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Subject: Summary and Analysis of Report on Criminal Case #18/41-03

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Summary and Analysis of Report on Criminal Case #18/41-03

By Peter Clateman

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On October 29, 2003, the General Prosecutor's Office published a "Report" setting forth the charges against Mikhail Khodorkovsky, then a board member of Yukos, Russia's largest oil company, who had been arrested the previous week. The charges in the Report have generally been described in the press as various counts of fraud connected with the privatization of shares in certain former state enterprises and tax evasion. However, I have not seen articles, particularly in the Western press, providing any real detail or flavor regarding the alleged crimes and how they were carried out. Therefore, I thought it might be interesting for JRL readers to have a more detailed summary and analysis of the charges.

The charges come against a background of controversy in which the decision to prosecute Mikhail Khodorkovsky has roundly been called "political". Of course, many of the allegations being leveled against Mr. Khodorkovsky in connection with the current charges have been widely discussed in the Russian press and have even been the subject of numerous previous court cases. Therefore, the fact that these matters never became the subject of a comprehensive criminal investigation and prosecution until this time may also be described as the result of earlier "political decisions". I hope that simply reading the prosecutor's indictment and taking it at face value will not be seen as taking one side or another in the political debate over this prosecution. Rather, it should be seen as perhaps the most apolitical approach to considering the significance and consequences of this case.

Reviewing the charges themselves also turns out to be an interesting exercise. This indictment signals an attempt by the prosecutor to mount an investigation and prosecution of financial crimes on an unprecedented level of complexity and sophistication in post-Soviet Russia. It is interesting and important to monitor whether this is being handled in accordance with the law. The Report has sparked some debate among my Russian colleagues regarding whether the charges against Mr. Khodorkovsky are properly formulated under Russian law and what they may indicate about changes in the practices of the prosecutor overall.

I am a US lawyer who has practiced commercial law in the US, Europe and Russia, so my observations are from the perspective of general legal observer and not an expert in Russian criminal law. However, I have reviewed the relevant provisions of Russian Criminal Code and other relevant legislation before making my comments. I have also read a number of other Russian indictments over the past few years which has given me some basis for comparison when reviewing the Report regarding the charges against Mr. Khodorkovsky.

A rough translation of the Report (not for publication) is being prepared which I can make available by request to pclateman@spkgroup.com.

General Observations

The Report apparently consists of the main body of the indictment or criminal complaint (“????????????? ??”) against Mr. Khodorkovsky (I will assume below that the Report in fact contains the entire substance of the indictment, at least with respect to the charges mentioned). The Report (as with an indictment or criminal complaint) does not set forth the actual evidence gathered by the prosecutor against Khodorkovsky, but rather sets forth the factual story (to be proven at trial with particular evidence) that contains the basic elements required to support the criminal charges made against Khodorkovsky. It is too early to speculate whether the prosecutor can prove any of his allegations or to guess what defenses Khodorkovsky’s lawyers may raise—it is too early to guess who will win (or should win, if you are among those who assume that “politics” have determined the actual outcome in advance). At this stage, however, we can analyze whether the prosecutor has failed to produce a “well-plead” indictment. To determine if an indictment is well plead, we must assume that all of the facts alleged by the prosecutor are true and then analyze whether such facts substantiate the crimes with which Mr. Khodorkovsky is charged. It would not be unusual in a complex criminal fraud case in the US for certain charges in an indictment to fail before trial. Therefore, it is a worthwhile exercise to analyze whether this indictment is “well plead” under Russian law, particularly in light of the fact that this case that appears to be one of the most ambitious prosecutions of financial crime brought in Russia to date.

In my view, the Report is generally well written. This basic observation is worth making because this has not been the case with similar documents in a number of other recent high profile prosecutions. The allegations describe in a relatively clear manner what would appear to the general legal observer as several counts of rather straightforward acts of fraud, embezzlement and tax evasion. However, as I will point out below, a number of the charges appear not to be properly pleaded under Russian law and, in my view, the prosecutor should be forced to strike out such charges or amend the indictment.

It is worth mentioning, and dispelling, one criticism of the indictment I have heard from some colleagues in advance of the discussion below. This criticism comes from Russian lawyers who remind me that Russian law is very formalistic; it prefers “form” over “substance”. They argue that viewing an action as illegal and, in particular, criminal under Russian law requires a very explicit legal prohibition and that the prosecutor cannot apply the “spirit” or “intent” of the law, but only the “letter” of the law. This tendency is part of Continental European legal culture in general (and modern US criminal law is calls for strict reading of criminal laws), but in Russia this principle of the legal culture is taken to an extreme. This legalistic extremism is often attributed to decades of living under an overly burdensome system of rules that were neither rational nor respected and therefore only observed in a token fashion. However, acceptance of “formal” compliance despite obvious indications that a “substantive” violation is taking place can often masks incompetence and corruption.

While it is important to recognize that Russian law strictly avoids applying the “spirit” or “intent” of legislation, there is a difference between interpreting the law widely (which is not allowed) and applying it to factually complicated situations (which is allowed). For example, fraud has a very simple legal definition (under both Russian and Anglo-American law): the taking of another person’s property by deceit. It is clearly fraud under Russian law (confirmed by various Russian colleagues) to go to a car dealership, enter an agreement to purchase a car having the intention

not to pay, show the dealer a fake wire instruction from your bank indicating that payment for the car has been made, drive away from the dealership in the car and then hide yourself and the car from the dealer when he comes to get his money and repossess the car. This is not just "breach of contract"; it is a criminal fraud. If you do the same thing but go to the dealer as the representative of a Panamanian company which you have set up using a Lichtenstein trust which you control via agreement with a Dutch law firm and then, when the dealer comes to get his money, you not only physically hide the car but transfer its ownership to a series of companies that you have set up through similar structures, you have still committed fraud. But you have made it more difficult for everyone to catch you. Of course, prosecuting modern fraud usually requires proving who controls such structures—fraud involves deceit, and therefore it requires increasingly sophisticated means to trick people and to catch fraudsters.

