# Swiss Supreme Court upholds multibillion-dollar Yukos award

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In *Decisi*on *4A_492/2021*, the Swiss Supreme Court upheld a USD5 billion award won by Yukos Capital, rejecting Russia's application to set it aside based on lack of jurisdiction and breach of public policy.

## Speedread

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In a recently published French-language decision that has been slated for publication in the *Official Journal of the European Union*, the Swiss Supreme Court rejected Russia's petition to set aside a USD5 billion award in favour of Yukos Capital, a finance company of the Yukos group, under the Energy Charter Treaty (ECT).

The Swiss Supreme Court upheld the arbitral tribunal's jurisdiction under a provisional application of the ECT, which Russia had signed but never ratified, considering that it was not incompatible with Russian law. It found that the loans granted by Yukos Capital to its parent company Yukos Oil qualified as protected investments within the meaning of the ECT and did not constitute an abuse of rights. The Supreme Court also rejected Russia's argument that the investment was illegal, as well as the argument that the damages awarded to Yukos Capital enriched the injured party and therefore violated Swiss international public policy.

The decision addresses several issues of Swiss procedural and public international law that may prove relevant in future proceedings before the Swiss Supreme Court and elsewhere, and gives clear guidance as to the admissibility of new evidence in set-aside proceedings before the Supreme Court. (*Decision 4A_492/2021 (24 August 2022)*.)

## Background

Article 26 of the Energy Charter Treaty (ECT) provides the dispute resolution mechanisms available to an investor, which include international arbitration.

Article 45(1) of the ECT provides that "[e]ach signatory agrees to apply the treaty provisionally pending its entry into force for such signatory … to the extent that such provisional application is not inconsistent with its constitution, laws or regulations".

Article 190(2) of the of the Swiss Private International Law Act (PILA) provides that:

> "The award may only be challenged:

 

…

(b) if the arbitral tribunal wrongly accepted or declined jurisdiction

…

(d) if the principle of equal treatment of the parties or the right of the parties to be heard was violated

(e) if the award is incompatible with public policy".

## Facts

Yukos Capital, a finance company of the Yukos group, granted two loans to its parent company Yukos Oil in 2003 and 2004, funded by non-recourse, back-to-back loans from other Yukos Oil subsidiaries.

In 2013, Yukos Capital initiated arbitration against the Russian Federation under the ECT, arguing that the loans it had granted to Yukos Oil constituted protected investments within the meaning of the ECT, which had been illegally expropriated by Russia in the process of Yukos Oil's bankruptcy.

In an interim award on jurisdiction dated 18 January 2017, the arbitral tribunal rejected some of Russia's jurisdictional objections, holding by a majority that Russia was bound by the provisional application of the ECT, which the state had signed but never ratified, and that the loans at issue constituted protected investments. Russia applied to set aside the interim award, but the Swiss Supreme Court ruled that the challenge was premature because the arbitral tribunal had not yet dealt with all of the state's jurisdictional objections (see Decision 4A_98/2017 (20 July 2017) discussed in *Legal update, Swiss Supreme Court finds that challenge to Yukos Capital jurisdictional award is premature*.)

The arbitral tribunal issued its final award on 23 July 2021, rejecting further jurisdictional objections and awarding, by a majority, some USD5 billion to Yukos Capital under the 2003 loan. The recovery of sums advanced under the 2003 loan after May 2004 was reduced by 50% and no sums were awarded under the 2004 loan on the ground that Yukos Capital had lent these amounts at a time when it was reasonably foreseeable that those funds would be lost, thereby causing or contributing to its own loss.

The final award was accompanied by two partial dissenting opinions, one as to the amount of compensation, the other concluding that the majority's decision resulted in unjust enrichment, putting Yukos Capital in a better financial position than it would have been in without the purported ECT breaches. The latter was because, under the global economic transaction, Yukos Capital's role was limited to transferring money from one company of the Yukos group to another for a profit (that is, the difference in interest rates between the disputed loan and the back-to-back loan, referred to as the "spread").

 

In September 2022, Russia applied to set aside both the interim award on jurisdiction and the final award, arguing that the arbitral tribunal had wrongly upheld its jurisdiction and that the final award violated public policy.

## Decision

The Swiss Supreme Court dismissed the setting aside application.

