MONCKTON CHAMBERS

OAO *Neftyanaya Kompaniya Yukos v. Russia*, Just Satisfaction, 31 July 2014, Application no. 14902/04: ECtHR's Largest Ever Award for Just Satisfaction

Conor McCarthy
August 2014

In this landmark decision on just satisfaction (following its earlier decision on the merits of the dispute in 2012) the European Court of Human Rights made, by far, its largest ever award for pecuniary loss, ordering Russia to pay in the region of 1.9 billion Euros in compensation to the former shareholders of Yukos, (plus any tax that may be chargeable in respect of that sum). The Court made awards in respect of the retroactive imposition of penalties on the applicant company (c. 1.3 Billion Euros) and unlawful interference with its rights under Article 1, Protocol 1 of the Convention on account of the enforcement proceedings taken against it (c. 0.6 Billion Euros).

The Court did not address the decision by the Russian authorities to auction OAO Yuganskneftegaz, one of Yukos's most valuable assets, a decision which the Court had earlier found in its decision on the merits of the dispute, extinguished the company's "only hope of survival". Furthermore, in its earlier findings on merits, the Court determined that the haste with which Russia's domestic courts had conducted the tax proceedings had violated Yukos's right to a fair hearing under Article 6, ECHR. The court declined to make any award in respect of this violation, finding an absence of a sufficient causal connection between the violation in question and pecuniary harm to Yukos.

Introduction

The events underlying the Yukos case occurred in the early 2000s, a period of considerable economic and political upheaval in Russia. Between 2002 and 2003 the Russian authorities investigated the tax affairs of Yukos. This culminated, in April 2004, in the company being assessed as having accumulated huge tax liabilities, in part, according to the findings of the Russians authorities, as a result of Yukos having used impermissible sham companies to evade tax. Yukos was ordered to pay approximately 1.4 bn Euros in tax arrears for the year 2000, 1 bn Euros in interest and a further 0.5 bn Euros in enforcement penalties. In the same month proceedings were initiated against Yukos alleging improperly declared tax liability and seeking the attachment of the company's assets as security for the claim. A hearing was held in respect of the Tax assessment between 21 and 26 May 2004, with much of the evidence in support of the assessment (running to several tens of thousands of pages) being served on 17 May 2004 and in subsequent days immediately prior to the hearing. The assessment was upheld with Yukos

found liable to pay well over 1.3 Bn Euros in respect of tax in the year 2000, together with almost 1 bn in interest and 0.5 billion in penalties. Subsequently, the penalty imposed on Yukos (approximately 0.5 bn Euros) was doubled when the tax authorities determined that Yukos had used similar tax arrangements in 2001 to those used in 2000.

On 30 June 2004, the Appeal Court issued a writ for the enforcement of Yukos's assessed liabilities, compelling compliance within 5 days. Upon Yukos's failure to pay the sums within the required period, further penalties of 7 % of the debt were levied. Yukos's requests to extend the very short deadline for payment were unsuccessful. In the next six months there followed further tax re-assessments for each subsequent year to 2003, including in particular huge assessments to VAT as well as profits taxes, penalties and interest, ultimately totalling some Euros 24Bn. The enforcement of these liabilities was immediate and in the absence of immediate payment in full incurred further surcharges.

Yukos were unable to obtain sufficient liquid funds to meet the liability. In December 2004 the majority of the shares in its largest and most profitable subsidiary, Yuganskneftegaz, ("YNG"), were auctioned to meet its tax liability, rendering insolvency inevitable. Yukos was declared insolvent in August 2006.

Background: The ECtHR's Decision on Merits 2012[1]

Before the ECtHR, Yukos challenged the manner of the company's treatment by the Russian authorities, contending, among other things, that (1) the lack of time given for preparation for the tax proceedings, together with other procedural irregularities, resulted in a breach of Article 6 of the Convention; (2) the manner of enforcement of the tax assessments and the forced sale of its subsidiary had been unlawful, arbitrary and disproportionate.

In its findings on merits, issued in March 2012, the ECtHR found that the treatment of Yukos by Russia had violated the company's rights under the Convention, in particular the right to a fair hearing under Article 6 (1), ECHR and its proprietary rights under Article 1, Protocol 1 of the Convention. Specifically, the Court found:

(a) Article 6 (1) of the Convention had been violated in consequence of the wholly insufficient time given to Yukos to prepare its case at first instance and on appeal in respect of its alleged tax liability;

(b) Article 1 of Protocol No. 1 had been violated on account of the 2000-2001 Tax Assessments in the part relating to the imposition and calculation of penalties, which did not comply with the requirements of legality under Article 1, Protocol 1. The Enforcement fee of 7% levied in respect of these unlawful fees were also found to be unlawful in consequence;

(c) Article 1 of Protocol No. 1 was also found to be further violated as a result of the enforcement proceedings against the company in that the domestic authorities failed to strike a fair balance in relation to the measures employed to enforce tax liability against Yukos. In particular the Court based this finding on the rigid

1. OAO Neftyanaya Kompaniya Yukos v Russia (2012) 54 E.H.R.R. 19.

> approach adopted in relation to the timing of the enforcement of the tax liability and the almost immediate forced sale of YNG, Yukos's most profitable subsidiary. As regards the latter issue the Court found that Russia should have, and failed to, afford serious consideration to alternative means by which liabilities could be met. In addition, the Court found that the rigid and inflexible manner of the application of the enforcement fees (1 bn Euros) "was completely out of proportion to the amount of the enforcement expenses which could have possibly been expected to be borne" by Russia and which, "because of its rigid application, instead of inciting voluntary compliance, contributed very seriously to the applicant company's demise".