The criticism of the indictment that I wish particularly to dispel up front is the view that the attempt by the prosecutor in this case to unravel complicated corporate structures and see them as part of one large fraud is somehow in contradiction with the letter of Russian law. This position would basically mean that virtually all modern fraud is not subject to prosecution in Russia. I think this position is not right (and the majority of my Russian colleagues back me up on this). If the legal theory of the crime is correct, then the complexity of the fact pattern is not question of law, but a matter of evidence, the prosecutor's skill and his or her desire to tackle a complicated case.

Summary of Charges

The Report is generally organized according to the various charges, but for purposes of summary, I have made this organization more distinct. For shorthand, I refer to Mikhail Khodorkovsky as "K" and Platon Lebedev as "L". Platon Lebedev is a fellow "core shareholder" of Yukos and a long-time partner of Khodorkovsky's. Lebedev was also head of Menatep Group, the holding company that was formed by the core Yukos shareholders to hold their shares as well as other significant assets owned by them in Russia.

1. 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 of the Criminal Code)

The essence of the charge is that K and L were responsible for the creation and activities of a group of legal entities that participated in the 1994 privatization tender for a 20% stake of a petrochemical company called "Apatit" (apparently, this is one of the largest petrochemical enterprises in Russia with annual revenue in the hundreds of millions of dollars; there was considerable press and scandal surrounding its privatization and it was generally reported that it was acquired by companies associated with K). As part of the tender, the winning bidder was required to make an investment in the company. However, not only was the required investment not made, but it is alleged that a series of actions taken by K and L show that they had no intention of making such a payment from the start—that is, neither K, Menatep nor the bidding companies, which allegedly were under their control, had any intention of fulfilling the tender conditions from the moment they first submitted their bids and that they took measures to hide the non-payment and avoid legal attempts to enforce the payment obligation. The scheme set forth is a straightforward fraud.

K's leadership of the "organize group"

The establishment of an “organized group” is important to pleading this charge both because it is necessary to establish that K was culpable (since the prosecutor does not appear to be able to assert that K was involved in the day-to-day execution of the fraud), but also because fraud committed through use of an “organized group” is a more serious degree of fraud under the Russian Criminal Code (similar to US laws that establish higher penalties for crime committed by organized groups). (While there are certainly nuances of meaning, an “organized group” under the Criminal Code appears roughly equivalent to a group of accomplices under US law.) The prosecutor alleges the existence of the organized group by reference to K’s official status as Chairman of the Board and co-founder of Bank Menatep. The legal entities involved in the transactions constituting the fraud (that is, all of the entities mentioned below as members of the “organized group”) were either founded by Bank Menatep or its affiliates or by employees of the Bank. The officers and directors of these various “shell” companies were either employees of the Bank and its affiliates or hired “nominal” directors, i.e., director who simply signed documents at the direction of the founders of the company without playing a substantive role in the company (a typical arrangement for companies in offshore jurisdictions).

The indictment then argues that the actions of the various legal entities involved should be attributed to the individuals who formed the group since these legal entities should be viewed as the “alter egos” of K and L. While “alter ego” is a term from US law, it appears to best fit the Russian-law argument that the prosecutor is making. The prosecutor alleges that these entities “did not actually possess any functions and characteristics of a legal entity envisaged by Art. 48-50 of the Civil Code of the Russian Federation, namely: they did not own, possess under their own economic control or day-to-day management any specific property, could not independently without any instructions from K and other persons acquire and exercise any property rights, could not perform activities the core purpose of which was to derive profits, as their activities were loss-making and intended for committing theft by K and another members of the organized group.” The prosecutor, of course, will have to bear the burden of proving such assertions at trial (presumably through financial records, lists of directors and signatories, records of corporate activity, or lack thereof, etc.). I note, however, that these factors provided by the Civil Code are basically the same as the factors that would be used in the US and other jurisdictions to demonstrate that a company was the “alter ego” of an individual or group of individuals.

The prosecutor alleges further grounds supporting the existence of an organized group and for viewing certain legal entities involved as the “alter ego” of the principal individuals: the fact that the relevant legal entities kept their bank accounts at Bank Menatep or its affiliates and after the liquidation of Bank Menatep, at its successor, “Bank Menatep St. Petersburg”; the accounting for the companies involved was carried out initially by a subsidiary of Bank Menatep or at later times by affiliates/successors of Bank Menatep, which were controlled by K; some of the shareholders in the relevant companies were founded in turn by offshore companies related to K, L and Menatep showing an attempt to hide their relationship with these companies.

Privatization of Apatit

In June-July 1994, L, reporting to K, “instructed” Menatep employees to go to Murmansk where the privatization of 20% of Apatit was taking place. On

June 27, 1994, L in his capacity as President under the charter of Bank Menatep signed three letters of guarantee, one for each of three shell companies as being the instruments of the alleged "organized group". The letters guaranteed each company's performance of its obligations under its bid for the Apatit shares, should that company win the tender. Such a guarantee letter was officially required under the tender rules. K, acting through L and the organized group, knew that the shell companies participating in the tender would not fulfill their investment obligations should they win.

The three companies whose obligations were guaranteed by Bank Menatep, and a fourth company, also alleged to be under control of Menatep and acting under control of the organized group, submitted bids to the tender on June 30, 1994. Under the rules of the investment tender, bidders were to compete in terms of their commitment to invest in Apatit should they win the bid. The actual price of the shares, however, was fixed at nominal value. Each of the companies that were part of the alleged organized group placed bids proposing different investment commitments. One of the four companies was declared the winner. However, it turned out that each of these four companies had placed bids higher than any other bidder (it is not in fact clear whether there were any other bidders). K then allegedly procured that three of these companies pull out of the tender, leaving only the lowest-bidding company, Joint Stock Company "Volna", which was declared the new winner of the tender. (While the Report refers to such behavior "deceitful", such bidding practices were quite common due to poorly drafted bidding rules. In any event, the prosecutor has not actually made a formal charge in the indictment regarding this bidding practice.)

