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International Arbitration Case Law

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HULLEY ENTERPRISES LIMITED (CYPRUS)
V.
THE RUSSIAN FEDERATION
(PCA CASE NO. AA226)

FINAL AWARD

Case Report by Margie-Lys Jaime **
Edited by Ignacio Torterola***

In its Award of 18 July 2014, the Tribunal found the Russian Federation liable in three arbitration cases under the UNCITRAL Arbitration Rules (PCA Case Nos. AA226 —Hulley, AA227 —Yukos Universal Limited, and AA228 —Veteran Petroleum Limited) for breach of its obligations under Article 13(1) (Expropriation) of the Energy Charter Treaty. The Tribunal awarded Claimants with over US$ 50 billion in damages, the largest amount awarded in the history of investment arbitration to date.

Main Issues:	jurisdiction – fork in the road provision; jurisdiction – legality requirement; jurisdiction – taxation exclusion; treaty obligations – fair and equitable treatment; treaty obligations – tantamount to expropriation; contributory fault; interest and quantification of damages; costs.
Tribunal:	Hon. L. Yves Fortier PC CC OQ QC (Chairman), Dr. Charles Poncet and, Judge Stephen M. Schwebel.
Claimant's counsel:	Professor Emmanuel Gaillard, Dr. Yas Banifatemi, and Ms. Jennifer Younan of Shearman & Sterling LLP.
Defendant's Counsel:	Dr. Claudia Annacker, Mr. Lawrence B. Friedman, Mr. David G. Sabel, Mr. Matthew D. Slater, Mr. William B. McGurn, Mr. J. Cameron Murphy of Cleary Gottlieb Steen and Hamilton LLP; and, Mr. Michael S. Goldberg, Mr. Jay L. Alexander, Dr. Johannes Koepp, Mr. Alejandro A. Escobar of Baker Botts LLP.

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Digest

1. Facts and Procedural History of the Case

After the collapse of the Soviet Union, Yukos was incorporated as a joint stock company in 1993 by Presidential Decree. By 2002, Yukos integrated group became the largest oil company in Russia, with main production subsidiaries in Yuganskneftegaz (YNG), Samaraneftegaz, and, from 1997, Tomskneft.

Pursuant to the low-tax region program established in the 1990s in Russia to foster economic development, Yukos group (which controlling shareholders were OAO Yukos Oil Company, Hulley Enterprises Limited (Cyprus), Yukos Universal Limited (Isle of Man) and Veteran Petroleum Limited (Cyprus), collectively the Claimants in the arbitration), was allowed to exempt from the portion of the federal corporate profit that was payable to its budged. However, in 2002 these exemptions were revoked at the Closed Administrative Territorial Units, known as ZATOs. From 1 July 2002 until 31 December 2003, tax benefits in other low-tax regions were significantly reduced and as of 1 January 2004, the existing tax investment agreements were terminated.

Starting in July 2003, the Russian Federation initiated a series of criminal investigations against Yukos management, on charges including embezzlement and fraud, forgery, money laundry, and tax evasion, crowning in the arrestment and conviction of several key Yukos officers. Furthermore, other measures against Yukos and associated companies were taken, including massive tax reassessments, VAT charges, fines, asset freezes, which ended in the forced sale of Yukos' core oil production subsidiary (YNG) on 19 December 2004, the bankruptcy of Yukos in 2006 and finally, the struck off the Russian register of legal entities on 21 December 2007.

On 2 November 2004, Claimants delivered to the President of Russia notifications of claims, alleging violation of its obligation under the Energy Charter Treaty (ECT). Having failed to settle their disputes amicable, Claimants initiated arbitration proceedings against Respondent pursuant to the ECT and the Arbitration Rules of the United Nations Commission on International Trade Law of 1976 (UNCITRAL Rules), seeking damages in excess of US$ 114 billion. Claimants alleged that Respondent failed to treat their investments in Yukos in fair and equitable manner in breach of Article 10(1) of the ECT, and that Respondent expropriated Claimants' investments in breach of Article 13(1) of the ECT.

