). Anything less is allowing a State to negatively influence the value of the investment to its own benefit (not to mention effectively backing out of the promises it made in the BITs). While some tribunals have said that BITs do not fully protect investors from all forms of political risk (a statement with which I would fully agree), tribunals are increasingly drawing the line of protection inconsistently. It would sometimes seem, as an investor, you can expect a reasonable damages award from a State that implements a one-off rogue measure. But if the State goes completely rogue, you might only be able to expect a much lower level of compensation. Does this make sense? I don't think so, and I hope this issue can get ironed out in subsequent awards. While many of my comments might sound favorable to investors, they really are not. States benefit greatly from foreign investment, and adopting an attitude that is unfavorable to investment cannot possibly result in positive economic development. ✦

Recent Damages Awards

***Gold Reserve Inc. v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB(AF)/09/1)**

Date of the Award:
September 2014

Claimant:
Gold Reserve Inc.

Respondent:
Bolivarian Republic of Venezuela (Respondent)

Members of the Tribunal:
Professor Piero Bernardini (President), Professor David A.R. Williams, and Professor Pierre Marie Dupuy

Sector:
Mining concessions, mining rights

Applicable Treaty:
Treaty between the Government of Canada and the Government of Venezuela for the Promotion and Protection of Investments, which entered into force on January 28, 1998 ("Canada —Venezuela BIT" or "BIT")

Background:
In early 1999, Claimant acquired two mining concessions in Southeastern Venezuela for the extraction of gold, copper, and molybdenum. The Brisas Concession, granted on April 18, 1988, covered near-surface gold resources located within the 500-hectare Brisas property. The Unicornio Concession, granted on March 3, 1998, covered the hard-rock mineralization underlying the Brisas Concession. Both concessions were granted for a period of 20 years, and could be extended for two additional 10-year terms. Claimant planned to exploit these two concessions together as part of a larger Brisas Project. Claimant developed the Brisas Project, culminating in the issuance on March 27, 2007, of a Construction Permit by the Ministry of the Environment. But on April 14, 2008, that Ministry declared the "absolute nullity" of the permit and revoked it for reasons of public order. On May 25, 2009, the Ministry of Mines terminated the Brisas Concession. In October 2009, Respondent seized Claimant's assets and occupied the site of the Brisas Project. On June 17, 2010, the Ministry of Mines terminated the Unicornio Concession as well.

Claimant initiated an ICSID (Additional Facility) arbitration against Venezuela on October 21, 2009, arguing that Respondent's conduct and actions regarding its investments in Venezuela had breached a number of provisions of the Canada-Venezuela BIT.

The Tribunal ultimately held that Venezuela had breached its obligation under the BIT to accord fair and equitable treatment to Claimant's investments. The Tribunal awarded US$713 million in damages, with Pre-Award interest compounded annually to accrue at the US Treasury bill rate, and Post-Award interest compounded annually to accrue at the rate of LIBOR plus 2%. Each side was ordered to bear its own legal costs, except that Respondent was ordered to pay US$5 million to Claimant as part of the latter's legal costs and expenses. The costs of the arbitration, i.e., the fees and costs of the Tribunal and ICSID, were equally split between the parties.

Damages:
The parties agreed that the appropriate measure of damages in the circumstances of the case was the Brisas Project's fair market value, and that the correct valuation date was April 14, 2008.

Claimant's valuation methodology consisted of calculating the weighted average of (i) the discounted cash flow (DCF) method (50%), (ii) the comparable publicly traded company method (35%), and (iii) the comparable transaction method (15%). According to Claimant, this weighted average methodology ensured that the valuation was not over-sensitive to changes in inputs, and not too far removed from the market. Claimant's valuation of the Brisas Project's fair market value as of April 2008 amounted to US$1,374,492,000.

Respondent relied on the DCF method only, arguing that valid comparables did not exist due to the high variance in the geology and mineralization of the different projects. Respondent, however, did not produce its own DCF calculation. Instead, it made a number of corrections to Claimant's model, allowing for lower metals recovery, higher smelter charges, a two-year delay to obtain additional permits, and a slower speed at which Claimant would receive revenue. Respondent also amended other inputs in Claimant's DCF model, including gold and copper prices, inflation, and the cost of capital. Once the model was adjusted, Respondent contended that the Brisas Project had a fair market value of zero as at April 14, 2008.