After being declared the winner, Volna signed agreements to acquire the shares (20% of Apatit) for nominal value (on the order of \$200,000) with a commitment to invest RUR 563 billion (approximately \$283 million at the then-current exchange rate) within one year of the date of acquisition, with 30% of that sum to be invested within one month. However, Volna and its guarantors failed to make the initial payment as required on September 1, 1995. Volna was warned by the Murmansk prosecutor on November 16, 1994 that it would bring suit for non-payment. The prosecutor submitted such a complaint to the Arbitration Court in Murmansk to annul the purchase agreement and to obtain return of the Apatit shares on November 29, 1994.

2. Willful violation of an effective court order by an employee of a commercial organization (part 3, Article 33 and Article 315 of the Criminal Code of the Russian Federation)

This charge accuses K, acting through the organized group, of violating an order of a Moscow Arbitration Court directed at Volna ordering it to return the Apatit shares to the government of Murmansk. K is alleged to have knowingly caused this violation because he was aware of the order, yet did not cause the shares to be returned even though he allegedly controlled both Volna and the "fictitious" companies to which Volna transferred the Apatit shares in "sham" transactions. The prosecutor refers to the fact that the demand to return the shares had become a somewhat public scandal to support the claim that K consciously caused the order to be violated.

While the theory of this charge is not straightforward and will require considerable evidence to prove, the charge does appear to be properly pleaded.

False representation to the court

Having won an order against Volna requiring it to return the Apatit shares,

the Murmansk prosecutor sought to have this order enforced by a Moscow court (apparently, the Moscow court had jurisdiction to enforce the order of the Murmansk court). On August 16, 1995, it is alleged that someone acting under K's direction submitted payment orders to the Moscow Arbitration court purportedly demonstrating that Volna had made the required payments to Apatit. As a result, the Moscow court declined to enforce the order of the Murmansk court. However, while such funds had been paid to Apatit, the funds were allegedly returned to Volna from Apatit's account on the same day. It is stated that such "deceit" before the court was criminal, but there is no specific charge made against K with respect to these allegedly false representations to the Moscow court.

Concerned that the Murmansk government would nevertheless continue to seek recovery of the Apatit shares, K allegedly organized the transfer of the shares from Volna to two other Russian companies and then their further transfer to three other Russian companies, all of which are alleged to be controlled by members of the organized group. These companies in turn were owned by a holding company on Cyprus and a holding company on the Isle of Man.

The Report describes the interlocking ownership between the companies involved in the share transfers. It also notes that the Menatep affiliate, Russian Trust and Trade (which the Report asserts was under K's control), provided secretarial services to some of the companies referred to above and that the general directors of some of these companies were employees of Russian Trust and Trade.

On February 12, 1998, the Moscow Arbitration court, reversing itself on appeal, and upheld the order against Volna to return the Apatit shares to the Murmansk government. However, representatives of Volna, allegedly acting on K's behalf claimed that they were unable to return the shares as they had been transferred to third parties. However, such transfers were made to "fictitious" companies under K's control and therefore K had the actual authority to cause the shares to be returned. To bolster its assertion that K was aware of the order and the circumstances surrounding the return of the Apatit shares, the Report refers to the fact that Duma deputies and various regional governors had become involved in investigating the Apatit privatization and the entire affair was being covered in the press.

I note that the allegation is not being made that K caused the transfer of the Apatit shares to other shell companies in violation of a court order, but rather that he failed to secure the return of the shares from such shell companies in order to comply with the order. While such allegations, if proved, would in my view constitute the crime charged (violating a court order), the prosecutor will clearly have to overcome significant burdens of proof to establish that such companies and the transactions in which the Apatit shares were transferred were false to the extent that they could simply be unwound and, furthermore, that K has sufficient control of these entities to take such actions.

Amicable settlement obtained by false pretenses

On March 20, 2002, L, allegedly under K's control and acting as the Chairman of the Board of the Russian company International Financial Association "Menatep" ("MFA Menatep"), wrote to the Property Committee of the Russian Federation offering a cash settlement of the Murmansk Property committee's claims against Volna for return of the Apatit shares in lieu of their return citing the "inability" to return the shares. As a result, a person working for and under the supervision of K and L concluded a

settlement of the claims for RUR 479mm (\$15,130,000), which sum was represented as the difference between the price paid for the Apatit shares by Volna and their actual value. This price was supported by a report by the valuation firm LLC "VS-Otsenka", which is alleged to be a false report. The supposed correct difference between the nominal value paid by Volna for the shares and their actual value is claimed to be approximately \$62mm (this is, the value of the shares was the amount Volna agreed to pay for them including both purchase price and investment commitment). The agreement itself is alleged to be null and void both because it was based on a false valuation but also because it was premised, as stated in the agreement, on the ability of Volna to return the shares (which was a false premise as alleged above). Again, no separate charge is lodged for presenting this "false" agreement to the court.

By causing this settlement agreement to be presented to the Moscow court, K and L procured court approval of the settlement and dismissal of the suit for return of the Apatit shares on November 22, 2002. Presenting this "false" agreement to the court does not appear to constitute a separate charge, but rather constitutes part of the charge that K violated the order to return the shares by not using the authority and power he allegedly had to do so. The prosecutor apparently presents the history of the amicable settlement in the indictment in order to anticipate the argument by the defense that the amicable settlement vitiates the fraud—since the amicable settlement itself was obtained under false pretenses, it is no defense against the charge of fraud or the charge that K violated the order of the Moscow court.

