The Yukos Money Laundering Case: A Never-Ending Story

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by
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1. The Brief Story of Yukos Group

The beginning of the first decade of the twenty first century is famous for its corporate governance and accounting scandals, which finally led to the adaptation of the Sarbanes-Oxley Act in the US and analogous legislation around the world. The events of September 11th 2001 led to the adaptation of the complex, multi-level, international anti-money laundering legislative framework, which has respectively had a great impact on the anti-money laundering regimes worldwide. This adaptation, however, appears to also be capable of generating uninvited money laundering scandals. Before the universal adaptation of internationally recognised principles of the anti-money laundering fight, such scandals could be understood as the logical implication of the non–compliance of the several countries, but now it is evident that grounds for known international corporate failures are much deeper and need to be thoroughly researched.

The notorious Yukos Oil Company\(^1\) case, which has been on-going since early 2003, can be taken as a striking example of a new type of corporate disaster, representing a potential danger which has not yet been properly estimated.\(^2\)

Yukos Oil Company was one of the biggest Russian “virtually integrated holding companies”\(^3\) created in the course of large scale Russian privatization and sold to the Menatep Group, in one of the infamous post-soviet “loans for shares” tenders.\(^4\)

The loans-for-shares programme of 1995 has been widely criticized for its lack of transparency and for its fraudulent arrangements. Under this programme, the gems of the Russian economy—most promising...
companies in the industrial and energy sector—were in fact sold out to businesses in exchange for minimal loans to the Government.\textsuperscript{5}

Yukos was no exception. Yukos, under Menatep’s control, widely used asset-stripping techniques, as did the majority of Russian production companies sold to oligarchy groups. This allowed the controlling shareholders to enjoy the benefits of non-transparency and transfer pricing, which resulted in excessive profit.\textsuperscript{6} However, in 2000, under the leadership of Mikhail Khodorkovsky, the core Menatep Group shareholder, the Company changed its strategy and began implementing international standards of reporting and accountability. Within several years Yukos, from being an oligarchic structure, evolved into a favorite of the Russian securities market and companies such as Standard and Poor’s, which rate corporate governance.\textsuperscript{7} The Company approved its own ADR programme and published annual and quarterly accounts, audited by PWC.\textsuperscript{8}

\textbf{Figure 1. The General Structure of the Yukos Group}
The Yukos case is known as a complex and ambiguous composition of fraud, tax evasion, and other criminal cases, launched against several Yukos shareholders, managers and employees.\(^9\) The backbone of the case is the money laundering charges brought against the organized criminal group, which allegedly comprised of the Company’s top managers and was headed by the former core shareholder and CEO, Mikhail Khodorkovsky. Khodorkovsky and his allies have been charged with the laundering of approximately 27 bn. US dollars; the approximate equivalent of the Company’s profits over a four-year period.\(^11\) Some commentators think that the Yukos case is a reflection of the general problems of partisan and predatory privatization in Russia:

*Privatization did create the property owners in the Russian Federation—masses of small shareholders without any power to influence decisions over the enterprises they “own”. It also produced few “new Russians”, who have acquired enormous wealth by skillfully taking advantage of the weaknesses of the transition period, including the lack of transparent and clear rules and diminished law enforcement capacities of the State. In the absence of appropriate rules to regulate or mechanisms to monitor the developments, the market-oriented transformations, particularly privatization, stimulated an unprecedented rise in the legalization of criminal assets and property acquired by unlawful means.*\(^12\)

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The factors and circumstances leading to the collapse of Yukos are manifold, and can be analyzed from different angles. Yukos defenders, amongst whom are prominent politicians, lawyers and analysts, clearly see a political motivated element to the case, arguing that Yukos individuals have been prosecuted and the Company is facing liquidation exclusively because of Khodorkovsky’s political and public activities.13 Others consider Khodorkovsky to be a mere criminal who headed Russia’s most powerful and dangerous “corporate criminal group”.14 The moderate analysts see in the Yukos collapse, a culmination of Putin’s fight against oligarchs, in his quest to strengthen a weak Russian state, and the clash between different influential Kremlin groups, struggling for oil revenues. These moderates nevertheless recognize the element of selective treatment in the Yukos/Khodorkovsky case.15

The core question in the Yukos story is how a company with accounts audited by one of the biggest auditing firms, with shares listed on international stock exchanges, considered a paragon of the Russian corporate governance and transparency, has become involved in a money laundering scandal of unprecedented magnitude: to the sum of 27 bn. US dollars.

2. The Yukos Case: The Timeline and the Consequences

The Yukos case began effectively in 2003 when the political thrust of the case was highlighted by a report titled ‘The State Versus the Oligarchy” published by the

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Council for National Strategy. The report was openly aimed at oligarchs who were accused of privatisation by theft, impoverishment of the nation, the “creation of a system of anti-national values” and high treason (by appealing for help to outside countries and “representing outside interests”). They were also accused of forcing through “oligarchic modernization”, and ultimately of trying to acquire a dominant position in the state.

The real confrontation between Yukos and the State, represented by the General Prosecutors Office, started on 2 July 2003 when Khodorkovsky’s personal friend and the GEO of the Menatep Group, Platon Lebedev, was arrested. The arrest of Lebedev was widely interpreted as a “warning” to Khodorkovsky to leave Russia. However, Khodorkovsky did not leave, instead making desperate attempts to mitigate the attack on Yukos and his allies. He travelled to the US, aiming to persuade high ranking US politicians to intervene, and he made a hectic tour around the main Russian regions, meeting the governors. Putin’s allies viewed such an undertaking as a political gesture and Khodorkovsky was arrested in Nvisibisk and charged with various counts of fraud and tax evasion. His hearing lasted for approximately a year, and regardless to the efforts of numerous lawyers, he and his friend Lebedev were sentenced to 8 years detention in Chita, Siberia, the furthest region in Russia. Lawyers have since filed several applications with the European Court of Human Rights (ECHR), which have yet to be decided.

In July 2003, the Ministry of Tax and Levies initiated an extraordinary audit of Yukos’s books, as a result of which Yukos was hit with a claim for $3.5bn. The same action was repeated over three times in three subsequent years, totalling a claim of

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16 For more details see Mikhail Delyagin, The Yukos Case as a Mirror on the “Dictatorship of Squalor’, (Moscow: Institute for Globalization Issues, 2005), 16.
19 Fortescue, Russian’s Oil and Barons and Metal Magnates at 123-26.
approximately 27 bn. US dollars. The Government decided to organize a forced sale of Yukos’ main production unit, Yganskneftegas, in December 2004. The management, who flew out of the country under pressure from the prosecutor, undertook an unprecedented attempt to block the action by filing a Chapter 11 application with the US bankruptcy court in Houston. The Court initially issued a TRO, prohibiting Russian companies and western banks from participating in the questionable auction for several years, but finally the application was declined. In spring 2006, Yukos’ western creditors commenced the liquidation procedure. By June 2007, the majority of Yukos’ assets had been sold on auction and had been acquired mainly by the state-owned companies of Gazprom and Rosneft.

Dissatisfied with the fact that Khodorkovsky’s first term in prison would be coming to its mid-point in October 2007, enabling him to ask to be released on payroll, Kremlin “hawks” arranged for a second group of charges to be brought against Khodorkovsky and his allies. These charges are known as “The Second Khodorkovsky case” or “The Money-Laundering Case”.

**Figure 2. Diagram of the Yukos case**

**THE YUKOS CASE**

**CRIMINAL**

- **Personal Taxes**
  - “First” Khodorkovsky & Lebedev Case

- **General Fraud**
  - Cases of the managers and employees

**Administrative and Civil**

- **Yukos Corporate Tax Evasion**

**Taxes, Embezzlement & Money Laundering**

- **Organised Criminal**
  - “Second” Khodorkovsky & Lebedev Case

- **Money Laundering Overseas**
  - Cases of the managers and employees

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24 Tim Osborne, ‘Testimony before the Senate Foreign Relations Committee “Democracy on the Retreat in Russia”’, (The Senate Foreign Relations Committee website, 2005), 22 at 2-4.
26 Osborne, ‘Testimony before the Senate Foreign Relations Committee “Democracy on the Retreat in Russia”’, at 5-6.
The complexity of the Yukos case could be seen from the following figures: the total number of exclusively personal criminal cases, launched against managers, employees or affiliated persons of the Company has exceeded one hundred,\(^{30}\) the overall number of the individuals, charged or prosecuted – more than 60,\(^{31}\) the number of court cases in different jurisdictions,\(^{32}\) including Russia, has already exceeded 500,\(^{33}\) the number of individuals on the Interpol search list is 15.\(^{34}\) The case is also famous for the biggest tax claim sum in recent Russian history and the biggest laundered amount of funds.\(^{35}\)


\(^{31}\) See Krutilin, ‘Criminal Alphabet of Yukos’

\(^{32}\) Just one example, PACER list of filings for the case ‘In Re Yukos Oil Co.’ (Judge: Letitia Z. Clark, Date filed: 12/14/2004, Date terminated: 05/06/2006) contains 244 entry. Available at: https://ecf.txcb.uscourts.gov.

\(^{33}\) Personal calculations of the author. The figure includes separate court hearings on the tax debts of each subsidiary, extradition, criminal and ECHR cases.

\(^{34}\) As of May 1, 2007

The impact of the Yukos on the western and international case law is quite significant. For example, the Yukos case has already led to disputes on the problem of “politically motivated” crimes in contemporary Europe, and the use of financial crime charges for politically motivated prosecution. Another example is the contribution, provided by the Yukos Chapter 11 case decision, to American bankruptcy case law. This case has actually already been recognised as a benchmark case, concerning the “forum shopping problem”. Even more interesting might be the decision of the ECHR on the Yukos “tax story”, which is highly likely to set a new benchmark for ECHR tax cases.

3. The Money Laundering Legislation of the Russian Federation

It is widely recognized that the period of transition from socialism to capitalism in the Russian Federation appeared to present limitless opportunities for international money laundering.

Money-laundering in the Russian Federation is closely intertwined with the wide-ranging political, economic and social processes in the country. It has actually become one of the core characteristics of contemporary capitalism in the Russian Federation. It is accepted that, in Russia, it remains incredibly difficult to prosecute alleged criminals due to the lack of appropriate legal frameworks to fight sophisticated financial crimes. However, the Yukos case demonstrates the opposing tendency, confirming that Russian anti-money laundering legislation is a valid legal instrument even for combating such sophisticated organized crimes.