### Admissibility of new evidence in setting-aside proceedings

The Supreme Court first examined the issue of admissibility of new evidence in setting-aside proceedings. It recalled the rule under Swiss law that the prohibition against relying on new evidence in setting-aside proceedings only pertains to factual exhibits, not legal exhibits that support the legal arguments of the petitioner. New legal opinions, legal commentaries or case law that post-date the award are admissible, but only to the extent that they reflect or describe the state of the law as of the date of the award. By contrast, new legal exhibits that amount to new developments compared to the state of the law as of the date of the award, are inadmissible. This is because the Supreme Court reviews the legal findings of the arbitral tribunal based on the state of the law prevailing at the date of the award.

When setting-aside proceedings are directed against both an interim award and a final award, the Supreme Court held that the relevant date to determine the admissibility of new evidence is the date of the award targeted by the ground for setting aside in support of which the new evidence has been filed. On this basis, the Supreme Court found that new legal opinions submitted by the applicant to support and complement its legal arguments were admissible, whereas court and arbitral decisions rendered after the interim award on jurisdiction, as well as reports by the International Law Commission or the EU established after that date, were inadmissible (as were the corresponding submissions of the parties).

### Provisional application of the ECT

The first jurisdictional ground raised for setting aside the award was that the arbitral tribunal had erred in finding that Article 26 of the ECT (providing for recourse to arbitration) was provisionally applicable in the case at hand because such provisional application was incompatible with Russian law within the meaning of Article 45(1) of the ECT.

Among other things, the Supreme Court examined the meaning and scope of Article 45(1) (the so-called "incompatibility clause") and considered that two interpretations were possible:

- That "such provisional application" referred to the principle of the provisional application of the ECT, in its entirety, in which case a state could refuse to provisionally apply the ECT only if the principle of provisional application is incompatible with its domestic law (the "all or nothing" approach).
- That a state should provisionally apply certain provisions of the ECT except those that are incompatible with its domestic law (the "piecemea"' approach, based on the wording "to the extent", which implies that the scope of the provisional application may vary).

The Supreme Court found that that there was no need to take a final position on this issue of interpretation because the provisional application of the ECT was, in any event, in its view not incompatible with Russian law.

The Supreme Court underlined that provisional application is the rule under the ECT and the incompatibility clause the exception. Accordingly, it is for the party alleging the existence of an incompatibility between the provisional application of an ECT provision and its domestic law to prove such incompatibility. According to the Supreme Court, the relevant date to assess whether there is an incompatibility is the date on which the arbitration was initiated. After examining in great detail the

 

different arguments raised by the parties, the Swiss Supreme Court concluded that the applicant had failed to demonstrate that the provisional application of the ECT is incompatible with Russian domestic law.

## Qualification of the disputed loans as protected investments under the ECT

The second jurisdictional ground for setting aside was that, by concluding that the loans granted by Yukos Capital to its parent company qualified as protected investments under the ECT, the majority had disregarded the network of economic transactions in which the loans were included and therefore wrongly assumed jurisdiction. Russia argued that the loans between Yukos Capital and Yukos Oil, on the one hand, and the back-to-back loans between Yukos Capital and its lenders, on the other hand, could not be viewed as two separate sets of transactions, but had to be viewed as a single transaction in which funds flowed within the group of companies, passing provisionally through Yukos Capital. Hence, Yukos Capital was not the true economic owner of the loans. Russia further argued that the loans lacked the inherent characteristics of an investment, since Yukos Capital had neither made any genuine contribution nor incurred any risk in entering the loans.

The Supreme Court observed that the definition of the term "investment" given by Article 1(6) of the ECT is very broad ("'Investment' means every kind of asset, owned or controlled directly or indirectly by an investor"; "'Investment' refers to any investment associated with an economic activity in the energy sector") and does not contain any requirement as to the origin of the funds invested. According to the Supreme Court, the only extraneity requirement under the ECT concerns the investor, not the investment.

The Supreme Court found that the arbitral tribunal had rightly concluded that, to qualify as a protected investment under the ECT, it was sufficient for a loan to be granted in favour of a company active in the energy sector (which was the case of Yukos Oil), without any need for the loan itself to be assigned to the performance of an economic activity in the energy sector. More generally, the Supreme Court underlined in its decision that the ECT only required the investment to be "associated with", and not devoted to the performance of "an economic activity in the energy sector".