3. Causing large-scale economic harm to the owner of property through deceit other than by theft (points a and b, part 3, Article 165 of the Criminal Code of the Russian Federation)

K is charged with causing Apatit to sell its production at below market prices to entities under the control of his organized group, which these entities resold at market prices, causing economic harm to the other shareholders of Apatit, who were deprived of the right to participate in the profits derived from the proceeds of such sales. This charge constitutes a straightforward embezzlement.

The Report claims that K and the organized group owned the majority of the equity of Apatit (although the Report only specifically describes the acquisition of 20% of Apatit, it was widely reported in the press that other companies affiliated with Menatep acquired a controlling stake through other processes). The Report also claims that the intermediate companies through whom the group resold the production were also under the group's control, but the names of these companies are not specified and the basis for their connection with K is not set forth in the same level of detail as it is set forth with respect to the other charges. (However, in relation to this charge, it is not necessary to assert that these intermediate companies were "fictitious" legal entities, but rather simply that K somehow had an economic interest in their profits from the resale of the production—which the Report does assert, albeit without details.) The scheme is alleged to have been conducted between 1995 and 2002, but the amount of the "lost profits" are only given for the period of 2000 through 2002 in the amount of RUR 6.2 billion, which each shareholder suffering a portion of such loss in proportion to its shareholding.

Although the pleading is very brief and does not give much indication of the nature of the evidence to be presented in support of such charges, I see no ground to argue that the charge is improperly pleaded. The charge

does, however, represent a rare attempt to charge a senior manager or shareholder with embezzlement under this provision of the Criminal Code in connection with a transfer pricing scheme. Despite the lack of prosecutions, these schemes are reputed to have been extremely widespread in the Russian economy during the past decade.

4. 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 of the Criminal Code)

K is accused of committing fraud through use of an organized group in relation to the 1995 acquisition by a company related to the Menatep group of a 44% stake in "The Scientific Research Institute for Fertilizer and Insecto-Fungicides in the name of Prof. Ya. V. Samoilov" ("NIUIF") (NIUIF had certain valuable assets related to the petrochemical industry and also owned a building worth approximately \$20 million). The mechanism of the alleged fraud is the same as that described above in count 1 in relation to the Apatit privatization tender: "fictitious" companies established by Menatep entered into an investment tender with the support of a Menatep guarantee. Various facts are alleged directed at establishing not only that the company that won the tender did not fulfill its investment obligations, but also that K and other members of the organized group entered the tender with such intention. Furthermore, after winning the tender, they allegedly took measures to hide their non-fulfillment of the investment obligations and to prevent enforcement of these obligations. As noted above, this is a straightforward fraud, although substantial evidence will be required to prove it.

As in the pleading of the charge of fraud with respect to the privatization of Apatit, the Report sets forth various allegations that establish the bases for claiming that K and various persons who constituted an "organized group" controlled the legal entities that carried out the fraud. These allegations include the following: that Menatep guaranteed the bidder's participation in the tender (the implication is drawn that a bank would not guarantee the obligations of a shell company with no assets or operations if such company were not basically its alter ego); that various entities involved were founded by individuals employed in the Menatep group who answered to K ex officio; that such individuals appeared as officers and/or directors of companies involved in the fraud; that the accounting and secretarial functions for such companies were maintained by Menatep affiliates; that the relevant companies maintained their bank accounts with Menatep affiliates; that documents related to their operation were kept at Menatep or its affiliates; and that the relevant companies were "fictitious" and served as alter egos of K (did not have any economic activity not related to their participation in the fraud, did not have any other assets or revenue, were loss making, appeared to answer to instructions of Menatep personnel, etc.). The Report also alleges that the actions of the group members in furtherance of the fraud were coordinated, which presumably indicates that evidence of such coordination will be presented.

As in the case of the privatization of Apatit, the prosecutor appears to allege that fraud or deceit was used by K and the organized group to win the tender process itself. However, these accusations are not specified in detail and do not constitute a specific charge in the Report.

After having been declared the winner of the investment tender, the company established by Menatep, Joint Stock Company "WALTON", failed to make the investment required of it under the contract with the State Property Fund,

which it entered into as winner of the tender. K, L and the organized group, however, allegedly schemed to create the appearance of having complied with the investment obligation in the following manner. They allegedly “tricked” the management of NIUIF into believing (falsely) that the invested funds would be subject to corporate tax. Therefore, they convinced the managers to enter into a scheme to defer such taxes by receiving the money from WALTON and then immediately returning under a separate side agreement. K and L allegedly promised if they did this by the end of 1995, WALTON would then re-pay the money in 1996, thereby deferring the tax liability. WALTON paid the amount of the required investment from its account in Menatep to NIUIF’s account in Menatep on December 29, 1995 and NIUIF returned the money to WALTON the next day, December 30, 1995. However, WALTON never repaid the funds to NIUIF as promised.

5. Willful violation of an effective court order by an employee of a commercial organization (part 3, article 33 and article 315 of the Criminal Code of the Russian Federation)

This charge mirrors charge “2” described above in relation to the Apatit privatization. As in that situation, the government eventually protested the failure of the tender winner to fulfill its investment commitment. The government successfully brought suit to annul the privatization and obtained an order for return of the shares. The indictment, alleging that the shares never left K’s control despite transfers among numerous legal entities, charges K with violating the court order by failing to procure return of the shares as required by the court order.

K and the organized group allegedly organized an initial round of transfers of NIUIF shares from WALTON in early 1996 to three shell companies also controlled by K and the group. The price paid by the shell companies was a small fraction of their estimate market value. Members of the group procured an attestation from the management of NIUIF in the purchase agreements that the investment commitment had been fulfilled (although it had not). Such attestation was obtained to create the appearance that the shell companies acquiring the NIUIF shares from WALTON were purchasers “in good faith” and had no basis to doubt that WALTON properly owned the shares and had the right to sell them. The State Property Fund further confirmed the fulfillment of the investment requirement, acting upon the confirmation of NIUIF’s management, but failing to obtain independent confirmation that the investment had been made. However, during the summer of 1997, the State Property Fund discovered that WALTON had failed to fulfill its investment commitment and brought suit in the Moscow Arbitration Court. In November 1997, the Moscow court annulled WALTON’s original purchase contract for the NIUIF shares and ordered the return of the shares.

