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**TITLE:**

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**Publisher citation:**

**OpenAIR citation:**

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## **Yukos Case: Background and the Main Themes\***

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Arbitral awards in investor-state disputes are often so extensively commented upon that, for those who take an interest in the area, it can become hard to say which is more voluminous – the actual case record or its academic and media coverage. Such attention is understandable; the subject of investment arbitration is fascinating, and cases like *Yukos* only reinforce this point. After ten years which the parties spent arguing in front of various courts and tribunals, the three final awards of 18 July 2014<sup>1</sup> awarded *Yukos's* former majority shareholders an all-time record amount in compensation for investment arbitration – more than \$50 billion (to put this number in perspective, this is roughly equivalent to 13% of Russia's federal budget revenue for 2014<sup>2</sup>).

The *Yukos* affair is also intricately interwoven with Russian politics and modern Russian history, which makes it even more interesting at times like the present, when Russia frequently makes headlines in international news. In this context, it is no wonder that this case has generated a dozen books, innumerable articles and media reports running for thousands of pages. What is slightly surprising is that so little of this commentary has come from native Russians.<sup>3</sup> It might well be that the strong flavor of politics in this case has discouraged many Russian legal researchers from writing on the topic; only a handful of publications in Russian are in existence to date.<sup>4</sup>

This paper, without an ambition of providing a comprehensive account, aims to give the reader a brief summary of the facts, to outline the history of legal proceedings, and to point out some of the recurring themes surrounding the discussions of *Yukos* case.

### **The background**

The story of *Yukos* began in the 1990s, the times of massive privatization in Russia – the difficult times, accompanied by many controversial events and decisions.<sup>5</sup> In 1995 the ownership of the oil company's shares was transferred from the Russian state to a group companies concentrated

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\* Paper presented at the *Yukos* case roundtable at the Energy Arbitration Conference in Edinburgh, 29 October 2015.

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<sup>1</sup> *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, UNCITRAL (ECT), PCA Case No. AA 227; *Hulley Enterprises Limited (Cyprus) v. The Russian Federation*, UNCITRAL (ECT), PCA Case No. AA 226; *Veteran Petroleum Limited (Cyprus) v. The Russian Federation*, UNCITRAL (ECT), PCA Case No. AA 228, Final Award (hereinafter *Yukos* Final Awards; reference to page numbers shall be to *Yukos Universal Limited (Isle of Man)* award).

<sup>2</sup> Артем Филипенко, 'Гаагский суд приговорил Россию выплатить \$50 млрд по делу ЮКОСа' (RBC, 28 July 2014) <<http://www.rbc.ru/politics/28/07/2014/939219.shtml>> accessed 27 October 2015.

<sup>3</sup> Алексей Исполинов, 'Гаага, ЮКОС, год спустя. Некоторые размышления' (Zakon.ru, 16 July 2015) <[http://zakon.ru/blog/2015/7/16/gaaga\\_Yukos\\_god\\_spustya\\_nekotorye\\_razmyshleniya](http://zakon.ru/blog/2015/7/16/gaaga_Yukos_god_spustya_nekotorye_razmyshleniya)> accessed 27 October 2015.

<sup>4</sup> See e.g. И.В. Рачков, 'Бывшие акционеры "ЮКОСа" против России. Комментарий к арбитражному решению под эгидой Постоянной Палаты Третейского Суда в Гааге' *Международное правосудие*, 2014, No 3.

<sup>5</sup> See generally Carol Scott Leonard, David Pitt-Watson, *Privatization and Transition in Russia in the Early 1990s*. Routledge, 2013.

around bank Menatep.<sup>6</sup> This group of companies was controlled by several individuals (all of them were Russian nationals and Russian citizens): Messrs Khodorkovsky, Lebedev, Nevzlin, Dubov and Shakninsky. Later, in arbitral proceedings, Russia's counsel would somewhat pejoratively label this group 'the oligarchs'.<sup>7</sup> Several years after the initial acquisition, the majority shareholding in *Yukos* was transferred to offshore companies located in Cyprus and the Isle of Man. However, the ultimate beneficiaries of the shareholding remained the same, retaining their control of *Yukos* via the chain of trusts and intermediary companies in several jurisdictions, including Gibraltar, Jersey, Guernsey and the British Virgin Islands.<sup>8</sup>

