ARBITRATION IN CIS COUNTRIES: CURRENT ISSUES

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ARBITRATIONS IN THE ENERGY SECTOR: SHAREHOLDERS OF YUKOS V. THE RUSSIAN FEDERATION

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Introduction

- *Hulley Enterprises Limited* (Cyprus) *v. The Russian Federation*
- *Yukos Universal Limited (Isle of Man) v. The Russian Federation*
- *Veteran Petroleum Limited (Cyprus) v. The Russian Federation*

Interim Awards on Jurisdiction and Admissibility dated 30 November 2009.

The tribunal: L. L. Yves Fortier, CC, QC (Chairman), Dr. Charles Poncet (appointed by the Claimants), and Judge Stephen M. Schwebel (appointed by the Russian Federation)

Introduction

- The Energy Charter Treaty – an international convention governing cooperation between participating states in the energy sector which was signed on 17 December 1994 and entered into force on 16 April 1998. As of October 2009, 46 states had ratified the ECT.
- The Russian Federation signed the ECT on 17 December 1994 and submitted for ratification to the State Duma on 26 August 1996, but it was never ratified. On 20 August 2009 the Russian Federation notified Portugal, as depository of the ECT, of its intention not to become a party to the ECT.

Questions

- Is the Russian Federation bound by the ECT on the basis of its provisional application?
- Are the Claimants and their investments protected by the ECT (given that, as it was alleged by the Russian Federation, the Claimants' beneficial owners are "Russian oligarkhs")

Is the Russian Federation bound by the ECT on the basis of its provisional application?

The ECT provides for the possibility of a so-called *provisional application* of the ECT by a state that signed but not yet ratified the ECT, pending its ratification:

- **Article 45(1)**: "*Each signatory agrees to apply this Treaty provisionally pending its entry into force for such signatory in accordance with Article 44, to the extent that such provisional application is not inconsistent with its constitution, laws or regulations.*"
- **Article 45(2):**

  "*(a) Notwithstanding paragraph (1) any signatory may, when signing, deliver to the Depository a declaration that it is not able to accept provisional application. The obligation contained in paragraph (1) shall not apply to a signatory making such a declaration. Any such signatory may at any time withdraw that declaration by written notification to the Depository.*

  (b) Neither a signatory which makes a declaration in accordance with subparagraph (a) nor Investors of that signatory may claim the benefits of provisional application under paragraph (1).

  (c) Notwithstanding subparagraph (a), any signatory making a declaration referred to in subparagraph (a) shall apply Part VII provisionally pending the entry into force of the Treaty for such signatory in accordance with Article 44, to the extent that such provisional application is not inconsistent with its laws or regulations."

Is the Russian Federation bound by the ECT on the basis of its provisional application?

- The Claimants: the Russian Federation applied the ECT provisionally
- The Russian Federation: it applied provisionally only those parts of the ECT that were not inconsistent with the Russian Federation's constitution, laws or regulations. The dispute resolution provisions of Article 26 of the ECT are inconsistent with Russian law, because investor-state disputes are not arbitrable and because Russian law does not allow shareholders of a company to claim damages caused to the company by third parties.
- The Claimants: in order for the ECT not to apply provisionally, the Russian Federation should have made declarations pursuant to Article 45(2) or Article 45(1) of the ECT. The inconsistency referred to in Article 45(1) of the ECT relates to the principle of provisional application of the ECT per se, not to the specific provisions of the ECT. The principle of provisional application per se is recognized by Russian law.

Is the Russian Federation bound by the ECT on the basis of its provisional application?

The Tribunal therefore had to address the following issues:

- Is a declaration required under Article 45(2) in order for the ECT not to apply provisionally?
- Is a declaration required under Article 45(1) in order for the ECT not to apply provisionally?
- Does the *inconsistency wording* refer to the principle of provisional application per se or to specific provisions of the ECT?
- Is the principle of provisional application inconsistent with Russian law?
- Is Article 26 of the ECT inconsistent with Russian law?

Is a declaration required under Article 45(2) in order for the ECT not to apply provisionally?

- This question depended solely on the interpretation of Article 45(2) of the ECT.
- Article 31(1) (General Rule of Interpretation) of the Vienna Convention on the Law of Treaties 1969 ("**VCLT**"): "*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.*"

Is a declaration required under Article 45(2) in order for the ECT not to apply provisionally?