To avoid returning the shares from the shell companies that had acquired them, K and the organized group allegedly organized two further rounds of transfers to other shell companies. The Report sets forth grounds for establishing that these further companies were under K’s control through the organized group. These transfers were carried out between January 5 through 19, 1998 (after the court order requiring return of the shares went into effect).

6. Large-scale tax evasion carried out through an organized group (part 3 of Article 33 and points a, g, part 2 of Article 199 of the Criminal Code)

K and the organized group are accused of evading taxes in 1999 by causing

companies under his control to pay taxes with promissory notes of Yukos rather than in cash, as required by the Tax Code, and that such violation of the Tax Code was a violation of the Criminal Code's prohibition on tax evasion.

Of all the charges in the Report, this one and the next two are the most serious ones from the economic perspective of Yukos and its subsidiaries. If the schemes described were in fact illegal (even if they were not criminal), the implication is that Yukos could owe hundreds of millions of dollars in back taxes.

The allegations against K and organized group in relation to this charge begin, as in the previous charges, with a relatively detailed recitation of the connections between K, L and Menatep and the companies used in the scheme. The companies were created between 1995 and 1997. A few of these companies were allegedly involved in the scheme involving the privatization of Apatit. Various characteristics of the shell companies used in the scheme are recounted to establish that they did not conform to the characteristics of "legal entities" set forth in Article 48-50 of the Russian Civil Code, and therefore should be treated as the alter egos of K.

"Illegally" obtaining tax concession

Having set forth the basis for viewing K as the head of an organized group, the Report goes on to set forth a scheme whereby companies controlled by this group "illegally" obtained tax concessions, which were used to reduce the tax liabilities of Yukos and its affiliates. K, through the organized group, allegedly caused a series of companies to be formed in a special low-tax zone (which I refer to by its Russian abbreviation, "ZATO") in the Sverdlovsk Oblast. These companies transferred their management function to "Yukos Refining and Marketing", of which L was president. K, L and the group then transferred proceeds from the refining, storage and sale of oil and oil products of other business related to Yukos to these companies. One of these companies, LLC "Business Oil" took advantage of a tax concession (i.e., greatly reduced tax rates) applicable to companies who operate in a ZATO, although it had no real activity in the ZATO. As a result of taking advantage of such concession, Business Oil improperly reduced its 1999 tax liability by RUR 1.2 billion.

It does not appear that the use of this tax concession is viewed as a ground for this particular charge of the indictment. However, the "illegal" use of this tax concession is a ground for the next charge discussed below, so I discuss this scheme in more detail below.

Improper payment of tax with promissory notes

In July, August, October, November and December 1999, Business Oil and three other companies in the same region, each of which was allegedly founded and controlled by the organized group, transferred approximately RUR 5.3 billion in promissory notes of Yukos to the local tax authorities for the payment of taxes. The Report states that this payment violated Article 45 of the Tax Code, which specifies that taxes must be paid in cash, not in-kind. While the practice of paying taxes in-kind (particularly in promissory notes) was widespread before 1998, the introduction of the new Tax Code in 1998 specifically prohibited such payments.

While it may have been a violation of the Tax Code for these companies to pay taxes in promissory notes, violation of the Tax Code is not a criminal

offense in itself. The Criminal Code must specify what constitutes a criminal offense. The provision of the Criminal Code to which the prosecutor refers in the charge is Article 199, which makes it a criminal offense to file a tax return containing false information with the purpose of avoiding tax. To support a charge under this provision, the prosecutor would have to allege that K caused a particular tax filing to be made that contained false information and set forth some reason why such information was false. However, the prosecutor simply fails to make any such specific allegation (in connection with this charge, the prosecutor fails even to refer to any particular tax filing made in 1999). This charge, therefore, does not seem to be properly pleaded.

Even if there had been a false tax filing made in connection with Business Oil's payment of taxes with promissory notes in 1999, there is another element of the charge which, it could be argued, the prosecutor has also failed to substantiate: that the tax evasion was "large scale" (more than 500 times the minimum wage in tax was evaded; this sum is on the order of \$10,000). While "large scale" turns out not to be very large indeed, the indictment simply asserts that the amount of tax evaded was the entire amount of the tax due (which for all four companies is alleged to be RUR 5.4 billion). In other words, the prosecutor implies that payment in promissory notes equals no payment at all. The defense may argue that some assertion that the government actually suffered economic damage is necessary to substantiate that there was large scale tax evasion—in other words, an allegation that the promissory notes were worth less than the actual tax due is missing. Furthermore, without some allegation that the government was actually damaged, the defense could argue that the prosecutor has made no allegation that goes toward establishing criminal intent—that is, the simple fact of payment with promissory notes itself does not indicate that the accused had the intent to evade tax. Of course, the court would have to look at the economic substance of the violation rather than the formal breach of the Tax Code in order to accept such arguments, which as discussed above is against the usual inclination of Russian courts.

7. Repeated, large-scale tax evasion carried out through an organized group (part 3 of Article 33 and paragraphs a, v and g, part 2 of Article 199 of the Criminal Code)

In this charge, K is accused of causing the same four companies implicated in the previous charge to commit tax evasion for the year 2000. This tax evasion charged is based upon three separate grounds: (i) improperly paying taxes with promissory notes; (ii) improperly claiming tax concessions applicable to activity in a ZATO; and (iii) improperly "overpaying" taxes for 1999 with promissory notes and then using such false overpayment to offset against taxes due for the year 2000.