Upon the acquisition, *Yukos* and its shareholders enjoyed several relatively peaceful years; the company held a prominent position in Russian economy and wielded a considerable political influence.<sup>9</sup> Towards the end of this quiet period, *Yukos* was in the midst of a merger with another Russian oil company (Sibneft); if the merger went ahead, the resulting company would have been the fourth largest private oil producer worldwide, behind only BP, Exxon and Shell.<sup>10</sup> In terms of tax optimization, *Yukos* made use of low-tax regions in Russia as well as favorable international regimes, including the double taxation treaty between Russia and Cyprus.

The quiet period of prosperity for *Yukos* and its shareholders ended in 2003 when the Russian tax authorities took a closer interest in the company's tax optimization scheme. One element of this complex scheme was the use of 'trading companies' registered in Russia's low-tax regions. The conditions attached to the entitlement to lower taxation varied from region to region, but typically the requirement was for the taxpayer to have a registered office in the region, and to contribute to region's economy via local taxes and direct investment. The 2003 tax audit reports have concluded that *Yukos's* 'trading companies' were not conforming to these requirements. Instead, these companies were just empty shells serving exclusively as a means of reselling *Yukos's* oil 'on paper' within the *Yukos* group of companies. There was no rationale for their location in low-tax regions except for claiming tax benefits. These and other violations of Russian tax law detailed in tax audits resulted in demands to pay taxes equivalent to billions of US dollars.<sup>11</sup> This interest of the tax authorities has coincided with *Yukos's* CEO, Mr Khodorkovsky allegedly falling out with the Russian President at a meeting of the Russian Union of Industrialists and Entrepreneurs; with extensive searches and seizures of company's offices; with the company's auditor PricewaterhouseCoopers

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<sup>6</sup> Later, in the proceedings before the UNCITRAL arbitral tribunal, the Russian Federation will maintain that this process of gaining control over the company was conducted in a manifestly illegal manner. See the Russian Federation's Writ to Set Aside Arbitral Awards [http://old.minfin.ru/en/news/index.php?id\\_4=24358](http://old.minfin.ru/en/news/index.php?id_4=24358) accessed 27 October 2015, 20-22. The claimants in the UNCITRAL arbitrations will object that this was irrelevant for the dispute at hand, because they acquired the shares of *Yukos* after the alleged violations took place; the tribunal agreed with the claimants. See *Yukos* Final Awards (n 1) 409-412. See also below, the text accompanying note 28.

<sup>7</sup> See the Russian Federation's Writ to Set Aside Arbitral Awards (n 6) 20-22.

<sup>8</sup> *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, UNCITRAL (ECT), PCA Case No. AA 227; *Hulley Enterprises Limited (Cyprus) v. The Russian Federation*, UNCITRAL (ECT), PCA Case No. AA 226; *Veteran Petroleum Limited (Cyprus) v. The Russian Federation*, UNCITRAL (ECT), PCA Case No. AA 228. Interim Awards on Jurisdiction and Admissibility of 30 November 2009. Appendix 1. (hereinafter *Yukos* Interim Awards; reference to page numbers shall be to *Yukos Universal Limited (Isle of Man)* award).

<sup>9</sup> R. G. Gidadhubli, 'Yukos Affair: Putin Attacks Russia's Oil Barons' *Economic and Political Weekly*, Vol 38 No 47 (Nov. 22-28, 2003) 4949-4952.

<sup>10</sup> M. Kantor, 'Fifty Billion Dollars; The Yukos Damages Award' *OGEL* Vol. 13 – Issue 5 (August 2015) 94.