40 United Nations, Russian Capitalism and Money- Laundering at 1.

41 Ibid. at 21.

42 Ibid. at 7.
The development of anti-money laundering legislation in Russia has come through a number of significant obstacles. For a while the Russian Federation was strongly opposing the idea of anti-money laundering legislation and President Yeltsin personally vetoed one of the projects on anti-money laundering laws. Experts think that Russia's general inability to detect and to prosecute money laundering activities was created intentionally, and permitted former members of the Soviet governmental apparatus to legitimize their embezzled funds.\(^{43}\)

In 1996, the Russian Federation enacted a new criminal code that criminalized money laundering.\(^{48}\) The Code was a product of both the need to address the changing social, political, and economic conditions of contemporary Russian society, and the need to confront the drastic increase in post-Soviet crime.\(^{44}\) Article 174 of the Russian Criminal Code, entitled "Legalization of Money (Money-Laundering) or of Any Other Assets Acquired Illegally,"\(^{49}\) specifies punishment for financial transactions involving assets that have been acquired by illegal methods.\(^{45}\) Academics understand Article 174 only as a skeletal provision, purporting to criminalize money laundering activities. Stated in another way, "(the CCRF's) primary importance is as a theoretical normative statement... the new code announces the principles under which Russians one day hope to live."\(^{46}\)

On July 13, 2001, the Duma, proceeding with the fight against money laundering in Russia, passed an anti-money laundering bill.\(^{47}\) The law, as adopted, came into effect in February 2002.\(^{48}\) This law, which amended the Russian Criminal Code, actually established the general anti-money laundering framework in Russia.\(^{49}\) The


\(^{45}\) See CCRF art. 174.


\(^{47}\) The FATF Review to Identify Non-Cooperative Countries or Territories concluded, with respect to Russia, that: 'Currently the most critical barrier to improving its money laundering regime is the lack of comprehensive anti-money laundering law and implementing regulations which meet international standards. In particular, Russia lacks: comprehensive customer identification requirements; a suspicious transaction reporting system; a fully operational FIU with adequate resources; and effective and timely procedures for providing evidence to assist in foreign money laundering prosecutions.' Financial Action Task Force, 'Review to Identify Non-Cooperative Countries or Territories: Increasing the Worldwide Effectiveness of Anti-Money Laundering Measures', in FATF Secrictariat (ed.), (Paris Cedex: FATF, 2000), 24 at 9.


\(^{49}\) The Act was later amended several times and found its development in the decrees of the President, act of Government and regulations of the FIU and the Central Bank.
core characteristics of this framework, pertaining to the definition of money laundering and key elements of offenders’ liability, are the following:

1) The current legislation defines the offence of money laundering as: ‘the performance, for large amounts and with the aim of giving a legal appearance to their possession, use and disposal, of financial and other transactions with monetary funds and other assets which are known to have been acquired by other persons through criminal means (with the exception of the offences defined in articles 195, 194, 198 and 199 of this Code).’

This definition is valid for both offences of money laundering, incorporated in the Russian Criminal Code: Article 174 (when the laundering operations are conducted by a person who has not been involved in the predicate offence) and Article 174.1 (when the laundering operations are conducted by the same person, who committed the predicate offence).

2) The definition of laundering offences in the Russian Criminal Code remained rather broad since the notion of ‘crime’ under Russian law includes all criminal offences irrespective of their gravity. The previous definition did not make the offence dependant on the purpose of disguising the criminal origin of the money. However, the words ‘through illegal means’ were replaced by ‘through criminal means’, which meant that only criminal offences (offences defined by the Russian Criminal Code) may be regarded as giving origin to illicit funds.

3) In application to money laundering offences the Criminal Code contains the word ‘knowingly’, which also restricts the possible application of the articles 177-174.1. Essentially, this means that the offence must have been committed intentionally, negligence not being sufficient.

4) According to experts, article 6 of the Law containing reporting provisions is rather comprehensive in nature. It covers almost all activities commonly associated with money laundering.

In giving general assessment to the Russian anti-money laundering framework, experts have pointed out that the definition of the offence seems to meet minimum standards set by the Strasbourg Convention, and the

50 Tax crimes exception.
51 CCRF, art. 174 and 174.1.
52 It further excluded offences defined by articles 193, 194, 198 and 199 of the Criminal Code, i.e. the failure to repatriate funds in accordance with exchange control regulations, avoidance of the payment of taxes and customs duties (smuggling, however, remains a money laundering offence).
55 Ibid. at 634.
56 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime (Nov 8, 1990) CETS No. 141.
Recommendations of the OECD Financial Action Task Force on Money Laundering (FATF),\(^{57}\) and that Russia is moving towards a comprehensive anti-money-laundering regime.\(^{58}\)

However, as analysts have noted, in the Russian context, the question of defining the criminalization of money laundering has crystallized the moral issues at stake in implementing international recommendations in this field. The decision on whether or not to integrate forms of economic delinquency common within the Russian business community was liable to radically modify the objectives of anti-laundering and the definition of its targets.\(^{59}\) Favarel-Garrigues points out:

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\text{In analyzing the case of Russia, I wish to show that the implementation of international standards against money laundering does not necessarily imply a commitment to common values, or even to a common vision of the objectives of this campaign. The Russian example highlights, on the contrary, the latitude afforded to states to define the moral issues at stake in efforts to combat money laundering within their borders, in accordance with domestic concerns.}\(^{60}\)
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A number of factors support the hypothesis that the anti-laundering mechanism constitutes a valuable resource in the political management of the business community. Its instrumentalization is wholly in line with government action based on the exploitation of the legal vulnerability of Russian economic and financial elites.\(^{61}\)

His assumption, that such a regulatory instrument as money laundering legislation could ultimately be used to crack down on certain personalities and, ultimately, be used to intimidate the business community by centralizing information on bank transactions and institutions,\(^{62}\) has been fully confirmed by the recent Russian criminal cases.\(^{63}\)

The core message from this brief overview of contemporary Russian anti-money laundering legislation is that by the date of Mikhail Khodorkovsky arrest and by the time the Yukos case commenced, the core provisions of Russian anti money


\(^{60}\) Ibid. at 536.

\(^{61}\) Ibid. at 538.

\(^{62}\) Ibid.

laundering legislation had already been enacted. Of course, the legislation had not been developed enough in several important aspects, such as: comprehensive customer identification requirements, a suspicious transaction reporting system and an operational FIU with adequate resources, but the main elements were in place and generally complied with the main international guidelines. The “backbone” provisions were in place and found the reflection in case law.

4. Principles of the Khodorkovsky/Yukos Money Laundering Case

It is quite important to note that “The Yukos Money Laundering Case” has, actually, two dimensions. The first is criminal, stemming from “The First Khodorkovsky Case”, when he was charged with, amongst other charges, the organization and management of a network of shell companies, designed and used exclusively for the purpose of corporate tax evasion. This element migrated from the First Case to the Second Khodorkovsky/Yukos Money Laundering Case, where the organization and management of the shell companies’ network (offshore and onshore) was assessed as an episode of organized criminal activity, involving fraud and money laundering.

The second dimension of the Yukos case only deals with the taxation of Yukos as a corporate group. The claims of the Ministry of Tax and Levies, amounting to 27 bn. USD, are based on the assumption that the same network of shell companies, which was allegedly used for laundering funds, was used for corporate tax evasion. So, the money laundering charges and corporate tax claims originate from the same source – the Yukos corporate group structure and tax optimization schemes.

In the Yukos case, the prosecutors have actually created a completely new concept in Russian criminal law – the “criminal corporate group”: a corporate

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64 The FATF Progress Report on Non-Cooperative Countries and Territories published on 1 February 2001 concluded, with respect to Russia, that it intended to introduce the new AM legislation to the Duma by March 2001. In October 2002, the FATF removed four countries, including Russia, from the NCCT list.


67 See the Summary of the Chargers and Russian Federation v. Mr. M.B.Khodorkovsky, Mr. P.L.Lebedev, A.V.Kraynov (Court Decision), (Meshchansky District Court of the city of Moscow, 2005).

group, created for the purposes of tax evasion and money laundering and managed by a group of individuals recognized as an organized criminal group.\(^69\)

This situation quite evidently raises the question of how such a group could function for seven years under the supervision of numerous controlling bodies on a federal and regional level, seeing as it was regarded as one of the top taxpayers in the country, it had submitted thousands of pages of different reports and was audited by one of the top international auditing firms. The answer to this question can be found in the course of the analysis of the charges recently brought against Mikhail Khodorkovsky and his allies.

The Yukos/Khodorkovsky case is known for generating intense publicity, unprecedented in Russia. The General Prosecutor’s Office has itself published several important documents concerning “The First Case” including the Summary of the Judgment.\(^70\) When the investigation of “The Second Case” had been finished, the General Prosecutor’s Office published the Summary of the Charges, brought against Khodorkovsky and Lebedev, on its official website.\(^71\)

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\(^69\) The concept of an “enterprise” in the United States’ Federal Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1962, et seq., serves as a useful comparison to the legal concept of an organized group as defined in the Russian Criminal Code. As with Russian Criminal Code’s prohibition of illegal activity by an organized group, RICO too is directed at combating organized crime. In each case, the government must establish a nexus between the alleged criminal activities and some enterprise or organized group. Although the structure of a RICO enterprise can be either a formal, legal entity or an informal association, RICO requires in the first instance that the government allege and prove a structure for the making of decisions, separate and apart from the alleged racketeering activities, with the existence of an enterprise being a separate element, which must be proved by the prosecution. In addition, to prove a criminal association in-fact, the government must prove that “the various associates function as a continuing unit” for a “common purpose of engaging in a course of conduct.” Here too, the concept of an organized group in the Russian Criminal Code is similar to the notion of a RICO enterprise, with its stability requirement echoing RICO's continuity, and its complicity component mirroring common purpose, as to course of conduct. Sanford M. Saunders, Pappalardo, and Logan, ‘Analysis of the Criminal Charges against and the Trial of Mikhail B. Khodorkovsky and Platon Lebedev’.

However, in the Yukos case, the organized criminal group acquired all the companies, including Yukos, and created on their basis the corporate group, assimilated into the group, they also took the managerial positions, drew several managers and employees into the organized group activity, made the company the production and corporate leader of the Russian industry, almost bought Sibneft and merged with Exxon-Mobile and was ready to take the power in Russia. Perekrest, ‘What Is Mikhail Khodorkovsky Behind Bars for (Part 1)’, Perekrest, ‘What Is Mikhail Khodorkovsky Behind Bars for (Part 2)’, Perekrest, ‘What Is Mikhail Khodorkovsky Behind Bars for (Part 3)’, Perekrest, ‘What Is Mikhail Khodorkovsky Behind Bars for (Part 4)’, Perekrest, ‘What Is Mikhail Khodorkovsky Behind Bars for (Part 5)’. The question is whether Yukos really represented a “corporate organized group” or whether the existence of such a powerful business group was seen by the governing political elite as an imminent threat to its power. Volkov, ‘Standard Oil and Yukos Cases’.

The Yukos case demonstrates that there is a tendency towards the extensive and aggressive usage of the notorious Russian concept of the “organized group” for the prosecution of those whose prosecution, in other circumstances, would represent a difficult task. Notably, there is a similar tendency growing in the United States, and this is highlighted by Gerard Lynch in his essay on RICO: “...prosecutors have seized on the virtually unlimited sweep of the language of RICO to bring a wide variety of different prosecutions in the form of RICO indictments”. Gerard E. Lynch, ‘RICO: The Crime of Being a Criminal Parts I and II’, Colum. L. Rev., 87 (1987), 661-764 at 662.


