2007

The Yukos Money Laundering Case: A Never-Ending Story

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THE YUKOS MONEY LAUNDERING CASE:
A NEVER-ENDING STORY

Dmitry Gololobov*

I. A BRIEF STORY OF THE YUKOS GROUP ........................................ 711
II. THE YUKOS CASE: THE TIMELINE AND THE CONSEQUENCES ........................................................................... 716
III. THE MONEY LAUNDERING LEGISLATION OF THE RUSSIAN FEDERATION ........................................................................ 720
IV. PRINCIPLES OF THE KHODORKOVSKY/YUKOS MONEY LAUNDERING CASE .......................................................................................... 724
V. GENERAL CHARACTERISTICS OF THE CASE ................................................................................................................................. 726
A. Timing .................................................................................. 727
B. General Information on the Criminal Activities.................... 728
C. Approach to Business and Corporate Operations................ 729
D. Khodorkovsky’s Position in the Corporate Group .................. 730
VI. THE CORE EPISODES OF THE KHODORKOVSKY/YUKOS MONEY LAUNDERING CASE ................................................................. 734
A. Creation of the On-Shore Networks of Shell-Companies ............ 735
B. Creation of the Off-Shore Network of Shell (dummy) Companies ............................................................................................................ 739
C. Using the Auditor’s Opinion as a Shelter .............................. 741
D. Accumulation of Profit on the Foreign Accounts ................... 746
E. Redistribution of the Illegal Profit through Shared Re-distribution and Dividends ................................................................. 747
F. Laundering Operations ......................................................... 747
VI. TRANSFER PRICING ISSUES IN THE KHODORKOVSKY/YUKOS CASE ................................................................................................. 750
CONCLUSION .............................................................................. 762

I. A BRIEF STORY OF THE YUKOS GROUP

The first decade of the twenty-first century is famous for its corporate governance and accounting scandals, which finally led to the adoption of the Sarbanes-Oxley Act in the US and analogous legislation around the world. The events of September 11th, 2001 led to the adoption of a complex, multi-level, international anti-money laundering

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legislative framework, which has had a great impact on anti-money laundering regimes worldwide. This adoption, however, appears to also be capable of generating uninvited money laundering scandals. Before the universal adoption of internationally recognized principles against money laundering, such scandals could be understood as the logical implication of a country’s non-compliance. However, it is now evident that for the roots of known international corporate failures are much deeper and need to be thoroughly researched.

The notorious Yukos Oil Company case, which has been on-going since early 2003, can be taken as a striking example of a new type of corporate disaster. The case represents a potential danger that has not yet been properly estimated. Yukos Oil Company was one of the biggest Russian “virtually integrated holding oil companies” that was created in the course of large scale Russian privatization and sold to the Menatep Group in one of the infamous post-Soviet “loans-for-shares” tenders. According to the U.N. Office for Drug Control and Crime Prevention,

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

Yukos, under Menatep’s control, widely used asset-stripping techniques, as did the majority of Russian production companies sold to oligarchy groups. This allowed the controlling shareholders to enjoy the benefits of non-transparency and transfer pricing, which resulted in excessive profit. However, in 2000, under the leadership of Mikhail

4. See Bernard Black, The Corporate Governance Behavior and Market Value of Russian Firms, 2 EMERGING MARKETS REVIEW 89 ( 2001); Black et. al., supra note 2, at 1769–72; Merritt B. Fox & Michael A. Heller, Corporate Governance Lessons from Russian Enterprise Fiascoes, 75 N.Y.U. L. REV. 1720, 1743–45 (2000); Andreas Heinrich, Aleksandra Lis & Heiko Pleines, Corporate Governance in the Oil and Gas Industry. Cases from Poland, Hungary, Russia & Ukraine in a Comparative Perspective 18–20 (Koszalin Inst. Of Comparative European Studies [KICES], Working Paper No. 3, 2005; Iji, supra note 1, at 14–20; Carsten
Khodorkovsky, the core Menatep Group shareholder and CEO of Yukos, the Company changed its strategy and began implementing international standards of financial reporting and accountability. Within several years, Yukos evolved from an oligarchic structure into a favorite of the Russian securities market and companies such as Standard and Poor's, which rate corporate governance. The Company approved its own ADR program and published annual and quarterly accounts, which were audited by PricewaterhouseCoopers (PwC).

