

Yukos Affair, Part VII: Review of the Criminal Sentence and Appeal
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The criminal case at the heart of the “Yukos Affair” started with the arrest of Platon Lebedev in June 2003 and culminated in May 2005 with the reading of the 600 page-plus sentence of Mikhail Khodorkovsky (“K”), Platon Lebedev (“L”) and their one-time colleague Vladimir Krainov by the Meschansky District court. This comment, a further addition to a series of comments on legal aspects of the Yukos Affair that I have distributed on Johnson’s Russia List [1], reviews the Sentence and the first appeal of the Sentence, handed down by the court of cassation on September 22, 2005. [2] The premise of this series of comments is that regardless of what “political” motives may lay behind the Yukos Affair, the legal cases that comprise this affair show the Russian courts both struggling with important legal concepts and reaching new levels of understanding regarding modern fraud and tax evasion. These cases deserve attention not given to them in the general press, not just because of the legal issues addressed, but also because they provide an unusually detailed view into “business” in Russia.

This comment will review the evidence presented and the legal arguments made in the Sentence and the Appeal in an attempt to second guess the conclusions of both the trial and the appellate courts. There are a few caveats to be noted before embarking on such a project on the basis of the Sentence and the Appeal alone. Although the Sentence is extremely long and is supposed to contain all substantial evidence relied on by the trial court and provide the outline of its conclusion, it is not a full record of the trial and it does not contain the full text of the documents or witness testimony presented or the full reasoning behind many of the rulings made in the course of the trial. It is also difficult to judge the credibility of witnesses without having viewed their testimony. In the discussion below, I attempt to point out where such caveats arise and to qualify the analysis appropriately. In addition to these caveats, a disclaimer must also be made: this review of the court documents is not meant to determine whether or not the prosecutor or the courts acted independently in their actions. Whether proceedings are “real” or a form of theater, they have raised important arguments that deserve a critique.

Summary Analysis

The Sentence reveals that all of the original charges made against K (eleven charges) and L (ten charges) in their respective indictments were brought to trial. [3] As detailed in previous comments (see Yukos I and II), these charges for the most part constitute rather straightforward forms of fraud and tax evasion.

The trial court found K and L guilty as charged with respect to:

1. Fraud in the 1995 privatization 44% of the shares of the Scientific Research Institute for Fertilizer and Insecticides in the name of Ya. V. Samoilov (referred to by its Russian acronym “NIUIF”).
2. Criminal violation of a November 1997 court order to return the shares of NIUIF.
3. Diversion of funds in connection with a transfer pricing scheme to take profits out of the fertilizer company “Apatit” during 2000-2002.
4. Embezzlement of funds in connection with the ongoing transfer scheme to take profits out of Apatit during 1997-2000.
5. Criminal violation of a February 1998 court order to the return 20% of the shares of Apatit to the government, which the court found were obtained by fraud in 1994.
- 6, 7. Separate charges of personal tax evasion against each K and L for attempting to claim salary and other benefits paid by Rosprom, Yukos and Menatep as income derived from “independent entrepreneurial activity”, and thus avoid income and other taxes during 1998, 1999 and (with respect to L) 2000.
8. Organizing corporate tax evasion by Yukos through illegally taking advantage of onshore tax havens and paying taxes with promissory notes during 1998-1999.
9. Organizing the embezzlement of state funds by Yukos though claiming refunds in cash from the government based upon false overpayments of taxes in promissory notes during 1999-2000.
10. Diversion of some \$100 million funds from Yukos to companies controlled by Vladimir Gusinsky in 1999-2000.

Although these charges carry penalties of up to seven years each, due to the sentencing rules in the Criminal Code, which provide that the sentences for these crimes are to be serve “partially concurrently”, the overall sentence was only nine year. [4]

The trial court dismissed the following charges from the original indictments:

- + Fraud by K and L in connection with the 1994 privatization of 20% of Apatit—this charge was dismissed due to tolling of the statute of limitations.
- + Falsification of documents by K in connection with charge 6 above (personal tax evasion)—this charge was dismissed because the court found this charge to be what is called a “lesser included” offense of the charge of personal tax evasion (and therefore, K could not be convicted of both charges).

Contrary to most press coverage of the Appeal, which indicated that only cosmetic changes to the Sentence were made, the Appeal in fact made numerous changes to the Sentence and, moreover, overturned the following convictions:

2., 5.: Convictions of K and L for organizing the criminal violation of court orders were overturned on the grounds that the court did not find that any of the actions taken by K and L after the court orders came into effect could be considered to be criminal violations of the orders.

3. and 4. (in part): Convictions for the years 1997, 1998 and 1999 with respect to the scheme to take profits out of Apatit through transfer pricing were overturned due to tolling of the statute of limitations (convictions for 2000-2002 were upheld).

6. and 7. (in part): Convictions for personal income tax evasion by K and L for the year 1998 were overturned due to tolling of the statute of limitations (convictions for 1999 and 2000 were upheld).

8. (in part): Convictions of K and L for organizing corporate tax evasion by Yukos through use of promissory notes to pay taxes during 1998 and 1999 were thrown out on the grounds that, although such payment was illegal, it did not result in the filing of a "false tax return" during these years, which was the specific charge made by the prosecutor (the conviction of K and L for counts of tax evasion for these years by other means was upheld).

Charge 10: The conviction of K for criminal diversion of funds from Yukos was overturned on the ground that the diverted funds were themselves the fruits of other crimes (i.e., the other charges of tax evasion and fraud against the budget). Therefore, it reasoned, the further transfer of these funds to companies related to Mr. Gusinsky did not constitute a separate crime.

Since, as noted above, the sentences originally handed down were to be served "partially concurrently", the changes made by the appellate court to the Sentence resulted in the reduction of the jail time to be served by K and L by only one year (from nine to eight years).

As set forth in the analysis below, the most material errors of the trial and appellate courts appear to have been made in connection with the following charges:

1. The conviction of K and L of fraud in connection with the privatization of 44% of NIUIF through an organized group was not supported because this charge requires that the prosecutor prove that K and L formed an organized group in advance with the specific intent to commit the fraud. However, the evidence presented was very circumstantial and insufficient to show that K and L acted with such advance intent. Nevertheless, the evidence does show that a fraud was committed by senior Menatep official and that K and L were involved. Therefore, the evidence may support their conviction of a lesser degree of fraud.

2.,5. The appellate court's dismissal of the convictions of K and L of violating court orders was based upon reasoning that takes an extremely narrow view of the legal effect of court orders in Russia. The court's interpretation of the law is neither literal nor logical and leads to undesirable outcomes. Therefore, these convictions should not have been overturned.

Overall, the Sentence undertakes a detailed comparison of the evidence presented with the charges made and addresses dozens of legal arguments raised by the defense. The Appeal also responds to dozens of additional argument put forward logically and, in most instances, convincingly. In short, even if these proceedings were theater, they were at least in the style of realism.

Although the defense raised literally dozens of arguments and objections during the trial and appeal, the court responds adequately to most of these positions. As one might expect, many of the defense's arguments fall into the "worth-a-try" category. The defense can hardly be blamed for such efforts, but the proceedings cannot be judged simply by the number of arguments rejected. Discussion below will focus on identifying what appear to be the most significant errors of the court.

In procedural matters, the trial court appears to give the benefit of the doubt to the prosecutor and its witnesses in a number of instances. This type of bias in procedural matters is endemic in the Russian judicial system and it is difficult to say that the Sentence and Appeal reveal anything unusual in this regard. In particular, the "benefit of the doubt" appears to have been denied certain experts for the defense who testified on financial matters related to the fraud, embezzlement and tax evasion charges. While it is not clear that the court erred with respect to excluding or discrediting this testimony, the court clearly does not take a liberal approach to these witnesses. The court also gives the benefit of the doubt to the prosecution and its witnesses with respect to the admission of evidence from a key search of a Menatep compound outside Moscow. It appears clear from the court's own account of this search that a significant (but probably not unusual) degree of sloppiness occurred in the conduct of this search. While the defense's myriad of objections to this search are often unfounded or exaggerated, the court gives credence to the testimony of certain investigators regarding the conduct of this search which an objective reader finds difficult to believe. This bias leads to concern that a number of technical errors in the search may not have been more material than the court views them or that more errors occurred than the court admits.

In connection with this search of the Menatep compound, the court in one instance appears to have gone far beyond merely giving the benefit of the doubt to the prosecutor and permitted a serious violation of the defendants' rights by admitting evidence obtained from an office on the premises used by a law firm that serviced Menatep. No court order was obtained, as required under Russian law, for the search of the advocate's offices and the court's arguments for admitting this evidence despite such violation are not convincing. It is not clear what particular evidence was retrieved from this office, but it is possible that it included some of the key evidence used to prove some of the charges. This violation, therefore, could provide grounds for a higher court to declare a mistrial on some of the charges.