\(^71\) See the Summary of the Chargers. They have been accused of embezzlement by means of the large-scale misappropriation under Part 4 Article 160 of the Criminal Code of the Russian Federation and legalization
The allegations against Khodorkovsky and his allies have several general characteristics, which follow not only from the Summary of the Charges, but also from the Judgment brought in the first Khodorkovsky case, the Decision concerning the episode of the illegal privatization of Apatit, arbitration decisions on the tax claims against Yukos, and a number of other documents of less importance.

1) **Timing.** The organized criminal group headed by Khodorkovsky and his friend Lebedev (later – the head of the Menatep Group) was evidently formed as a group before 1994 when it was involved in the Apatit case. According to the Summary of the Charges the organized criminal group “have also been engaged in criminal activities in the country’s petroleum industry”. Therefore the “Menatep-Rosprom –Yukos” group, due to the vast variety of interests (property, oil production, banking,) can be called a “diversified organized criminal group”. Thus the activities of the criminal group lasted from approximately 1993 until 2003 (probably even longer, as the management allegedly controlled by Khodorkovky left the Company and flew to London in October –November 2004).

2) **General information on the criminal activities.** The prosecutors understand the whole story of the Mentap-Yukos-Rosprom Group as a continuous process of criminal activities focused on the misappropriation of privatized assets and obtainment of illegal profit from the misappropriated assets by means of tax evasion and money laundering schemes. Even salaries and annual bonuses paid to the employees and managers have been announced as a form of bribery:

(laundering) of money acquired through the commission of gross criminal acts under Part 4 Article174.1 of the Criminal Code of the Russian Federation.

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72 Russian Federation v. Mr. M.B Khodorkovsky, Mr. P.L Lebedev, A.V. Kraynov (Judgement).
73 Russian Federation v. Mr. M.B Khodorkovsky, Mr. P.L Lebedev, A.V. Kraynov (Court Decision).
74 Interregional Tax Inspection N1 v. Yukos (A40-61058/04-141-1510), System Garant (Federal Abitrasion Court of Moscow Region, 2005e).
75 For example, Sergey Pepeliaev, Marina Ivlieva, and Ivan Khamenushko, ‘Opinion Regarding Compliance with Legislation of Inspection Report No. 08-1/1 of December 29, 2003 Issued by the Tax Ministry of Russia’, (YUKOS Oil Company, 2004), 3, Genrikh Padva, ‘Transcript of the Closing Arguments as Given by Genrikh Padva, Lead Lawyer for Mikhail Khodorkovsky, in the Meshchansky Court on April 5’, (Moscow: KhodorkovskyTrial.com - Press Center for Mikhail Khodorkovsky, 2005), Genrikh Padva, ‘Transcript of the Closing Arguments as Given by Genrikh Padva, Lead Lawyer for Mikhail Khodorkovsky, in the Meshchansky Court on April 6’, (Moscow: KhodorkovskyTrial.com - Press Center for Mikhail Khodorkovsky, 2005).
77 For example, “In 1998 Khodorkovskiy, Lebedev and the other members of the organised group conspired to acquire by criminal means a majority shareholding in the said joint-stock company, for the purposes of which they acquired the shares of OAO Achinski NPZ, OAO Novosibirskoye Predispryatiye po Obespecheniyu Nefteproduktami, OAO Tomskn effteprodukt, OAO Khakasn eftefteprodukt, OAO Tomskn eftegofizika and OAO Tomskn ef VNK, incorporated by the Russian government into the authorised capital of OAO VNK (38% shareholding)”. The Summary of the Charges.
Khodorkovski and Lebedev bribed those shareholders who were not under their control and those members of the higher management (directive from the former shareholder in the person of the state) who were likely to put up active resistance to their nefarious activities. The bribe took the form of the unlawful payment of a bonus from the bank accounts of foreign companies under the control of Khodorkovski and Lebedev.\textsuperscript{79}

It should be noted that no charges of bribery have been officially brought against any managers of the group, so it is hardly possible to ascertain either the nature of the chargers or the persons who can be potentially charged.

The assessment of the general activities of the Yukos Group as a continuous criminal offence is confirmed by the amount of funds, allegedly laundered by the organized criminal group through Yukos.\textsuperscript{80}

3) **Approach to business and corporate operations.** The investigation considers even formal actions undertaken in the course of business and corporate activity of the group as a part of the continuous criminal offence. For example the corporate restructuring procedure which took place in 2000\textsuperscript{81} has been described in the Summary of the Charges as follows:

    *In order to fulfill his criminal aspirations ..., and obtain the right to their strategic and operational direction, Khodorkovski, together with the members of the organised group, created management companies controlled by them for OAO NK YUKOS and OAO VNK. For which purpose, on the instructions of Khodorkovski and the members of the organised group, the commercial establishments under their control founded OOO (limited company) YUKOS-Moskva, which became the management company for OAO NK YUKOS. Similarly in 1998 ZAO (closed corporation) YUKOS Exploration and Production (ZAO YUKOS EL) was created for the management of petroleum-extracting companies, and ZAO YUKOS Refining and Marketing (ZAO YUKOS RM) for the management of petroleum processing companies.*\textsuperscript{82}

This approach enables the prosecution to construe any corporate action as preparatory to further organized criminal activity.

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\textsuperscript{79}The Summary of the Chargers.

\textsuperscript{80}The total amount of money allegedly laundered by the organised group during the period 1998 to 2004 was 487,402,487,523.59 roubles (approximately 19 bn. USD) and 7,576,216,501.76 US dollars. For the comparison see Yukos performance at Yukos Oil Company, *Tax Slides Update*, Mikhail Khodorkovsky, *Yukos*, Yukos Oil Company (2003), 1-26.


\textsuperscript{82}The Summary of the Charges.
4) **Khodorkovsky’s Position in the Corporate Group.** Khodorkovsky’s position in the legal entities named in the Summary of the Charges in one of the key aspects of the case. In the “First Khodorkovsky Case” his lawyers extensively used the argument that neither Khodorkovsky, nor Lebedev controlled the corporate structure of the group of affiliated companies (the corporate group). The Summary does not name all the posts taken up by Khodorkovsky, but gives several examples of the control that Khodorkovsky and his allies exercised over the Corporate Group and the personnel.

**Figure 3. Summary of the Charges on Khodorkovsky’s Positions in the Group**

<table>
<thead>
<tr>
<th>YUKOS OIL COMPANY CONTROL</th>
<th>“…Khodorkovski and the other members of the organised group led by him had acquired the right to the strategic management of OAO YUKOS NK in 1996…”</th>
</tr>
</thead>
<tbody>
<tr>
<td>YUKOS’ SUBSIDIARIES CONTROL</td>
<td>“…the organised group of persons led by Khodorkovski procured the right to the strategic and operational management of the petroleum-extracting subsidiaries…”</td>
</tr>
<tr>
<td>THE PERSONNEL</td>
<td>“The administrative personnel appointed by Khodorkovski and the members of the organised group were mostly the former employees of the Menatep Bank and ZAO Rosprom, which were also used by the organised group to further their criminal designs…”</td>
</tr>
<tr>
<td>GENERAL POSITION AND THE ROLE AFTER THE FORMAL RESIGNATION</td>
<td>“Khodorkovski and Lebedev, who ran OAO NK YUKOS and occupied leading positions on the managing bodies of the company, and who had accumulated capital in the companies under their control by misappropriating the assets of its subsidiaries, withdrew from the managing bodies of OAO NK YUKOS without losing control of the strategic management of the company…”</td>
</tr>
</tbody>
</table>

From the last paragraph in the Table it becomes clear that the prosecutors have applied a concept similar to the US concept of the “controlling person”, or the UK

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83 See Padva, ‘Transcript of the Closing Arguments as Given by Genrikh Padva, Lead Lawyer for Mikhail Khodorkovsky, in the Meshchansky Court on April 5’, Padva, ‘Transcript of the Closing Arguments as Given by Genrikh Padva, Lead Lawyer for Mikhail Khodorkovsky, in the Meshchansky Court on April 6’.

84 The Summary of the Charges

85 Ibid.

86 Ibid.

87 Ibid.
concept of the "shadow director", to both Khodorkovsky and Lebedev. The diagram below clearly shows that they have proper grounds to prove that Khodorkovsky had been the sole controlling individual, not only for Yukos and Menatep Groups, but for the Open Russia Foundation as well. By emphasizing Khodorkovsky’s controlling and managerial functions the prosecutors want to show that all the cash flows, either within the Yukos Corporate Group, or outside it (dividends, paid to the Menatep Group; dividends paid by the Menatep Group to its shareholders and the funds distributed to the the Open Russia Foundation), were ultimately under control of the same person (Khodorkovsky) who perfectly understood their illicit origin. By introducing this concept the prosecutors purport to demonstrate that Khodorkovsky and other members of the organized criminal group actions were intentionally aiming at the continuous laundering of “dirty” funds, and their accumulation abroad.

88 Shadow directors arise from a statutory concept created under the Companies Act in order to extend obligations of directors to persons who exercise the same kind of influence over the company as appointed directors would do. They are, in effect, not real directors and have no legal powers to act on the company’s behalf. Simon Plant and Michael Prior, ‘Officers’ and Directors’ Liability in the Context of Insolvency’, Int’l Bus. Law., 28 (2000), 303-12 at 304. Shadow directors are persons in accordance with whose instructions the company’s directors are accustomed to act; thus a shadow director might be a significant shareholder or creditor of the company. A shadow director has been described as one who "lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself." Caroline Bradley, Transatlantic Misunderstandings: Corporate Law and Societies, U. Miami L. Rev., 53 (1998-1999), 269 - 315 at 293-94. He is not held out as a director by the company. To establish that a defendant is a shadow director of a company it is necessary to allege and prove: (1) who are the directors of the company, whether de facto or de jure; (2) that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so; (3) that those directors acted in accordance with such directions; and (4) that they were accustomed so to act. Caroline M. Hague, ‘Directors: De Jure, De Facto, or Shadow’, Hong Kong L.J. , 28 (1998), 304-14 at 307-08.