On 30 November 2009, the Tribunal rendered Interim Awards on jurisdiction and/or admissibility in the arbitration proceedings submitted by Claimants (PCA

Case Nos. AA226 —Hulley, AA227 —Yukos Universal Limited, and AA228 — Veteran Petroleum Limited), dismissing Respondent objections based on, *inter alia,* the definition of investment and investor, the fork-in-the-road exception, and the denial of benefits clause. Tribunal held it had jurisdiction over the Russian Federation, deferring its decision on the objection based on Claimant's alleged "unclean hands" theory and on Article 21 of the ECT (taxation exclusion) to the merits phase.

2. *Legal Issues Discussed in the Award*

(a) Jurisdiction

(i) Were claims barred by the "Fork-in-the-Road" provision of the ECT?

On 20 September 2011, the European Court of Human Rights (ECtHR) issued a judgment in *OAO Neftyanaya Kompaniya Yukos* v. *Russia*, rejecting that Respondent's taxation measures against Yukos were *mala fides*. The question presented before the Tribunal was whether Claimants' claims were barred by Article 26(3)(b)(i) of the ECT containing a fork-in-the-road provision. The Tribunal recalled its dismissal in the Interim Awards of Respondent's identical objection based on the "triple identity" test (¶ 1257), and dismissed the objection, not finding any reasons to reopen the issue. (¶ 1272).

(ii) Did Claimants act illegally so as to deprive them of the ECT protection?

Respondent moves forward its arguments based on Claimants' alleged "unclean hands", which would have, according to the Respondent, the effect of rendering Claimants' claims inadmissible and denying them the substantive protections of the ECT. Notwithstanding Respondent's arguments, the Tribunal concluded that the clean hands doctrine does not operate to deprive the Tribunal of its jurisdiction, render inadmissible any of the Claimants' claims or otherwise bar Claimants' from invoking the substantive protection of the ECT (¶ 1373). However, the Tribunal was from the view that Claimants' conduct had an impact on the Tribunal's assessment of liability and damages. (¶¶ 1633-1637).

(iii) The Taxation Carve-Out (Article 21(1) of the ECT)

While Respondent argued that the Tribunal lacked jurisdiction over claims with respect to taxation measures, Claimants contended that Article 21 carve-out does not apply to actions carried out "under the guise of taxation" and therefore, the claw-back provision in Article 21(5) applies to the expropriation standard under Article 13 of the ECT. Furthermore, Respondent argued that if the Tribunal were to find that both provisions apply, the Tribunal would be required to referral the case to the competent tax authorities.

The Tribunal dismissed Respondent's objection convinced that the referral mechanism in the claw-back provision would have been futile under the circumstances of the case. (¶¶ 1423-1424). Ultimately, the Tribunal considered that Article 21(1) only applies to *bona fide* taxation measures and not to the case at issue; therefore, it concluded that the Tribunal was entitle to consider the measures under both Articles 10 and 13 of the ECT. (¶¶ 1444, 1446).

(b) Merits

(i) Fair and Equitable Treatment (FET —Article 10(1) of the ECT)

Claimants' main argument was that Respondent's actions constituted a breach of the standard of due process and a denial of justice, which according to them are encompassed in the FET obligations under Article 10(1) of the ECT. In particular, Claimants pointed out the arbitrariness of Russian courts regarding the tax reassessment payment demands. Respondent, on the other hand, was from the position that Claimants have failed to establish that Respondent's conduct was the proximate cause of the loss of Claimant's investment, and that in any event, the challenged measures were an exercise of its sovereign power and not discriminatory. At the end, the Tribunal stated that it was unnecessary to decide on the alleged breach of the FET standard, under the basis of Respondent liability for breach of Article 13 (expropriation). (¶¶ 1449, 1585).

(ii) Expropriation

Most of the divergence between the Parties' positions concerned the legitimate expectations that Yukos had or could have had when implementing its tax optimization schema. In the view of the Tribunal, Claimants' expectations should have been that tax avoidance operations risked adverse reaction from Russian authorities. (¶ 1578).

However, the Tribunal found Respondent liable for breach of treaty due to the unlawful measures taken by the Russian Federation, which did not have the objective of collecting taxes but rather having an effect equivalent to expropriation. In this sense, the Tribunal considered that most of the conditions specified in Article 13(1) were not met. In particular, the Tribunal highlighted the harsh treatment accorded to Yukos' key officers and the lack of due process engaged by the Russian courts. (¶¶ 1579, 1581-1585).