Outline of the Sentence

The Sentence is divided into a preliminary 60-page summary of the charges against K, L and their associate Vladimir Krainov [5] and factual "episodes" behind the charges. The following 550 pages review the evidence presented in support of each charge against K, L and Krainov. Most of the legal arguments and procedural objections are

dealt with in the final 50 pages of the Sentence. The pronouncement of the sentence itself occupies the final four pages.

In accordance with what is apparently the common style, the court does not cross reference evidence reviewed with respect to different charges, but rather repeats the evidence relied upon for each charge separately. Given this practice, the large number of charges against multiple defendants and the unprecedented complexity of the case, the length of the Sentence is not surprising. While the defense has publicly claimed that the Sentence is full of “irrelevant” information, it is hard to find examples. We may speculate that the court chose to err on the side of inclusion in its review of the evidence to counter the public declaration by the defense that no evidence had been presented. While the text is perhaps more clearly written than the average trial court ruling, it suffers from lack of reader-friendly headings and intermediate conclusions. It is likely that, as the defense has claimed, the court did lift passages from the prosecutor’s written submissions and inserted them into the decision. It is, of course, normal practice for courts to lift sections from the parties’ submission in their rulings in Russia and elsewhere. It is particularly unsurprising in this case, in which much of the Sentence summarizes uncontested documentary evidence.

The case against the defendants has been built almost entirely upon documentary evidence. Witness testimony reviewed in the Sentence, for the most part, consists of confirmations by employees of Menatep companies regarding their employment, work duties and involvement in the production of specific documents. Expert testimony is used mainly to compute the damage caused by the various crimes (the amount of tax evaded, funds embezzled, etc.), but not establish the commission of the crimes themselves. The bulk of the evidence is directed at demonstrating the ownership and control of dozens of legal entities and establishing money flows and, with respect to certain charges, share transfers. There is no reason to doubt press reports that the trial was boring.

The Sentence: Charge by Charge

In the outline below, first number indicated before each charge indicates the order in which it is addressed in Sentence, except that charges that were dismissed are labeled “Dismissed”. Following the number of the charge, I note in brackets the order in which the charge appeared in the original indictments against K and L, respectively (for a detailed review of the indictments and original charges, see Yukos I and II). I also note in brackets at the end of each charge the company or person to which the charge relates.

1. [4(K); 5(L)] Fraud on a large scale committed through use of an organized group by obtaining rights to another’s property through deceit (points a and b of part 3 of Section 159). [NIUIF]

Dismissed [1(K); 1(L)] Fraud on a large scale committed through use of an organized group by obtaining rights to another’s property through deceit (points a and b of part 3 of Section 159). [Apatit]

K and L were charged with fraud in connection with two entirely separate privatizations in 1994 and 1995 (NIUIF and Apatit).

Under the scheme used to carry out these frauds, Menatep employees who reported directly and indirectly to K and L caused a series of offshore and Russian companies to be formed. A few of the Russian companies in this structure participated as bidders in the auction for shares in Apatit and NIUIF. Under the terms of the privatization, the price of the shares was fixed at a very small nominal value, but bidders competed in terms of the size of their investment commitment to each company. Menatep Bank guaranteed the investment commitment of each of its companies that participated in these auctions. When it was clear that only Menatep companies had succeeded in participating in the auctions, Menatep caused all of its companies, except the lowest-bidding company in each auction (“Volna” in the case of Apatit and “Walton” in the case of NIUIF), to withdraw from the auction after it concluded. Thus, Menatep succeeded in keeping the investment commitment very low. However, once the auction was completed, Menatep caused Volna and Walton to fake their compliance with the investment commitments (approximately \$283 million in the case of Apatit and \$25 million in the case of NIUIF) by temporarily transferring funds to the account of the privatized company and then securing their immediate transfer back to Menatep.

In both cases, the non-fulfillment of the investment conditions was discovered, local prosecutors got involved, and the privatizations were cancelled, resulting in court orders against Volna and Walton (February 1998 in the case of Apatit and November 1997 in the case of NIUIF) to return the privatized shares to the state. However, due to the fact that Volna and Walton had already transferred them to other companies, the court bailiff was unable to secure their return.

The evidence establishing the scenario outlined above is based on straightforward documentary evidence which is largely not contested by the defense.

The history of the participation of the various shell companies in the privatizations and the movement of the privatized shares among other shell companies is well documented, as is the non-fulfillment of the investment condition. With respect to the non-fulfillment of the investment condition, the Russian courts that annulled these privatizations in 1997 and 1998 concluded that the investments were not made, but the Sentence nevertheless repeats much evidence regarding the failure to fulfill these commitments including straightforward testimony from managers of the relevant companies and State Property Committee officials. [6]

Extensive documentary evidence is provided to demonstrate that the various companies involved were established by or on the instruction of Menatep employees or by individuals at its affiliate Russian Trust and Trade (“RTT”), a company that performed secretarial and administrative services for companies established by Menatep and other affiliates of the bank and its founders. While these directors and officers were usually persons who had professional duties at Menatep or RTT, occasionally such persons were drivers or family members of bank employees. These documents include foundation agreements, internal Menatep communications and communications between Menatep and RTT, employment records and internal procedural memorandum. Similar documents are used to show that the nominal

officers and directors of these companies had virtually no knowledge of the activities of the companies they worked for, performed all actions on behalf of such companies from their office at Menatep or RTT, did not receive a salary for working at these companies and signed documents on instruction from members of Menatep's investment department. The accounting functions of these companies were performed under contract by a Menatep affiliate. Witness testimony of numerous individuals who managed the affairs of these companies while employees of Menatep or RTT confirms this general organization of activity and that these employees acted on instructions from the Menatep investment department with respect to these companies.

The fact that these companies were also acting under control of Menatep and in the interests of one owner is also confirmed by the fact that Menatep guaranteed their substantial investment commitments in the privatization, although they had no assets. L personally signed these guarantee letters. The fact that one principal stood behind these companies is also supported by evidence that, when Volna and Walton resold the privatized shares to other shell companies, who in turn resold these shares multiple times, these transactions had no economic rationale: the price was extremely low and settled in most cases with promissory notes of shell companies which were not paid until much later or not at all.

Among a few striking pieces of evidence are internal Menatep documents showing that both Apatit and NIUIF were considered part of a group of assets related to Menatep called the "Mineral Group". In July 1999, at the time a public scandal regarding the privatization of these two companies was continuing, Menatep was openly planning to create the "Rosprom" holding with these two companies figuring as prominent members of that group. K and L personally led meetings as directors of the offshore Menatep holding company that adopted an official resolution on restructuring the Mineral Group, which called for various companies including Apatit and NIUIF to be brought under a more direct holding structure.

As mentioned in the "Summary Analysis" above, charge 1 (fraud with respect to the Apatit privatization) was thrown out by the trial court on the grounds that the statute of limitation had expired. K and L were convicted under charge 5 (fraud with respect to the NIUIF privatization) and their appeal of the conviction was rejected by the appellate court.

In my view, however, the evidence outlined in the Sentence is insufficient to demonstrate that K and L formed an "organized group" as charged to commit this fraud and therefore the charge should have been thrown out. To convict the defendants of committing the fraud through an organized group, the Criminal Code requires that it be proved that K and L formed the group with the specific intent to fraudulently acquire the NIUIF shares through this group. While the evidence clearly shows that the crime charged was committed by certain senior Menatep executives (in particular, the senior members of the "investment department" at Menatep) and that K and L had "motive and opportunity" to commit the crime, evidence regarding K's and L's direct involvement is almost non-existent.

What the prosecutor does show is that K and L were at the head of this structure and had the authority to order the companies in this structure to act. They were clearly

aware that these companies intended to participate in the privatization of NIUIF and supported this action (for example, by having Menatep issue guarantee letters for the participants in the auction). Moreover, as will be discussed below with respect to the following charges, after the authorities initiated steps to challenge the privatization and get the shares returned, they became involved in attempts to keep the shares out of legal reach of the courts so that they could not be returned to the government. However, evidence of direct involvement by K and L in the fraud is largely circumstantial. A couple of Menatep employees who served as “nominal directors” of the shell companies used in the scheme testify that they “usually” acted on orders from K and L, but sometimes these orders were given indirectly or they may have come from other senior executives without any indication that they originated with K or L. Some of the employee witnesses appear to have been a bit more expansive in describing K’s and L’s roles in directing such affairs in their pre-trial statements to the prosecutor, but by the time of their court testimony appear to have developed a more uniform story in which the role of K and L is more general and remote. While one suspects that such witnesses may be seeking to protect the defendants, their lack of credibility merely impeaches their testimony, but does prove the opposite of what they claim. The ability of the prosecutor to demonstrate the person involvement of K and L seems to have been seriously hampered by the fact that most of the senior level of Menatep executives, having fled the country, were not available as witnesses.

