DAMAGES: IN YUKOS ARBITRATION, ECT TRIBUNAL REJECTED DCF VALUATION, AND OPTS FOR "COMPARABLE COMPANIES" METHOD

By Jarrod Hepburn

(Editor's Note: This is article 3 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 2 discusses the liability holdings and is available here.)

After finding Russia liable for an expropriation of the investments of a trio of related investors in the now-defunct Yukos oil company, arbitrators in a new ruling under the Energy Charter Treaty turned to assess the damages owing.

As we reported in our original breaking news article on the July 18 2014 award, the tribunal awarded damages exceeding $50 billion US.* Below, we discuss in detail the tribunal's approach to damages valuation.

Tribunal grants compensation based on valuation at date of award, found to be higher than valuation on expropriation date

When it came to assessing compensation, the claimants had argued that they should be entitled to compensation calculated either on the date of expropriation – said to be November 21, 2007, the date that Yukos was struck off the register in Russia – or on the date of the award, whichever amount was higher.

The tribunal observed that, while the ECT specified the date of a taking as the proper valuation date, this was only relevant to lawful expropriations and did not necessarily apply to an unlawful expropriation. Thus, compensation should be assessed from whichever date was more favourable to the claimants.

However, the tribunal disagreed that the expropriation occurred in 2007. In its view, the “substantial and irreversible deprivation” arose on December 19, 2004, the date of the YNG auction.

The tribunal then proceeded to calculate the damages based on each valuation date (i.e. the date of taking and the date of the award) to determine which was higher. This was done under two main heads of loss: the value of Yukos shares on each date, and the value of unpaid dividends that the Yukos shareholders should have received up until each valuation date.

As a preliminary matter, the tribunal rejected two other potentially relevant features of the compensation analysis. Firstly, while the claimants had argued that they had a 70% chance of a
successful listing on the NYSE, leading to an increased valuation, the tribunal ruled that this was too uncertain to take into account. Secondly, the tribunal dismissed a suggestion that the positive effects of a planned merger between Yukos and Sibneft should be considered, stating that it was not convinced that Sibneft would actually have proceeded with the merger given Yukos’ situation at the time.

**Expert’s DCF model is rejected**

For the share valuation, the claimants’ expert had put forward three main valuation methods – a DCF model, the ‘comparable companies’ method, and the ‘comparable transactions’ method. These all valued Yukos at around US$90 billion on the claimants’ chosen date of 21 November 2007.

Notably, however, the tribunal rejected the DCF model, observing that the claimant’s expert had conceded at the hearing that the model was “influenced by his own pre-determined notions as to what would be an appropriate result”. The ‘comparable transactions’ method was also dismissed by the tribunal, finding that there were no comparable transactions to ground the valuation.

The tribunal thus relied on the ‘comparable companies’ approach. However, it accepted Russia’s expert’s corrections to the claimants’ proposed figure under this approach, based on the finding that the claimant’s side had weighted Rosneft, a company with very different “market metrics”, too strongly in the analysis. Instead of the claimants’ $92.9 billion, this gave a figure of $61.07 billion for Yukos’ value in 2007.

The next step was to adjust this figure, using the Moscow Stock Exchange’s RTS Oil and Gas Index, for each of the valuation dates. This gave $21.1 billion for the valuation on 19 December 2004, and $42.6 billion as at 30 June 2014 (the tribunal’s deemed date of the award).

**Lost dividends valued separately from shares**

The inclusion of a separate head for dividends was justified by the tribunal in finding that, while the value of Yukos shares on each date captured the expected future profits of the company, it did not capture the lost past profit that should have accrued, in the form of dividends.

Starting from the figures of lost cash flows in the claimants’ expert reports, the tribunal then observed that these cash flows formed part of the expert’s DCF valuation of Yukos, which had already been “convincingly criticized” by Russia’s expert. For instance, the tribunal said, the DCF model had ignored some of Yukos’ costs and had overestimated others. In addition, the model valued Yukos partly based on the actual results of Rosneft – but this ignored that Rosneft was a state-owned enterprise, which could avoid many business risks such as tax increases.

Furthermore, the tribunal found, the claimants had set up complex offshore structures – unknown even to Yukos President Steven Theede – to divert Yukos profits out of Russia, escaping both Russian tax authorities and claims on the profits by minority shareholders. The tribunal could “not exclude the possibility” that the claimants would have continued this practice, thus decreasing the formal dividends paid by the company.

Ultimately, the tribunal settled on discretionary, round numbers representing the dividends lost each year from 2004 to 2014. For the 2004 valuation date, a figure of $2.5 billion in unpaid dividends was set, while for the 2014 valuation date, the additional nine years of dividends produced a figure of $45 billion.

**Russia pleads failure to mitigate and windfall profits, but tribunal is unmoved**
An additional argument on quantum related to mitigation of losses. While Russia contended that Yukos should have mitigated its losses simply by paying the taxes assessed in early 2004, the claimants retorted that they could not be blamed for resisting Russia’s “extortion”. For its part, the tribunal considered that payment would have changed little, since Russia was set on destroying Yukos. In these circumstances, the tribunal held, the non-payment of tax did not amount to a failure to mitigate.