The Tribunal found that, even though the Brisas Project had never been a functioning mine, and thus did not have a history of cash flow that would normally lend itself to the DCF model, the DCF method could be reliably used in this case given the project's commodity nature and the detailed mining cash-flow analysis that the Parties had undertaken. The Tribunal, however, rejected Claimant's use of comparables: it held that the chosen comparables were not sufficiently similar to be used in a weighted valuation calculation. The Tribunal agreed, nevertheless, to refer to comparable companies and transactions to ensure that the DCF valuation was reasonable.

The Tribunal rejected Respondent's argument that the Brisas Project had a fair market value of zero as at April 14, 2008, noting that Respondent's analysis was not persuasive. The Tribunal cited Claimant's efforts and expenses to develop the project, the independent valuations by several banks consistent with Claimant's valuation, and the fact that financing had been arranged for the project as evidence that the Brisas Project was valuable. The Tribunal ultimately concluded that Claimant's DCF valuation of the Brisas Project was to be preferred.

The Tribunal proceeded, however, to reduce Claimant's DCF valuation by reviewing two main categories of calculations that formed part of Claimant's DCF model. The first concerned certain technical aspects of the Brisas Project itself. In particular, the Tribunal was not satisfied with Claimant's calculations of the costs associated with the hard-rock stockpiles that would be needed to ensure that a consistent copper head grade was fed into the processing plant. The Tribunal found it appropriate to deduct US$80 million from the Claimant's DCF calculation, thus taking into account the general costs that would likely arise in establishing and managing the hard-rock stockpiles. The Tribunal also disagreed with Claimant's approach of not incorporating into the DCF model any delay in obtaining additional permits. Although the Tribunal rejected Respondent's view that a two-year delay was appropriate, it did find that a one-year delay was reasonable. The Tribunal accordingly deducted US$108,500,000 from Claimant's DCF calculation (corresponding to one-half of Respondent's two-year delay deduction). The Tribunal further disagreed with Claimant's estimate of the Brisas Project's reserves and resources. The Tribunal found that the valuation should not include silver resources because Claimant had provided no evidence establishing that it had the right to mine silver. The Tribunal thus deducted US$31 million from Claimant's DCF calculation. The Tribunal also concluded that certain additional resources that Claimant had included in its valuation were too speculative, and therefore deducted an additional US$162 million corresponding to these additional resources. Finally, the Tribunal held that Respondent's analysis with respect to metal recovery rates and concentrate grades was more convincing than Claimant's, and accordingly found that Claimant's DCF calculation should be reduced by a further US$101 million.

The second set of calculations concerned the DCF model's financial aspects. Both parties used a weighted average cost of capital (WACC) to calculate the applicable discount rate. Claimant's WACC was 8.22%, while Respondent's was between 16.5% and 23.8%. As part of the cost of equity component of the WACC, Claimant used a country-risk premium of 1.5%, as compared to Respondent's premium of 6.7% to 16.4%. The Tribunal noted that Claimant's country-risk premium was too low because it only took labor risks into account, but failed to take other legitimate risks into account, such as political risk. However, the Tribunal rejected Respondent's inclusion of expropriation risk into the country-risk premium, finding it "not appropriate to increase the country risk premium to reflect the market's perception that a State might have a propensity to expropriate investments in breach of BIT obligations." Instead, it decided to adopt a country-risk premium of 4%, which increased the WACC discount rate to 10.09%. As a result, the Tribunal found it appropriate to deduct US$130 million from Claimant's DCF calculation.

In sum, the Tribunal deducted a total of US$612.5 million from Claimant's US$1,325,532,000 DCF valuation of the Brisas Project as at April 14, 2008. Accordingly, the Tribunal awarded Claimant damages in the sum of US$713,032,000.

continued on Page 6

continued from Page 5

The Tribunal noted that Claimant's country-risk premium was too low because it only took labor risks into account, but failed to take other legitimate risks into account, such as political risk.