The Decision on Just Satisfaction

Unsurprisingly in its findings on merits, the Court reserved issues of just satisfaction to separate proceedings. The Court made awards in respect of the retroactive imposition of penalties on the applicant company (c. 1.3 Billion Euros) and unlawful interference with its rights under Article 1, Protocol 1 of the Convention on account of the enforcement proceedings taken against Yukos (c. 0.6 Billion Euros). No award was sought (or made) in respect of non-pecuniary harm suffered by the company.

The judgment on just satisfaction is significant in a number of ways – both in relation to the questions it answers and those matters which the Court has left unanswered or, at least, those matters left unexplained.

Perhaps the most significant aspect of the judgment is its emphatic affirmation that a company which wishes to enforce rights under the Convention in relation to events prior to its liquidation can do so following that liquidation and, where appropriate, can successfully seek significant compensation where events leading to its liquidation have contravened its Convention rights, whether under Article 1, Protocol 1 or otherwise.

In addition, the Court has also provided some clarification of the "exceptional circumstances" in which the shareholders of a company may be entitled to seek compensation and the methods by which distribution will be managed in such circumstances. In the earlier case of *Agrotexim and Others v Greece* (1996) 21 E.H.R.R. 250, the Court held that it:

> 66. [...] considers that the piercing of the "corporate veil" or the disregarding of a company's legal personality will be justified only in exceptional circumstances, in particular where it is clearly established that it is impossible for the company to apply to the Convention institutions through the organs set up under its articles of incorporation or—in the event of liquidation—through its liquidators.

In its judgment on just satisfaction, the Court found that, notwithstanding Yukos's liquidation (indeed, because of it), shareholders were entitled to compensation in their own right for the pecuniary harm the company had sustained. Rather than pay such funds through the Yukos International Foundation for such purposes, the Court required Russia to arrange for direct payments of the funds to shareholders in proportion to their participation in the company's nominal stock at the date of dissolution.

OAO NEFTYANAYA KOMPANIYA YUKOS V. RUSSIA, JUST SATISFACTION

A number of other points in the decision are also striking. The Court expressly applied the orthodox *"restitutio in integrum"* [2] standard in respect of the unlawful retroactive penalties found to have been imposed on Yukos. This is in line with the approach adopted in numerous previous cases. An interesting issue, however, concerns how, precisely, quantum ought to be calculated in relation to conduct amounting to a disproportionate interference with rights under Article 1, Protocol 1 where the enforcement measures themselves in respect of the proprietary rights (in this case the taxes and charges) are not themselves found to be unlawful. Here, the question arises as to whether the *restitutio in integrum* principle is applicable in such circumstances and, crucially, how exactly it is to be applied.

As regards the enforcement fees levied against Yukos, the Court found that the 7% penalty was "completely out of proportion to the enforcement expenses" associated with the tax proceedings. The Court found that "in order to satisfy the requirements of proportionality the enforcement fee should have been reduced to 4%". The approach to assessment of quantum the court appears to envisage in such circumstances, (without having said so specifically) is to assess hypothetically the level at which a penalty would have been proportionate and award compensation in respect of the outstanding "disproportionate" element of the penalty or fee. Quite why the Court felt that 4% would have been proportionate is not entirely clear, given that the 4% figure was itself colossal and almost certainly not remotely reflective of the costs of enforcement proceedings.

Moreover, it seems that other aspects of the "disproportionality" of the enforcement proceedings (and their financial consequences for the company) were not addressed by the Court under this head of damage. In particular, the question of whether alternative (proportionate) means of enforcement would have allowed the company to continue in existence, to make profit or reduce losses was not addressed. Surprisingly the Court did not address the decision by the Russian authorities to auction Yuganskneftegaz, one of Yukos's most profitable assets (a decision which the Court found extinguished the company's "only hope of survival"). In particular, during the merits phase of proceedings, the Court found that the timing of Russia's decision to auction YNG, together with its failure to afford serious consideration to alternative means by which Yukos's liabilities could be met, contributed to a violation of Article 1, Protocol 1.

Despite this no mention was made of the auction or the consequences which flow from it (and their implications for quantum, if any) in the just satisfaction decision. As the court itself implicitly recognized, YNG did offer Yukos some prospect of survival and it potentially offered the prospect of further not inconsiderable profit. Furthermore, there was evidence before the Court that YNG had been sold at a substantial undervalue. Ordinarily, loss of opportunity and/or lost profit may properly be the subject of a separate award. It may be that it was felt that Yukos's liabilities were such that a further award in respect of pecuniary loss caused by the auction and the fire sale of YGN at less than market value

2. E.g. Reparation sufficient to put the injured party in the position the party would have been in had the unlawful act not occurred. The classic statement of this proposition is set out in Factory at Chorzow (Germany v. Poland), Merits, 1928, PCIJ Series A. No. 17, p. 47.

would have been speculative. Whatever the reasons may be, it is perhaps unfortunate that these issues were not directly addressed, especially given the scale of the sums involved.

Overall, though, the Yukos case was a difficult one for the Court, and not merely because of the many complex legal issues involved. Although the Court's reasoning is at times delphic, its approach to questions of just satisfaction is more principled than has, at times, been the case in the past. This is certainly a development to be welcomed.

Piers Gardner acted for the applicant company throughout this case (2004-14) including during the six years since Yukos was liquidated and struck from the register of companies in Russia

The comments made in this case note are wholly personal and do not reflect the views of any other members of Monckton Chambers, its tenants or clients.

Monckton Chambers
1 & 2 Raymond
Buildings
Gray's Inn
London, WC1R 5NR

Tel: +44 (0)20 7405 7211
Fax: +44 (0)20 7405 2084
Email: chambers@monckton.com
www.monckton.com