It is possible, given that K and L do seem to have been involved in or at least sanctioned the subsequent series of transaction in which the privatized shares were shuffled among a series of shell companies to avoid their return to the government after the privatization (I discuss this more below), that they could have been charged as “accessories after the fact” with respect to this fraud (and the Criminal Code does provide that this is one form of committing the crime). However, this is not the charge that the prosecutor has made.

In lieu of direct proof of premeditated fraud by K and L, the Sentence repeatedly refers to the fact that various employee-participants in the scheme reported to K and L because K and L were their ultimate bosses in the group structure of Menatep. The court, therefore, seems to indicate that K and L can be found criminally liable simply based on their ex officio supervisory role in the corporate structure over others who committed the crime. The fact that the court seems to rely so heavily on powers of K and L ex officio in establishing their guilt has led some Russian observers of this case to be concerned that Russian courts will now seek to apply “strict liability” to corporate officers for the criminal acts of their subordinates without a specific showing of criminal intent. Unfortunately, the Sentence (and the failure of the Appeal to correct this mistake) could be read as supporting such a rule. While the fact the various participants in the scheme did report ultimately to K and L is certainly important circumstantial evidence of their role, the Criminal Code provides no such blanket ex officio liability for corporate officers. Where strict liability exists, in Russia as elsewhere, it is usually limited to responsibility for physically dangerous activities undertaken by the company. Attempts to expand strict liability of corporate officers and directors by statute are usually quite controversial—witness the introduction of such liability with respect to the financial statements of public companies in the US under the Sarbanes-Oxley Act. Therefore, it would be an important step for a higher court to correct this error not only to ensure a proper result in this case, but to avoid further legal confusion in this area.

The defense, both at trial and on appeal, raised a few other arguments against this charge, but they deserve only brief attention. One such argument was that the prosecutor did not show the “stability” of the “organized group” because many of the individuals involved changed over time. However, the overlap of the “organized group” with the corporate structures of Menatep and its affiliates and the clear reporting lines and division of labor among members demonstrated in the Sentence actually reflects a very stable and organized group. Although some commentators do specify that “stability” is an characteristic of an organize group, this may be satisfied by the ongoing role of a few key individuals, even if numerous minor assistants change over time.

The defense also argued that the failure to pay the investment condition under the privatization (which was thousands of times higher than the purchase price) cannot constitute a basis for a fraud charge because the purchase price under the privatization agreement was paid; that is, so long as the state received the nominal purchase price for the shares, intentional violation of other economically material terms and conditions of the privatization cannot form the basis of a fraud. This argument attempts to assert a rather peculiar definition of fraud and the Criminal Code and commentary make clear that fraud may be based on any attempt to evade full or partial compensation for property, whether such compensation is formally called the “price”.

The defense also claimed that the ultimate owner of the various companies in the scheme at the time of the privatization was an “unnamed client” of Menatep and that this somehow exculpates K, L and the other members of the group. This claim is not very credible based on the evidence described and also because this claim appears only in witness testimony at trial and not in the pretrial statements of any of the witnesses. In any event, this distinction is irrelevant because it would not alter the fact that they committed the crime charged even if it could be shown that it was committed for the benefit of a client and not just for the benefit of K, L or Menatep.

2. [2(K); 2(L)] Willful violation of an effective court order by an employee of a commercial organization (part 3, article 33 and Article 315). [NIUIF]

5. [5(K); 6(L)] Willful violation of an effective court order by an employee of a commercial organization (part 3, article 33 and Article 315). [Apatit]

These charges relate to the violation by K and L of the court orders against Volna and Walton to return the shares they had acquired through privatization in Apatit and NIUIF, respectively, when the court overturned those privatizations. As with the fraud charges above, I treat these charges together, although they relate to completely separate incidents, because the schemes used in each episode are basically identical and similar evidence is used to establish that K’s and L’s involvement.

The Sentence summarizes extensive documentary confirmation regarding these transfers as well as witness testimony of the individuals who participated in this activity. This evidence, much of it repeated from the previous charges, demonstrates that K and L sat at the top of a structure of companies created by Menatep employees which were established for the purpose of carrying out the projects of Menatep and its

principals (e.g., the directors and officers were Menatep or RTT employees who were based at Menatep's or RTT's offices, acted on orders from their bosses at Menatep or RTT and received salary only from Menatep or RTT; the companies held bank accounts at Menatep; Menatep performed their accounting; their activity was economically detrimental to themselves, but beneficial to Menatep, etc.). After Volna and Walton acquired the Apatit and NIUIF shares, respectively, in privatization, these shares were transferred among companies in this structure at extremely low valuations and settled with promissory notes, which in turn appear to have been redeemed long after the transactions took place or not at all. Each of the agreements regarding the transfers were null and void because the law specifically prohibited further transfer of the shares until the privatization condition had been fulfilled, which it had not been. The transfers generally coincided with the threat of legal action against the shares.

By the time the court orders regarding return of the Apatit and NIUIF shares came into effect in February 1998 and November 1997, respectively, Volna and Walton had already transferred the disputed shares to other companies in the structure controlled by Menatep. Yet these initial transfers turned out to be only the beginning of a drawn-out cat-and-mouse game between prosecutors and State Property Committee officials, on one side, seeking return of the shares and Menatep representatives, on the other side, attempting to keep them out of reach of the courts. Although evidence of direct involvement by K and L with respect to the initial transfers is scant, after 1998 it becomes quite clear that the fate of these shares came under direct supervision by K and L in the context of the creation of the Rosprom holding. As discussed above, this holding was to encompass the various industrial and natural resource assets acquired by Menatep and its affiliates during the privatization period. Internal protocols, other documents and witness testimony confirm that K and L had decided to form the "Minerals Group" under Rosprom, which in turn included Apatit and NIUIF. Documents and testimony confirm that K and L assigned roles to various subordinates in the execution of the plan of forming this group.

As the prosecutors and the State Property Committee brought suits to annul the agreements by which Volna and Walton had transferred the privatized shares to other shell companies, K's direct advisor, a senior lawyer in the Menatep group, wrote memos advising on further share transfers, one of which discussed the need to "hang" the shares under shell companies controlled by offshore structures to protect them from legal action. Officials in the State Property Committee as well as local prosecutors began writing to members of the Duma and to senior members of the government and the presidential administration about the inability of the courts to secure return of the shares (it is possible that K and L were not aware of such correspondence, although in some instances, such correspondence was publicly discussed or addressed to Menatep or Apatit executives). The whole matter of the Apatit privatization and the legal cases to return the shares, as well as Menatep's and its principals' alleged role in the matter, were reported on in the press.

In the case of Apatit, this hide-and-seek ended with L personally proposing an "amicable settlement" to the State Property Committee —payment of \$15 million by Menatep on behalf of Volna to settle all claims regarding the shares (including the original \$243 million investment commitment). As the Sentence notes, this settlement (which was later annulled by another court and resulted in the official who agreed to it being brought up on separate charges) was beyond the authority of the

State Property Committee since it amounted to privatization of the disputed shares without a valid tender procedure ever being held.

We can summarize the above history of the disputed shares as follows:

- (i) K and L acquired the shares and put them in their “left pocket”.
- (ii) Knowing that the privatization under which they acquired the shares was fraudulent and that, therefore, the state is going to come after the shares, the shares are moved to K’s and L’s “right pocket”.
- (iii) Court orders come into effect ordering the shares to be returned from the “left pocket”.
- (iv) K and L learn of the court order, but fail to return the shares from their “right pocket” to the state.
- (v) Fearing further legal action, K and L organize the movement of shares from their “right pocket” to their “back pocket”.

The trial court found K and L guilty of these charges, but what exactly is criminal above this sequence of events?

Nothing is illegal about moving the shares from the “left pocket” to the “right pocket” (Step (ii)); these actions cannot violate the court orders since the court orders had not yet come into effect (Step (iii)).

However, did K and L violate the court orders by not causing the shares to be returned from their “right pocket” after learning of the order against the “left pocket” (Step (iv))? Under the extreme set of facts presented in this case, these “pockets” may be viewed as no different from the principals standing behind them—K and L (i.e., the “pockets” had no real corporate existence of their own, the “pockets” were entirely under the control of K and L, the movement of the shares between them constituted sham transactions concluded for the purpose of avoiding judgment, etc.). Therefore, one could argue that once K and L became aware of the court order, they were required to cause all of their “pockets” to obey it. While the court appears to agree that these companies were “fake” and controlled by K and L, it is not willing to require one legal entity to fulfill a court order directed at a different legal entity. This is not surprising since Russian law provides no formal mechanism for doing so in this situation.

