LIABILITY: IN YUKOS ARBITRATION, TRIBUNAL DWELLS ON DISPROPORTIONATE NATURE OF MEASURES, AND SEES NO NEED TO LOOK AT FET CLAIM

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(Editor's Note: This is article 2 in a three-part series examining in detail the recent awards rendered in a trio of arbitrations by majority shareholders of the Yukos oil company against the Russian Federation. Article 1 discusses certain jurisdictional issues and is available here. Article 3 discusses the damages valuations and is available here.)

Turning to examine Russia's liability for breaches of the Energy Charter Treaty in its July 18, 2014 arbitral award, the tribunal in a trio of related cases by Yukos shareholders devoted nearly half of their 600 page awards to factual analysis.

Those factual findings have been widely reported elsewhere in the extensive mainstream media focus on this case. In essence, the tribunal considered that Russia engaged in a calculated effort to destroy Yukos in the guise of tax collection. The state’s failure to respond meaningfully to Yukos’ settlement proposals raised “significant doubt” for the tribunal as to whether Russia truly intended to collect the taxes. The subsequent auction of Yukos’s main production asset, Yuganskneftegaz (YNG), was found to be rigged, and the later bankruptcy proceedings were the “final act of destruction” by the Russian state. Yukos officials were intimidated and harassed as part of a campaign to remove Mikhail Khodorkovsky as a political opponent.

Arbitrators in all three cases were Yves Fortier, Stephen Schwebel and Charles Poncet.

Legitimate expectations and proportionality appear as central elements of tribunal’s indirect expropriation analysis

Notably, after the tribunal’s extensive review of the factual background and witness testimony, together with its 300 pages of factual analysis and findings, the tribunal’s ultimate analysis and findings on Russia’s liability under the ECT amounted to a simple three pages.

On the question of indirect expropriation, the tribunal appeared to place the concepts of legitimate expectations and proportionality as central elements of its inquiry. The tribunal began by reviewing the propriety of Yukos’ own conduct. It noted that the company had doubts about the legality of its operations in the low-tax regions, and that its failure to obtain prior legal advice on these operations was “striking and may be suggestive”. The tribunal found no convincing explanation for certain “immense payments” to former employees, nor for some restructuring undertaken by Yukos “which may well have been carried out to frustrate investigation of perceived tax improprieties”.

In light of this, the tribunal found that Yukos should have expected some adverse reaction from
Russian authorities, potentially including tax investigation and enforcement measures.

However, the tribunal considered, Russia’s eventual response went beyond the company’s expectations, demonstrating that “the primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its valuable assets”. In particular, Yukos could not have expected the sale of YNG at such a low price “under questionable circumstances”. Similarly, the company could not have expected a VAT charge of $13 billion on oil that was exported and so should not have had any VAT charged at all. Without these two key events, the tribunal held, Yukos would have been able to pay the tax claims “justified or not”, and it would not have been bankrupted and liquidated.

(Editor's Note: the tribunal's desire for a "proportionate" response by states to investor misbehaviour, and the tribunal's subsequent decision to reduce damages awarded to the claimants due to their own culpability, are both reminiscent of the approach taken in the recent Occidental v. Ecuador award at ICSID, where arbitrator Yves Fortier also chaired the proceedings.)

Expropriation found unlawful: no public interest or due process

The tribunal then turned to determine whether the indirect expropriation was lawful, under the four criteria set out in the ECT.

Russia had argued that all its measures were in the public interest and “in accordance with international and comparable standards”. Indeed, Russia cited the finding of the European Court of Human Rights that the measures were in themselves legitimate exercises of regulatory power, with no evidence of political motivation. Russia argued that this finding “must be taken into account under Article 31(3)(c) VCLT in assessing whether [the measures] are within the bounds of generally recognized regulatory powers”.

However, the tribunal held that, while the expropriation was in the interests of Rosneft through its acquisition of YNG, it was “profoundly questionable” whether it was in the interests of the Russian “economy, polity and population”.

Similarly, the tribunal found no due process of law in Russia’s actions. Indeed, “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”. (Elsewhere in the award, the tribunal noted the widespread criticism, including by the European Court of Human Rights, of Mr Khodorkovsky’s arrest, trial and imprisonment.)

The lack of compensation from Russia, a further requirement for legality, was “incontestable”. As for discrimination, Russia contended that the relevant discrimination must be based on nationality to violate the ECT, rather than the alleged selective enforcement of laws. Given its views on the other criteria for lawful expropriation, the tribunal saw no need to rule on discrimination.

In light of the tribunal’s finding of unlawful expropriation, then, it was held unnecessary to decide on any breach of the ECT’s fair and equitable treatment guarantee.

In a companion article, we discuss the tribunal's approach to valuing damages.

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