- The Tribunal: "*the ordinary meaning to be given to the terms of Articles 45(1) and 45(2), when read together, demonstrates to the satisfaction of the Tribunal that the declaration which is referred to in Article 45(2) is a declaration which is not necessarily linked to the Limitation Clause of Article 45(1)*" (Interim Award, ¶264). There is no requirement in Article 45(1) that a declaration under Article 45(2) should be made in order not to apply the ECT because of the inconsistency. Declaration under Article 45(2), on the other hand, can be made not only if the provisional application is impossible for inconsistency, but for any reason. According to the Tribunal, this conclusion was supported by the use of the words "notwithstanding" in Article 45(2) of the ETC (Interim Award, ¶262)

Is a declaration required under Article 45(1) in order for the ECT not to apply provisionally?

- The Claimants: a declaration under Article 45(1) was required for reasons of transparency and predictability ("*no State is supposed to know or should be required to know another State's internal legal constraints*" (Interim Award, ¶273)). The Claimant also pointed out the fact that during negotiation of the ECT the Russian Federation, unlike some other states, "*emphasized the importance of provisional application*" (Interim Award, ¶277). Also, because the Russian Federation never indicated to the ECT Secretariat that it would not be applying the ECT provisionally, it should be estopped from relying on the *inconsistency provision* (Interim Award, ¶281)

Is a declaration required under Article 45(1) in order for the ECT not to apply provisionally?

- The Tribunal (again applying Article 31 of the VCLT): although during negotiation of the ECT some states, including the Russian Federation, insisted on transparency with regard to its provisional application, no notification requirement was ultimately included in Article 45(1) of the ECT. Although during negotiation of the ECT the Russian Federation supported provisional application, it never clearly excluded the possibility that it would later argue that it did not apply the ECT provisionally for reasons of inconsistency, and therefore it is not estopped (Interim Award, ¶288)

Does the *inconsistency provision* refer to the principle of provisional application per se or to specific provisions of the ECT?

- The Russian Federation: the ECT should be scrutinized for its consistency with Russian law. The words "*to the extent that*" refer to the scope of provisional application. (Article 45(1): "*each signatory agrees to apply this Treaty provisionally pending its entry into force for such signatory in accordance with Article 44, to the extent that such provisional application is not inconsistent with its constitution, laws or regulations.*")
- The Claimant: there should be an "all-or-nothing approach" to this clause, meaning that the whole ECT should apply provisionally if the principle of provisional application is consistent with Russian law. The words "*to the extent that*" are followed by "*such provisional application*", which proves that the *inconsistency provision* relates to the principle of provisional application

Does the *inconsistency provision* refer to the principle of provisional application per se or to specific provisions of the ECT?

The Tribunal:

- the key to interpretation of the *inconsistency provision* should be the adjective "*such*" in the phrase "*such provisional application*". The adjective "*such*" means "*that or those; having just been mentioned*" and "*of the character, quality, or extent previously indicated or implied*" (Interim Award, ¶304).
- Thus "*such provisional application*" means "*provisional application of this Treaty*" (Interim Award, ¶304).
- The ordinary meaning of "*this Treaty*", in its turn, is the Treaty as a whole and in its entirety, not just a part of it (Interim Award, ¶308). Hence, "*to the extent that such provisional application is not inconsistent with its constitution, laws or regulations*" should read "*to the extent that the provisional application of the entire Treaty is not inconsistent with its constitution, laws or regulations*".
- If the Russian Federation's interpretation of Article 45(1) were to be preferred, a state would be able to refer to its internal laws as an excuse to not comply with the Treaty. This would be fundamentally contrary to the *pacta sunt servanda* rule and Article 27 of the VCLT, which expressly prevents a state from invoking its internal legislation as justification for non-performance of a treaty (Interim Award, ¶313).
- Thus, the conclusion in Claimants' favour

Is the principle of provisional application inconsistent with Russian law?

- The Russian Federation did not seriously dispute that the principle of provisional application was consistent with Russian law (Interim Award, ¶330).
- Article 23(1) of the Russian Federation's Federal Law on International Treaties provides: "*an international treaty or a part thereof may, prior to its entry into force, be applied by the Russian Federation provisionally if the treaty itself so provides or if an agreement to such effect has been reached with the parties that have signed the treaty*". Thus Russian law recognizes the concept of provisional application of international treaties

Is the Russian Federation bound by the ECT on the basis of its provisional application?