Interest:
Claimant requested that pre-award interest be paid on any damages awarded at the rate of US Prime plus 2% compounded annually or, alternatively, LIBOR plus 4% compounded annually. Respondent, on the other hand, argued that it was well established that the appropriate pre-award interest rate was a risk-free rate, and further submitted that, if any interest was to be awarded, it should be at the US Treasury bill rate. Moreover, Respondent argued that simple, not compound, interest should be awarded in the circumstances of the case. The Tribunal found that the purpose of pre-Award interest was to ensure that Claimant was properly compensated for Respondent's breach of its fair and equitable treatment obligation. As such, it concluded that the US Treasury bill rate represented a reasonable and fair rate that would fulfill this purpose. But it rejected Respondent's contention that simple interest should be awarded. The Tribunal held instead that compound interest better reflected current business and economic realities, and thus the actual damage suffered by a party. Accordingly, the Tribunal ordered that Claimant was entitled to pre-Award interest, compounded annually, from April 14, 2008, to the date of the Award, at the US Treasury bill rate.

As for post-Award interest, the Tribunal found that the rate of LIBOR plus 2%, compounded annually, was an appropriate, commercial post-Award interest rate.

Costs:
The Tribunal held that it was appropriate in this case, given the serious and egregious nature of Respondent's breach, to apply the "loser pays" principle. But the Tribunal also noted the material disproportion that existed between the Parties' respective costs (in excess of US$20 million for Claimant, a little less than US$13 million for Respondent). As such, the Tribunal considered it appropriate for each party to bear its own costs, except that Respondent would reimburse Claimant for part of the latter's legal costs in the amount of US$5 million. The Tribunal further ordered that the fees and costs of the Tribunal and of ICSID would be split equally between the parties.

***SAUR International S.A. v. Argentine Republic* (ICSID Case No. ARB/04/4)**

Date of the Award:
May 22, 2014

Claimant:
SAUR International S.A.

Respondent:
Argentine Republic

Members of the Tribunal:
Juan Fernández-Armesto (President), Bernard Hanotiau, Christian Tomuschat

Sector:
Water and Sewage services

Applicable Treaty:
Agreement between the Republic of France and the Republic of Argentina for the Reciprocal Encouragement and Protection of Investments, signed in Paris on July 13, 1991 ("France — Argentina BIT" or "BIT")

Background:
In 1997, the Province of Mendoza, Argentina (the "Province") privatized OSM, a concessionaire for the performance of drinkable water and sewage services within the Province. An international public tender was launched for partially divesting OSM's shares, and SAUR International S.A. ("Sauri"), the wholly owned subsidiary of Saur, a French company specializing in water production, treatment, distribution, and sanitization, won the bid.

In 1998, Sauri spent US$72.4 million to acquire 32.08% of OSM's shares. On the same date, OSM signed a Concession Contract with the Province, becoming the concessionaire for the performance of public drinkable water and sewage services. On July 22, 1998, Sauri signed a Technical Assistance Contract with OSM, becoming the technical operator in exchange for 3% of OSM's billings.

Because of the 2002 financial crisis, the Province enacted emergency measures, which included "pesifying" OSM's dollar-based tariffs (i.e., mandatorily converting them into local currency at a 1:1 ratio, which had the effect of reducing tariff revenues by 2/3 in dollar terms).

On November 17, 2003, Sauri started ICSID arbitration proceedings against the Republic of Argentina, alleging that the measures enacted by the Province were in violation of the BIT. On December 15, 2005, the Province and OSM signed the so-called First Letter of Understanding, setting the basis for a renegotiation of the whole Concession Contract, including a revision of tariffs. As a result, the arbitration proceedings were stayed between April 7, 2006, and May 4, 2010.

On May 17, 2007, the Province and OSM signed the so-called Second Letter of Understanding. By this instrument, the parties agreed to increase OSM's tariffs by 19.7%, to require that OSM invest a certain amount of Argentine pesos per year, to liquidate both parties' reciprocal credits and debts, and to require the Province to otherwise maintain the Concession Contract as originally agreed. The Second Letter of Understanding was delayed in entering into force for one year, and during this period, OSM's situation worsened. As a result, OSM asked the Province to revise the tariffs. The Province recognized a tariff increase of 51.91%, but this was insufficient to bring OSM to a stable financial situation. Informed of a potential collapse in the sewage system, in August 2009, the Province issued a decree requiring the continuity of the service for 180 days, which was subsequently renewed for an additional 180 days. On July 12, 2010, the Province unilaterally terminated the Concession Contract due to Sauri's alleged fault. At the same time, the Technical Assistance Contract was automatically terminated.

One month after the Concession Contract was terminated, the Province reverted the concession to a new publicly owned company, and in October 2010, OSM's shareholders voted to dissolve the company.