Meanwhile, Russia had also argued that any compensation paid to the claimants would be a windfall given that they had already earned an unreasonable return from Yukos due to their tax evasion and asset-stripping. The tribunal, however, agreed with the claimants that any prior benefits were not relevant to valuation; the objective was merely to compensate the claimants for the loss suffered due to Russia’s ECT breaches.

**Simple interest awarded on unpaid dividends using ‘investment alternatives’ approach**

In determining the interest due to the claimants, the tribunal reviewed four possible approaches found in academic texts: the ‘investment alternatives’ approach, the ‘borrowing rate’ approach, the rate applicable in domestic law, and a ‘fair’ rate. After noting its wide discretion on the choice, the tribunal considered the various rates proposed by the claimants.

A rate based on LIBOR was rejected because that rate had been “discredited”, while using the yield on Russian sovereign bonds issued in USD would overcompensate the claimants, the tribunal said. Moreover, the US Prime rate plus 2% might be acceptable but was a borrowing rate, and there was no evidence that the claimants were forced to borrow due to Russia’s failure to pay compensation.

The ‘investment alternatives’ approach was favoured, leading to a choice of the average 10-year US Treasury bonds rate from 2005 to 2014, or 3.389%.

To calculate pre-award interest, this figure was applied to the value of the unpaid dividends due since 2004. Although the tribunal noted that compound interest was now common in international law, it was “just and reasonable” to award only simple interest on the dividend payments. For the 2014 valuation date, the tribunal gave no pre-award interest on the value of the shares, since the date of the award was used as the valuation date.

As for post-award interest if required, the tribunal set this at the US Treasury bond rate as at 15 January 2015, the payment deadline, with annual compounding.

**Final calculations**

In summary, then, the tribunal calculated compensation based on the 2004 date of expropriation at $21.1 billion in share value, $2.4 billion in dividends and $7.6 billion in interest on these amounts. Claimants were entitled to 70.5% of this amount in proportion to their shareholding in Yukos, giving $21.9 billion.

For the 2014 valuation date, the tribunal calculated $42.6 billion in share value, $45 billion in dividends and $6.9 billion in interest (on the dividends only). Claimants’ proportion of this figure was $66.6 billion. Since this amount was higher than the 2004 valuation, the tribunal held that the claimants were entitled to this amount.

**Damages reduced by 25%, following Oxy case, for Yukos’ own conduct in creating pretext for Russia’s actions**
At various points in the award, the tribunal canvassed questions of the impropriety of Yukos’ own conduct throughout the affair. This impropriety became most relevant to the principle of contributory fault, ultimately applied by the tribunal to reduce the claimants’ damages.

The tribunal set out three case-law categories of contributory fault: cases on the duty to mitigate losses, a separate concept; cases where the investor’s fault increased its losses but was unrelated to the state’s wrongdoing; and cases where the investor provoked or contributed to the state’s wrongdoing. The tribunal appeared to treat elements of Yukos’ conduct as falling within the third category.

In particular, the tribunal highlighted Yukos’ abuse of the domestic tax havens, and observed that President Putin had warned Mr Khodorkovsky directly about its tax situation in a public February 2003 confrontation between the two men. Although the tax investigations were ultimately a pretext for destroying Yukos, the tribunal held, the company’s own conduct had itself created the pretext for Russia, thus contributing to its own downfall. Similarly, concerns over Yukos’ abuse of the Cyprus-Russia double tax agreement provided further support and pretext for Russia’s subsequent actions.

The tribunal then considered what effect this contributory fault should have on the overall assessment of compensation. Notably, the role of the tribunal’s chair, Mr Fortier, as chair of the 2012 Occidental v Ecuador arbitration appeared to loom large in the tribunal’s reasoning on this point.

The tribunal cited the Occidental award’s view that it had a wide degree of discretion in nominating a precise figure, and it also observed that 25% was considered an appropriate figure in that case. In a paragraph strongly reminiscent of the equivalent paragraph in the Occidental award, the Yukos tribunal ruled that it would also apply a “fair and reasonable” figure of 25% to decrease the claimants’ compensation on grounds of contributory fault.

This reduced the figure of $66.6 billion to the final amount ordered, $50.02 billion.

**Costs order also reduced by 25%**

On the question of fees and costs, in a brief analysis, the tribunal saw no reason why Russia should not bear the full arbitral costs given that it had lost the case. These amounted to €8.4 million, including fees of €1.5 million, €1.7 million and €2 million for arbitrators Charles Poncet, Yves Fortier and Stephen Schwebel respectively.

As for the parties’ legal fees, the tribunal observed that it was not surprising that the figures claimed – around US$80 million for the claimants and US$27 million for Russia – were so high, given the complexity of the case.

However, the tribunal noted that some of the claimants’ claims were “plainly excessive”, and that the claimants’ damages experts were “of limited assistance to the Tribunal in its determination of Claimants’ damages”.

Exercising its discretion, the tribunal awarded the claimants a round figure of US$60 million, or about 75% of their fees claim.

The law firm Shearman & Sterling represented the claimants, whereas Russia was represented by Cleary Gottlieb and Baker Botts.
* After initial publication, a typo in this article was detected and corrected. The claimants sought up to 50 billion (not million) dollars, as is now properly reflected in the article text.

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