The Tribunal:

- The Russian Federation applied the entire ECT provisionally until 19 October 2009 (on 20 August 2009 the Russian Federation made a notification under Article 45(3)(a) of the ECT of its intention not to become a Contracting Party to the ECT; in accordance with that Article, termination of provisional application becomes effective 60 days after the date notification is received by the Depository) (Interim Award, ¶338).
- Pursuant to Article 45(3) of the ECT, investment-related obligations, including an obligation to submit disputes to arbitration, remain in force for a period of 20 years following the effective date of termination of provisional application. Thus, investments made in Russia up to 19 October 2009 will continue to benefit from protection under the ECT until 19 October 2029 (Interim Award, ¶339)

The Tribunal's conclusions on the consistency of provisions of the ECT with Russian law

Was not necessary for the Tribunal to decide as it reached the conclusion that the Limitation Clause related to the principle of provisional application rather than to each specific provision of the ECT. Still stated its conclusions in the Interim Award.

The Russian Federation:

- Article 26 of the ECT is inconsistent with Russian law because
  - investor-state disputes are not arbitrable and within Russian exclusive jurisdiction
  - the Claimants lack standing to bring the claims with respect to the issue of standing as under Russian law a shareholder cannot claim compensation of damages caused to the property of the company

The Tribunal's conclusions on the consistency of provisions of the ECT with Russian law

The Tribunal:

- the fact that investor-state disputes are arbitrable was confirmed by the Russian Federation's Law on Foreign Investments, which provides that parties may agree to submit investor-state disputes to arbitration. Agreement to submit this dispute to arbitration was expressed by signing the ECT by the Russian Federation, which results in provisional application
- the Claimants' claim is not a derivative claim on behalf of Yukos, but rather a claim for compensation of direct loss by the Claimants of their shares and their value, hence it is not inconsistent with Russian law
- the Explanatory Note which the Government of the Russian Federation submitted to the State Duma when the ECT was submitted for ratification: "*the legal regime of foreign investments envisaged under the ECT is consistent with the provisions of the existing Law of RSFSR on foreign investments in the RSFSR…*" (Interim Award, ¶374)

Are the Claimants and their investments protected under the ETC?

The Russian Federation:

- the Claimants do not qualify as "Investors" within the meaning of the ECT, because it is not them but the "Russian oligarchs" who are the real owners of Yukos
- the shares in Yukos are not "Investment" within the meaning of the ETC, because they were not paid with foreign capital

Are the Claimants "Investors" within the meaning of the ECT?

Article 1(7) of the ECT – "Investor" means:

"*(a) with respect to a Contracting Party:*

(i) a natural person having the citizenship or nationality of or who is permanently residing in that Contracting Party in accordance with its applicable law;

(ii) a company or other organization organized in accordance with the law applicable in that Contracting Party; …"

Are the Claimants "Investors" within the meaning of the ECT?

The Russian Federation:

- did not dispute the Claimants were organized in accordance with the laws of Contracting Parties (Cyprus and Isle of Man), but
- the general principles of international law require that the Tribunal go beyond that and should deny protection to the Claimants because they are shell companies controlled by Russian nationals (Interim Award, ¶¶406, 407)

Are the Claimants "Investors" within the meaning of the ECT?

The Tribunal:

- interpretation of Article 1(7) of the ECT on the basis of its plain language, as required by Article 31 of the VCLT, leads to the conclusion that it does not impose any requirements on an Investor other than that it must be "*organized in accordance with the law*" of a Contracting Party (Interim Award, ¶411);
- The Tribunal "*knows of no general principles of international law that would require investigating how a company or another organization operates when the applicable treaty simply requires it to be organized in accordance with the laws of a Contracting Party*" (Interim Award, ¶415)
- Thus, the Claimants qualify as Investors for the purposes of Article 1(7) of the ECT. However, the Russian Federation's argument about control of the Investor should be considered in the context of Article 17 of the ECT, which allows a state to deny protection to companies that, although registered in a Contracting State, do not conduct significant business activity in that state and are controlled by nationals of a third state (Interim Award, ¶412)

Do the Claimants "own or control" Investments protected under the ETC?

Article 1(6) of the ECT – "Investment" means:

- "*… every kind of asset, owned or controlled directly or indirectly by an Investor and includes:*
  - *a) tangible and intangible, and movable and immovable, property, and any property rights such as leases, mortgages, liens and pledges;*
  - *b) a company or business enterprise, or shares, stock, or other forms of equity participation in a company or business enterprise, and bonds and other debt of a company or business enterprise;*
  - *c) claims to money and claims to performance pursuant to contract having an economic value and associated with an Investment;*
  - *d) Intellectual Property;*
  - *e) Returns;*
  - *f) any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector …*"

Do the Claimants "own or control" Investments protected under the ETC?