But what about moving the shares from the “right pocket” to the “back pocket” after becoming aware of the court orders? Article 315 of the Criminal Code makes it a criminal act not only to disobey a court order directly, but knowingly to hinder its performance. While the “right pocket” may be not be required to disgorge the shares under an order addressed to the “left pocket”, it is certainly under an obligation not transfer them further, at least until it has gone to court and clarified its own rights over the shares. [7]

The appellate court, however, simply rules that the history of the shares after they were moved from Volna and Walton irrelevant since the respective orders were not addressed to the companies that received the shares. Although the appellate court recognizes that the K and L had a duty not to hinder performance of the court order, it states without explanation that these actions also did not hinder performance. This seems wrong. This result, unfortunately, appears to sanction an all-too-common and simple method for secreting assets in Russia—just keep shuffling them between pockets.

3. [3(K); 3(L)] Causing economic harm to the owner of property through deceit without evidence of conversion, committed on a large scale through an organized group (points a and b, part 3, Article 165). [Apatit]

4. [4(L)] Embezzlement of property entrusted to the accused, committed on a large-scale through an organized group (part 4, Article 160). [Apatit]

These charges both relate to the scheme organized and managed by K and L to embezzle funds from Apatit from 1997 through 2002 by causing Apatit to sell its fertilizer products at below-market prices to various companies under their control, which resold them at market prices, depriving the company of profits and its other shareholders (including the state) of dividends. As noted in previous comments (see Yukos I and II), this is a straightforward embezzlement scheme.

The Sentence relates how, shortly after the privatization of the Apatit shares in 1994, K personally visited the Apatit plant in Murmansk. The general director at the time and other witness testified regarding this visit, indicating the K clearly came as representative of the winning bidder of the privatization with a team of Menatep employees. This meeting made clear that Menatep would manage Apatit going forward and the general director was in fact replaced immediately and Menatep employees and their appointees took over management. In the course of 1995, the day-to-day supervision of Apatit appears to have shifted from Menatep to Rosprom, although many of the same individuals were involved. An internal Rosprom protocol issued by K as chairman of Rosprom from December 1995 entitled “Procedure of agreeing the activity of selling fertilized concentrate” establishes that Apatit had to agree its monthly sales schedule and prices with Rosprom. K’s long-time business partner Brudno who served as deputy director of Rosprom, had to sign off personally on any Apatit transactions above a few hundred dollars. Subsequent internal memos indicate that such a control structure was maintained in the following years. Several witnesses also confirm their role in the structure and that they were recruited to perform their particular tasks by senior Menatep executives, including in a few instances K or L personally. Diaries of L and Krainov, who appears to have acted as a high-level assistant to L with respect to Apatit matters, contain numerous entries indicating meetings regarding this group of companies and the sale of Apatit’s output through the this structure. Although Apatit began to sell virtually all of its output through this new structure, it appears that its ultimate customers remained largely the same as before Menatep took over.

The companies through which Apatit’s production was sold were established and controlled by Menatep and Rosprom. Many of the companies used in the structure overlap with those used in the charges described above and the Sentence provides

detailed evidence (much of it repeated) to demonstrate this control. The sale of fertilizer products from Apatit is traced contract by contract to demonstrate that profits were siphoned off to the shell companies under the control of K and L. Although the specific companies to which Apatit sold virtually all of its output changed every year or two during the relevant period, the scheme remained the same—the companies were controlled by Menatep/Rosprom and they acquired the fertilizer at below market price and resold it at market price, keeping the profits. These companies usually did not pay cash to Apatit for its products, but rather paid in promissory notes. Apatit's debt and tax arrears soared as it was starved for cash by this process.

In their testimony, K and L offered the explanation that the control that Menatep exercised over Apatit in this period was due to the fact that Menatep was a creditor of the company and had the right to manage its sales proceeds to secure repayment of the loans. While such a structure is plausible, it would typically be set out in security agreements, but it does not appear that the agreements in evidence contained this type of arrangement. Furthermore, this claim would not explain why Rosprom was involved in such control or why Menatep and Rosprom continued to be involved beyond the term of any loans. In any event, this theory explains Menatep's involvement in the sales process, but does not provide valid grounds for these companies to siphon off profits.

The defense also argued that K and L could not be convicted of the crimes charged because the relevant Criminal Code sections require that someone be deprived of property or be directly harmed. Although other shareholders may have lost the opportunity to receive dividends as a result of the schemes, this is not the type of deprivation of property or direct harm required by the law. Of course, this argument is not valid because it ignores that Apatit itself is the victim and has been directly harmed.

At trial, the prosecutors submitted an expert report estimating the economic damage caused to Apatit by the transfer pricing scheme. This report was not admitted by the court on procedural grounds which I discuss below. The court nevertheless discusses the contents of this report and concludes that it is not convincing as it contradicts other evidence establishing the scale of the surplus profits skimmed from Apatit by this scheme, including contract-by-contract review of these profits. In any event, the expert's report does not appear to argue that no damage was caused, and therefore it appears only to be relevant to the scale of the damage and not whether a crime occurred.

Despite the evidence described above, it was clear by the closing of the trial that the statute of limitations (four years) had tolled for the counts relating to the years 1997-99 and that these counts should have been dismissed. There is simply no discussion of the statute of limitations with respect to these charges in the Sentence, so it is possible that it was not raised by the defense either. The appellate court briefly notes this error and dismisses these counts, leaving only those for 2000-2002.

With respect to these remaining counts, the trial court and the appellate court struggle as to which article of the Criminal Code applies to this entire scheme. For operating this scheme during 2000-2002, K and L were charged in some instances with

violations of Article 160 of the Criminal Code—the conversion of property “entrusted” to the accused; i.e., embezzlement. The appellate court considers this classification to be an error and reclassifies these counts as violation of Article 165—causing economic harm through deceit or abuse of trust. The appellate court’s reasoning on this point appears confused, but this reclassification, as it turns out, has had no effect on the severity of the sentence. Since the issues raised by this question are rather technical and specific to these articles of the Criminal Code, I leave analysis of this discussion to a footnote. [8]

6. [10 (K)] Tax evasion by a physical person on large scale through knowingly filing false information in a tax filing (part 2, Article 198). [K personally]

7. [10 (L)] Tax evasion by a physical person on large scale through knowingly filing false information in a tax filing (part 2, Article 198). [L personally]

Dismissed [11 (K)] Repeated falsification of official documents (part 2, Article 327). [K personally]

K and L were each charged with evading taxes by improperly taking advantage of a special low-tax regime applicable to independent entrepreneurs. The tax evasion took the form of filing tax declarations misstating that the source of certain income for 1998, 1999 and (in the case of L) 2000 was consulting services rendered for a couple of offshore companies when in fact such income was really salary earned by K and L as executives at Yukos, Rosprom and Menatep.

As discussed in my comment to the indictment (see Yukos I), this charge constitutes a rather straightforward form of tax evasion. Although the low-tax regime applicable to small entrepreneurs was widely abused before undergoing reform after 2000, the structure used by K and L was more elaborate than the more common form of abuse and was more blatant. [9]

The tax regime available to small entrepreneurs in Russia resembles similar regimes available in Europe which allow small entrepreneurs to provide simplified accounting to the authorities and also apply a simplified (and often very low-rate) tax regime to their income. The Sentence reviews the documents submitted by K’s and L’s representatives to obtain a “patent” to use this regime and to satisfy the regular reporting requirements for use of this regime during the relevant years. In addition to such official filings, K and L entered contracts to perform general consulting services regarding Russian markets with two offshore companies, ownership of which the Sentence ultimately traces back to Menatep and its core shareholders.

The Sentence sets forth various forms of evidence supporting its conclusion that these consulting contracts were “fake” and really represented pay for work at Yukos, Rosprom and Menatep. No record of services being rendered under the consulting agreement was made available. The scope of services under the agreements is vague. The companies for which services were performed were shell companies managed from within Menatep and do not seem to have been involved in any activity calling for wide ranging consulting services on Russian markets. All of the work performed in preparing applications for K and L to receive status as entrepreneurs and fill out their tax forms was performed by Yukos or Menatep employees. An internal

memorandum addressed to K in fact sets forth a plan to use this scheme to pay all of the senior Yukos managers as entrepreneurs to enable them to save tax on what was clearly their Yukos salaries in 2000. The defense argues that this memorandum is inadmissible because it is dated 2000, after the years for which K and L are charged (except for the charge against L for 2000). While the fact that this document does not relate to the years covered by the charge, it does tend to show what is called a “pattern of behavior” and the date alone does not appear to give grounds to exclude it from evidence under the Criminal Procedure Code.

The strongest circumstantial evidence of the false nature of these consulting agreements is the clear mismatch between K’s and L’s wages at Menatep, Yukos and Rosprom, which amount to nominal sums of a few thousand dollars per year during this period, and the much larger sums received under these consulting agreements—from a few hundred thousand per year up to \$5 million by K in 1999. While this entire charge of tax evasion may seem petty in light of the fact that they involve evasion of a couple of million dollars of tax by two of Russia’s richest men, the Sentence reveals the surprising fact these consulting contracts constituted virtually all of K’s and L’s declared income from all sources during these years. It seems likely that this charge has been brought as a proxy for charging them with grossly underreporting their income in general.