The ICSID arbitration proceedings were reopened when Respondent failed to comply with the Second Letter of Understanding. Claimant alleged that Respondent had violated its legitimate expectations and failed to

comply with the obligation to provide transparent and impartial measures, amounting to a violation of the fair and equitable treatment standard. Moreover, Claimant alleged that Respondent had engaged in a process of "creeping" expropriation that culminated with the Province's termination of the Concession Contract.

In a prior Decision on Liability, the Tribunal found that Sauri was expropriated when the Province issued the decree for reestablishing the continuity of the service and the Concession and Technical Assistance Contracts were terminated. It also held that Respondent violated the fair and equitable treatment standard when it postponed the entry into force of the Second Letter of Understanding, bringing OSM to a severe financial situation as well as worsening the collapse of the potable water service.

Damages Claim:
Claimant asked the Tribunal to award damages for direct expropriation deriving from the measures adopted by the Province and for the violation of the fair and equitable treatment standard resulting from the delayed entry into force of the Second Letter of Understanding. As to quantum, Claimant argued that the expropriation had to be compensated in an amount equal to the value of its equity investments in OSM and the Technical Assistance Contract. Claimant had initially claimed damages of US$143.9 million, equal to twice the amount of its initial investment. In light of the Decision on Liability, however, Claimant conceded that compensation should be calculated starting from the date on which the Second Letter of Understanding was to enter into force (i.e., September 17, 2007). This resulted in Claimant reducing its claim to US$40.255 million.

continued on Page 8

continued from Page 7

Equity Investment Damages:
Claimant proposed to calculate the value of the loss in its equity investment assuming the Province complied with its obligations in the Second Letter of Understanding. For that purpose, it calculated a discounted cash flow (DCF) valuation as of September 7, 2007, until the original termination date of the Concession Contract in 2023. Argentina, in turn, suggested that damages for each of Claimant's successful claims of breach (i.e., fair and equitable treatment and expropriation) should be calculated separately, and that there should be no compensation for expropriation because the Concession was worthless by August 2009.

The Tribunal rejected Argentina's arguments and essentially accepted Claimant's damages valuation model. The Tribunal held that damages for both breaches should be treated together, on the grounds that the fair and equitable treatment violation in September 2007 affected the value of the Concession as of the date of effective taking in August 2009. The Tribunal also accepted the 6% discount rate in Claimant's DCF model, on the grounds that, despite being a low rate by Argentine standards, the parties had agreed to it in the Second Letter of Understanding as Claimant's expected rate of return.

The Tribunal held that damages for both breaches should be treated together, on the grounds that the fair and equitable treatment violation in September 2007 affected the value of the Concession as of the date of effective taking in August 2009.

The Tribunal also addressed another of Argentina's arguments, namely, that there was a risk that Sauri could obtain a double compensation due to the parallel proceedings pending before the Argentine courts for the termination of the Concession Contract. The Tribunal acknowledged the risk in principle but held that since it was issuing its award first, the problem should be addressed in the local court proceedings. In sum, the Tribunal determined that the value of Claimant's equity investment in OSM on September 17, 2007, was equivalent to US$20,643,021 (this amount was slightly below the amount claimed by Sauri because of a very small difference in the rate of conversion from AR$ to US$).

Technical Assistance Contract Damages:
The Tribunal found that it had jurisdiction to award this head of damages due to a causal link between Sauri's claims under the BIT and the Technical Assistance Contract. The Tribunal agreed with Claimant that the postponement of the Second Letter of Understanding impeded the increase of OSM's tariffs, resulting in a great loss for Sauri because the revenues from the Technical Assistance Contract were calculated as a percentage of OSM's billings.

The Tribunal also awarded damages for this head until the end of the Concession's term in 2023, despite the fact that the Technical Assistance Contract only had a term of five years. The Tribunal noted that the contract would automatically extend for successive five-year terms absent either party's objection, and concluded that in a "but for" world neither party would have had a reason not to extend the contract until 2023.

Accordingly, the Tribunal accepted in full Claimant's calculation of US$19,347,090, subject only to the same slight adjustment in the rate of conversion from AR$ to US$.

Costs:
The Tribunal determined that Respondent had to bear the procedural costs because Sauri won on all claims. It ordered Argentina to pay US$685,000, also taking into account that the proceedings lasted more than 10 years. In addition, it condemned Respondent to pay all the Claimant's legal and accounting fees, which amounted to €1.486,975,13.