The Supreme Court considered that there was no reason to disregard the legal owner of an investment and look instead to its beneficial owner, since the ECT provides that an investor may "own" or "control" an investment. The arbitral tribunal had therefore rightly concluded that the loans granted by Yukos Capital constituted assets owned by an investor and were associated with an economic activity in the energy sector.

The Supreme Court further noted that Article 1(6) of the ECT does not contain any express requirement of a "contribution" having to be made, or "risk" assumed, by the investor, which according to the Supreme Court raises the question of whether such requirements are implicitly contained in the notion of investment. The Supreme Court ultimately refused to take a position on this controversial issue, finding instead that the criticism raised against the arbitral tribunal's decision in this case was, in any event, devoid of any merit for the following reasons:

- The contribution element was satisfied since the loans resulted in an international financial flow between a foreign investor and a Russian company. The Supreme Court observed that it is common for international groups of companies to carry out financial transactions amongst different entities of the group, including for tax reasons. Since the ECT contains no restriction as to the purpose pursued by the investor, nothing in the ECT prevents an intra-group loan granted for tax reasons from qualifying as a protected investment within the meaning of Article 1(6) of the ECT.
- The risk element was also satisfied since it was Yukos Capital that bore the risk of default by Yukos Oil. According to the Supreme Court, Russia's argument that Yukos Capital did not bear any risk because, in the event of default by Yukos Oil, Yukos Capital had no obligation to repay its own lenders, conflated the legal concept of risk and the economic consequences of its occurrence. The Supreme Court considered the fact that Yukos Capital had protected itself against the risk of default by negotiating back-to-back loans that reduced or even eliminated the financial consequences of the occurrence of such risk to be irrelevant.

 

The Supreme Court concluded that the arbitral tribunal had rightly qualified the loans as protected investments within the meaning of Article 1(6) of the ECT.

## Alleged abuse of rights

The third jurisdictional ground raised by Russia was that, even if the loans qualified as protected investments under the ECT, Yukos Capital was not entitled to ECT protection because it had committed an abuse of rights since:

- The purpose of the ECT was to promote genuine investments in the energy sector, and not circular flows of capitals designed to avoid taxes.
- The 2003 loan had been granted at a time when it was foreseeable that the funds would not be repaid given the tax and criminal investigations pending against Yukos Oil and its directors.

The Supreme Court referred to other recent decisions addressing the issue of abuse of rights and reiterated that, as a rule, the concept must be restrictively applied. In the present case, the Supreme Court found that there was no basis in the ECT to suggest that an investment associated with an economic activity in the energy sector and motivated by tax reasons is incompatible with the purpose of the ECT, which seeks to promote all investments (broadly defined) associated with an economic activity in the energy sector. Yukos Capital had therefore committed no abuse of rights by repatriating assets to Russia as loan proceeds to avoid Russian taxes.

As for the argument that it was foreseeable, when the 2003 loan was granted, that it would not be repaid, the Supreme Court expressed doubts as to whether such a position could amount to an abuse of rights. The arbitral tribunal had correctly considered that the issue of whether the risk of default was foreseeable related neither to the tribunal's jurisdiction nor to the admissibility of the claim, but rather to the question of causation and the claimant's contribution to its own damage, which are both substantive issues which the Supreme Court cannot review. The Supreme Court further held that, in any event, based on the factual findings of the award, the risk of Yukos Oil's default was not objectively foreseeable when Yukos Capital extended the 2003 loan.

For these reasons, the Supreme Court ruled that Yukos Capital had not committed an abuse of rights by seeking ECT protection for its 2003 loan.

## Alleged illegality of the investment

The fourth jurisdictional ground for setting aside was that the arbitral tribunal had wrongly assumed jurisdiction by incorrectly limiting its analysis of the legality of the alleged investments to the question of the existence of a criminal intent, whereas "simple" regulatory breaches of Russian tax law/or of the double taxation treaty between Russia and Luxembourg (or both) were sufficient to render the investment illegal and therefore deprive the arbitral tribunal of jurisdiction.

The Supreme Court found this grievance inadmissible for two reasons:

- It held that the alleged illegality of an investment cannot affect the jurisdiction of the arbitral tribunal in the absence of an express compliance clause in the ECT, or of any other indication that the legality of the investment has an impact on its qualification as a protected investment within the meaning of Article 1(6) of the ECT. The Supreme Court referred to Decision 4A_65/2018 of 11 December 2018 (see *Legal update, Swiss Supreme Court dismisses challenges to interim award on jurisdiction in investor-state arbitration*), in which it had analysed (for the first time) the impact of the legality of an investment both on the arbitral tribunal's scope of decision and the Supreme Court's scope of review in setting-aside proceedings.