K’s and L’s own testimony regarding these charge does little to dispel the accusations and is not very credible. Both acknowledged having being aware that their advisors were registering them as small entrepreneurs and that they had used this regime in their tax declarations. They claim that services were performed under the consulting agreements, but do not recall these particular agreements, what in particular the services consisted of nor even the names of the companies for which they were performed (although these companies as is made clear elsewhere in the Sentence were an integral part of the Menatep structure and one of them even maintained offices in the Menatep compound outside Moscow) until they were presented with the documents in the course of reviewing evidence for the trial. K justifies his non-recollection by claiming that he performed consulting services for lots of different companies. However, this version does not jibe very well with the fact that virtually all of his income for 1998 and 1999 came from the two companies in the charge and that he declared no income from any of the other consulting arrangements he referred to. K refused to name these other companies for which he consulted on the grounds that he is prohibited to do so under confidentiality agreements.

The defense raises as a legal argument against this charge the fact that K’s activity for these years passed an audit by the Tax Authorities, which it argues bars any claim. However, the court finds that these audits do not prove that the scheme was legal since the Tax Authorities were not apprised of information that would have revealed the substance of the transactions (that no services were performed, that the shell companies for which services were performed were linked to K and L, that the money for these services ultimately came from Yukos, etc.). Moreover, there does not appear to be any rule that passing a tax audit bars criminal liability for the matters audited. The defense also objects to certain expert testimony regarding the calculation of the tax avoided (I discuss below the objection to the admission of this report). The court reviews this calculation in some detail and it is apparent that some

tax was avoided. Therefore, this expert's testimony is relevant to the amount of the tax, but is not necessary to establish whether a material sum was avoided.

The appellate court upheld this conviction as well as the trial court's rulings on the evidentiary issues related to these charges.

The trial court dismissed the charge related to this episode made by the prosecutor against K for submitting "forged" documents to a government body (Article 327 of the Criminal Code). As discussed in my original comments to this charge in the indictment (see Yukos I), the charge seemed to confuse forged documents with documents containing false information. The appellate court, however, does not overturn the charge on the fact that the accusation is confused. Instead it notes that, if this charge in fact relates to the submission of official documents for tax purposes, K cannot be convicted for these same acts under both Article 198 (tax evasion by submission of documents containing false information) and Article 327. The second charge is what would be called in the US a "lesser included" offense of the first charge. On this basis, the trial court dismissed the charge against K.

8. [6, 7 (K), 7, 8 (L)] Tax evasion on a large scale carried out through an organized group (part 3, Article 33 and points a and b, part 2 of Article 199). [Yukos]

This charge accuses K and L of organizing tax evasion by causing certain Yukos-controlled companies to file fraudulent tax returns in 1999 and 2000. These returns were false because: (i) these shell companies took advantage of various corporate tax concession applicable to companies that invest in certain regions within Russia, despite the fact that they did not make any investments and did not fulfill other criteria; (ii) these companies did not pay their taxes in cash, as required by the Tax Code, but rather managed to get local officials to accept promissory notes; and (iii) in the year 2000, these companies reported overpayment of taxes in 1999, which was false because these payments had been made in promissory notes, which did not in fact constitute valid payment.

The Sentence traces the formation of the various companies used in this scheme and demonstrates (using the same type of evidence discussed above) that these companies were controlled by senior members of the Menatep/Yukos team, who in turn reported to K and L. Internal documents and agreements show that Yukos Refining and Marketing (a Yukos subsidiary responsible for its oil trading business) acted as the management company for most of Yukos's production subsidiaries and also as an agent for the shell companies involved in trading oil for Yukos from the onshore tax havens. K and L, each in turn, served as chairman of the management board of this company. They were also the ultimate controlling shareholders of the entire group of companies and held various directorships in the group. The Sentence describes internal Yukos memoranda which spell out the entire structure of the scheme and clearly establish it was created to minimize taxes by maximizing the amount of revenue and profit that Yukos realized through the companies in the low-tax zone. The activities of these companies were included in internal accounting reports as well as the consolidated management accounts of Yukos. Payments between these companies were rarely settled in cash, but rather through mutual offsets and exchange of promissory notes. During L's tenure as head of Yukos Refining and Marketing,

various documents and correspondence show him to have been active in managing the financial operations of the companies in this structure.

As I have outlined in other comments (see Yukos I and VI), Russian law at the time was quite clear that the onshore tax havens available in certain regions known as “closed autonomous territorial regions” could legally grant concessions only to companies that invested in the region and, moreover, had actual operational control in the region. [10] Unlike other low-tax regimes in many offshore jurisdictions, the law was clear that the investment requirement and presence in the region was not strictly formal. The shell companies used by Yukos, according to their own accounts, made virtually no investments in the region and had virtually no assets in the region or elsewhere. They were clearly shell companies that neither participated in any real way in oil trading, never actually took delivery of any oil and were managed by Menatep or Yukos employees in Moscow. Under such circumstances, these Yukos affiliates were not entitled to the special concessions they used. When the local tax authorities began to dispute the activities of these companies in 2001, these companies were merged into a companies in another region under the jurisdiction of a different branch of the tax authorities. Evidence that K and L were aware of and actually oversaw these mergers is clear from internal documents.

K and L argued that agreements entered into between the shell companies in the low tax region and the local administration granting the disputed tax concessions to these companies mean that the concessions were legal and/or that it was not criminal to take advantage of them. The conclusion of these agreements in itself does not provide an affirmative defense if the conclusion was contrary to the rules. Moreover, it appears (although the details are not provided) that these agreements were entered into based upon certain premises which did not exist and contained obligations which were not fulfilled.

K and L also argue that a certain report of an expert they hired to analyze oil prices was improperly excluded from evidence. As I discuss below, this report was properly excluded, but the expert who produced it was permitted to testify directly in court. The expert apparently argued that the market price at which the shell companies bought oil from Yukos production companies was not “below market” in the market that existed at the time in the low-tax zone. Such an argument seems irrelevant to the charge since, as noted above, this charge was not brought on a transfer pricing theory and therefore the fair market price of the oil products sold does not affect the validity of the charge. Furthermore, the price of oil in the low-tax zone itself hardly seems relevant to the activities of these shell companies, which clearly did not buy or sell oil in their nominal location of incorporation nor did they ever take delivery of oil in that region.

With respect to the counts of this charge related to payment of taxes with promissory notes, as noted in my original comments to this charge (see Yukos I), such payment may have been illegal under the Tax Code, but it does not violate Article 199 of the Criminal Code, which covers tax evasion only through filing a false return. Since the taxes were actually paid after the returns were filed, such payment did not result in a violation of Article 199. The appellate court picked up this argument and dismissed these counts on this basis.

The count of this charge related to reporting overpayment of taxes in 2000 based on payment of taxes with promissory notes in 1999 does, however, fall under Article 199 since claiming overpayment constituted filing a false return. The defense attempted to argue that payment of taxes with promissory notes was in fact legal in 1999 as the changes to the Tax Code that made this practice illegal were interpreted during 1999 to allow various forms of payment in-kind to continue. The court did not believe the testimony of the defense's expert on this point, apparently on the grounds that he lacked qualifications and experience. Review of official communications of the Tax Authorities and other actions during this period would be necessary to evaluate what types of transactions may have continued to be sanctioned and whether the payment scheme used by these shell companies fell under one of the valid types of payment. I have not been able to conduct such a review and can only note here that the defense may be a valid argument with respect to this count.

I note that K and L are accused of committing this tax evasion through an "organized group". As noted above with respect to charge 1, this requires that it be shown that K and L organized the group in advance with the intent to commit the specific tax evasion with which they are charged. It is a difficult call to make based on the Sentence whether the evidence is sufficient to prove such advance intent with respect to each of the counts. However, committing tax evasion through an organized group is not a separate degree of the crime under Article 199 of the Criminal Code. All forms of criminal participation in the crime are treated equally (supervision of the scheme, participation in forwarding the scheme, attempting to hide the scheme from the authorities, etc.). The evidence does support finding one or more of these forms of criminal participation, so the prosecutor's claim that this crime was committed through an "organized group" is not critical to the conviction.

9. [8(K); 9(L)] Fraud on a large scale committed through use of an organized group by obtaining rights to another's property through deceit (points a and b of part 3 of Section 159) [Yukos]

Having reported overpayment of taxes in 1999 and 2000 with promissory notes as described above in charge 8, the Yukos shell companies participating in the scheme claimed and received tax refunds. These refunds, based on tax not legally paid, constituted an illegal fraud on the state budget.

