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YUKOS: LANDMARK DECISION ON THE ENERGY CHARTER TREATY

In a landmark decision rendered on November 30, 2009, an Arbitral Tribunal constituted pursuant to the Energy Charter Treaty and the UNCITRAL Arbitration Rules, and sitting in The Hague under the auspices of the Permanent Court of Arbitration,[1] ruled that the Russian Federation is bound by the Energy Charter Treaty notwithstanding that it was never ratified by the Duma, by virtue of its provisional application of the Treaty.

The decision, which rejects the Russian Federation's objections to the Arbitral Tribunal's jurisdiction and the admissibility of the claims, allows the majority shareholders of former Yukos Oil Company to proceed with the merits of their claims against the Russian Federation, in what is the largest arbitration ever in the history of international arbitration.

Background of the Dispute

In 2003, Yukos Oil Company was a business success, ranked as the largest oil company in Russia and producing over 1 million barrels of oil a day. It was on the verge of implementing its merger with Sibneft, thus becoming the fourth largest oil company in the world. That same year, however, the Russian Federation launched coordinated attacks on Yukos Oil Company that resulted in its dismantlement, the expropriation of its assets and final liquidation in November 2007.

In 2005, Hulley Enterprises Limited, Yukos Universal Limited (two subsidiaries of GML Limited), and Veteran Petroleum Limited (the pension fund established in 2001 for the benefit of former Yukos employees), which collectively owned over 60% of the shares in Yukos Oil Company, initiated three arbitration proceedings against the Russian Federation under the Energy Charter Treaty (the "ECT" or "Treaty"). In the arbitrations, the majority shareholders of Yukos complain of the arbitrary, unfair and discriminatory treatment, and the unlawful expropriation of their investment by the Russian Federation, seeking compensation for an aggregate amount up to USD 100 billion.

The Energy Charter Treaty: Significant Precedential Value of Decision

The ECT is a multilateral convention, today binding on 50 parties, the main purpose of which is to strengthen the rule of law in energy matters. It contains substantive provisions on the protection of investments in the field of energy, and provides a dispute resolution mechanism through binding investor-State arbitration allowing investors to enforce their rights under the Treaty.

The rulings of the Arbitral Tribunal in the *Yukos* matter are of crucial importance for investors operating in the energy sector:

- The Russian Federation is bound by the ECT even though the Treaty was never ratified by the Russian Duma; as such, it is bound by the investor-State arbitration provisions of the Treaty.
- The termination of the provisional application of the Treaty by the Russian Federation in the Summer of 2009 has no impact on investments made before such termination took effect on

October 19, 2009. As a result, investments made prior to that date will continue to be protected for 20 years pursuant to the express provisions of the Treaty, *i.e.* until October 19, 2029.

- The protection of the ECT is granted to qualified investors holding a qualified investment. For a company or organization to qualify as an investor under the Treaty, no conditions other than those of the Treaty are required, including as regards ownership or control. For an investment to qualify under the Treaty, no conditions other than those of the Treaty are required, including as regard an injection of foreign capital.
- The 'denial of benefits' provision of the ECT confers a right that, in order to be effective, must be exercised and that, once exercised, operates only prospectively.

Russia is bound by the ECT

The Arbitral Tribunal held that the Russian Federation, in signing the ECT in 1994, accepted its provisions on provisional application contained in Article 45. Article 45(1), in particular, provides that:

> "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 Tribunal held that the provisional application of the Treaty is fully consistent with both Russian law and Russian treaty practice. The binding character of the Treaty includes the obligation to arbitrate investment disputes pursuant to its Article 26. This ruling is evidently of particular significance for investors in the energy sector in Russia.

The Tribunal further found, pursuant to Article 45(3) of the Treaty, that the decision of the Russian Federation to terminate provisional application of the ECT, which was issued on July 30, 2009 and became effective on October 19, 2009, had no bearing either in the present case or, for that matter, as regards investments made in Russia in the field of energy prior to October 19, 2009. In other words, a signatory's decision not to become a party to a treaty entails consequences for the future only. As far as investments made prior to the effective date of termination, they will continue to be protected for 20 years pursuant to Article 45(3), *i.e.* until October 19, 2029. The Tribunal held in this respect that:

> "[P]ursuant to Article 45(3)(b) of the Treaty, investment-related obligations, including the obligation to arbitrate investment-related disputes under Part V of the Treaty, remain in force for a period of 20 years following the effective date of termination of provisional application. In the case of the Russian Federation, this means that any investment made in Russia prior to 19 October 2009 will continue to benefit from the Treaty's protections for a period of 20 years—*i.e*, until 19 October 2029."

Criteria for ECT Protection

Another crucial aspect of the decision is the Tribunal's dismissal of the Russian Federation's arguments relating to the definition of an 'investor' and of an 'investment' under the ECT. The Russian Federation alleged that the Claimants did not qualify as protected investors under Article 1(7)(a)(ii) of the Treaty on the ground that they were entities owned or controlled by Russian citizens or nationals. The Russian Federation further alleged that the Claimants' investment could not be protected under Article 1(6) of the Treaty because there had been no injection of foreign capital into Russia.

Definition of an ECT 'investor'

Article 1(7)(a)(ii) of the Treaty requires that, for a company or organization to qualify as a protected investor, it must be "organized in accordance with the law applicable in that Contracting Party." The *Yukos* Tribunal emphasized in this respect that it was bound to interpret the terms of the ECT, including Article 1(7)(a)(ii), not as they might have been written but as

they were actually written. It further held that Article 1(7)(a)(ii) of the ECT contains no additional requirements—including as regards control or ownership—other than that the claimant company be duly organized in accordance with the law applicable in a Contracting Party:

> "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. The principles of international law, which have an unquestionable importance in treaty interpretation, do not allow an arbitral tribunal to write new, additional requirements—which the drafters did not include—into a treaty, no matter how auspicious or appropriate they may appear."