The Yukos case is a complex and ambiguous composition of fraud, tax evasion, and other criminal cases that were launched against several Yukos shareholders, managers and employees. The backbone of the case

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5. See, e.g., Iji, supra note 1, at 30–34.


is the money laundering charges brought against the organized criminal group, which allegedly comprised of the Company's top managers and was headed by Khodorkovsky. Khodorkovsky and his allies have been charged with laundering approximately 27 billion U.S. dollars—the approximate equivalent of the Company’s profits over a four-year period.9

The complexity of the Yukos case could be seen from the following figures: the total number of exclusively personal criminal cases launched against managers, employees, or affiliated persons of the Company has exceeded one hundred;10 the overall number of the individuals, charged, or prosecuted totalled more than sixty;11 the number of court cases in different jurisdictions,12 including Russia, has already exceeded five hundred;13 the number of individuals on the Interpol search list is fifteen.14 The case is also famous for the biggest tax claim sum in recent Russian history and the largest amount of laundered funds.15


12. For example, a PACER search of cases filed under "In Re Yukos Oil Co." before Judge Letitia Z. Clark (Bankr. S.D. Tex. R. 1001(c)) turns up 244 results between Dec. 14, 2004 and Mar. 5, 2006 (on file with author). See also U.S. District Court, https://ecf.txsd.uscourts.gov.

13. This figure was obtained through the author’s personal calculations and accounts for court hearings on the tax debts of Yukos subsidiaries, extradition and criminal cases, and cases before the European Court of Human Rights.


The factors and circumstances leading to the collapse of Yukos are manifold, and can be analyzed from different angles. Some commentators think that the Yukos case is a reflection of the general problems of partisan and predatory privatization in Russia:

Privatization did create the property owners in the Russian Federation—masses of small shareholders without any power to influence decisions over the enterprises they “own.” It also produced few “new Russians,” who have acquired enormous wealth by skillfully taking advantage of the weaknesses of the transition period, including the lack of transparent and clear rules and diminished law enforcement capacities of the State. In the absence of appropriate rules to regulate or mechanisms to monitor the developments, the market-oriented transformations, particularly privatization, stimulated an unprecedented rise in the legalization of criminal assets and property acquired by unlawful means.16

Yukos defenders, among them prominent politicians, lawyers and analysts, clearly see a political motivated element to the case. The defenders argue that Yukos individuals have been prosecuted and the Company is facing liquidation exclusively because of Khodorkovsky’s political and public activities.17 Others consider Khodorkovsky to be a mere criminal who headed Russia’s most powerful and dangerous “corporate criminal group.”18 The moderate analysts see in the Yukos collapse a culmination of Putin’s fight against oligarchs, his quest to strengthen a weak Russian state, and the clash between different influential Kremlin groups

struggling for oil revenues. These moderates nevertheless recognize the element of selective treatment in the Yukos case.  

Yukos’s accounts were audited by one of the biggest auditing firms. The company had shares listed on international stock exchanges, and it was considered a paragon of Russian corporate governance and transparency. The core question in the story then is how such a company has become involved in a money laundering scandal of unprecedented magnitude.

II. THE YUKOS CASE: THE TIMELINE AND THE CONSEQUENCES

The Yukos case effectively began in 2003, when a Council for National Strategy report titled “The State Versus the Oligarchy” highlighted the political thrust of the case. 20 The report was aimed at oligarchs who were accused of privatization by theft, impoverishment of the nation, the “creation of a system of anti-national values,” and high treason by appealing to outside countries for help and “representing outside interests.” They were also accused of forcing through “oligarchic modernization,” and ultimately of trying to acquire a dominant position in the state.