<sup>11</sup> *Yukos* Final Awards (n 1) 170-192.

withdrawing its previous audit reports; with the Sibneft merger being unwound through the courts; and with Khodorkovsky, Lebedev and several other company employees being charged with various crimes and placed under arrest.<sup>12</sup>

From that point on, the pace of legal proceedings against *Yukos* kept accelerating. Bailiffs enforcing the tax claims promptly seized the company's assets, selling among the first priorities *Yukos's* primary asset, the production company Yugansknetegas ("YNG") which provided the main revenue stream for *Yukos*. The company made a desperate attempt to prevent the auction, filing for bankruptcy before the US Bankruptcy Court for the Southern District of Texas and obtaining an order enjoining many potential bidders from participation in the auction.<sup>13</sup> Nevertheless, YNG was soon auctioned off and acquired by a hitherto unknown entity called Baikal Finance Group, which in turn was purchased by the state-owned oil giant Rosneft a few days later. Eventually *Yukos* was put into bankruptcy, all of its assets were sold off, and officially the company ceased to exist in 2007. Mr Khodorkovsky remained in prison until 2013 when he was eventually pardoned and set free.<sup>14</sup>

### **The proceedings**

Against this background, what is commonly referred to as the '*Yukos* case' includes at least three relatively separate lines of attack which former *Yukos* shareholders launched against Russia:

1. Proceedings before the European Court of Human Rights (ECtHR). These proceedings comprised:
  - a. Several cases in which Messrs Khodorkovsky, Lebedev and others complained of their treatment in the course of criminal proceedings in Russia. In these cases, some violations of the European Convention on Human Rights (ECHR) were recognized, and some (relatively modest) amounts in compensation were awarded. Among other things, the ECtHR decided that the evidence presented by the applicants was insufficient to justify the conclusion that Khodorkovsky's and Lebedev's criminal prosecution was politically motivated.<sup>15</sup>
  - b. The claim lodged by *Yukos* itself. In this case the ECtHR has likewise rejected some allegations and recognized breach of the ECHR in other instances, notably the breach of the Article 1 of Protocol No. 1 to the European Convention on Human Rights in relation to relatively small portions of tax claims against *Yukos* which the court found to be unjustified. In July 2014 the ECtHR awarded the former *Yukos* shareholders €1.87 billion, its highest ever award.<sup>16</sup> The ruling in

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<sup>12</sup> *Yukos* Final Awards (n 1) 257-279.

<sup>13</sup> Matteo M. Winkler, 'Arbitration without Privity and Russian Oil: The *Yukos* Case before the Houston Court' 27 *U Pa J Int'l Econ L* 115 (2006).

<sup>14</sup> 'Mikhail Khodorkovsky freed after pardon from Vladimir Putin', *The Guardian* (20 December 2013) <<http://www.theguardian.com/world/2013/dec/20/mikhail-khodorkovsky-freed-putin-pardon-russia>> accessed 27 October 2015.

<sup>15</sup> Press Release issued by the Registrar of the Court ECHR 236 (2013) 25.07.2013, 9 <<http://hudoc.echr.coe.int/app/conversion/pdf/?library=ECHR&id=003-4445686-5349935&filename=003-4445686-5349935.pdf>> accessed 27 October 2015.

<sup>16</sup> Case of OAO Neftyanaya Kompaniya *Yukos* v Russia (Application no 14902/04), Judgment (Just Satisfaction), 31 July 2014.

favor of former shareholders rather than the applicant itself was explained by dissolution of *Yukos* at the time the judgment was rendered; it is estimated that there are around 55 000 such former shareholders.<sup>17</sup> Russia was requested to produce a plan for the payment of this sum but has not done so at the time of writing.

2. Arbitral proceedings initiated by *Yukos Capital S.a.r.l.*, a Luxembourg-based entity, against former *Yukos's* subsidiary companies currently owned by Rosneft, including YNG. These claims were based on the transactions, notably loans, which were made between *Yukos Capital S.a.r.l.* and *Yukos's* subsidiary companies before the former majority shareholders lost control over the company; invariably these transactions contained an arbitration clause. In one episode, an ICC award rendered in favor of *Yukos Capital S.a.r.l.* in Moscow was annulled by the Russian courts, but was nevertheless enforced in the Netherlands.<sup>18</sup> It was reported that in 2015 *Yukos Capital S.a.r.l.* and Rosneft have settled the outstanding claims between themselves.<sup>19</sup>
3. Arbitral proceedings brought before investment arbitration tribunals by the former *Yukos* shareholders against Russia, including the main set of proceedings referred to above, which were initiated under the Energy Charter Treaty (ECT) in accordance with the UNCITRAL Rules and administered by the Permanent Court of Arbitration in the Hague. Prior to this, two similar 'test cases' brought by minority shareholders (see *Quasar de Valores SICAV SA*<sup>20</sup> and *RosinvestCo Uk Ltd*<sup>21</sup>) were heard under bilateral investment treaties by Stockholm Chamber of Commerce arbitral tribunals. Both 'test cases' were decided in favor of the claimants, and subsequently the UNCITRAL tribunal relied heavily on their findings – despite the fact that one of them (*RosinvestCo Uk Ltd*) was then already annulled by Swedish courts.<sup>22</sup>