The American concept of “control-person liability” is much broader. Controlling shareholders of corporations in the United States may be subject to a duty of fair dealing similar to the duties imposed on directors and officers of the corporation, and breach of this duty will give rise to liability in the same way. Unlike the liability imposed on shadow directors in Britain, this liability will not arise only on insolvency of the corporation. Moreover, the liability is for breach of a duty of loyalty rather than for breach of a duty of care. Bradley, Transatlantic Misunderstandings: Corporate Law and Societies’, (at 293-94. The term “control-person liability” in the United States is frequently used to refer to provisions in the federal securities laws which impose liability for violations of those laws on control-persons as well as on the persons directly responsible for the violations. When a person is civilly liable under the Securities Act of 1933, the same liability applies to “(e)very person who, by or through stock ownership, agency or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls” the other person. The Securities Act of 1933 §15, 15 U.S.C. §770 (1998). Cf The Securities Exchange Act of 1934 §20A, 15 U.S.C. §78a (1998) It should be noted that several Yukos minority shareholders have made an attempt to prove that certain controlling persons concealed the risk of the Russian Federation taking action against Yukos by failing to disclose: (1) that Yukos had employed an illegal tax evasion scheme since 2000; and (2) that Khodorkovsky’s political activity exposed the Company to retribution from the current Russian government, but failed to state a claim for primary liability. The Court, amongst other things, remarked: “To make out a prima facie case of control person liability under Section 20(a), “a plaintiff must show a primary violation by the controlled person and control of the primary violator by the targeted defendant, and show that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person.” SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996). See In re. Yukos Oil Securities Litigation (S.D.N.Y. 2004)
It is also should be noted that although Russian law does directly recognize the concept of “shadow directorship” or the “controlling person” in the form as they are recognized by the UK and US legislation and case law, Article 56 of the Civil Code and Article 3 of the Federal Law on Joint Stock Companies, provides that if a person is able to give orders to a company, they can be held liable for the

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damages incurred in a course of the company’s bankruptcy, if the bankruptcy arose from such orders.90

Therefore, by describing Khodorkovsky’s position inside and outside Yukos Group in detail and stressing his actual managerial position, the investigation aims to solve the threefold problem:

1) To prove Khodorkovsky’s actual position as a head manager and core owner of the Group before and after his formal resignation, for the purpose of the ongoing criminal investigation and the pending court hearing in Russia;

2) To create proper grounds for the Yukos money laundering case in the light of current European anti money laundering legislation, including confiscation, seizure and civil recovery provisions, which may help the investigators to seize the funds allegedly belonging to Menatep, Khodorkovsky and his allies abroad;

3) To create grounds for prospective civil actions against Khodorkovsky in the West and internationally, by additionally confirming his role as the ultimate controlling person in the Group.

5. The Core Episodes of the Khodorkovsky/Yukos Money Laundering Case91

The Summary of the Charges represent a “secondary” document, which just summarizes the main points of the official charges, in the form that the prosecution would like to represent to the public. Yet the Khodorkovsky/Yukos case is extremely complicated from a legal perspective, spans over a ten-year history of several dozens of companies, and is interrelated with quite a number of other corporate, tax and criminal cases, therefore the episodes covered in the money laundering case should be analyzed in line with the corporate story of the Group and other significant data.

5.1. Creation of the On Shore Networks of Shell-Companies.


91 The Summary of Charges also includes an episode on the illegal alienation of the subsidiaries shares belonging to VNK, 53 per cent stock of which was acquired by Yukos on the privatization tender. However, this episode does not concern the main Yukos operational schemes and does not represent the case that needs an in-depth analysis.
Stage 1. The prosecutors clearly see two stages in the development of the Yukos’ shell-company network. The first stage, which lasted approximately from 1997 to 2000, is characterized by using mostly shell companies\(^{92}\) registered in so-called “closed cities” or ZATOs;\(^{93}\) areas which were authorized to grant tax exemption to the companies producing something in their territory.\(^{94}\)

Thus, between 1997 and 1998 in the closed community of Lesnoi (one of the ZATOs) the subordinates of Khodorkovski, Lebedev and the other members of the organised group registered at their instigation the following commercial organisations:…

These organisations were essentially dummy legal entities, using the movement through them of petroleum, petroleum products, securities and cash as their raison d’être. On behalf of these dummy companies, which gave them the right of ownership of the extracted petroleum, Khodorkovsky, Lebedev and the other members of the organised group disposed of the petroleum as if it were their personal property.\(^{95}\)

The key element of the scheme of alleged fraud, tax evasion and money Laundering used by Yukos, was the large-scale usage of so-called “shell” or “dummy” companies. It is important to note that before the Yukos case, this term had had an extremely rare application in Russian case law.\(^{96}\) The definition of the “shell” or “front” company, given in the Judgment on Khodorkovsky case, is,

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\(^{92}\) During this period the secretarial services to the Company were provided by Peter Bond and the holding and secretarial company Valmet Group Limited (Bermuda). The Summary of the Chargers.

\(^{93}\) ZATO (zakrytye administrativno-territoriaVnye obrazovaniya) or closed cities. “ZATO are closed cities in several senses. They are physically closed in that there is often a pre-fabricated concrete wall surrounding them with the city boundaries ignoring regional and local administrative boundaries. Administratively, they are closed in that they require a permit to visit, though this has become more lax in the post-Soviet era. Perhaps most importantly, these company towns closely tied to the military industrial complex are budgetarily independent of the region in which they are located. Residents of a region, including finance officials, often know little about public finance inside the ZATO and even deny their existence.” Although ZATO residents were able to live somewhat independently off the region in the Soviet era, they now must use many public services of the region, though they contribute no money to help support these services.” Gregory Brock, ‘Public Finance in the ZATO Archipelago’, Europe-Asia Studies, 50/6 (September 1998 1998), 1065-81 at 1065.


\(^{95}\) The Summary of the Chargers.

actually, the first comprehensive definition that sets standards for Russian case law.97

The companies... had not actually possessed any functions or features of a legal entity, envisaged by articles 48 through 50 of the Civil Code of the Russian Federation, i.e.:

- did not possess, manage or operate a separate property for processing, storage and sale of crude oil and oil products,
- were not able to achieve and exercise their rights of property on their own without the orders,
- were not able to perform their activity, the main objective of which was to receive profit, since their activity was unprofitable,
- meant for the purposes of evasion of taxes by the oil-production and oil-refining subsidiary enterprises of OAO 'NK 'YUKOS', engaged in sale of oil and oil products, and profit-making organizations affiliated to it.98

Although, the substance of the term “shell company”, as it is understood by the Russian court, is close to that of international case law,99 the absence of consistent practice raises the question of application of the “Rule of Law” in Russian Federation in general, and in the Yukos Case in particular.100

It should be noted that according to the Arbitration court decisions, the network of on-shore companies was created and used mainly for the purpose of tax evasion.101 So, only after obtaining illegal profit derived from the tax evasion...

97 It should be noted that the same position has been expressed in the Yukos-related tax cases. See Interregional Tax Inspection N1 v. Yukos (A40-61058/04-141-1510), Tax Inspection N 5 v. Zao "Pwc", (Moscow City Arbitraz Court, 2007), A. Rodionov, Tax Schemes, for Which Khodorkovsky Has Been Detained. (Moscow: Vershina, 2005) at 58-68.

98 The position of Yukos regarding the shell companies : “Inspection Report alleges that these 17 companies acted as front companies, although it is said in the Inspection Report that all of them were duly registered and operated as autonomous legal entities. These companies were duly registered for tax purposes as independent taxpayers. Saying that these companies acted as front companies actually leads to ignoring the independent status of these legal entities...” Pepeliaev, Ivlieva, and Khamenushko, ‘Opinion Regarding Compliance with Legislation of Inspection Report No. 08-1/1 of December 29, 2003 Issued by the Tax Ministry of Russia’.


100 See Peter L. Clateman, ‘Yukos Part VI: Tax Claims Revisited’, Johnson’s Russia List (2005), 1-20, and Rodionov, ‘A Look at Khodorkovsky and Lebedev's Taxes’. Both sources perfectly illustrate that regardless to the questionable character of the tax optimization schemes used by Yukos, the same schemes were employed by 90% of the big Russian corporate groups. See as an example OAO Lukoil, 'Consolidated Financial Statements (Prepared in Accordance with Us Gaap) as of December 31, 2001 and 2000 and for Each of the Years in the Three Year Period Ended December 31, 2001.' (2002).

101 See Interregional Tax Inspection N1 v. Yukos (A40-61058/04-141-1510), and comments to it in Rodionov, ‘A Look at Khodorkovsky and Lebedev's Taxes’, Rodionov, Tax Schemes, for Which Khodorkovsky Has Been Detained.
operations, could the network of “shell” companies be used for its “secondary purpose” – for the purpose of laundering of the illegal gains.\textsuperscript{102}

\textellipsis\ evasion of OJSC NK YUKOS from payment of taxes resulted in application of illegal tax evasion scheme, discovered during performed traveling tax inspection of OJSC NK YUKOS. 22 entities were registered in territories with preferential taxation regime and semblance was created regarding their activity of purchase and sale of oil and oil products, so that tax payment obligation arose with these entities, rather than with OJSC NK YUKOS. The mentioned entities unlawfully applied benefits and hence did not pay taxes. Since it was established in the course of the inspection that OJSC NK YUKOS is the actual owner of oil and oil products, then the obligation to pay taxes to the budget, unpaid from the amount of earnings received from sales of oil and oil products, appeared with OJSC NK YUKOS.\textsuperscript{103}

This “dual” approach, based on the recognition of the illicit nature of the Yukos’ offshore and onshore company network, has actually allowed the authorities “to kill two birds with one stone”: the tax side of the story has lead to the liquidation of the company and forced sale of its assets; the money laundering aspect has led to new charges being brought against its owners and managers.

\textbf{Figure 5. Business operations and cash flow of the Company}

\textsuperscript{103} Interregional Tax Inspection N1 v. Yukos (A40-61058/04-141-1510)
Stage 2. The prosecutors point out that by 2001 Khodorkovsky, and the other members of the organised group, concentrated a huge amount of wealth in Russia and in foreign companies under their control, and because of the criminal nature of the accumulated capital and their intent to continue increasing that capital, the group of changed the system of misappropriating petroleum and laundering money. As a result they organised a new system to move petroleum and products via companies, registered in the regions that gave them tax breaks. For this purpose the executives of the companies, controlled by the organized group, drew up appropriate agency agreements, purchase and sale agreements, commissions and other documents needed for the purchase and sale between petroleum and products companies. The key principals of the system were, according to the prosecutors, “false” publicity gained through the scheme of forced changeability:

With the aim of concealing the bogus nature of the said companies from the tax and other regulatory authorities, the plan worked out by Khodorkovsi and the other members of the organised group to

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104 Evenkia, Mordovia and some others.

105 The Summary of the Chargers.
misappropriate other people’s wealth entrusted to them made provision for the periodic renewal of the artificial systems of sales of petroleum and petroleum products, i.e. the regular replacement in these systems of just the dummy organisations – the petroleum raiders – which were engaged in the resale of petroleum and petroleum products to other organisations, including newly founded ones.106

The investigators say that between 2001 and 2003 Khodorkovsky and the other members of the organised group misappropriated 202,214,394 tonnes of petroleum from the main Yukos production subsidiaries, with a total value of 27 bn. USD.107

5.2. Using the Auditor’s Opinion as a Shelter.

According to the prosecutors, while using the network of shell companies, Khodorkovsky and his allies, acting as managers of the corporate group, undertook several steps to conceal the illegal character of the operations:

….Khodorkovsky and the members of the organised group declared the balances of these dummy companies, which they nominally referred to as operational companies, side by side with the balances of their subsidiary petroleum-extracting and petroleum-processing plants when presenting their financial statements to the international auditors. By this deception they convinced everybody that the dummy companies were all within the sphere of influence of OAO NK YUKOS108.

Prosecutors point out that having received the false opinion from the auditors, that no infringements had been involved in the sale of petroleum and products, the members of the organised group continued to use the major portion of the funds for their personal enrichment and just a fraction was paid to the production companies engaged in petroleum extraction and processing, allowing the criminal scheme to run.109 However, the Summary of Charges contains no evidence that the funds accumulated on the balance of the corporate group as a consolidated company, were used illegally or were in violation of the appropriate corporate procedures. The absence of any significant violations has been confirmed by the consolidated accounts audited by PwC since the

106 Ibid.
107 Ibid.
108 Ibid.
109 Ibid.
beginning of 1997." Nevertheless, the charges are based on the assumption that the consolidated accounts of the Company are just a method of concealing the embezzled and laundered funds. Respectively, PwC’s opinion is considered as a tool for such concealment.