The real confrontation between Yukos and the State, represented by the General Prosecutors Office, started on July 2nd, 2003 when Khodorkovsky’s personal friend and the CEO of the Menatep Group, Platon Lebedev, was arrested. 22 Lebedev’s arrest was widely interpreted as a “warning” to Khodorkovsky to leave Russia. However, Khodorkovsky did not leave. Instead, he made desperate attempts to mitigate the attack on Yukos on his allies. He traveled to the United States, aiming to persuade high ranking US politicians to intervene, and he made a hectic tour around the main Russian regions meeting the governors. 23 Putin’s

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20. See Delyagin, supra note 17, at 16.


22. Fortescue, supra note 8, at 121–23; Press-Center Timeline, supra note 10.

allies viewed such an undertaking as a political gesture, and Khodorkovsky was arrested in Novisibisk and charged with various counts of fraud and tax evasion. His hearing lasted for approximately a year. Regardless of the efforts of numerous lawyers, he and Lebedev were finally sentenced to 8 years detention in Chita, Siberia. Lawyers have since filed several claims with the European Court of Human Rights (ECHR). These filings have yet to be decided.

In July 2003, the Ministry of Tax and Levies initiated an extraordinary audit of Yukos's books. As a result of the audit, Yukos was hit with a claim for $3.5 billion. The same action was repeated over three times in three subsequent years, totaling a claim of approximately 27 billion U.S. dollars. The Government decided to organize a forced sale of Yukos's main production unit, Yganskneftegas, in December.


2004. The management, which flew out of the country under pressure from the prosecutor, undertook an unprecedented attempt to block the sale by filing a Chapter 11 claim with the US bankruptcy court in Houston. The court initially issued a temporary restraining order, prohibiting Russian companies and western banks from participating in the questionable auction for several years, but finally the claim was declined. In spring 2006, Yukos’s western creditors commenced the liquidation procedure. By June 2007, the majority of Yukos’s assets had been auctioned off and acquired, mainly by the state-owned companies of Gazprom and Rosneft.

Supporters of Putin at the Kremlin were aware that Khodorkovsky’s first term in prison would be coming to its mid-point in October 2007, at which point Khodordovsky would be able to request release on payroll. The supporters therefore arranged for a second group of charges to be brought against Khodorkovsky and his allies in February 2007.

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33. See Theede, Democracy on the Retreat, supra note 30; Catherine Belton, Banks Want Yukos Ruled Bankrupt, MOSCOW TIMES, Mar. 13, 2006, at 1.
The impact of the Yukos case on western and international case law is quite significant. For example, the Yukos case has led to disputes over the definition of what constitutes a politically motivated crime in contemporary Europe, and disquiet over the use of financial crime charges to camouflage politically motivated prosecution. Another impact is the

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contribution, provided by the Yukos Chapter 11 case decision, to American bankruptcy case law. This case has actually already been recognised as a benchmark case concerning the “forum shopping problem.” Even more interesting might be the decision of the ECHR on the Yukos “tax story,” which may set a new benchmark for ECHR tax cases.

III. THE MONEY LAUNDERING LEGISLATION OF THE RUSSIAN FEDERATION

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

The development of anti-money laundering legislation in Russia has come through a number of significant obstacles. For a period of time, the Russian Federation strongly opposed the idea of anti-money laundering legislation, and President Yeltsin personally vetoed one of the projects on anti-money laundering laws. Experts think that Russia’s general inability to detect and to prosecute money laundering activities was created inten-
tionally, and permitted former members of the Soviet governmental apparatus to legitimize their embezzled funds. 43

In 1996, the Russian Federation enacted a new criminal code that criminalized money laundering. 44 The Code was a product of both the need to address the changing social, political, and economic conditions of contemporary Russian society, and the need to confront the drastic increase in post-Soviet crime. 45 Article 174 of the Russian Criminal Code, entitled “Legalization of Money (Money-Laundering) or of Any Other Assets Acquired Illegally,”46 criminalizes financial transactions involving assets that have been acquired by illegal methods. 47 Academics understand Article 174 only as a skeletal provision. Stated another way, “[the CCRF’s] primary importance is as a theoretical normative statement . . . the new code announces the principles under which Russians one day hope to live.”48