 

- It found that if anything, an undue limitation by the arbitral tribunal to its power of examination constitutes a breach of a party's right to be heard. Therefore, the grievance raised in this case that the arbitral tribunal had unduly limited its analysis of the legality of the investments to the sole question of the existence of a criminal intent amounted, if anything, to a violation of the right to be heard, within the meaning of Article 190(2)(d) of the PILA, and not to a wrong ruling on jurisdiction. The Supreme Court nonetheless analysed the grievance and concluded that it was in any event unfounded.

### Alleged violation of public policy

The last ground for setting aside raised by Russia was that the award was incompatible with public policy in that it violated the principle of prohibition of enrichment of the injured party. It awarded several billion US dollars in principal and interest to Yukos Capital under the 2003 loan, whereas Yukos Capital would have been entitled only to a fraction of these amounts under the overall contractual scheme. Yukos Capital was not entitled to retain the amounts paid by Yukos Oil under the loan for more than one day under the back-to-back loan agreements. Therefore, its only damage was the loss of the "spread" under the 2003 loan, namely less than USD10 million.

The Supreme Court confirmed that the prohibition of enrichment of the injured party is a fundamental principle of Swiss law and part of domestic public policy. It further recalled that it had previously left open the question of whether this principle also amounts to a matter of international public policy within the meaning of Article 190(2)(e) of the PILA. The Supreme Court ultimately left this general question unresolved, as it found that there was no violation of international public policy in the sense of Article 190(2)(e) in the present case.

The Supreme Court found that the arbitral tribunal had rightly considered that the fact that Yukos Capital was contractually bound under the back-to-back scheme to transfer all amounts received from Yukos Oil to its own lenders had no bearing on the fact that only Yukos Capital had the right to seek repayment of the loan to Yukos Oil and was therefore the sole legal owner of the investment. The Supreme Court concluded that, by ordering the payment of damages equivalent to the principal and interest due under the loan (rather than the profit that Yukos Capital was supposed to make under the transaction), the award did not violate international public policy in the sense of Article 190(2)(e) of the PILA. Namely the essential and broadly recognised values which, according to the prevailing views in Switzerland, should constitute the basis of any legal order.

## Comment

The underlying award was one of the largest ever challenged before the Swiss Supreme Court and the resulting decision, at 85 pages, is the longest ever published in setting-aside proceedings in Switzerland. The decision addresses several issues of Swiss procedural and public international law that may prove relevant in future proceedings before the Swiss Supreme Court and elsewhere.

First, the Supreme Court provided clear guidance as to the admissibility of new evidence in setting-aside proceedings before the Supreme Court: new legal exhibits are admissible to the extent they reflect or describe the state of the law existing as of the date of the award, whereas new legal exhibits and other evidence concerning legal developments that took place after the challenged award was rendered are inadmissible.

Second, the Supreme Court found that, in the absence of an express compliance clause in an investment treaty (or any other indication that the legality of the investment has a bearing on the qualification as a protected investment under the treaty), the issue of the legality of an investment pertains to the merits and not to jurisdiction. This means that, in the absence of an express compliance clause or similar, the Swiss Supreme Court will only review the legality of the investment from the restricted standpoint of the incompatibility of the award with public policy and not with the wider power of review it applies to the arbitral tribunal's findings on jurisdiction.

 

Third, although the Supreme Court refused to take a position on the controversial issue of whether the notion of "investment" under the ECT necessarily implies an element of "contribution" made, and "risk" assumed, by the investor, it nevertheless gave some useful guidance as to how such elements may be assessed under the ECT:

- Nothing in the ECT prevents an intra-group transaction motivated by tax optimisation reasons from qualifying as a protected investment under Article 1(6) of the ECT, provided the transaction in question is associated with an economic activity in the energy sector.
- The existence of a risk assumed by an investor should not be assessed by reference to other transactions concluded by the same investor with third parties to reduce or eliminate the financial consequences of the investment risk.

## Case

*Decision 4A_492/2021 (24 August 2022)* (Swiss Supreme Court).

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