Definition of an ECT 'investment'

The Tribunal also found that the Treaty, by its terms, applies to an 'investment' owned nominally by a qualifying 'investor'. It held that the Russian Federation's submission that simple legal ownership of shares does not qualify as an investment under Article 1(6)(b) of the ECT finds no support in the text of the Treaty:

> "The Tribunal reads Article 1(6)(b) of the ECT as containing the widest possible definition of an interest in a company, including shares (as in the case at hand), with no indication whatsoever that the drafters of the Treaty intended to limit ownership to 'beneficial ownership'."

As regards the Russian Federation's allegation that, in order to qualify under the ECT, an 'investment' requires an injection of foreign capital, the Tribunal held that the definition of an investment in Article 1(6) of the ECT does not include any additional requirement with regard to the origin of capital or the necessity of an injection of foreign capital:

> "[t]he definition of investment in Article 1(6) of the ECT does not include any additional requirement with regard to the origin of capital or the necessity of an injection of foreign capital . . . . The Tribunal cannot in effect impose upon the parties a definition of 'Investment' other than that which the parties to the ECT, including Respondent, have agreed."

The 'Denial of Benefits' Clause Contains a Right that, in order to Produce Effect, Must Be Exercised

One of the Russian Federation's further allegations was that the Claimants were barred from bringing a claim because they were owned or controlled by Russian citizens or nationals and, as such, fell within the exclusion of the 'denial of benefits' clause contained in Article 17(1) of the ECT.

Article 17 of the ECT provides that:

> "Each Contracting Party reserves the right to deny the advantages of this Part [Part III: Investment Promotion and Protection] 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."

The Tribunal dismissed the Russian Federation's argument and provided important clarification on the mechanism of the denial of benefits clause.

The Tribunal held that the denial of benefits provision in Article 17(1) does not affect the dispute resolution mechanism in the Treaty (which is not comprised in its Part III) and cannot be exercised as to defeat the investors' legitimate expectation of substantive treaty protection under Part III of the Treaty. Confirming the rulings of the Tribunal in the *Plama v. Bulgaria* case, the *Yukos* Tribunal held that Article 17(1) does not constitute an automatic denial of benefits; rather, it confers a right that must be exercised in order to produce effect:

> "Article 17(1) does not deny *simpliciter* the advantages of Part III of the ECT—as it easily could have been worded to do—to a legal entity if

> the citizens or nationals of a third State own or control such entity and if that entity has no substantial business in the Contracting Party in which it is organized. 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."

Further confirming the *Plama* decision, the Tribunal in the *Yukos* matter held that when the right to deny advantages of Part III is exercised, it can only be prospective from the date of its exercise. Indeed, a retrospective application of a denial of benefits clause would be inconsistent with the Treaty's objectives of promotion and protection of investments:

> "To treat denial as retrospective would, in the light of the ECT's 'Purpose,' as set out in Article 2 of the Treaty ('The Treaty establishes a legal framework in order to promote long-term cooperation in the energy field . . .') be incompatible 'with the objectives and principles of the Charter.' Paramount among those objectives and principles is 'Promotion, Protection and Treatment of Investments' as specified by the terms of Article 10 of the Treaty. Retrospective application of a denial of rights would be inconsistent with such promotion and protection and constitute treatment at odds with those terms."

Finally, the Tribunal introduced an important element as regards the mechanism of Article 17 when it found that a 'third State' under this provision refers to a non-Contracting State and therefore does not include the State hosting the investment. Indeed, the Tribunal held that "[t]he Treaty clearly distinguishes between a Contracting Party (and a signatory), on the one hand, and a third State, which is a non-Contracting Party, on the other," and that, as a consequence, "the Russian Federation, for purposes of Article 17 of the ECT, is not a third State."

The Crucial Impact of the Decision for Investors

The Interim Award rendered in the three arbitrations against the Russian Federation goes far beyond the specific case of the majority shareholders of former Yukos Oil Company. It has significant precedential value for all investors in the energy sector who can claim the protection of the ECT.

Investors operating in the territory of all ECT Parties can find in the Award valuable guidance on the conditions under which an investor and its investment can be protected under the ECT, and on the mechanism of the denial of benefits clause contained in Article 17.

For protected investors operating in Russia, the furtherance of the rule of law is now reinforced by the Award rendered by a high-caliber international Arbitral Tribunal holding that the Russian Federation is bound by the ECT and that investments made prior to the termination of provisional application continue to benefit from the Treaty's protection for a period of 20 years, *i.e.* until October 19, 2029. This decision also puts an end to the Russian Federation's recent attempts to portrait the ECT as a "stillborn" instrument that needs replacement.[2] Quite to the contrary, the ECT is a very effective multilateral instrument protecting investors in the field of energy, with 24 arbitrations initiated to this date pursuant to the investor-State arbitration provision of the Treaty.

[1] The Arbitral Tribunal is composed of L. Yves Fortier, CC, QC (President), Judge Stephen M. Schwebel and Dr. Charles Poncet. The decision referred to here is the Interim Award rendered on November 30, 2009 in each of the three arbitrations initiated by the majority shareholders of former Yukos Oil Company against the Russian Federation: *Hulley Enterprises Limited v. The Russian Federation* (PCA Case No. AA 226), *Yukos Universal Limited v. The Russian Federation* (PCA Case No. AA 227), *Veteran Petroleum Limited v. The Russian Federation* (PCA Case No. AA 228).
Shearman & Sterling LLP represents the Claimants in these arbitrations.

[2] See in particular the "Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles)" proposed by President Medvedev at the G8 Helsinki meeting of April 21, 2009.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact:

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