It is quite important to note that the role of the international auditor (PwC) in the collapse of Yukos, and its alleged involvement in the Yukos schemes, had not been assessed in any way until the Russian Ministry of Tax and Levies, represented by one of its inspections, filed an unprecedented application with the Moscow Arbitration Court, claiming PwC’s actual knowledge, and its direct facilitation of, the Yukos fraudulent tax schemes. The Moscow court actually sided with accusations from Moscow city tax officials, who claimed that PwC had aided Yukos in perpetrating tax evasion by covering up the company’s tax shelter schemes, and drawing up two different audit reports in over three years. Accordingly, the court found that the audit agreements between Yukos and PwC Audit for the years 2002-2004 were invalid because they constituted illegal and unethical deals according to the Civil Code of the Russian Federation. The court awarded the government 16.8 million rubles ($480,000) in restitution.

This case is the first and the only example of when a company such as PwC has been recognized as an accomplice and a facilitator of the Yukos schemes.

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111 The position of the investigators generally complies with paragraph seven of the Resolution of the Supreme Court of the Russian Federation Plenary Session of 28 December 2004 N 64 “On the court policy on the application of the criminal law on the tax crimes”, which provides that persons, who facilitated tax crimes by means of providing the intellectual assistance in a form of advice, are criminally liable as other accomplices of the offence. See the Resolution of the Supreme Court of the Russian Federation Plenary Session of 28 December 2004 N 64 “On the court policy on the application of the criminal law on the tax crimes”, available at: Law of Russia in English / System GARANT (http://www.garant.ru/nav.php?pid=286&ssid=89&mv=1).


113 The court case revealed that the firm had compiled two sets of accounts — one for internal use, that warned of illegal actions taken by Yukos; and another for shareholders. Tax Inspection N 5 v. ZAO ‘PwC’.


115 Many experts think that this unprecedented decision has been masterminded by one of the Groups in the Kremlin Administration, and aims not only to contribute to the second Khodorkovsky case, but to put the big shots of international audit in Russia under statutory control. Read together Yelena Komarova, ‘PwC Appeal Likely to Be Sustained at Top Level’, The Moscow News (2007). Kommersant.Com, ‘Supreme Arbitration Court Winds up Moscow Subordinate’, Kommersant Russia’s Daily Online (2007). Sergei Nenashev, ‘Supreme Arbitration Court Applies Raiders Methods’, Kompromat.RU (Moscow, 2007). Vladimir Solovev, ‘Who and Why Destroys Moscow Arbitration Court’, Kompromat.RU (Moscow, 2007).
although PwC had used the same formula to describe the tax risk for all its “big” clients in the Russian oil sector, which is clearly seen from the table below.

Facing a significant threat of losing its Russian business and, quite evidently, with criminal charges against several key employees, PricewaterhouseCoopers finally decided to withdraw all its Yukos audit reports. The auditor said that it had withdrawn Yukos’ audits from 1995 to 2004 because of the existence of new information, which could have influenced those reports, had it come to light earlier. “PwC now believes that information and representations which were provided to PwC by Yukos’ former management may not have been accurate,” the firm said in its statement, published on the Russian office website. The letter, sent on June 15 to Yukos’s liquidator, says that PwC believes the Yukos management lied by declaring that its main trading structures, Baltic Petroleum, South Petroleum and Behles, were not affiliated to the company. The letters also provide three other reasons for the unprecedented withdrawal: (1) the Yukos management failed to provide enough information on whether Russian entities, later used by Yukos, were in arm’s length transactions or not; (2) the management also failed to disclose information on “significant payments” the company made to entities owned by the shareholders of Menatep Bank, which went bust in the August 1998 financial crisis (3) the management failed to inform the auditor about payments, made by the Menatep Group to several Yukos managers. It needs no comment that all these allegations perfectly comply with the charges, recently brought against Mikhail Khodorkovsky and his allies, analyzed below. It should be noted that Russian legislation and judicial doctrines during these years have changed more substantially than, for example, British legislation and case law has over a couple of centuries. These substantial changes enable any auditor to find numerous omissions and inaccuracies in the data disclosed to him, and repeat PwC’s trick.

121 For example, the Regulations on affiliated entities were approved by the Russian Securities Market Regulator only in 1999. See Decision of the Federal Commission of the Securities Market N 7 “On registration and information disclosure of affiliated persons” from September 30, 1999 available at: Law of Russia in English / System GARANT (http://www.garant.ru/nav.php?pid=286&ssid=89&mv=1).
PwC’s withdrawal decision, recognized as completely politically driven by several experts, is likely to produce an unprecedented effect on the Yukos case by, on the one hand, eliminating one of the most powerful arguments of the defense and, on the other hand, providing the lawyers with more evidence of politically motivated influence.\textsuperscript{122}

The PwC story is far from at an end as it is evident that both parties will appeal to the Supreme Arbitration Court, whose final ruling sets precedent on any occasion, and it will set the benchmark for auditors’ liability in Russia.\textsuperscript{123}

**Figure 6. Yukos and TNK-BP US GAAP tax risk notes for 2002**

<table>
<thead>
<tr>
<th>Yukos PwC</th>
<th>TNK International Limited\textsuperscript{124} PwC</th>
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<tbody>
<tr>
<td><strong>Note 19: Commitments and Contingent Liabilities. Taxation.</strong></td>
<td><strong>Note 18: Commitments and Contingent Liabilities. Taxation.</strong></td>
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<tr>
<td>Russian tax legislation is subject to varying interpretations and periodic changes, which may be retroactive. Further, the interpretation of tax legislation by tax authorities as applied to the transactions and activities of the Company may not coincide with that of management. As a result, certain transactions may be challenged by tax authorities and the Company may be</td>
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</tr>
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</table>


\textsuperscript{123} PwC was “tried” under Article 169 of the Civil Code - citing “violation of the fundamental principles of law and order and morality.” However, the international auditor found an influential Russian backer in Anton Ivanov, the chairman of Russia’s Supreme Arbitration Court. ‘Market participants should be assured that there are basic principles which ought not to be violated. If we apply Article 169 of the Civil Code without grounds, belief in the stability of (business) contracts will be undermined,’ said Ivanov in a statement which appeared in the media just a day before the Moscow Arbitration Court heard the case against PwC. Experts and print media were quick to recognize in the statement an early, hidden hint to the court regarding the PwC case’s outcome. Komarova, ‘Pwc Appeal Likely to Be Sustained at Top Level’.

assessed additional taxes, penalties and interest. Consolidated tax returns are not required under existing Russian tax legislation and tax audits are performed on an individual entity basis only. Tax periods remain open to review by the tax authorities for three years.  

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<th>5.3. Creation of the Off-shore Network of Shell (dummy) Companies.</th>
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</table>

The Summary of Charges provides that, for the purpose of legalising the misappropriated petroleum, Khodorkovsky acquired dummy companies abroad and through them created a network of foreign sales organisations for petroleum and products based on the following pattern: Yukos (or a dummy company registered in Russia in a preferential tax assessment zone) sold oil and products to a controlled foreign company registered in Switzerland, which resold them to a controlled foreign company registered offshore, which, in turn, resold them to an actual buyer at a petroleum-processing plant, in the form of a foreign company.  

The objective of Khodorkovski, Lebedev and the other members of the organised group was to mislead the regulatory authorities and foreign businessmen by including in the network a foreign company controlled by them and registered in Switzerland, which was enough to impart an image of reliability and trustworthiness to OAO NK YUKOS operations involving the export of petroleum and petroleum products.

The fact that almost all major Russian companies used the same tax optimization schemes has never been a secret and has been addressed by several pieces of research, commenting on Russian corporate governance problems. All Russian oil and gas corporations have off-shore companies networks, which reside

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125 Yukos Oil Company, 'U.S. GAAP Consolidated Financial Statements. 31 Dec. 2002.'


128 The Summary of the Charges.

primarily in the same jurisdictions as Yukos.\textsuperscript{130} It is only in the case of Yukos that the creation of several off-shore companies has been recognised as a constituent part of the criminal offence. The fact that information about the core off-shore companies, which were directly controlled by Yukos, had been publicly disclosed according to the regulations of the Federal Securities and Exchange Commission has not been given any consideration at all.\textsuperscript{131}

\textbf{Figure 7. The offshore network of Yukos before the collapse}

\textsuperscript{130} See as an example the structure of Alfa Group at http://www.alfagroup.ru/276/about.aspx
\textsuperscript{131} See http://www.yukos.ru/files/10938/spisok_03_11_03.pdf
5.4. Accumulation of profit on the foreign accounts.

The key element of the charges is that by organising the sale of petroleum and products by the Swiss company to the “shell” offshore company, the organised group accumulated part of the money, laundered through the sale of misappropriated petroleum, in their off-shore bank accounts in order to reduce the

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132 In a Case Under Chapter 15 of the Bankruptcy Code Case No. 06-B-10775-RDD. Declaration of Gerhard H. Gispen. (Appeal Brief Par. 1.11 pages 6 and 7).
tax burden on the Company’s profits obtained via illegal operations. The prosecutors claim that Khodorkovsky and the other members of the organised group transferred funds from the bank accounts of the “trading” shell companies (SPVs) to the bank accounts of the other (“financial”) shell companies (SPVs) controlled by them. Subsequently, the organised group manipulated these funds for their own interests.\(^{133}\)

The fact that quite a number of Russian companies used offshore schemes and fund-accumulation techniques is quite evident.\(^{134}\) Moreover structuring the corporate group cash flow through offshore treasury companies is an internationally recognized business practice.\(^{135}\) So, the prosecutors’ approach to business practice erodes the line between legal business operations and illegal business practices, putting political prosecution issues on the agenda.

5.5. Redistribution of the Illegal Profit through Shared Re-distribution and Dividends

The final “masterstroke” of the prosecutors was the part of the Summary that stated that, Khodorkovsky had redistributed the share capital of the Menatep Group, under the guise of official dividend payments, amongst the several members of the organised group for the purpose of concealing their “remuneration” for the crimes committed. The investigation claims that it was done with the purpose of making them partners and owners of shares in Yukos, and other companies on the accounts of which the legalized funds were kept.\(^{136}\)

Taken separately from other episodes, these allegations mean that any redistribution of shares in a holding company (a head company of a corporate group) could be taken as concealment of illegal operations inside the group.

5.6. Laundering operations

In the Summary of Charges, the prosecutors have separately enumerated several laundering operations, allegedly conducted by the members of the organized

\(^{133}\) The Summary of the Charges.