The key finding of the UNCITRAL tribunal in the Final awards was that, contrary to Russia's position that treatment of *Yukos* was a legitimate exercise of its taxation powers, the tax claims were merely a tool to achieve a purpose that had nothing to do with taxation. The purpose of the tax claims was: the elimination of a potential political opponent (Mr Khodorkovsky) and the appropriation of *Yukos's* assets.<sup>23</sup> Consequently, the Russian Federation was found to be in breach of Art. 10 of the ECT (expropriation), and compensation was awarded to the claimants in the amount of approximately \$50 billion (from an initial claim of \$114 billion).

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<sup>17</sup> Neil Buckley, 'Former Yukos shareholders awarded \$50bn in damages against Russia' *Financial Times* (28 July 2014) <<http://www.ft.com/cms/s/0/f5824afa-1623-11e4-8210-00144feabdc0.html#axzz3rldk48Vt>> accessed 27 October 2015.

<sup>18</sup> Court of Appeal of Amsterdam, 28 April 2009.

<sup>19</sup> Rosneft's official website <[http://www.rosneft.con/news/news\\_in\\_press/01042015.html](http://www.rosneft.con/news/news_in_press/01042015.html)> accessed 27 October 2015.

<sup>20</sup> *Quasar de Valores SICAV SA v The Russian Federation*, the SCC Arbitration Award, 20 July 2012 (hereinafter *Quasar*).

<sup>21</sup> *RosinvestCo Ltd v The Russian Federation*, SCC Arbitration V (079/2005), Final Award, 12 September 2010.

<sup>22</sup> Svea Court of Appeal, Case No T 10060-10, Judgment of 5 September 2013.

<sup>23</sup> *Yukos* Final Awards (n 1) 275, 447.

Currently the Russian Federation is challenging the \$50 billion awards in Dutch courts on a number of grounds;<sup>24</sup> and the claimants are making the first attempts to enforce the awards against Russia's sovereign assets in various European countries, including France and Belgium.<sup>25</sup>

### **The main themes and issues**

In a case of such gargantuan proportion, any closed list of the main issues or themes must necessarily be somewhat subjective. Below is the author's attempt to single out two of the main themes that seem to be central and recurring in various forms in the course of discussions revolving around this legal struggle.

**(1) Definition of the parties to the dispute.** The parties' submissions to the tribunal often created the impression of attempting to present their opponent as a single entity, rather than a loosely connected group of individual actors.<sup>26</sup> This was also reflected in the media which told the story from the perspective of a struggle between two well-defined sides.<sup>27</sup> The reality, however, is more complicated, which creates a potential for competing lines of reasoning based upon different definitions of a 'party'. This juggling has manifested itself, for instance, in the following.

- First, the claimants' side is comprised of a number of former *Yukos* managers and companies registered in Cyprus, the Isle of Man, the British Virgin Islands and Gibraltar; the respondent generally refers to them collectively as 'the oligarchs'. This ambiguity apparently had some effect on the minds of arbitrators, and ended up benefitting both parties on different occasions. For instance, at the jurisdiction and admissibility stage of the UNCITRAL arbitral proceedings, one of the respondent's arguments was that the case was essentially a domestic dispute between the Russian state and a group of Russian 'oligarchs' – which is the situation the ECT, created for the protection of genuine foreign investors, was never intended to encompass. On this point, the tribunal disagreed noting that the text of the ECT does not support going beyond the claimant companies' separate legal personality.<sup>28</sup> On the other hand, at the merits stage, the tribunal found a 25% contributory fault on the claimants' side, finding that the demise of *Yukos* was in part a result of its management's actions and holding the claimants liable for those actions. This was done on the basis that the claimants collectively (i.e. Hulley Enterprises Limited, Yukos Universal Limited, and Veteran Petroleum Limited together – although the latter two companies could only be characterized as minority shareholders) exercised control of *Yukos*.<sup>29</sup> In so doing, the tribunal seems to be disregarding the claimants' separate legal personality and implying the existence of a common will behind the three claimant companies.<sup>30</sup>

- Secondly, the respondent's side comprises the Russian Federation itself, as well as hundreds of Russian tax inspectors, bailiffs, bankruptcy practitioners and judges who, according to the claimants' case, were acting as a coordinated mechanism implementing a single political will. Despite

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<sup>24</sup> See generally the Russian Federation's Writ to Set Aside Arbitral Awards (n 6).