Improper payment of tax with promissory notes

The prosecutor identifies an aggregate sum of approximately RUR 11.5 billion in taxes paid by these four companies in promissory notes in 2000. As in the previous charge, the prosecutor fails to identify a tax filing containing false information, and therefore the charge should fail unless amended.

Furthermore, the prosecutor once again does not make any allegations regarding the value of the promissory notes of Yukos used to pay the taxes. As explained above, this provides the defense with the arguments that the "large-scale" aspect of the tax evasion charge has not been

substantiated and also that no allegation going toward establishing criminal intent has been made since no allegation is made indicating whether the accused economically evaded any taxes.

“Illegally” obtaining tax concessions

In 2000, Business Oil once again took advantage of tax concessions granted to companies on revenues derived from activities in a ZATO. The amount of the tax concessions it enjoyed were allegedly RUR 1.57 billion. The indictment alleges that Business Oil's use of this tax concession violated Article 5 of the RF law “On the Closed Administrative-Territorial Zone” of July 14, 1992. However, this law sets forth norms applicable to how the administration of the ZATO must account for its tax base before the federal government. The law is not directed at taxpayers, although the provision cited does make it clear that only enterprises whose revenue is truly derived from activity in the ZATO should be granted the tax concession. Presumably, the administration of the ZATO must decide how to implement these rules by establishing some procedure for granting the special tax concession, but the Report does not cite such regulations and simply fails to indicate on what basis it asserts that Business Oil did not have the right to claim the tax concession (or, alternatively, obtained such right falsely by fraud or bribery).

As mentioned above, a violation of Article 199 of the Criminal Code must be based upon a false tax filing. The prosecutor indicates that Business Oil's use of the concession on its 2000 tax filing rendered it false and constitutes a violation of Article 199. However, the allegation that Business Oil did not have the right to the concession is a separate question of law that must be substantiated by further factual allegations. The only relevant factual allegation we are given is that Business Oil had no activities in the ZATO. This is not sufficient to conclude (based only upon reference to the laws cited by the prosecutor) that Business Oil did not have the right to the tax concession. Unless the prosecutor can site additional facts or regulations, there are not sufficient allegations to establish that Business Oil did not have the right to the concession and that a false tax filing was made.

Improperly claiming a tax offset based on false overpayments

Under this scheme, K is charged with causing Business Oil improperly to “overpay” its taxes in 1999 with promissory notes. That is, it transferred to the tax authorities notes of claimed value greater than its actual tax bill in 1999. Then, claiming that it had overpaid its taxes in 1999, it claimed that it was entitled to offset such overpayment against its taxes in 2000. The amount of such offset is alleged to be RUR 1.06 billion.

In this instance, the prosecutor is specific regarding the filing of a false return as required to substantiate a charge under Article 199: the claim of overpayment of taxes in 1999 on Business Oil's 2000 tax filing was false because the “overpayment” was invalidly made with promissory notes. In this respect, the charge appears to be properly pleaded.

Nevertheless, this charge is also subject to attack by the defense on the additional grounds indicated above. Since the prosecutor fails, as in the previous charge, to make any allegation regarding the value of the promissory notes, this may be ground for the defense to claim that the “large-scale” nature of the tax evasion has not been substantiated. Also, as noted above, it may be argued that criminal intent has not been properly alleged if there has been no proper allegation establishing that some tax

was in fact evaded.

8. Multiple instances of 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 of the Criminal Code)

Under this charge, the same companies involved in the previous counts of tax evasion are alleged to have organized further false "overpayments" of taxes with promissory notes and then illegally obtained cash refunds of such "overpayments" from the State. The prosecutor characterizes this as a scheme to defraud the state of money (as opposed to simple tax evasion) because K and the organized group allegedly orchestrated the overpayments with the intent of claiming the false refunds and then took measures to hide the false nature of the refunds from tax inspectors.

Based on false overpayment of taxes with promissory notes in 1999, the four shell companies in the aggregate claimed and received tax refunds of RUR 129 million in December 2000. The funds were transferred to accounts of these companies in an affiliate bank of Menatep.

These companies made further tax "overpayments" in 2000. In the beginning of 2001, local tax inspectors initiated audits of the four companies. For the purpose of avoiding discovery of the illegal refund scheme, K and the organized group caused the companies to be removed from the tax rolls of the City of Lesnoi in the Sverdlovsk region and merged, on March 6, 2001, into another "false" company, LLC "Perspectiva-Optimum". Perspectiva-Optimum was registered in the Aginsk-Buryat National Region of Russia. As a result of the merger, the additional false "overpayments" of taxes by the four companies were transferred onto the books of Perspectiva-Optimum. K and L allegedly then caused Perspectiva-Optimum in May 2001 to claim and to receive refunds of such "overpaid" taxes in cash in the amount of RUR 83 million.

The Report further alleges that the organized group under K's control registered a separate group of companies in the Chelyabinsk Region. However, the Report fails to specify allegations substantiating the connection between these companies and K and the rest of the organized group. There may be grounds for challenging the charge based on this omission (assuming the actual indictment also has such omissions), but it is likely that the assertion of control is sufficient for purposes of the indictment. The specific facts supporting the allegation of control may be provided later in the proceedings.

K and the organized group allegedly caused these companies to be removed from the tax roles of the Chelyabinsk Region and merged into a company called LLC "TK Alkhanai" on March 16, 2001. Alkhanai was registered in the Aginsk-Buryat National Region. These companies had paid tax with promissory notes resulting a false "overpayment", was transferred onto the balance of Alkhanai through the merger. Alkhanai then proceeded illegally to claim tax refunds in the amount of RUR 171 million based upon such overpayments, which were received in May 2001.