On July 13, 2001, the Duma, proceeding with the fight against money laundering in Russia, passed an anti-money laundering bill. 49 The law, as adopted, came into effect in February 2002. 50 This law, which amended the Russian Criminal Code, established the general anti-money laundering framework in Russia. 51 The current legislation defines the offence of money laundering as “the performance, for large amounts and with the aim of giving a legal appearance to their possession, use and disposal, of financial and other transactions with monetary funds and other assets which are known to have been acquired by other persons through criminal means (with the exception of the offences defined in

44. Uголоvныи Kодекс RF [UK] [The Criminal Code of the Russian Federation] No. 63-FZ (Russ.).
46. CCRF Art. 174
48. The FATF Review to Identify Non-Cooperative Countries or Territories concluded with respect to Russia the following: “Currently the most critical barrier to improving its money laundering regime is the lack of comprehensive anti-money laundering law and implementing regulations which meet international standards. In particular, Russia lacks: comprehensive customer identification requirements; a suspicious transaction reporting system; a fully operational FIU with adequate resources; and effective and timely procedures for providing evidence to assist in foreign money laundering prosecutions.” Fin. Action Task Force on Money Laundering [FATF], Review to Identify Non-Cooperative Countries or Territories: Increasing the Worldwide Effectiveness of Anti-Money Laundering Measures, at 13 (June 22, 2001), http://www.fatf-gafi.org/dataoecd/56/41/33922055.pdf.
50. The Act was later amended several times and found its development in the decrees of the President, act of Government and regulations of the FIU and the Central Bank.
articles 195, 194, 198 and 199 of this Code). This definition applies to offenses under both Russian Criminal Code Article 174 and Article 174.1. Article 174 pertains to laundering operations conducted by a person who was not involved in the predicate offense, while Article 174.1 deals with laundering operations conducted by the same person who committed the predicate offense.

Some core characteristics can be gleaned from this framework. For example, the definition of laundering offenses under the Russian Criminal Code remains rather broad since the notion of “crime” under Russian law includes all criminal offenses irrespective of their gravity. The previous definition did not make the offense dependent on the purpose of disguising the criminal origin of the money. However, the words “through illegal means” were replaced by “through criminal means.” The replacement signifies that only criminal offenses (offenses defined by the Russian Criminal Code) may be regarded as giving origin to illicit funds.

Under the definition for money laundering, the word “knowingly” restricts the possible application of the articles 174–174.1. Therefore, money laundering offenses are restricted to those that have been committed intentionally, with negligence not being sufficient. In addition, according to experts, Article 6 of the Russian anti-money laundering bill is rather comprehensive in nature. It covers almost all activities commonly associated with money laundering.

In assessing the Russian anti-money laundering framework, experts have pointed out that the definition of the offense seems to meet minimum standards set by the Strasbourg Convention and the Recommendations of the OECD Financial Action Task Force on Money Laundering (FATF). The experts believe that Russia is moving towards a comprehensive anti-money-laundering regime.

51. Ugolovnyi Kodeks RF [Criminal Code] arts. 174 (Russ.).
53. See Burnham, supra note 45, at 367–68. It further excluded offenses defined by articles 193, 194, 198 and 199 of the Criminal Code, i.e. the failure to repatriate funds in accordance with exchange control regulations, avoidance of the payment of taxes and customs duties (smuggling, however, remains a money laundering offence). Ugolovnyi Kodeks RF [Criminal Code] arts. 193–94, 198–99 (Russ.).
56. See Chung, supra note 43, at 634.
58. See Schaer, supra note 54, at 370.
However, as analysts have noted, defining the crime of money laundering in the Russian context has crystallized the moral issues at stake in implementing international recommendations. The decision on whether to integrate forms of economic delinquency common within the Russian business community could radically modify the objectives of anti-money laundering and the definition of its targets. Favarel-Garrigues pointed out the following:

In analyzing the case of Russia, I wish to show that the implementation of international standards against money laundering does not necessarily imply a commitment to common values, or even to a common vision of the objectives of this campaign. The Russian example highlights, on the contrary, the latitude afforded to states to define the moral issues at stake in efforts to combat money laundering within their borders, in accordance with domestic concerns.