<sup>25</sup> Neil Buckley and Courtney Weaver, 'France and Belgium Freeze Russian State Assets Over Yukos Case' *Financial Times* (18 June 2015) <<http://www.ft.com/cms/s/0/3ab475a6-15da-11e5-a58d-00144feabdc0.html#axzz3rldk48Vt>> accessed 27 October 2015.

<sup>26</sup> *Yukos* Final Awards (n 1) 20-48.

<sup>27</sup> See, e.g., *France and Belgium Freeze Russian State Assets Over Yukos Case* (n 25).

<sup>28</sup> *Yukos* Interim Awards (n 8) 147-160.

<sup>29</sup> *Yukos* Final Awards (n 1) 500-510.

<sup>30</sup> Wojciech Sadowski, 'Yukos and Contributory Fault' OGEL Vol. 13 – Issue 5 (August 2015) 29-30.

the lack of conclusive evidence in this regard, the tribunal seems to have accepted this view. One has to wonder how much of this acceptance was due to perceptions of Russia in the minds of the public in Western countries.

**(2) Proper (and improper) use of the investment treaty protection mechanism.** On the one hand, it can be argued that the victims of expropriation should be entitled to defend their rights before an impartial international tribunal, and an award of fair compensation for the lost investment should always be welcomed. On the other hand, in cases where the underlying dispute would not involve foreign investors and relates only to internal Russian matters, it does not seem completely fair to give the opportunity to use the investment treaty protection to some to Russian investors who happen to have structured their holdings via foreign holding companies, and yet deny it to other Russian investors.

A connected but separate issue is the use of the ECHR complaint mechanism and investment treaty claims in parallel. As the matters stand now, the parties have the clear opportunity for ‘forum shopping’ and obtaining double compensation, or at least the compensation for different episodes or components of their overall claims. For example, the ECtHR found it problematic to hold that the prosecution of Khodorkovsky and Lebedev was politically motivated, whereas the investment treaty tribunals had no such difficulty. In another instance, the reasoning which the *Quasar* tribunal put forward to justify one of its conclusions (and the UNCITRAL tribunal reiterated) included an express assertion that the “ECHR appears... to have entirely missed the point being made”.<sup>31</sup>

Such inconsistent findings between these two forums, possibly based upon different standards of proof and approaches to the states’ ‘margin of appreciation,’ are seen through such examples to be a reality rather than an abstract possibility.

## Conclusion

*Yukos* is undoubtedly one of the most curious cases in the history of investment treaty arbitration. Unless the Dutch courts set the UNCITRAL final awards aside, many of the future discussions are likely to be shaped by the jurisprudence on the issues of enforcement of arbitral awards against a sovereign state. Cases such as *Sedelmayer*<sup>32</sup> have demonstrated how hard (but not impossible) it is to find property unprotected by sovereign immunity. In addition, it is already a recurring question among commentators whether Rosneft’s foreign assets can be used to satisfy the claims on the grounds that Rosneft was acting as an extension of the state, having acquired the major part of assets formerly belonging to *Yukos*.<sup>33</sup> In all probability, in the coming years we are likely to hear a lot more about this case.

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<sup>31</sup> *Quasar*, para 82; *Yukos* Final Awards (n 1) 238.

<sup>32</sup> *Mr Franz Sedelmayer v The Russian Federation*, 2 Stockholm Int’l Arb Rev 37.

<sup>33</sup> See, e.g., Maria Davies, ‘Winning the Battle Does Not Mean Winning the War: Challenges Facing the *Yukos* Shareholders in Enforcing Their Arbitration Awards Against the Russian Federation in England and Wales’ *OGEL* Vol. 13 – Issue 5 (August 2015) 54.