\(^{136}\) The Summary of the Charges.
group through the corporate structure of the Company. All the operations generally complied with the publicly known business activities of the Company and its core shareholder the Menatep Group. The bulk of these activities was respectively disclosed in the audited, quarterly and annual, Company accounts. The list of “laundering” operations includes:

**Figure 8. The Table of the Money Laundering Charges and Business operations comparison.**

<table>
<thead>
<tr>
<th>THE SUMMARY OF CHARGES</th>
<th>THE BUSINESS SUBSTANCE OF OPERATIONS</th>
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| Cancellation of the Menatep Bank’s creditor indebtedness to foreign banks, restructured on Yukos, the money from which (credit) was used by Khodorkovsky to acquire shares of Yukos through the Menatep Group. | In 1998 the Russian ruble collapsed, taking Bank Menatep with it. Its banking license was respectively revoked and a 31.9 percent holding in Yukos, pledged on security of $266 million, was taken into possession by three banks: the Standard Bank of South Africa, the Japanese Daiwa Bank and Germany’s West LB Bank. Khodorkovsky urged the banks to accept a three-year repayment plan that would be secured by oil exports rather than shares in Yukos, but the banks refused, taking control of their shares in Yukos. Soon afterwards, they dumped their shares, recovering only about half of their loan.

Subsequent to Bank MENATEP’s bankruptcy in 1999 and continuing into 2000, Yukos entered into a series of transactions, in which it acquired the rights to collect from Bank MENATEP from third party assignors. Through this procedure the indebtedness of the Banks was restructured and the Yukos’ |

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137 Ibid.
shares were bought back. Similar restructuring schemes were used by other Russian business groups.\textsuperscript{142} The transaction was fully disclosed in the Annual Report for the Year 2000 (Note 8).\textsuperscript{143} This voluntary buy-out scheme was quite evidently aimed at mitigation of the adverse effects incurred by the Bank MENATEP’s clients and had primarily a reputational goal.

<table>
<thead>
<tr>
<th>Action</th>
<th>Description</th>
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<tr>
<td>Acquisition of euro-bonds and currency bonds from foreign companies to the amount of 1 billion US dollars, which were transferred to the shell companies controlled by the organized group.</td>
<td>The acquisition of different types of securities has always been regarded as a conventional treasury and investment operation of any corporate group, which needs to invest the temporary available funds.\textsuperscript{144} For comparison annual reports of any big Russian oil company could be taken. TNK –BP Limited Consolidated Financial Statements for 2004 provide that at 31 December 2004 and 2003 the Group had USD 700 million of Eurobonds issued and outstanding.\textsuperscript{145}</td>
</tr>
<tr>
<td>The performance of various financial exchange operations to a total amount of more than 264 billion rubles, and the laundering of this money in the bank accounts of Russian and offshore company networks. The transferring of funds of offshore “shell” companies, disguised as dividends, to a sum of more than 4.2 billion US dollars, into the bank</td>
<td>The main argument against this claim is that all operations, enlisted in the Summary of Charges, were simply transfers of funds inside a corporate group, without which it cannot function as a group.\textsuperscript{146} The funds remained properly reflected in the Consolidated Financial Statements of the Group, and all the operations with them were conducted in accordance with the centralized financial policy and relevant internal policies.</td>
</tr>
</tbody>
</table>

\textsuperscript{142} Ibid. at 43. Yukos Oil Company, ‘U.S. GAAP Consolidated Financial Statements, December 31, 2001’, at 6-8.  
\textsuperscript{144} For a comparison with the Yukos’ reports, the TNK-BP reports can be taken. See TNK-BP Limited, ‘TNK-BP Limited US GAAP Consolidated Financial Statements for Full Calendar Year 2004’, TNK International Limited, ‘Consolidated Financial Statements. 31 Dec. 2002’.  
\textsuperscript{145}
The legitimacy of intra-group transfers is recognized internationally and subject to the anti-avoidance rules. For example the Rosneft Consolidated Financial Statements for the years 2003, 2004, 2005 provide: “…the guarantee obligations of OJSC Yuganskneftegaz with respect to the loan described above have become intercompany in nature”.

Transferring funds amounting to 2.8 billion US dollars as credits from the offshore “shell” companies to Yukos and its subsidiaries.

The prosecutors aim to represent the treasury operations, i.e. intra-company loans common for any corporate group, as illegal activities.

The analysis of the Summary of the Charges gives quite evident, but surprising results:
Yukos as a corporate group has generally complied not only with international business practice, but with the practices of comparable Russian companies. The language of the Summary does not show any corporate restructuring transactions or business operations that cannot be found in the accounts and reports of other Russian oil giants. The only assumption is, which may be still used by the prosecutors, that the transfer pricing schemes used by Yukos were so blatant, that they may qualify as embezzlement.

6. Transfer pricing issues in the Khodorkovsky/Yukos Case

For the “Second Khodorkovsky case/Yukos Money Laundering Case” the prosecutors chose the model of the predicate offence, never used before in the recent history of Russian criminal justice. According to their innovative scheme, all acts of sale of crude from the Yukos’ production companies to the SPVs (“dummy” or “shell” companies, also controlled by Yukos,) at a price which was evidently below the market price, should be deemed as a predicate offence for the further acts of laundering. So, the prosecution says that transfer-pricing sales represent

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147 See Colin G. Davis and Daron Gunson, Squires: Tax Planning for Groups of Companies (LexisNexis, 2006) at 1102.


149 For example the same loan was provided to Mazeikiu Nafta. See Yukos Oil Company, ‘Annual Report for 2002’, (YUKOS Oil Company, 2002) at 56. See also Green, ‘Transfer Pricing Techniques for Group Treasury Companies’.
acts of embezzlement, and as all operations have been conducted under the
alleged control of Khodorkovsky and the other members of the organized criminal
group, the following operations with oil and funds represent a continuous series of
money laundering acts.\textsuperscript{150} It should be noted that the detailed analysis of the
Yukos affair as a whole shows that, initially, the investigators aimed to use the fact
that the production companies had actually overproduced oil, to create their
“Yukos Money Laundering Case”.\textsuperscript{151} The offence of over-production, according to
Russian criminal case law, could qualify as illegal entrepreneurship, which can be
deemed a predicate offence for the further money laundering operations.\textsuperscript{152}

However, the investigators have declined this scheme, as acts of illegal
entrepreneurship do not amount to a serious criminal offence in Russia, and the
prosecutors have obviously found them not completely suitable for such a
significant criminal case.\textsuperscript{153} As Russian criminal law contains tax crime exception
provisions in respect of money laundering offences, the Summary of the Charges
does not mention tax evasion issues, describing the schemes used for the alleged
corporate tax evasion as schemes designed and used for money laundering.\textsuperscript{154}

The existence of “tax exemption” in Russian Criminal Law may be viewed as a
repetition of a typical mistake made previously by other countries. In the earlier
attempts to deal at an international level with laundering, explicit exceptions were
made for tax offences. Many jurisdictions do not have such a wide category of
predicate offences, and exclude tax offences, but now the problem of how to
fight the nexus of money laundering and tax evasion is currently being debated at
an international level.\textsuperscript{155}

According to conventional understanding, transfer pricing enables a parent
company to concentrate profits, to funnel profits to foreign subsidiaries, to transfer
profits to subsidiaries located in well-established tax havens, or to simply evade

\textsuperscript{150} The Summary of the Charges.

\textsuperscript{151} Kommersant, ‘Third Case of Pavel Anisimov’, Kommersant, June 21, 2006, Kommersant.Com, ‘Heads of
Yukos’s Subsidiary Suspected of Money Laundering’, Kommersant Russia’s Daily Online

\textsuperscript{152}CCRF, art. 171 and 174. See also V.K. Duynov et al., Comments to the Criminal Code of the Russian
Federation (Moscow: Walters Kluwer, 2005) at art.171, art 174, Alexander Guev, Comments to the Criminal

\textsuperscript{153} CCRF, art. 171. See also Guev, Comments to the Criminal Code of the Russian Federation for Entrepreneurs
at art.171.

\textsuperscript{154} CCRF, art. 174.

\textsuperscript{155} “The reasons are not difficult to guess. Schemes to avoid tax frequently depend upon complex routings of
deals without apparent commercial rationale. Money movements under a tax avoidance scheme make
money movements that are laundering the profits of crime less easy to detect. If the law of taxation could be
altered in such a way as to discourage ‘artificial’ avoidance schemes then the laundering disposals would no
longer sit amidst their camouflage. This can be used as an argument for general anti-avoidance rules.” Peter
(2005), 353-73 at 360-61.
The argument of the prosecutors, regarding the Yukos tax schemes, are based on the following assumptions:

1) The sale and purchase agreement between Yukos-controlled entities were false, as they named Yukos as a purchaser, when it actually was not.

   The agreements regarding the purchase and sale of petroleum were bogus because they contained the false information that OAO NK YUKOS was a purchaser of petroleum, whereas Khodorkovski, Lebedev and their friends were perfectly well aware that OAO NK YUKOS was not in fact a purchaser of petroleum, and that the products of the petroleum-extracting companies were shipped directly and independently to Russian and foreign customers\textsuperscript{157}.

2) The price of oil and products was not at market price and was determined by the members of the organized group. It represented only the cost of extracting the raw material and was on average 2-4 times lower than the market price\textsuperscript{158}.

3) The third argument was not expressly reflected in the Summary of the Chargers, but it is seen from the Arbitration Court decisions on the Yukos tax claims and concerns the public auctions\textsuperscript{159} conducted by the Company’s production subsidiaries for the oil produced. The actions have been declared sham, as concealing the true nature of the transaction, aimed at sale of the crude to the Yukos-controlled “sham” companies (SPVs) for tax evasion purposes\textsuperscript{160}.

Combining the above argument with the arguments concerning Khodorkovsky’s ultimate managerial position in the Yukos Corporate Group, which allowed him directly and indirectly exercise control under all the entities involved in the allegedly fraudulent schemes, they came to the conclusion that the organized criminal group headed by Khodorkovsky had committed embezzlement of the oil and funds of the production subsidiaries of the company.

Taking into consideration the tremendously complicated and confusing situation with the trading operations of the holding companies in The Russian Federation since their creation and until 2003, several remarks regarding trading operations of Russian holding companies have to be made:

1. Russian holding companies (or, as they are called in the privatization legislation “vertically integrated companies”) were incorporated as vertical corporate groups, in which the head holding company quite commonly

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\textsuperscript{156} Toshihiko Shiobara, ‘Oversights in Russia’s Corporate Governance: The Case of the Oil and Gas Industry’, in Shinichiro Tabata (ed.), Dependent on Oil and Gas: Russia’s Integration into the World Economy (Slavic Research Center, 2006), 85-115 at 93.

\textsuperscript{157} The Summary of the Chargers.

\textsuperscript{158} Ibid.