A number of factors support the hypothesis that the anti-laundering mechanism constitutes a valuable resource in the political management of the business community. Its instrumentalization is wholly in line with government action based on the exploitation of the legal vulnerability of Russian economic and financial elites.

His assumption, that a regulatory instrument such as money laundering legislation could be used to crack down on certain personalities and ultimately be used to intimidate the business community by centralizing information on bank transactions and institutions, is strongly supported by the recent Russian criminal cases.

61. Id. at 529.
62. Id. at 538.
63. Id.
The core message from this brief overview of contemporary Russian anti-money laundering legislation is that, by the time of Mikhail Khodorkovsky arrest and the commencement of the Yukos case, the core provisions of Russia’s anti-money laundering legislation had already been enacted. Of course, the legislation had not been developed enough in several important aspects, such as a comprehensive customer identification requirements, a suspicious transaction reporting system and an operational Federal Investigation Unit (FIU) with adequate resources, but the main elements were in place and generally complied with the main international guidelines. The “backbone” provisions were in place and reflected in case law.

IV. Principles of the Khodorkovsky/Yukos Money Laundering Case

It is important to note that the Yukos case has two dimensions. The first is criminal and stems from the “First Khodorkovsky/Yukos Case” (hereinafter the First Case), when Khodorkovsky was charged with, among other charges, organizing and managing a network of shell companies that were designed and used for the purpose of corporate tax evasion. This dimension migrated from the First Khodorkovsky/Yukos Case to the Second Khodorkovsky/Yukos Case (hereinafter the Second Case), where the organization and management of the offshore and onshore shell companies network were assessed as an episode of organized criminal activity that involved fraud and money laundering.


68. See The Summary of the Charges, supra note 15; Court Decision (Meschansky Dist. Ct., City of Moscow, May 16, 2005).
The second dimension of the Yukos case only deals with the taxation of Yukos as a corporate group. The claims of the Ministry of Tax and Levies, amounting to 27 billion U.S. dollars, are based on the assumption that the same network of shell companies, which was allegedly used for laundering funds, was also used for corporate tax evasion. Therefore, the money laundering charges and corporate tax claims originate from the same source: the Yukos corporate group structure and tax optimization schemes through the creation of the shell companies network.

In the Yukos case, the prosecutors have actually created a new concept in Russian criminal law known as the "criminal corporate group." The criminal corporate group is a corporate group created for the purposes of tax evasion and money laundering. It is managed by a group of individuals recognized as an organized criminal group.

The strategy of the Russian prosecutors can be understood from the comparative analysis of the Russian and U.S. legislation. The concept of an "enterprise" in the United States' Federal Racketeer Influenced and Corrupt Organizations Act (RICO) serves as a useful comparison to the legal concept of an organized group as defined in the Russian Criminal Code. As with the Russian Criminal Code's prohibition of illegal activity by an organized group, RICO too is directed at combating organized crime. In each case, the government must establish a nexus between the alleged criminal activities and some enterprise or organized group. Although the structure of a RICO enterprise can be either a formal, legal entity or an informal association, RICO requires in the first instance that the government allege and prove a structure for the making of decisions, separate and apart from the alleged racketeering activities, with the existence of an enterprise being a separate element, which must be proved by the prosecution. In addition, to prove a criminal association in fact, the government must prove that "the various associates function as a continuing unit" for a "common purpose of engaging in a course of conduct." Here too, the concept of an organized group in the Russian Criminal Code is similar to the notion of a RICO enterprise, with its stability requirement echoing RICO's continuity, and its complicity component mirroring common purpose, as to course of conduct.