The Sentence reviews much of the evidence discussed above to establish K's and L's supervisory roles in managing Yukos's oil trading activity. K and L were clearly aware of these tax refunds and took various steps to forward them and also to prevent the authorities from questioning them after they took place. However, as with the previous charge, the evidence that they committed this crime through formation of an organized group is not strongly supported by the evidence outlined in the Sentence.

K and L also offer another defense with respect to this charge. They claim that no harm came to the government since, although the Yukos affiliates received tax refunds in cash after paying taxes in promissory notes, some of the notes were eventually paid and others were exchanged for a valuable stake in a gas station venture in the region in which the companies were established. The court notes, however, that these moves to settle the promissory notes took place, for the most part, after July 2003, at which point the local authorities had cancelled the tax concession

and began active efforts to review the various schemes that had been employed. Legally, efforts directed at restitution once the crime has been uncovered do not negate the crime. The trial court excluded an expert report submitted by Yukos which argued that the shares received by the local government in the gas station chain were at least as valuable as the tax owed. [11] I discuss the procedural issues regarding exclusion of this report below. However, I note here that this report and the expert's testimony regarding these moves to settle the notes do not appear to be relevant given the court's view that they constitute post-hoc acts of restitution. The court also questioned the extent to which these efforts were actually carried out since the local officials involved in both the original tax schemes and in these attempts at restitution are themselves being tried for corruption in connection with this activity. The court rejected the validity of some of the documents indicating these promissory notes had in fact been settled on the grounds that the agreements indicating such settlement were not produced by the defense during the investigation, but only surfaced at trial, that these agreement were signed by officials also under indictment and that the claim that the note had in fact been settled was supported by a note from one of the officials involved.

10. [9 (K)] Causing economic harm to the owner of property through deceit without evidence of conversion, committed on a large scale through an organized group (points a and b, part 3, Article 165 of the Criminal Code).

K was charged with diverting funds from Yukos entities in 1999 and 2000 to companies controlled by Vladimir Gusinsky. K organized this transfer without any valid purpose and Yukos supposedly received nothing in return. Yukos was therefore damaged. As I noted in my comment to the indictment (see Yukos I), such a diversion of funds is criminal in Russia, as they would be elsewhere, but the indictment contained very little detail regarding how this scheme was carried out.

The Sentence reviews the flow of funds under this scheme in some detail, but the logic in this part of the Sentence is very difficult to follow. Some RUR 2.6 billion were sent by Yukos companies to companies in Vladimir Gusinsky's Media Most group. However, rather than showing that these funds were not returned, the Sentence demonstrates quite clearly through specific agreements, internal memoranda and correspondence that in 2000 Yukos managers, including K, developed a plan to retrieve these funds from Media Most. According to these documents, they considered these funds to have been "lent" to Gusinsky's companies. In the end, Yukos acquired a valuable building in central Moscow from entities in the Media Most group as repayment for a large portion of the funds forwarded. Regarding the rest of the funds, the Sentence does not make clear what happened, but it does appear that attempts were made to retrieve these funds. In short, the evidence presented tends to controvert the accusation that funds were diverted, and rather demonstrates that the intent was for them to be repaid.

This portion of the Sentence is quite poorly written and its style differs from the writing in other portion of the Sentence. One is led to the hermeneutical guess that this portion of the Sentence was written based on material submitted by a different set of prosecutors, perhaps those who worked on the indictment of Gusinsky. These intricate financial relations between Yukos and Gusinsky's Media Most group, which was at the time already in the throws of bankruptcy, raises a series of interesting

questions, but the Sentence simply does not state in any clear way how Yukos was damaged or how a crime was committed by K in relation to this episode.

In the end, the appeals court threw out this conviction, but not on the basis of the lack of clear evidence discussed above. Instead, the appellate court found that the funds forwarded to the Media Most companies could not be the subject of an illegal diversion. The court identified these specific funds with the fruits of the tax schemes used by Yukos. Since these funds, as the fruit of a crime, were not legally owned by Yukos in the first place, the court reasons that K cannot be accused of illegally depriving Yukos of these funds. The problem with this argument is that the court does not make clear how it succeeds identifying the specific funds channeled from Yukos to Media Most with the fruits of the tax evasion. Money is fungible and the entities involved also had legitimate funds at their disposal. It is possible that the appellate court has put forth this argument for dismissing the charge, rather than simply finding the conviction unfounded, as a way to avoid openly recognizing the sloppy work of the prosecutor and trial court with respect to this charge.

Additional Arguments Raised and Rejected at Trial and on Appeal

Discussion below reviews some of the objections raised by the defense at trial and on appeal that appear to be material, to have some merit or to have been dismissed without an adequate explanation by the court. As a foreword to this discussion, it should be noted that it is rare in the contemporary Russian judicial system for courts to allow any but the most material and blatant technical and procedural errors to be grounds for excluding evidence, declaring mistrials or overturning convictions on appeal. A lower level of sensitivity to procedural errors may partially be justified by the fact that most trials do not involve juries. Judges, as triers of fact, are theoretically more capable of correcting for errors in their consideration of evidence than are juries and so errors in “bench trials” should have less affect on the outcome. However, the poor attention paid to procedure and procedural rights simply represents a far lower standard of due process and professionalism. This low standard is so extreme that, sadly, the first reaction of most people familiar with the judicial system to hearing that a conviction had been overturned based on a procedural violation would be to suspect that the defense had corrupted the court.

While it is important to point out the errors that can be detected in the Sentence and Appeal, it is unrealistic to expect that any of the convictions would be overturned based upon most of them. The review below identifies only one objection—a violation of attorney client privilege—that could realistically be a basis for overturning the conviction of K and L on some of the charges if a higher court decided to make a test case of the matter.

Admission/Exclusion of Expert/Specialist Reports and Testimony

One of the objections the defense raised at trial, on appeal and publicly is the exclusion from the trial of reports prepared by certain experts engaged by the defense. According to discussion in the Sentence, the excluded reports were produced by five experts, the contents of which are briefly described. It appears that these reports supported two types of arguments by the defense: that the various schemes used by Yukos and K and L did not constitute corporate or personal tax evasion or

embezzlement, and that the damage caused by these schemes was, in any event, less than claimed by the prosecutor.

The main reason given by the trial court for excluding these reports is that they were prepared by the experts before they were appointed by the court. The Criminal Procedure Code clearly requires that experts be appointed by the court before they prepare their reports. The defense appears to have argued that these reports should be admitted on the grounds that the Criminal Procedural Code permits the defense to gather and to submit general “documentary evidence”. In other words, the defense submitted these reports not as “expert reports” but as some general form of documentary evidence, not necessarily produced by an expert (in a sense, “taken for what they are worth”). This argument for admitting such reports is novel and is not supported by the Code, interpreted under the standard rules. [12] The submission of expert testimony is typically subject to a special procedure in most jurisdictions, which cannot be avoided simply by changing the label.

In any event, these experts were permitted to testify at trial as “specialists” and appear to have relayed the substance of their reports verbally in court. The court reached various conclusions about the admissibility and quality of this testimony which is very difficult to second guess given the limited details provided in the Sentence. Characterizing this discussion in general, I would say that the court does appear to take a rather skeptical approach to these witnesses. For example, it excludes some of the testimony of two of these witnesses on the basis that they lack appropriate practical professional experience, although such witnesses appear to have had reputable academic knowledge of the relevant fields. On the other hand, the line up of experts is surprisingly unimpressive and their testimony opened some clear points of criticism. A couple of the specialists appear to have lacked specific accounting or financial analyst qualifications, despite giving testimony on these topics. One of the specialists provided no more evidence of his qualifications in economics (the area of his testimony) than an identity card showing he was the Deputy Director of economics institute of the Urals department of the Russian Academy of Science. One of the specialists appears to have completely changed her answer to a key question under repeated questioning by the defense. Two of these witnesses appear to have had prior relations with Apatit and the administration of the City of Lesnoi on matters related to their testimony which, although not grounds for automatic exclusion under the Criminal Procedure Code, would tend to question their independence. [13]

The court does describe in summary fashion both the testimony of the specialists that it admitted as well as the testimony and reports that it excluded to demonstrate that such evidence was not credible, irrelevant or did not contradict the other evidence relied on by the court in reaching its judgments. This discussion appears to be an attempt to argue that the decision to exclude some of this evidence did not have a material affect on the trial (perhaps to diminish the chance that a retrial would be ordered if its rulings on this evidence are overturned on appeal). The court’s own summary of both the excluded and admitted evidence provided by these experts does, of course, support the view that this evidence was material and it is difficult to come to a different conclusion based on the Sentence. As noted above, much of this testimony relates either: (i) to whether the schemes themselves were illegal (which arguments can be reviewed without reference to the expert’s opinion, with the exception of legal issues raised in connection with charge 9 above) and (ii) to the size

of the damage caused by the schemes (which is not relevant to the fundamental question of guilt, but only to the damage caused). Therefore, it does not appear likely that the rulings regarding these experts and their testimony were key to the convictions.