K and the organize group allegedly further caused the removal of Perspectiva-Optimum and Alkhanai from the tax rolls of the Aginsk-Buyat National Region through merging them in May 2001 into LLC "Investproyekt", a company registered in the Shabalin Region of the Kirov Oblast. Then, in August 2001, they allegedly caused the removal of Investproyekt from the tax rolls of the Shabalin Region and its re-registration in the Chernyshev Region of the Chitin Oblast. This was allegedly done for the purpose of

further hiding the proceeds of the group's illegally obtained tax refunds. The group then caused Investproyekt to seek further tax refunds of false tax "overpayments" that were still on its balance sheet. Such refunds in the amount of RUR 24 million were received during October-November 2002.

9. Large-scale embezzlement (or waste) of property entrusted to the accused committed through an organized group (points a and b, part 3 of Article 160 of the Criminal Code).

K is accused of organizing the embezzlement during July 1999 and April 2000 of funds belonging to Yukos and its subsidiaries through the companies LLC "Mitra" and LLC "Grace" for the benefit of companies controlled by Vladimir Gusinsky. This embezzlement was achieved simply by making various bank transfers in the aggregate amount of RUR 2.65 billion from the accounts of Yukos, Mitra and Grace to various companies controlled by Mr. Gusinsky "under the guise" of promissory note transactions. However, it is alleged such transfers were without any real consideration being received by Yukos, Mitra and Grace.

This charge of embezzlement is pleaded extremely briefly, but appears to contain sufficient allegations—that K controlled Yukos, Mitra and Grace and therefore their assets were "entrusted" to him, that particular funds were transferred and that there was no legitimate purpose or reason such transfers, which were made "without compensation". It is not alleged whether or how K benefited from such transfers. However, the relevant article of the Criminal Code encompasses the crime of "waste", and it does not appear that demonstrating that the accused received any particular benefit is an element of this crime. Of course, the allegedly unexplained transfer of approximately \$200 million from companies controlled by K to companies controlled by Vladimir Gusinsky has attracted much attention, even if this allegation is not a legally necessary element of the charge.

In order to bolster its claim that K controlled the funds of Yukos and the various companies alleged to be associated with K and the organized group, the Report notes in this section that K and the organized group maintained "consolidated accounts" of the various companies which accumulated and tracked the proceeds of the transfer pricing and tax evasion schemes described above. Indicating the existence of such evidence is not necessary to support any of the charges made—factual allegations are necessary, but it is not necessary to specify what evidence will be brought to bear to prove them. It is therefore interesting that the prosecutor chooses to tip his hand regarding what may be prime evidence at trial—the existence of consolidated accounts would give strong support to the prosecutor's allegation that the entities involved in the various schemes were managed and organized centrally.

10. Large-scale tax evasion by a physical person through knowingly providing false information in tax filing (part 2, Section 198 of the Criminal Code).

K is accused of personally and illegally taking advantage of a special tax regime available to "individual entrepreneurs" (individuals conducting business without forming a company) to simplify the tax regime applicable to small businessmen. Under this regime, an individual conducting business without forming a legal entity may pay a flat fee to obtain a "patent" that frees him or her from paying income tax and state pension fund contributions and also from maintaining detailed business records, which would be required if the normal tax regime applied to them. In particular,

K is accused of hiding income he received as an employee of Closed Joint Stock Company "Rosprom" and Open Joint Stock Company "Yukos-Moskva" as "consulting fees" received as an "individual entrepreneur".

Report sets forth how K allegedly made false tax filings in connection with claiming this special tax status for 1998 and 1999:

On November 24 and March 1, 1998, applications were filed on K's behalf in which allegedly contained the false information that K was in the business of providing consulting services as an individual entrepreneur. Based on these applications, K was issued a patent permitting him to avail himself of the simplified tax regime for the year 1998. For the purpose of furthering his intent to abuse the patent regime, K allegedly entered into agreements with the companies Hinchley Limited and Status Services Limited, incorporated on the Isle of Man. These agreements were allegedly "fake" in that they governed the provision of consulting services by K to these companies in connection with "financial and economic development and regulation in Russia" which neither party truly believed would be provided. Various payments totaling about RUR 10 million were received and recorded in K's accounts of his entrepreneurial activity, which are official documents for tax reporting purposes under the relevant tax law. These payments were recorded as payments for services under the consulting contracts, but it is alleged that no services were performed and that these payments really represented compensation for work done by K in his capacity as an employee of Rosprom. These payments were also improperly reported in K's tax declarations filed in 1999 as income from entrepreneurial activity.

The same sequence of activity was allegedly repeated in 1999—false application stating that K engaged in entrepreneurial activity were made to obtain a patent covering 1999; K received payments from Hinchley and Status Services under false consulting agreements; and the proceeds were improperly reporting as income from entrepreneurial activity in K's tax filings. The total mis-reported income for 1999 was RUR 142 million. In 1999, it is alleged that these payment for "consulting services" were actually compensation for K's employment with Rosprom and Yukos-Moskva (a principal Yukos subsidiary).

There is little question that the patent system for individual entrepreneurs has been abused in Russia, and apparently to a greater extent before this legal regime underwent amendments which have been ongoing since 2000. Such abuse, however, was the result of the fact that this system, which is common in Europe, was adopted in Russia without a number of safeguards and limits that are part of this regime in other countries. It basically offered a big loophole in the tax system. I have encountered skepticism from lawyers in Moscow regarding this charge against K since many lawyers used the patent regime themselves to reduce their taxes and advised clients on how to use it legally. The major loophole in the regime took advantage of the fact that Russian law provided few substantive tests to look through the form of a consulting agreement to determine whether the agreement actually masked an employment relationship. If K had not been an employee of Rosprom and Yukos-Moskva and had entered into contracts directly with these companies to provide consulting services, then it might have been possible to take advantage of the patent regime loophole. However, under the structure used, K remained an employee of Rosprom and Yukos-Moskva and received payments indirectly through offshore companies, to whom, it is alleged that no services whatsoever were actually provided. It would seem that this structure does not fit within the loophole.