72. SAUNDERS ET AL., supra note 67.
However, in the Yukos case, the organized criminal group acquired all the companies, including Yukos, and used these companies to organize the corporate group. Assimilated into the group, they also took the managerial positions, drew several managers and employees into the organized group activity, made the company the production and corporate leader of the Russian industry, almost bought Sibneft and merged with Exxon-Mobil, and were ready to take power in Russia.\footnote{This situation raises the question of how such a group could function for seven years under the supervision of numerous controlling bodies on a federal and regional level; since it was regarded as one of the top taxpayers in the country, it had submitted thousands of pages of financial reports and was audited by one of the top international auditing firms.\footnote{The answer to this question can be found in the analysis of the charges recently brought against Mikhail Khodorkovsky and his allies.} The Yukos case also demonstrates that there is a tendency towards the extensive and aggressive usage of the notorious Russian concept of the “organized group” for the prosecution of those whose prosecution, in other circumstances, would represent a difficult task.\footnote{V. GENERAL CHARACTERISTICS OF THE CASE

The General Prosecutor’s Office has published several important documents concerning the First Case, including the Summary of the Judgment.\footnote{When the investigation of the Second Case had been finished, the General Prosecutor’s Office published the Summary of the}


\footnote{74. The question is whether Yukos really represented a “corporate organized group” or whether the existence of such a powerful business group was seen by the governing political elite as an imminent threat to its power. Volkov, supra note 18.}

\footnote{75. Notably, there is a similar tendency growing in the United States, and this is highlighted by Gerard Lynch in his essay on RICO: “[P]rosecutors have seized on the virtually unlimited sweep of the language of RICO to bring a wide variety of different prosecutions in the form of RICO indictments.” Gerard E. Lynch, Rico: The Crime of Being a Criminal Parts I and II, 87 COLUM. L. REV. 661, 662 (1987).}

Charges brought against Khodorkovsky and Lebedev on its official website. 77

The allegations against Khodorkovsky and his allies have several general characteristics that follow not only from the Summary of the Charges, but also from the judgment in the First Case, 78 the decision concerning the episode of the illegal privatization of Apatit, 79 arbitration decisions on the tax claims against Yukos, 80 and a number of other documents of lesser importance. 81 The characteristics are discussed below.

A. Timing

The organized criminal group headed by Khodorkovsky and Lebedev was allegedly formed as a group before 1994 when it was involved in the Apatit case. 82 According to the Summary of the Charges, the

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77. See The Summary of the Charges, supra note 15. They have been accused of embezzlement by means of the large-scale misappropriation under Part 4 Article 160 of the Criminal Code of the Russian Federation, Ugolovnyi Kodeks [UK] [Criminal Code] art. 160 (Russ.).

78. See Judgment, supra note 35.

79. See Court Decision (Meshansky Dist. Ct., City of Moscow, May 16, 2005).

80. See Interregional Tax Inspection N1 v. Yukos, A40-61058/04-141-1510 (Federal Arbitration Court of Moscow Region, 2007).

81. See, e.g., Russ. Fed’n v. Khodorkovsky, Tr. of the Closing Argument by Def.’s Att’y, April 5, 2005 (on file with author) [hereinafter April 5 Closing Argument]; Russ. Fed’n v. Khodorkovsky, Tr. of the Closing Argument by Def.’s Att’y, April 6, 2005 (on file with author) [hereinafter April 6 Closing Argument]; Letter from Sergey Pepeliaev J.D., Professor of Financial Law at the State University Higher School of Economics, Member of the Presidium of the Russian Tax Law Association, Aarina Ivlieva, J.D., Assistant Professor of Administrative and Financial Law at the Law Department of the Moscow State University & Ivan Khamenushko, J.D., Lecturer in Administrative and Financial Law at the Law Department of the Moscow State University (Jan. 15, 2004), available at http://www.yukos.com/taxes/final.pdf).