Interest:
The Tribunal awarded pre- and post-Award interest at the rate of 6%, compounded annually, again reasoning that this was the rate of return agreed upon in the Second Letter of Understanding.

Hulley Enterprises Limited (Cyprus) v. Russian Federation; Yukos Universal Limited (Isle of Man) v. Russian Federation; Veteran Petroleum Limited (Cyprus) v. Russian Federation (PCA Case No. AA226)

Date of the Award:
July 18, 2014

Claimants:
Hulley Enterprises Ltd., Yukos Universal Ltd., and Veteran Petroleum Ltd.

Respondent:
The Russian Federation

Members of the Tribunal:
Yves Fortier (President), Charles Poncet, Judge Stephen Schwebel

Sector:
Hydrocarbons production, refining, and distribution

Applicable Treaty:
Energy Charter Treaty ("ECT")

Background:
The dispute arose out of a tax audit and reassessment imposed on Yukos by the Russian tax authorities in 2003. In 2004, the Russian government ordered Yukos immediately to pay US$24 billion in back taxes after re-attributing the profits of Yukos's foreign trading companies to Yukos itself and refusing at the same time to allow the company to claim any VAT exemptions or refunds. The Russian government then moved to seize and sell Yukos's largest oil-producing division, Yuganskeneftegaz, to a shell corporation controlled by Russia's State-owned oil company, Rosneft, for less than US$10 million, even though Yuganskeneftegaz was reportedly worth billions at that time.

One year after the auction of Yuganskeneftegaz, the Russian government forced Yukos into bankruptcy and auctioned off its remaining assets, a majority of which went to Rosneft. At the same time, the Russian authorities summarily tried Mikhail Khodorkovsky (the CEO and majority owner of Yukos) and Platon Lebedev (another Yukos executive) and sentenced them to a decade in jail in a remote Siberian labor camp.

Yukos Universal (a company from the Isle of Mann), Hulley Enterprises, and Veteran Petroleum (the latter two Cypriot corporations) — which collectively owned a 70% shareholding in Yukos — commenced an arbitration under the ECT, seeking compensation for the expropriation of their interests in Yukos as a result of Russia's actions.

Findings on Jurisdiction and Liability:
In an Interim Award on Jurisdiction and Admissibility dated November 30, 2009, the Tribunal ruled that Russia was bound by the ECT, notwithstanding that the Russian parliament had never ratified it, by virtue of the ECT's provisional application mechanism. In a Final Award dated July 18, 2014, the Tribunal rejected Russia's remaining preliminary objections that had been joined to the merits, namely, that Claimants had not come to the Tribunal with "clean hands" and that the ECT's tax carve-out should preclude their claim. The Tribunal also determined that Rosneft's actions were attributable to Russia.

On the merits of the case, the Tribunal concluded that Russia's actions "have had an effect 'equivalent to nationalization or expropriation'" and met none of the conditions under the ECT for the expropriation to be lawful. Having thus found that Russia's actions amounted to an unlawful expropriation, the Tribunal considered it unnecessary to decide whether or not Russia had also breached its obligation to afford fair and equitable treatment to Claimants under the ECT.

Valuation Date:
Claimants argued that they should be compensated the higher of the valuation of damages as of the date of the breach or the date of the Award. For that purpose, they asserted that the date of the expropriation of their investment was November 21, 2007, the date on which Yukos was struck off the Russian register of legal entities.

continued on Page 10

Recent Damages Awards

continued from Page 9

Russia counter-argued that "the valuation date should be when the purported substantial deprivation of the investor's investment has occurred." While Russia did not propose any specific alternative date when Claimants lost control of their investments, its expert on damages suggested at the hearing that such a date would, in any event, have to be before the end of 2004.

The Tribunal agreed with Russia that the date of November 21, 2007, could not be the date of Yukos's expropriation because it was clear that a substantial and irreversible deprivation of Claimants' assets occurred on December 19, 2004, the date of the Yuganskeneftegaz auction.

The Tribunal thus determined the date of expropriation to be December 19, 2004. The Tribunal also held that Claimants were entitled to select either the date of expropriation or the date of the Award as the date of valuation. For purposes of its calculations, the Tribunal determined the date of the Award to be June 30, 2014.