Apart from the exclusion of its own expert reports, the defense objected to the admission of an expert report submitted by the prosecution on procedural grounds. The defense claimed that L did not give consent, as required under the Criminal Procedure Code, to expert examination of information recovered from him. Such consent is required from parties appearing as witnesses with respect to the charge. The discussion of this point in the Sentence is not very clear, but it appears that the court does not recognize this objection on the grounds that L was not yet named as a witness in the criminal matter under which the expert was appointed (and therefore the need for consent did not yet arise). The court also claims that L was in fact a defendant in a related charge, and consent from defendants is not required before undertaking expert examination. It is difficult to judge whether the court's explanation is well grounded since we are not given the procedural history of the criminal cases. It should be noted that this report, however, addresses the amount of tax avoided by K and L by using the regime for small entrepreneurs and does not appear to be key to finding their activity illegal in general.

The defense also objected to the admission of another report prepared by a team of accountants in relation to charge 3 against L (embezzlement from Apatit) on the grounds that the experts involved were appointed before this charge was formally brought against L. The Criminal Procedure Code provides that the defense must be notified of the appointment of an expert and have the opportunity to review the scope of the appointment, object to the expert, review the expert's work and put its own questions to the expert. The Sentence does not provide a very clear summary of the arguments on this question. It appears that this expert report covered more than one charge related to the same circumstances (charges 3 and 4) and that charge 4 had already been brought against L at the time the expert was appointed. Therefore, it appears that the defense's position was not that L did not have the chance to exercise his rights with respect to the report, but rather that L did not exercise these rights knowing the full scope of charges for which the report would be used. This is a less straightforward objection, but one that appears correct (at least with respect to excluding use of the report with respect to charge 3). Despite this error, it does not appear that this expert report was particularly controversial or fundamental with respect to the question of guilt under charge 3.

Exclusion or Disqualification of Certain Documents

-- The court excluded or considered questionable various documents concerning relations between the shell companies in the low-tax zone of Lesnoi and the local administration and local department of the Tax Authorities. These documents included records of tax inspections and various agreements showing redemption of some of the promissory notes used in the schemes discussed above. The court found these documents suspect for various reasons, including the fact that they are dated after the opening of the criminal case against K and L and involve officials who are themselves have been charged with crimes relating to these matters. The court also notes, as discussed above, that documents demonstrating attempts at restitution of

fraudulently obtained funds in response to fear of detection do not alter the fact that the crime occurred.

-- The defense presented various internal orders of Menatep, RTT and certain Yukos companies as well as the labor books of K and L which it claimed demonstrate that the prosecution has presented an inaccurate history of the positions held by K and L in these companies. These documents contradict the resumes of K and L as set forth by the prosecutor, but the court notes that other evidence, including internal minutes, orders and correspondence, support the prosecutor's version of this history. Even if the prosecutor's version is inaccurate, the defense's version is not significantly different and so the contradictions do not undermine the overall conclusion that K and L were the ultimate principals behind the group.

Validity and Conduct of Certain Searches

-- The defense objected to the admission of evidence gathered from searches in which certain errors or procedural violations occurred. While the court denied that many of these errors occurred, it classified most of the remaining errors as "technical" and therefore not grounds to declare the search invalid or exclude any evidence. Examples of such errors include: errors in the date of the search on certain pages of the search protocol; details about the exact location in which evidence was found was not listed in the protocol; the names and addresses of some search witnesses were not listed properly; pages of the protocol were misnumbered or not signed by all search witnesses or investigators. The defense identified a number of other similar technical errors.

The Criminal Procedural Code provides that evidence is to be excluded if its collection involved violation of the defendant's rights under the Code. Clearly, some level of forgiveness of technical procedural errors applies in Russia as elsewhere. The burden is on the prosecutor to prove that the error is technical (i.e., the mistake did not result in a violation of any substantive rights of the defendant or lead to any serious question regarding the quality of the evidence). The Sentence does in most instances make a logical case for finding various errors to be "technical".

-- However, with respect to the search of a Menatep compound in the Moscow suburbs, it is more difficult to conclude that all of the literally dozens of objections raised by the defense with respect to a search this search were "technical". This compound housed significant document archives of the group and some of the significant evidence at trial appears to have been gathered during this search. Most of the errors cited (although not necessarily recognized by the court) appear to consist of technical errors in the search protocol. However, others involve such violations as: the failure of witnesses to the search to have been in place at all times and for investigators to have remained within their view at all times; the absence of written confirmation from search witnesses that they were read their rights; the failure to present the search protocol at required times; the exclusion of two advocates from the search scene although they claimed to have the right to witness the search; and others. In each instance, there is conflicting evidence and testimony regarding whether such violations actually took place or whether they are being mischaracterized or distorted by the defense. Sorting out which violations were material and whether these violations give rise to serious questions about any of the evidence is difficult for a

number of reasons. As required by law, Menatep's advocates were advised of the search and were present to witness it (although two advocates claiming the right to participate in the search were excluded). These advocates as well as some of the witnesses (who turned out to be employed by Menatep companies) appear to have been very active in attempting to lodge complaints and record errors during this search and were generally uncooperative with the investigators in an apparent attempt to generate grounds for later objection. Reviewing the competing claims made about the conduct of this search is hampered by the fact that the witnesses to this search from both sides who gave testimony in court do not appear credible as their testimony is often blatantly self-serving, contradictory and/or in conflict with other facts.

It is worth observing, however, that there are only two instances where the defense specifically alleges that attempts to taint evidence took place. In one instance, a defense witness claims that a certain folder was taken out of the room he was in by an investigator. The number of pages in the folder was counted before it had been removed and the number of pages increased after the folder was returned (it is not stated how many or which pages were added). This witness admitted in court that he may have miscounted the pages the first time. The other instance involves the defense's claim that the copying of data from a server on the compound was not properly witnessed and that various circumstances indicate the prosecutor may have tampered with the data. For example, the investigators provided the technician with the media used to copy data from the server (the technician confirmed this, but noted the media was new in its packaging and was blank when he started to use it). The defense also notes that the technician's own records indicate that the amount of data on the hard disk used to copy files somehow increased after the search took place. The technician, however, explains this as the result of de-archiving files on the disk which increased the amount of space they occupied.

If we accept the defense's version of how this search was conducted, it appears to have been rather sloppy and there are potentially a number of violations that should have resulted in exclusion of some of the fruits of the search. It is clear even from the Sentence that the court chose to believe some rather incredible and contradictory testimony from the government investigators regarding the conduct of this search. However, there do not appear to be any specific grounds to believe that evidence tampering or falsification took place and it does appear that the defense pointed to any particular piece of evidence that it claimed was faked or altered (although it made general claims in this regard). Of course, procedures exist so that the defense need not prove that evidence was faked or altered in order for it to be excluded, but it is worth noting that the Sentence does not reveal any basis for some of the more extreme claims regarding the conduct of the trial and mishandling of evidence that have been made.

Violation of Legal Privilege

In addition to the objections reviewed in connection with the search of the Menatep compound in the Moscow suburbs, the defense objected to two additional aspects of this search on the grounds of violation of attorney-client privilege (or "advocate's confidentiality", as it is known in Russia).

The first claim of violation of privilege by the defense arises out of the search of an office belonging to the law firm ALM Feldmans which was located in part of one of the buildings in the Menatep compound. The defense argues that evidence collected from this office should be excluded since no court order was obtained, as required by law. Furthermore, the documents obtained, regardless of the validity of the search itself, should have been inadmissible under attorney-client privilege.

Under the Law on Advocate Activity and the Advocate Profession (the “Law on Advocates”), a search of an advocate’s office can only be undertaken by court order (regular search orders are signed by the prosecutor) and documents produced by or given to the advocate in connection with his or her appointment cannot be used as evidence against the client. The trial court, however, made two arguments to avoid respecting this privilege. Firstly, the court argues that the Criminal Procedure Code, which provides that evidence is to be excluded if it was obtained in violation of the Code, does not provide for exclusion of evidence based on other laws. Since the Code does not mention the protections granted by the Law on Advocates, this law cannot be a basis for excluding evidence. This argument has apparently been used by other courts in recent years to admit evidence obtained from an advocate’s office without a court order. However, after both the Sentence and Appeal were decided, the Constitution Court of Russia has in fact issued a binding ruling stating that evidence obtained in violation of the privilege established in the Law on Advocates and the Advocate Profession must be excluded, even if the Criminal Procedure Code does not explicitly say so. [14] Therefore, the court’s legal position on this point is now in clear error.