Some colleagues have also expressed skepticism regarding this charge because it will require the prosecutor to prove that no services were provided under the consulting agreements. It is correct that the prosecutor will have to prove this allegation, but it is not impossible to do and therefore not relevant to the question of whether the charge can be made. If we wish to speculate on what may happen at trial, there are certainly many types of evidence that could serve to establish the no services were performed under the consulting contracts—for example, internal documents or witnesses that simply describe the idea behind the scheme. We may also speculate on all the witnesses and evidence K may have at his disposal to contradict the allegation.

11. Repeated falsification of official documents (part 2, Article 327 of the Criminal Code).

K is accused of falsifying an “official document” that confers on the holder either a special legal right or status or the release of a legal obligation.

The prosecutor seeks to create an additional criminal charge in connection with K’s alleged abuse of the patent tax regime as described above. The prosecutor alleges that various documents submitted to obtain the patent and then confirm that it was used to avoid income tax on “entrepreneurial activity” contained false information. The false data was, as described above, misrepresentation of the nature of payments made to K as a “consultant”. To be brief, this charge seems confused. This section of the Criminal Code clearly applies to forgery—that is the document itself must be fake; it is not a “forgery” for a document to contain false statements. This section would apply, for example, if someone forged the patent itself and attempted to show it to a tax inspector to justify non-payment of income tax.

On the other hand, if the prosecutor desires to charge K with additional offenses in connection with this abuse of the patent regime, there are other articles of the Criminal Code available (for example, Article 171, which specifically deals with submission of false information to state bodies in connection with the conduct of entrepreneurial activity).

Conclusion

A number of the charges in the Report do not appear to be “well plead”. That said, a number of substantial charges, particularly those related to fraud, appear to be rather straightforward and it may be easy for the prosecutor to correct some of the errors in the pleading with respect to the defective charges. Therefore, this is not an indictment that as a whole can be “thrown out of court” (rejected in a summary proceeding). There are serious issues to be resolved at trial.

As mentioned, due to the nature of the charges, very complex and usually hard-to-find evidence will be required to meet the burden of proof required for conviction in a Russian criminal proceeding (which legal scholars will argue is, theoretically, at least as high in a Russian court as in a US court). For example, absent key cooperative witnesses, establishing the existence of an organized group controlled by K will require particularly potent documentary evidence. The prosecutor at times hints at the existence of such evidence, but it not clear how close such information, even if it exists, comes to linking K personally to the alleged crimes.

There has been much comment on the justice of this prosecution, particularly in the West, if indeed, as many claim the activities of which Khodorkovsky is accused were rampant in Russia in the 1990s. Of course, "everyone was doing it" is not a valid legal defense against any of the charges. In any event, it is not clear that these charges relate to particular schemes that in fact were all that common. The schemes are in fact peripheral to the privatization free-for-all of the early- and mid-1990s. Of course, if billions of dollars are extracted in taxes and fines from Yukos or confiscated from its core shareholders through this case, the effect will be a return to the state of much property acquired by Khodorkovsky and his partners through privatization. Nevertheless, the charges themselves do not directly call into question the "privatizations of the early 1990s", as some of the reporting of this case has implied. The case will not form a basis for mounting legal challenges to privatization. Only two of the charges in fact relate to privatization and they relate to attempts to evade the commitments made by the winner of a tender without calling into question the tender process itself.

While the claim that "everybody was doing it" is not a defense, with respect to some of the tax charges, the notion that certain tax schemes were carried out with the knowledge of the tax authorities and may have even passed tax audits may give K an affirmative defense that his use of such schemes lacked criminal intent. (Even if criminal charges fail, the tax schemes may be disallowed and Yukos may be assessed hundreds of millions in back taxes and penalties). In the US, the reliance on outside tax advice and the successful review of a scheme by auditors is often raised as a defense against charges of criminal tax evasion. "Reliance on advice" has not been tested as a defense against criminal tax evasion charges in Russia, and it is not likely that such a defense would be recognized in Russia, at least in the near future. Some practitioners with whom I have spoken, however, believe that passing an audit by the tax authorities themselves could provide a valid defense (assuming that corruption was not involved in passing such audits).

The Report contains a glaring and significant omission which deserves some comment. Although so many of the activities forming the basis of the allegation in the Report required the active or passive complicity of bureaucrats and other government officials, it does not appear that any charges of corruption (under provisions for bribery, negligence and/or abuse of office) have been brought. The Report is simply devoid of even basic allegations in this direction. It is possible that the prosecutor is seeking the cooperation of officials, and is therefore holding back charges to give them the incentive to cooperate. Of course, the decision not to attempt to prosecute at least some of the government officials involved in these schemes will be seen as a "political" decision. Such a decision would be disappointing if it were based simply upon a decision to protect the officials. However, it could also represent a political decision to prosecute these actions on the basis of charges of fraud and tax evasion so that this case will serve to demonstrate that such crimes will be prosecuted.

Finally, it is difficult to review this Report without addressing the constant comparisons that are being made, particularly in the Russian press, between the case against Khodorkovsky and his Menatep partners and the Enron case. I have not reviewed the actual indictment against the senior Enron officials, so I can only comment on this comparison on a very general level. There is certainly some similarity between the cases in that both will require the prosecution to establish the level of involvement and culpability of principals who are accused of directing the actions of literally dozens of people and legal entities, while perhaps

taking very little action personally. Undoubtedly, similar forms of evidence will be marshaled to establish these elements. We are also likely to hear similar arguments from the defense against finding that the principals had the necessary level of involvement and culpability. However, it seems that, with respect to the charges themselves—the allegations of fraud, assets stripping and tax evasion—the charges against Khodorkovsky are all far more straightforward than the charges that have been made against the Enron executives. While there are charges of asset stripping against certain executives in the Enron case, the main charges relate to fraud against the securities market based upon false accounting. This is a relatively abstract form of fraud and it is not likely that such fraud will become well defined or prosecuted in Russia in the near future.

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