(iii) Contributory Fault

The legal principle of contributory fault was invoked by Respondent in the sense that it would deprive Claimants from the benefits of the ECT. The Tribunal rejected Respondent's interpretation and considered that Claimants' conduct were not material to the subsequent events. In particular, the Tribunal remarked that Yukos' tax avoidance arrangements in some low-tax region did not justify

the disproportionate and tantamount to expropriation of Claimants' investment. (¶¶ 1633-1635). Finally, the Tribunal decided to apportion the responsibility among the Parties (25 percent for Claimants and 75 percent for Respondent), taking into account the circumstances of the case. (¶ 1637).

(c) Damages and Interests

The Tribunal stated that in the case of an unlawful expropriation, Claimants were entitled to interest in order to ensure full reparation. (¶ 1677). After analyzing all possible approaches, the Tribunal decided to award Claimants interest on a rate based on ten-year U.S. Treasury bond rates over the period from 1 January 2005 to 30 May 2014. The Tribunal distinguished between pre-award and post-award interests, ruling that Claimants should be awarded with a simple pre-award interest and with a compounded post-award interest (¶¶ 1685-1689).

Moreover, the Tribunal held that Claimants were entitled to select between the date of the expropriation and the date of the award for the date of the valuation, whichever sets the higher amount. In this sense, the Tribunal determined the expropriation date as 19 December 2004 (YNG auction), and not 21 November 2007 (Yukos struck off the Russian register of legal entities), previously claimed to be the expropriation date. (¶ 1762). Regarding the valuation methods, the Tribunal was not convinced by the primary methods presented by Claimants, in particular the Discount Cash Flow method, and considered that the comparable companies' method according to the RTS Oil and Gas index was the most appropriate means of determining Yukos' value.

As a consequence of the Tribunal's decision on Claimant's contribution to their own prejudice, the amount of damages was reduced by 25 percent to approximately US$ 50 billion. (¶ 1827). Respondent was awarded with a period of grace of 180 days (15 January 2015), in which the compound post-award interest is not computed.

(d) Costs

The Tribunal concluded that Respondent shall cover the costs of arbitration, which were approximately over US$ 11 million. (¶ 1869). Regarding the allocation of costs for legal representation and assistance of the Parties, the Tribunal considered that the egregious nature of the measures taken by Respondent in breach of the ECT entitled Claimants with a part of their costs and ordered the reimbursement of US$ 60 million, approximately 75 percent of Claimants' total costs. (¶ 1888).

3. Decision

The Arbitral Tribunal unanimously:

"(a) DISMISSES the objections to jurisdiction and/or admissibility, based on Article 21 of the Energy Charter Treaty;
(b) DISMISSES the objections to jurisdiction and/or admissibility, pertaining to Respondent's contentions concerning "unclean hands" and "illegal and bad faith conduct";
(c) DISMISSES the renewed objections to jurisdiction and/or admissibility based on Article 26(3)(b)(i) of the Energy Charter Treaty;
(d) HOLDS that the present dispute is admissible and within the Tribunal's jurisdiction;
(e) DECLARES that Respondent has breached its obligations under Article 13(1) of the Energy Charter Treaty;
(f) ORDERS Respondent to pay to Claimant Hulley Enterprises Limited damages in the amount of USD 39,971,834,360;
(g) ORDERS Respondent to pay the amount of EUR 3,388,197 to Claimant Hulley Enterprises Limited as reimbursement for the costs of the arbitration;
(h) ORDERS Respondent to pay the amount of USD 47,946,190 to Claimant Hulley Enterprises Limited for a portion of the costs of its legal representation and assistance in the arbitration proceedings; and
(i) ORDERS Respondent to pay to Claimant Hulley Enterprises Limited, if within 180 days of the issuance of this Award Respondent fails to pay in full the amounts set forth in paragraphs (f), (g) and (h) above, post-award interest on any outstanding amount starting from 15 January 2015, compounded annually. Post-award interest shall be determined as the yield on 10-year U.S. treasury bonds as of 15 January 2015 and then the dates of compounding yearly thereafter."