The other argument used by the trial court to admit this evidence was based on another rule that, I am told, has developed in court practice: a search of an advocate’s offices without a court order is not grounds for excluding evidence collected if the investigators did not know that the office belonged to an advocate (a variation on “ignorance is bliss”). While this argument may seem absurd, the context from which it sprang must be understood. The special status granted to advocate’s offices under Russian law is widely abused. Many (if not most) large companies employ one of their “in-house” lawyers as an “outside” advocate and designate this lawyer’s office inside the company as an “advocate bureau”. The idea is to have a “safe room” in the company where documents can be stashed in the event of surprise actions by regulatory bodies. During routine actions, the regulators do not expect to find an advocate’s office and are often frustrated to find that they must return with a court order to enter a certain room. This gives the company time for all sorts of “remedial measures”.

The trial court’s use of this argument suffers from two problems. Firstly, it is clear from the summary of the investigators’ own testimony in the Sentence that their claim to have been ignorant that they had entered an advocate’s office is not credible (just one reason to suspect this is that they admitted to having seen a big sign on the door stating that it was law office). Secondly, in my view, this ad hoc rule itself does not hold up to scrutiny—a rule that can easily be abused is not the solution to the abuse of another rule. The real solution to the abuse of the privilege attaching to advocates’ offices would be to develop a more substantive definition of an advocate’s office. However, such a definition has not been developed. Therefore, office of ALM Feldmans located inside a building on a Menatep compound in the Moscow suburbs is

as good an advocate's office as any and it is hard to argue that it was not subject to privilege regardless of why it was put there.

Therefore, it would seem that the defense's has strong grounds to argue that evidence recovered from the offices of ALM Feldmans should not have been admitted at trial. It is not clear exactly which evidence was recovered from this office, but the search of the Menatep compound overall did clearly produce a number of key documents. Therefore, it is possible that this error would be grounds for a higher court (assuming it desired to make a statement in this area) to declare a mistrial on any of the convictions that were based in a material way on such evidence.

The second violation of privilege claimed by the defense in connection with the search of the Menatep compound arises from the search of the office of Vladimir Dubov, one of Menatep's "core shareholders", a close associate of K and L through the 1990s and a former Yukos executive. The claim to privilege is based on the fact that Dubov was a member of the Duma at the time of the search (ironically, chairman of the tax subcommittee). Duma members are entitled to constitutional immunity, which is reflected in the Law on Status of Members of the Federation Council and the State Duma (No. 3, dated May 8, 1994). Any search of a deputy's office or home can only take place in the context of a Duma-approved investigation.

The court refused to exclude the fruits of this search based on the claimed violation of Dubov's immunity as a Duma members by making the same "ignorance is bliss" argument it used above to ignore the privilege attaching to the advocate's office: the investigators were not aware that they had entered a Duma representative's office, so the "honest mistake" is not grounds for exclusion. Once again, the investigators' testimony on this point is not credible (the investigators admitted to having seen the "Duma Deputy" sign on the door). In any event, as stated above, the very reasoning behind the court's argument is unlikely to stand up to further scrutiny. However, although there is little guidance as to what constitutes an advocate's offices, there are probably some limits as to what may be considered the office of a Duma deputy for purposes of privilege. Since Duma members are provided with an official office, it is not clear that the privilege applies to just any office they may choose to occupy. Furthermore, it is not clear that such a privilege should apply to an office not related to the deputy's official duties and which has been provided to him on the premises of a private company. Duma members are in fact prohibited from engaging in private business while holding office. Therefore, it is arguable that the privilege should not extend to an office clearly used for activity incompatible with the deputy's status as a member of the Duma. The defense's claim of violation of privilege in this instance probably does not pass scrutiny, in a court more inclined to give weight to such issues.

Notes:

[1] Previous comments appeared in JRL #s 7426, 8170, 8171, 8204, 8353, 9020 and are collected at <http://www.cdi.org/russia/johnson/jrl-yukos-legal.cfm>. These previous comments are referred to as "Yukos I – VI" in the text.

[2] The Sentence was made available on the website of the General Prosecutor of the Russian Federation in August 2005. The Appeal was posted on the site in October, 2005. Both documents are still available on the site as of the time of writing this comment in March 2006.

[3] A few minor technical changes to the specific qualifying elements of the charges have been made, most of which relate to changes to the Russian Criminal Code introduced after the charges were brought.

[4] There does not appear to be much debate over the specific sentences handed down by the court, so this comment will not review the calculation of jail terms.

[5] This comment will not discuss the parts of the Sentence or the Appeal that relate specifically to Krainov, an associate of K's and L's who was convicted of running certain transfer pricing schemes on behalf of Menatep.

[6] Although these earlier cases were brought by the state prosecutor, they appear to have been civil suits which would apparently prevent the prosecutor from claiming estoppel on the issues decided in such cases in the criminal cases. In other words, the prosecutor has to prove these assertions in this case, even though they were proved in previous civil cases.

[7] The Sentence indicates that the court order against Walton to return the NIUIF shares to the State Property Fund also placed these shares under arrest. Therefore, any further movement of these shares by any party would clearly be a violation of this order. The Sentence does not indicate that the court order against Volna to return the Apatit shares also contained language arresting the Apatit shares.

[8] The appellate court makes two principle arguments for reclassifying these counts from Article 160 to Article 165:

First, the court argues that the facts do not constitute a crime under Article 160 because the funds "embezzled" were not "entrusted" as required under Article 160 to K and L in the first place because these assets came under their control as a result of their fraudulent acquisition of Apatit's shares. This logic is, first of all, factually confused since the fraud did not secure control of the company for K and L since it related only to 20% of Apatit. Moreover, it confuses control over the company's shares with control over its assets. The general director of the company is entrusted with its assets ex officio. In other words, he or she does not need to take assets by force or by deceit or the methods described in other articles of the Code. The duty not to abuse this authority (a fiduciary duty) is not eliminated even if the particular individual would not have been appointed to the position of general director but for some other fraud. The court also implies that having converted Apatit's shares illegally, K and L cannot also be charged with taking the company's assets (you can't illegally appropriate the same thing twice). Of course, this argument also confuses the company's shares with its assets and, so long as there were other shareholders in Apatit, it is clear that illegal conversion of Apatit's assets is separate from conversion of its shares.

Secondly, the court argues that Article 160 requires conversion of “property”, but profits from the sale of fertilizer products were not “property” belonging to Apatit. Article 165 applies since this article prohibits causing economic harm by deceit or abuse of trust. This argument fails to recognize that fertilizer products are property and that selling them for less than full value in violation of a fiduciary duty to the company is an illegal conversion.

[9] The most typical form of abuse of the tax regime available to small entrepreneurs is for a company to enter into a “consulting” agreement with a person who is really an employee, thus enabling both the employee and company to pay substantially lower taxes and social insurance contributions. This scheme is relatively difficult to police because the line between “employee” and “consultant” requires substantive review of the real day-to-day relations between the individual and the company. However, under the scheme set forth in the Sentence, K and L, they continued to be actual full-time employees on the payroll of Yukos, Rosprom and/or Menatep, while they did not provide any services under the consulting contracts under which they received the bulk of their income. Under such circumstances, the pretense of the “consulting” arrangement is not merely questionable, but rather black and white.

[10] As noted in my comment to the Resolution of the Tax Authorities setting forth the tax claims against Yukos for the year 2000 (see Yukos VI), the scheme to channel oil revenue through low-tax zones to reduce tax can be considered illegal on a number of different grounds. The most straightforward ground is that the scheme involved illegal transfer pricing—revenue and profits was channeled to the company in the low-tax zone by having the Yukos production companies sell products to them at artificially low prices. Because of the use of transfer pricing, this scheme would have constituted tax evasion even if the shell companies in the low-tax zone had obtained the tax concessions legitimately.

[11] This expert report or a version of it appears to be posted on the website www.mbktrial.com. The report purports to show how the promissory notes transferred to the budget of the City of Lesnoi as tax payments in lieu of cash were partially redeemed and partially exchanged for interests in a local gas station joint venture. This report does not appear to be very helpful to the defense since it confirms that the steps undertaken redeem/exchange the promissory notes only started after criminal investigations were opened and that, in the end, the City of Lesnoi was stuck with illiquid interests in a private venture in lieu of tax payments. This report cites a further PWC report which it claims valued the interests in the gas station venture at approximately the amount of the remaining tax debt. That report and its assumptions and qualifications are not available on the site.

[12] Article 86 of the Criminal Procedural Code gives defendants broad rights to collect “evidence”. However, Article 57, regarding the status of experts, makes clear that any expert reports should be submitted through the procedures specified in the Code.

[13] One witness who gave testimony regarding Apatit’s investment program had worked for the consulting company that was chiefly involved in developing that program. Another witness who testified about the legality of use of the low-tax zones had participated in writing an official report commissioned by the City of Lesnoi to

respond to review the effectiveness of the low-tax regime. This witness relied on this work and not documents from the trial record in making his testimony.

[14] Constitution Court decision No. 439-O of November 8, 2005.