The Russian Federation:

- the Claimants were not "true" owners of the shares because "*Messrs. Khodorkovsky and Lebedev have admitted that they are the beneficial owners of Yukos and its assets*" (Interim Award, ¶¶421, 422). The Russian Federation further argued that the ECT did not state whether the ownership mentioned in Article 1(6) of the ECT should be legal or beneficial, and that in such cases "*general international law ignores nominal or record ownership in favor of real or beneficial*" (Interim Award, ¶420)
- the shares in Yukos owned by the Claimants did not qualify as an Investment because they were not paid with foreign capital (Interim Award, ¶422).
- The Tribunal:
- there is no indication in Article 1(6) of the ECT that the ownership should be beneficial. Applying Article 31 of the VCLT, the Tribunal concluded that simple legal ownership of shares qualifies as Investment under Article 1(6)(b) of the ECT (Interim Award, ¶429)
- whether the Russian Federation's assertion regarding the origin of capital is true or not, there are no additional requirements in Article 1(6) of the ECT as to the origin of capital (¶431)

Was the Russian Federation entitled to deny protection to the Investors under Article 17 of the ECT?

Article 17 of the ECT provides:

- "*Each Contracting Party reserves the right to deny the advantages of this Part* [i.e. Part III] *to:*
  - *(1) a legal entity if citizens or nationals of a third state own or control such entity and if that entity has no substantial business activities in the Area of the Contracting Party in which it is organized …*".

Part III of the ECT sets out substantive provisions on protection of Investments, including standards of treatment (Article 10) and a general prohibition against expropriation (Article 13)

Was the Russian Federation entitled to deny protection to the Investors under Article 17 of the ECT?

The issues between the Parties:

- is notification required to deny protection under Article 17 of the ECT, and did the Russian Federation fulfill this requirement?
- were the substantive conditions for the application of Article 17 of the ECT met?

Is notification required to deny protection under Article 17 of the ECT, and did the Russian Federation fulfill this requirement?

The Russian Federation:

- no notification is required – it is rather a requirement on a company that falls within the scope of Article 17 to obtain a commitment that it will be treated as a protected investor;
- if there is a notification requirement, it was fulfilled by the Russian Federation (a) by entering into the partnership and cooperation agreement between Russia and EU dated 24 June 1994, which provides that companies having only a registered office and not conducting business activity in a contracting state are not considered companies of that state, or (b) by the statements made by the Russian Federation in the course of the arbitration proceedings (Interim Award, ¶445)

Is notification required to deny protection under Article 17 of the ECT, and did the Russian Federation fulfill this requirement?

The Tribunal:

- "*Article 17(1) does not deny simpliciter the advantages of Part III of the ECT – as it easily could have been worded to do…. It rather reserves "the right" of each Contracting Party to deny the advantages of that Part to such an entity. This imports that, to effect denial, the Contracting Party must exercise the right*" (Interim Award, ¶455)
- the P&C Agreement cannot be deemed notification, because it makes no reference to the ECT (and the ECT does not make any reference to the P&C Agreement) (Interim Award, ¶456). As for the Russian Federation's statements made in the arbitration, they could not have a retrospective effect in the light of the objective of the ECT to promote long-term cooperation in the field of energy (Interim Award, ¶457)

Issues left for the merits stage

- whether or not the Claimants have "unclean hands" and whether or not their corporate personality should be disregarded because they are instrumentalities of a "criminal enterprise" (Interim Award, ¶435),
- whether or not the Claimants' claims should be precluded (as a matter of jurisdiction or admissibility) by operation of Article 21 of the ECT (Taxation Measures), which, according to the Russian Federation, excludes the jurisdiction of the Tribunal with respect to all measures of taxation exercised by the Russian Federation (Interim Award, ¶584), and of course
- whether or not the Russian Federation committed a breach of Part III of the ECT (i.e., the substantive provisions relating to the protection of Investments) and, if there indeed was such a breach, what the amount of damages should be. (An SCC tribunal hearing the arbitration *RosInvestCo UK Ltd. v. the Russian Federation* (*SCC Arbitration V(079/2005*)) found in its award dated 12 September 2010 that the Russian Federation is liable for expropriation of the investment of a minority shareholder in Yukos, though in that proceeding only minimal damages were awarded).

Arbitrations in the Energy Sector: *Shareholders of Yukos v. the Russian Federation*

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