Quantum of Damages:
Claimants requested that Russia be ordered to pay compensation in an amount it estimated at no less than US$114.174 billion. Claimants argued that their damages should be primarily calculated using a discounted cash flow (DCF) method and a comparable-transactions analysis.

Russia did not put forward a methodology for valuing Yukos or any valuation figures of its own. Russia's expert did, however, provide a "corrected" version of Claimants' comparable-companies analysis, making adjustments for what he considered to be the principal errors and reaching a "corrected" value in the amount of US$67.862 billion.

The Tribunal found that neither of the primary valuation methods put forward by Claimants could be sufficiently reliable to ground a determination of damages for this case. Generally, the Tribunal expressed limited confidence in the damages analysis conducted by Claimants' damages experts. By contrast, the Tribunal expressed a measure of confidence in Russia's expert's comparable-companies analysis.

Basing its analysis on the comparable-companies method, the Tribunal concluded that the total amount of Claimants' damages based on a valuation date of December 19, 2004 was US$22 billion, whereas the total amount of their damages based on a valuation date of June 30, 2014 would be US$66.7 billion. Since the Tribunal had concluded that Claimants were entitled to the higher of these two amounts, it awarded damages in the amount of the US$66.7 billion prior to applying a 25% deduction reflecting Claimants' contributory fault.

In that respect, the Tribunal concluded that Yukos's conduct in certain low-tax regions in Russia, and its utilization of the Cyprus-Russia Double Taxation Agreement, had contributed to its shareholders' injury by making the company vulnerable to Russian tax audits. On that basis, the Tribunal reduced the amount of damages owed to Claimants by 25% — from US$66.7 billion to US$50 billion.

Post-Award Interest:
Claimants requested Post-Award interest at the rate of LIBOR plus 4% compounded annually from the date of the Award until the date of full payment. Russia argued that Claimants were not entitled to any post-award interest.

The Tribunal granted Russia a 180-day grace period (i.e., until January 15, 2015) to pay the Award. After that date, the Tribunal held that post-award interest would compound annually at a rate equal to the yield on 10-year US Treasury bonds as of the dates of compounding.

Costs:
The case is noticeable for the magnitude of the arbitration costs and attorneys' fees. Claimants' attorneys' and experts' fees and expenses amounted to US$81.5 million, while Russia spent US$31.5 million on its defense. The arbitration costs themselves came to more than US$11 million, including US$1.3 million for the fees of the Assistant to the Tribunal, and US$1.2 million charged by the Permanent Court of Arbitration for its administrative services.

Noting that some of the fees and expenses claimed by Claimants appeared excessive, the Tribunal ordered Russia to pay only around 75% of those costs, or US$60 million. The Tribunal also ordered Russia to pay the entirety of the arbitration costs of US$11.3 million. ✦

King & Spalding's International Arbitration Group
Who We Are

King & Spalding's International Arbitration practice has been ranked among the best in the world by *Chambers Global*, *Global Arbitration Review*, *The Legal 500*, and the *American Lawyer's Focus Europe*, among others. *Chambers USA* has called King & Spalding "one of arbitration's biggest success stories."

We are world leaders in both investment and international commercial arbitration. In 2015 *Chambers Global* ranked King & Spalding as one of four firms in Band 1 for international arbitration, highlighting the Firm's "stellar reputation" and noting that "what makes them great lawyers is that they understand arbitration … and the limits of what can and cannot be advanced." Similarly in 2015, *Global Arbitration Review* recognized King & Spalding's international arbitration group as one of the top five international arbitration practices in the world emphasizing that the Firm has "built its name on results."

King & Spalding's International Arbitration Group includes Guillermo Aguilar-Alvarez, Roberto Aguirre Luzi, James Berger, Doak Bishop, John Bowman, Henry Burnett, James Castello, Nicholas Cherryman, Adrian Cole, Charles Correll, Egishe Dzhazoyan, Ken Fleuriet, Staurt Isaacs, Ed Kehoe, Craig Miles, Caline Mouawad, Jane Player, Jennifer Price, John Savage, Jan Schäfer, Eric Schwartz, Reggie Smith, Tom Sprange, Margrete Stevens, and Sarah Walker among others. Our team has more than 80 members in our Abu Dhabi, Atlanta, Dubai, Frankfurt, Houston, London, Moscow, New York, Paris, San Francisco, Singapore, and Washington, D.C., offices. The group includes lawyers who are natives of several different countries and regions and who have been educated in different legal traditions. King & Spalding's International Arbitration Group presents a culturally and educationally diverse group of lawyers, which greatly contributes to their proven ability to understand and address the intricacies of international disputes.