\textsuperscript{159} See the scheme N 5

\textsuperscript{160} See Interregional Tax Inspection N1 v. Yukos (А40-61058/04-141-1510)’.
owned 50%+1 of the ordinary voting shares.\textsuperscript{161} So, there were a large number of minority shareholders in the subsidiaries, who quite rightly demanded dividends from the production companies where they held stock.\textsuperscript{162} It strongly contradicted the very idea of “virtually integrated holding companies” which had to profitable as consolidated corporate groups.\textsuperscript{163} Until 2006 there were no mechanisms for the compulsory buyout of minority stock, and that put newly established corporate groups in an ambiguous position, when, on the one hand, they did not want to pay shareholders-blackmailers who tried to enforce their rights, and, on the other hand, they had no legal means for the effective compulsory consolidation of the minority stock at the level of the head company.\textsuperscript{164}

2. The transfer-pricing scheme was usually realized as followed:

   a) large-scale oil companies sold oil obtained from their subsidiary oil producing companies to their affiliated companies, or SPVs, registered in domestic offshore, or preferential tax zones, at the price of one-half or one-third lower than the international price;

   b) the affiliated companies sold the oil to their subsidiary refineries at the price of two thirds of the international prices, therefore, most profits were accumulated in the affiliated companies registered in domestic offshore or preferential tax zones.\textsuperscript{165}

3. Transfer pricing rules were first introduced in Russia in 1999 and since then the “arm’s length” concept has remained relatively unchanged.\textsuperscript{166} The Russian transfer pricing rules are mainly contained in articles 20 (“related parties”) and 40 (“principles of determining prices of goods (work, services) for tax


\textsuperscript{165} Shiobara, ‘Oversights in Russia’s Corporate Governance: The Case of the Oil and Gas Industry’, at 93.

purposes”) of the Russian Tax Code.\textsuperscript{167} The Code provides the Ministry of Tax and Levies with a mechanism known internationally as “price adjustment”.\textsuperscript{168} Russian Tax Code codifies an arm’s length method as the basis for determining corporate income.\textsuperscript{169} Although these provisions were introduced together with the First Part of the Tax Code, a lack of the judicial practice, the weakness of the general tax administration and general problems in the Russian Federation’s economic system gave birth to a confusing system of statutory willful blindness, where big corporations paid taxes not on the basis of the Tax Code, but on the basis of a special agreement with the Ministry of Tax and Levies, and the Government closed its eyes to the universal application of questionable tax optimization schemes.\textsuperscript{170}

4. The weaknesses in the transfer-pricing legal framework played a huge role in the Yukos tax case, where the tax authorities were forced to apply and further develop a “bad-faith taxpayer” concept\textsuperscript{171} to penalize the company


\textsuperscript{168} Article 40 of the Tax Code of the Russian Federation prescribes some cases in which the tax authorities have the right to control prices used in transactions. According to Clause 1, Article 40, the prices for taxes are applicable to the prices of goods, works, and services, specified by transaction parties, supposing these prices correspond to the level of market prices. In order to monitor whether this premise is fulfilled, the tax authorities are given the right to check the legitimacy of transaction prices only in the following circumstances: (1) transactions between “interdependent” persons; (2) good exchange (barter) transactions; (3) foreign trade transactions; and, (4) transactions where the level of prices used by the taxpayer for identical goods fluctuates by more than 20 percent in either direction over a relatively short period of time. See the Tax Code of the Russian Federation (Part 1) (hereinafter “Tax Code”), available at: Law of Russia in English / System GARANT (http://www.garant.ru/nav.php?pid=286&ssid=89&mv=1)

\textsuperscript{169} Nadia Havard, ‘Comparative Analysis of Tax Incentives Provided by the United States, the United Kingdom, and Russia to Domestic and Foreign Businesses’. Alb. L. Rev., 67 (2003-2004), 1159-83 at 1167.


\textsuperscript{171} In the Yukos case, the Constitutional Court confirmed that the notion of a “bad-faith taxpayer” does exist. However, it did not provide a definition. Since then the concept of good faith seems to have been developed for a particular meaning for tax purposes and the courts have started to apply it in practice. Naturally, controversy has arisen. On April 24, 2006, the Supreme Arbitration Court introduced a draft of the Information Letter called “Concerning Circumstances Which Cast Doubt on a Taxpayer’s Good Faith in Connection with the Resolution of Tax Disputes in Arbitration Courts”. The letter offers an open list of circumstances which may cast doubt on a taxpayer’s good faith. In particular, this list includes the following:

- the terms of transactions are not the most beneficial for a taxpayer;
- accounting for transactions does not reflect their economic substance;
- the alienation of assets and subsequent acquisition of rights to those assets.
- transactions between related parties in connection with loans and the sale of goods, work or services with the subsequent offset of mutual liabilities, causing a decrease in tax accruals;
- a taxpayer conducts and accounts for only those operations which are directly concerned with obtaining tax benefits, if the type of activity involved requires that other operations be conducted as well. Ernst & Young, ‘Taxpayers’ Good Faith Questioned’, Russian Tax Brief (May, 2006), 3-4 at 3-4.
for tax evasions, instead of adjusting the intra-group resale prices used.\textsuperscript{172}

Some commentators have made attempts to justify the application of the unprecedented concept in the Yukos case:

\textit{The short conclusion …. is that the tax claims brought against Yukos are based on schemes that would be considered blatant tax evasion in most countries. As is common in blatant fraud or tax cases, there may be a number of theories available to challenge the illegal behavior. The Russian Tax Authorities in fact set forth a number of parallel theories for questioning these tax schemes. The Tax Authorities clearly are using this case (along with a number of other relatively recent cases) to signal that they will use various legal tools that have not previously (or very rarely) been used, although they are explicitly and implicitly built into Russia’s Civil Code, to prevent classical forms of “abuse of rights” and “bad faith” behavior. The intent appears to be to introduce a degree of “substance-over form” thinking into the enforcement of Russian tax law and to reign in some of the more blatant forms of abuse that have been staples of “doing business” in Russia in the post-Soviet period. There is little doubt that such rules, which exist in just about every western jurisdiction in some form and are built into Russia’s own law, will eventually be applied in practice in Russia.\textsuperscript{173}}

However, an analysis of existing Russian case law shows the only legal concept for challenging the “transfer-pricing” schemes would be for the tax authorities to challenge the pricing in the agreements between the Yukos production company, and to adjust the price paid by the SPVs upward to market rates.\textsuperscript{174} This would result in a re-computation of the production subsidiary’s taxes, as if it had received market price for its products. However, under this theory, the tax claims would have to be brought against the various Yukos production subsidiaries that sold products at below-market prices, and not against Yukos.\textsuperscript{175} Therefore, all the taxes

\textsuperscript{172} The prospective legislative developments drastically change the previous guidelines and bring them more in line with OECD standards. The draft law introduces three new transfer pricing methods – the method of secondary product, transactional net margin method (TNMM), profit split method (PSM) – that shall be applied along with currently existing CUP, subsequent sales method and cost plus method. The priority of methods would be changed as well – CUP would be the preferable method, PSM has the lowest priority and all other methods shall be applied under the best method rule.

Moreover, the new rules provide a detailed description of methods that would permit the elimination of certain loopholes in current legislation. For instance, the draft law finally defines the notions of “regular costs” and “regular profit” required for application of methods., Vasutin and Kosheleva, ‘Russian Transfer Pricing Rules: On the Verge of Change’.. Another revolutionary development relates to the definition of ‘related parties transactions’. The Tax Code currently envisages very narrow criteria stipulating that for tax purposes only parties with more than 20 percent direct or indirect capital participation shall be deemed related. Introducing provisions allowing for the conclusion of advance pricing agreements. Svetlana Stroykova, ‘Government Focuses on Transfer Pricing’, International Tax Review (2007).

\textsuperscript{173} Clateman, ‘Yukos Part Vi: Tax Claims Revisited’.

\textsuperscript{174} Pepeliaev, Ivlieva, and Khamenushko, ‘Opinion Regarding Compliance with Legislation of Inspection Report No. 08-1/1 of December 29, 2003 issued by the Tax Ministry of Russia’.

\textsuperscript{175} Clateman, ‘Yukos Part Vi: Tax Claims Revisited’.
of the corporate group imputed to Yukos should have been respectively recalculated. However, the complexity and unpredictable results of this method (the complete recalculation might not have given a figure, sufficient for the forceful sale of the Yukos assets) excluded it from the agenda of the Russian authorities.

5. Russian corporate law generally demands the same “arms-length” approach to the transactions of companies as does Western and international corporate law. The special procedure of approving the related parties and major transactions must be respectfully applied to all the transactions inside the corporate groups.

6. It should be noted that due to the peculiarities of the Russian oil trading system, the application of the “fair market price” rule faced significant problems. As the export capacity of the Russian oil companies was restricted by the physical pumping capacity of the export pipeline, belonging to the state-controlled company “Transneft”, they were allowed to sell approximately one third of the produced crude to overseas consumers. The rest of the oil had to be sold on the internal market or refined and sold as products. Therefore, there was the “world” fair market price, fixed by the international rating agencies for overseas sales, and the “internal” fair market price for domestic sales. The internal market price did not actually exist as there was no public exchange for oil contracts, and the bulk of oil was refined. This phenomenon could easily be explained by political factors: the internal price of oil was deemed a core macroeconomic factor that determined the rest of the internal prices. If it had not been statutory indirectly controlled, the country would have faced a tremendous price rise shock. So, the artificial absence of an internal market price should be understood as state policy, which, of course, suppressed the internal market of oil and encouraged the application of the transfer-pricing schemes.


180 In case of Yukos, the free sale price of its subsidiary mining companies exceeded five times the transfer price of their affiliated refineries. Shiobara, ‘Oversights in Russia’s Corporate Governance: The Case of the Oil and Gas Industry’, at 96.

The line between optimization, avoidance and evasion was completely unclear, which made the application of the transfer-pricing schemes, based on the complete disregard of the “substance over form” principle, a must for all big corporate groups.  

8. One of the reasons why transfer-pricing schemes have become less popular, apart from the consequences of the “Yukos Affair”, is merely that amendments have been made to the tax laws. The sales of mining minerals were targets of taxation, until the introduction of the mining tax on mineral resources, integrating a “user fee” on underground resources, a deduction for reproducing minerals and resource bases, and excise taxes on oil and gas, at the beginning of 2002.  

The transfer pricing methods could deduct 16 percent off 24 percent of the profit tax in 2003. Nevertheless, it can be concluded that the incentive to underestimate sales has also faded, because in 2002 the rate on taxable profit was reduced. 

The above arguments generally describe the situation that took place in Russia between early 90’s and the beginning of the Yukos case. They provide a foundation on which to understand the reasons why Yukos, like many other production companies, aggressively used transfer-pricing operations incorporated in its tax and cash flow optimization schemes.

Having reviewed the situation in Russia, it makes sense to take a brief look at existing international practice, which considers transfer-pricing within the related groups of a corporation one of the greatest problems in international tax law. It is widely recognised, that the arm’s length principle, as embodied in the model tax treaties and OECD Guidelines, is universally accepted throughout the world. This principle permits national tax authorities to adjust the accounts of enterprises under common control, if they consider that “conditions are made or imposed between the two enterprises in their commercial or financial relations, which differ from those which would be made between independent enterprises”, in order to

181 Ibid. at 95-101.
183 Shiobara, ‘Oversights in Russia’s Corporate Governance: The Case of the Oil and Gas Industry’, at 97.
184 Ibid. at 93.
185 In addition, since 2004, regional preferential privileges concerned with the profit tax have been restricted within 4 percent points of 24 percent. Ibid. at 97.
reallocate profit which would have accrued but for those conditions.\textsuperscript{188} By incorporating the separate entity concept, the arm’s length principle places related and unrelated enterprises on an equal footing for tax purposes, avoiding the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity.\textsuperscript{189} In practice, however, transfer-pricing disputes have entailed negotiation and bargaining over the “fair profit allocation”. Both officials and business representatives, have continually tended to reject the possibility of developing explicit criteria for profit allocation, and have preferred to focus on price adjustments.\textsuperscript{190}

The experience of tax authorities reveals the difficulty of allocating profit by means of price adjustments. The British HM Revenue and Customs, which strongly advocated the separate accounting approach, uses negotiation to agree a reasonable basis for pricing.\textsuperscript{191}

U.S. transfer-pricing is based on the arm’s length standard and implies the separate entity concept.\textsuperscript{192} It is recognized that the U.S. transfer-pricing rules are inconsistent with modern business models, which organize by process rather than by function.\textsuperscript{193} In contrast with the UK approach, in the USA the procedures have become increasingly juridified, since the politicisation of the problem in the

\begin{footnotesize}
\begin{enumerate}
\item[190] Picciotto, ‘Transfer Pricing and Corporate Regulation’, at 398.
\item[191] Ibid.
\item[192] There are three traditional specified transactional methods set forth in the U.S. transfer pricing regulations: comparable uncontrolled price (CUP) (or, in the case of intangibles transfers, comparable uncontrolled transaction (CUT)), cost-plus, and resale price. The CUP method uses prices in comparable transactions between or with unrelated third parties. The cost plus method is used when the costs incurred for supplying a product are known. The transfer price is then determined by adding a reasonable markup to the cost. The resale price method is used when the ultimate sales price to arm’s length third parties is known. Here, the transfer price is determined by reducing the price by a reasonable markup. Robert T. Cole, Practical Guide to U.S. Transfer Pricing, ed. 2d (Matthew Bender, 2001) at para. 7.01.
\item[194] On the procedures, also initiated by the US authorities and on which considerable stress is being placed, is for ‘advanced pricing agreement’ (APAs). This allows, at the taxpayer’s initiative, the negotiation of an agreed transfer pricing method which the tax authorities would accept, and which might remain valid, providing there is no change in the key parameters identified in the agreement, for several years. Since the procedure requires the same effort and level of disclosure as a contested audit, it is likely to be initiated only by firms at high risk of tax scrutiny. However, political pressure has led to a much more active programme of examination of TNCs, especially of foreign firms entering the US market which are popularly suspected of not playing fair. Picciotto, S. (1992). Transfer Pricing and Corporate Regulation Corporate Control and Accountability. McCahery en al. Oxford, Clarendon Press.
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Approved in 1968, the regulations on transfer pricing defined five categories of transaction (for loans, services, leasing, intangibles, and tangibles), and specified rules for determining prices for each. Furthermore, for each of the five categories of transactions they specified that the primary test of price should be the “comparable uncontrolled price” (CUP), the price that would have been charged by uncontrolled parties dealing at arm’s length. Regardless to the sophisticated legislative efforts, the problem of transfer pricing in multinational companies in the US is still on the agenda, including proposals to use criminal legislation for ensuring the effective enforcement.

So, although the existing international practice shows the importance and actual incontestability of the arm’s length principle, the legislative and political history of anti-transfer pricing rules worldwide clearly demonstrates that they need a comprehensive and balanced approach, which inevitably includes element of negotiation between a taxpayer and the tax authorities. The Yukos case does not set up an example of such approach.

Regardless to the legal, economic and political arguments, either justifying the application of the Yukos transfer pricing schemes, or declaring them an essential element of blatant tax evasion, qualification of these schemes as a form of embezzlement raises significant questions. Russian legislation and case law consider, as embezzlement, an act of personal misappropriation or transfer to a third person without any compensation of the assets, which have been entrusted to the offender. The assets may also be under his control due to other legitimate reasons (agreement, order, etc.) and he could exercise the rights of possession, management or delivery in respect of these assets. The replacement of assets for less valuable ones shall also be considered as embezzlement. So, according to the commentators the corpus delicti in the offence of embezzlement should involve the following characteristics:

1) The offender has the legal and official control over the certain assets (he does not hold them illegally). This control may originate from an agreement, power of attorney or orders of the owner.

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196 Ibid. (at 52-58.
200 Embezzlement by means of the large-scale misappropriation. The Summary of the Chargers.
2) The offender has a legal right to alienate the assets to himself or transfer assets to a third party.\textsuperscript{202}

Therefore, this legislative and case law approach in application to Khodorkovsky/Yukos case raises two questions:

1) Can a chief executive officer or a “shadow director” (or the actual controlling person, not depending on his formal status) of the managing company be considered as a “controlling person” in the meaning given to its definition by article 160 of the Russian Criminal Code and Russian Case Law?

Taking into consideration the language of the Summary of the Charges, the position of the commentators\textsuperscript{203} and the judgments, brought in the “First Khodorkovsky case”,\textsuperscript{204} this question is highly likely to get a positive answer.\textsuperscript{205} However, this decision will set a precedent for other Russian corporate groups and may urge them to change their management structures.

2) Can transfer pricing transactions, conducted for the benefit of the parent company that fully owns its subsidiary, be considered as damaging for the subsidiary?

This question is important, as in Russian case law, the responsibility of the parent company for the damages caused to its fully owned subsidiary, as a member of a multi-level corporate group, is not clear.\textsuperscript{206} Nevertheless, Article 71 of the Law “On Joint Stock Companies” points out that either an individual manager or a managing company owes same general fiduciary duties of loyalty and care to the

\textsuperscript{202}Duynov et al., \textit{Comments to the Criminal Code of the Russian Federation} at art. 160.


\textsuperscript{204}That time he was sentenced for “embezzlement of other people’s property entrusted to the guilty party in large scale” regarding the Apatit trading scheme. See \textit{Russian Federation v. Mr. M.B.Khodorkovsky, Mr. P.L.Lebedev, A.V.Kraynov (Judgement)}, at at14-19. However, later, the Moscow City Court stated in the its cassation decision that “the apatit concentrate has not been entrusted to Khodorkovsky and Lebedev”. See the Lebedev’s Legal Team Supervision appeal to the Presidium of the Moscow City Court of December 26, 2005, available at: <http://www.platonlebedev.ru/docs/default.asp?sid=2&mid=1478&open=1#doc> This decision may create certain problems for the second case, but it is evident that this inconvenient precedent can be easily overruled.

\textsuperscript{205}In the “Apatit episode” in the “First Khodorkovsky Case” the Court used the formula “Mr. M.B.Khodorkovsky, Mr. P.L.Lebedev acting as members of the organized group fraudulently misappropriated shares in OAO ‘Apatit’ and, holding the major equity of the above company, acquired the right to strategic and day-day management thereof by electing their subordinates to the leading positions with OAO ‘Apatit’, i.e. the Board of Directors and Director General”. Taking into consideration the language, used in the Summary of the Chargers, the similar approach will be used in the second “Khodorkovsky case”. Ibid. at 14. See also Figure 4 on the managing position of Khodorkovsky.

\textsuperscript{206}Shitkina, \textit{Holding Companies: Legal and Corporate Governance Issues} at 328, 412.
company they manage as they owe in the UK and US law. Article 6 of the Law also fixes the responsibility of the parent company whose instructions have led to the insolvency of its subsidiary. The US law would give a similar answer to this question by using “separate entity”, “limited liability” and “piercing veil” doctrines.

Concluding the part on the Yukos transfer pricing problem, it is important to stress that all Russian oil companies used different transfer pricing schemes which varied in the level of prices, types of SPVs and other aspects. The new precedent, which is likely to be set in the new Khodorkovsky/Yukos case, is sure to create a new legal threat for all Russian production majors, which will exist at least for seven years, and could be used as a effective tool in a new wave of politically motivated redistribution of big property and industry in Russia.

7. Conclusion

It is not surprising that even a brief analysis of the Yukos’ corporate structure and business operations in comparison with the recently brought money laundering charges, shows that similar allegations based on the creative application of the money laundering legislation could be effectively brought against any corporate group in Russia. The important point is that it could be done in full compliance with the current Russian anti-money laundering legislation, which is regarded by the international experts to be a consistent part of the international anti money laundering framework. This situation simultaneously raises several problems:

1. The problem, which stems from the application of national anti-money laundering legislation, adopted in compliance with recent international guidelines, to multinational corporate groups, can be better seen in examples originating from countries with transition economies. Multinational business groups from such countries aim to conquer the international securities markets, showing an unprecedented level of production and capitalization growth. The majority of such corporations, acting primarily in the oil, gas and metal sector, demonstrate a high level of compliance with the most advanced international corporate governance, accounting and other standards, retaining the best

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209 Shitkina, Holding Companies: Legal and Corporate Governance Issues at 316-329.

consultants, lawyers and auditors, available on the market, who assist the companies’ shares to become “blue chips”.\textsuperscript{211} However, the Yukos case shows the general vulnerability of such compliance. The company, known in the international business community as a leader, which set standards for Russian corporate governance in transition, within months became an example of the most outrageous corporate collapse in recent Russian corporate history. This case puts on the international agenda the question of whether or not advanced international corporate standards, even when meticulously applied by companies from the countries with transition economies, can protect international investors from unexpected scandals and losses. It also raises the question of what role of the anti-money laundering legislation may play in the promotion of such scandals.\textsuperscript{212}

2. The Yukos case has already given birth to a number of unprecedented decisions and is still creating precedents for international case law.\textsuperscript{213} More news is expected from the ECHR, where at least six Yukos-related applications have been filed. There are two main questions which are still outstanding and have to be addressed in the Yukos case: the role of the gatekeepers, including primarily the international auditors, in the collapse of Yukos, and the political motivation and its significance for corporate cases, such as the Yukos case, where the criminal and corporate tax evasion allegations were completely interrelated and used, not only for the attack on the individuals, but also as an attack on their economic wealth, which represented a danger for the existing political regime. The answer to the second question does not seem as evident as some experts are eager to represent it. The position of Amnesty International, which has refused to declare Khodorkovsky as a political prisoner, leaves a lot of room for further discussion and stresses the importance of the ECHR position. The judicial battles, unfolding around the PwC role in the


Yukos case in Russia, are unlikely to come to an end for at least a couple of years and have a good chance of migrating to the US courts. Nevertheless, answers to these two questions would permit a full stop to the Yukos story and answer a principal political question: What did Yukos and its shareholders actually represent? An “organized corporate criminal group” of tremendous complexity and power or an extremely powerful group of individuals who were regarded as a danger to the interests of Putin’s ruling elite?

3. The Yukos case has unveiled the possible dangers of money laundering legislation in hands of transition economy governments with and weak democratic traditions. Even if the anti-money laundering laws of the country comply with international pronouncements to the letter, there are still a number of ways to use they can be used with the sole purpose of pressing political opponents. In the Yukos case, money laundering charges were interrelated with the charges of corporate tax evasion, which, taken separately, in Russia, represent a rather weak tool for suppressing the political opponents, but are perfect for the confiscation of assets. This allowed the investigators to represent the activities of the giant corporate group as a process of committing organized criminal offence, which continued for more than seven years.