Members of the group have handled arbitrations under the rules of the ICSID, the International Chamber of Commerce International Court of Arbitration (ICC), the Inter-American Commercial Arbitration Commission (IACAC), the American Arbitration Association (AAA) and its International Centre for Dispute Resolution (ICDR), the China International Economic and Trade Arbitration Commission (CIETAC), the Dutch Arbitration Institution (NAI), the German Institution of Arbitration (DIS), the London Court of International Arbitration (LCIA), the Stockholm Chamber of Commerce (SCC), the Singapore International Arbitration Center (SIAC), the Vienna International Arbitral Centre (VIAC), the World Intellectual Property Organization (WIPO), the United Nations Commission for International Trade Law (UNCITRAL), the Zurich Chamber of Commerce (Swiss Rules), and the Iran-US Claims Tribunal, among others.

King & Spalding's International Arbitration practice offers demonstrated experience, deep knowledge, recognized leadership, wide diversity, and a long-established determination to offer the best representation possible. It is "one of arbitration's biggest success stories" not only for itself, but also for its clients.

Quantum Quarterly Editors


Craig S. Miles
+1 713 751 3259
cmiles@kslaw.com


Silvia Marchili
+1 713 276 7320
smarchili@kslaw.com

Quantum Quarterly Contributors


Louis-Alexis Bret
+1 212 556 2283
lbret@kslaw.com


Cedric Soule
+33 1 7300 3931
csoule@kslaw.com


Camilla Gambarini
+1 713 751 3200
cgambarini@kslaw.com

King & Spalding's International Arbitration Group Contacts

Abu Dhabi


Adrian Cole
acole@kslaw.com

Atlanta


Brian White
bwhite@kslaw.com

Dubai


Raza Mithani
rmithani@kslaw.com

Houston


Roberto Aguirre Luzi
raguirreluzi@kslaw.com


Doak Bishop
dbishop@kslaw.com


John Bowman
jbowman@kslaw.com


Wade Coriell
wcoriell@kslaw.com


Silvia Marchili
smarchili@kslaw.com


Craig Miles
cmiles@kslaw.com


Kevin Mohr
kmohr@kslaw.com


Jennifer Price
jprice@kslaw.com


Reggie Smith
rsmith@kslaw.com

Frankfurt


Jan Schäfer
jschaefer@kslaw.com

London


Ruth Byrne
rbyrne@kslaw.com


Nicholas Cherryman
ncherryman@kslaw.com


Egishe Dzhazoyan
edzhazoyan@kslaw.com


Stuart Isaacs
sisaacsqc@kslaw.com


Jane Player
jplayer@kslaw.com

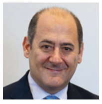

Tom Sprange
tsprange@kslaw.com


Sarah Walker
swalker@kslaw.com

Moscow


Ilia Rachkov
irachkov@kslaw.com

New York


Guillermo Aguilar-Alvarez
gaguilar@kslaw.com


James Berger
jberger@kslaw.com


Henry Burnett
hburnett@kslaw.com


Ed Kehoe
ekehoe@kslaw.com


Caline Mouawad
cmouawad@kslaw.com


Eric Schwartz
eschwartz@kslaw.com

Paris


Joël Alquezar
jalquezar@kslaw.com


Vanessa Benichou
vbenichou@kslaw.com


James Castello
jcastello@kslaw.com


Ken Fleuriet
kfleuriet@kslaw.com


Joëlle Herschtel
jherschtel@kslaw.com

San Francisco


Charles Correll
ccorrell@kslaw.com

Washington, D.C.


Margrete Stevens
mstevens@kslaw.com

Singapore


Elodie Dulac
edulac@kslaw.com


Simon Dunbar
sdunbar@kslaw.com


John Savage
jsavage@kslaw.com

King & Spalding is an international law firm with more than 800 lawyers in Abu Dhabi, Atlanta, Austin, Charlotte, Dubai, Frankfurt, Geneva, Houston, London, New York, Paris, Riyadh (affiliated office), San Francisco, Silicon Valley, Singapore and Washington, D.C. The firm represents half of the Fortune 100 and in Corporate Counsel surveys consistently has been among the top firms representing Fortune 250 companies. For additional information, visit www.kslaw.com.