82. This case is understood as a core part of the First Case, as it unfolded around the problem of fair privatization in Russia. The case began in 1994 when Bank Menatep and its controlled companies won a tender for Apatit, Russia’s largest fertilizer company. The government auction to privatize 20% of Apatit was won by Volna, a firm controlled by the Menatep group. According to the tender, Volna paid $225,000 for the stock and had to invest $283 million within a year in the development of the company and the city where the company was located (the “Investment Plan”). Volna failed to fulfill several material requirements of the Investment Plan due to, among a number of other reasons, the fact that the conditions of the Investment Plan were outdated and its fulfillment would lead to negative consequences for the company and its investors. However, the authorities succeeded in terminating the sale and purchase agreement in the Arbitration Court, so the share of Apatit had to be returned to the state. By the time the court decision became enforceable, the notorious shares were resold to other companies and could not be transferred back to the state. This series of events led to the lengthy and fruitless dispute between the State, represented by the Federal Property Fund (hereinafter the Fund), and the Menatep Group.

In 2002 the Menatep and Yukos officials reached a compromise agreement with the Fund, under which a settlement was paid to the Fund in the amount of $15 million as consideration for non-returned shares. Just before the attack on Yukos the Prosecutor General conducted a special review of the Apatit privatization procedure and the results of the tender
organized criminal group "[has] also been engaged in criminal activities in the country's petroleum industry." Therefore the "Menatep-Rosprom-Yukos" group, due to the vast variety of interests (property, oil production, banking), can be called a "diversified organized criminal group." According to the General Prosecutor, the activities of the criminal group lasted from approximately 1993 until 2003. The activities of the group arguably lasted even longer, since the members of the management allegedly controlled by Khodorkovsky left the company and flew to London in October-November of 2004.

B. General Information on the Criminal Activities

The prosecutors understand the whole story of the Mentap-Yukos-Rosprom Group as a continuous criminal act that is focused on the misappropriation of privatized assets and obtainment of illegal profit from the misappropriated assets through tax evasion and money laundering schemes. The assessment of the general activities of the Yukos Group as a continuous criminal offence is confirmed by the amount of funds allegedly laundered by the organized criminal group through Yukos.


83. The Summary of the Charges, supra note 15.
85. For example, "In 1998 Khodorkovski, Lebedev and the other members of the organised group conspired to acquire by criminal means a majority shareholding in the said joint-stock company, for the purposes of which they acquired the shares of OAO Achinski NPP, OAO Novosibirskoye Predpriiatye po Obedpecheniyu Nefteproduktam, OAO Tomsknepetroprodukt, OAO Khakasnepetroprodukt, OAO Tomsknephytegeofizika and OAO Tomsknepet VNK, incorporated by the Russian government into the authorized capital of OAO VNK (38% shareholding)." The Summary of the Charges, supra note 15.
87. The total amount of money allegedly laundered by the organized group during the period 1998 to 2004 was 487,402,487,523.59 rubles (approximately 19 billion USD) and 7,576,216,501.76 USD. Compare Incremental Tax Assessed, supra note 30, with Mikhail Khodorkovsky, Chairman, Executive Comm., Bd. of Dirs., Yukos Presentation in London (2003) (on file with author), at 1–21; Tax Slides Update, supra note 69.
Even salaries and annual bonuses paid to the employees and managers have been announced as a form of bribery:

Khodorkovski and Lebedev bribed those shareholders who were not under their control and those members of the higher management (directive from the former shareholder in the person of the state) who were likely to put up active resistance to their nefarious activities. The bribe took the form of the unlawful payment of a bonus from the bank accounts of foreign companies under the control of Khodorkovski and Lebedev.\footnote{88. The Summary of the Charges, supra note 15.}

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

C. Approach to Business and Corporate Operations

The investigation considers even formal actions undertaken in the normal course of business and corporate activity as a part of the continuous criminal offence. For example the corporate restructuring procedure which took place in 1998\footnote{89. \textit{See}, e.g., Iji, \textit{supra} note 1, at 20–22; Yousef-Martinek, Raphael Minder & Rahim Rabimov, \textit{Yukos Oil, A Corporate Governance Success Story?}, \textsc{The Chazen Web Journal of International Business} (Fall 2003), http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/715/Yukos%5Fproof%2Epdf.; Mikhail Khodorkovsky, Chairman & CEO of Yukos Oil Co., Speech at the 2nd International Oil Summit in Paris: The Third Alternative (Apr. 25, 2001), \textit{in Yukos Review} 3 (May–June 2001) at 16–19.} has been described in the Summary of the Charges as follows:

In order to fulfill his criminal aspirations . . . and obtain the right to their strategic and operational direction, Khodorkovski, together with the members of the organised group, created management companies controlled by them for OAO NK YUKOS and OAO VNK. For which purpose, on the instructions of Khodorkovski and the members of the organised group, the commercial establishments under their control founded OOO [limited company] YUKOS-Moskva, which became the management company for OAO NK YUKOS. Similarly in 1998 ZAO [closed corporation] YUKOS Exploration and Production (ZAO YUKOS EL) was created for the management of petroleum-extracting companies, and ZAO YUKOS Refining and
Marketing (ZAO YUKOS RM) for the management of petroleum processing companies.\textsuperscript{90}

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

D. Khodorkovsky’s Position in the Corporate Group

Khodorkovsky’s position in the legal entities named in the Summary of the Charges is one of the key aspects of the First Case. In the First Case his lawyers argued extensively that neither Khodorkovsky nor Lebedev controlled the corporate structure of the group of affiliated companies (hereinafter the Corporate Group).\textsuperscript{91} The Summary does not name all the posts taken up by Khodorkovsky, but it provides several examples of the control that Khodorkovsky and his allies exercised over the Corporate Group and the personnel.

\textbf{FIGURE III}

\textbf{SUMMARY OF THE CHARGES ON KHODORKOVSKY’S POSITIONS IN THE GROUP}

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yukos Oil Company control</td>
<td>&quot;Khodorkovski and the other members of the organised group led by him had acquired the right to the strategic management of OAO YUKOS NK in 1996.\textsuperscript{92}&quot;</td>
</tr>
<tr>
<td>Yukos’ subsidiaries control</td>
<td>&quot;The organised group of persons led by Khodorkovski procured the right to the strategic and operational management of the petroleum-extracting subsidiaries.\textsuperscript{93}&quot;</td>
</tr>
<tr>
<td>The personnel</td>
<td>&quot;The administrative personnel appointed by Khodorkovski and the members of the organised group were mostly the former employees of the Menatep Bank and ZAO Rosprom, which were also used by the organised group to further their criminal designs.\textsuperscript{94}&quot;</td>
</tr>
<tr>
<td>General position and the role</td>
<td>&quot;Khodorkovski and Lebedev, who ran OAO NK YUKOS and occupied leading positions on the managing bodies of the company, and who had accumulated capital in the companies under their control by misappropriating the assets of its subsidiaries, withdrew from the managing bodies of OAO NK YUKOS without losing control of the strategic management of the company.\textsuperscript{95}&quot;</td>
</tr>
</tbody>
</table>

\textsuperscript{90} The Summary of the Charges, \textit{supra} note 15.
\textsuperscript{91} April 5 Closing Argument, \textit{supra} note 81; April 6 Closing Argument, \textit{supra} note 81.
\textsuperscript{92} The Summary of the Charges, \textit{supra} note 15.
\textsuperscript{93} The Summary of the Charges, \textit{supra} note 15.
\textsuperscript{94} The Summary of the Charges, \textit{supra} note 15.
\textsuperscript{95} The Summary of the Charges, \textit{supra} note 15.
It is clear from the last paragraph of the Table that the prosecutors have applied a concept similar to the U.S. concept of the “controlling person,” or the U.K. concept of the “shadow director,” to both Khodorkovsky and Lebedev. Understanding of both concepts is important for the analysis of the Yukos case in general, and the Second Case in particular. Simon Plant and Michel Prior describe the concept of “shadow director” in the following way: “Shadow directors arise from a statutory concept created under the Companies Act in order to extend obligations of directors to persons who exercise the same kind of influence over the company as appointed directors would do. They are, in effect, not real directors and have no legal powers to act on the company’s behalf.”

Although a shadow director has no legal power, he wields considerable influence within the company while being somewhat immune from accountability. They are “persons in accordance with whose instructions the company’s directors are accustomed to act; thus a shadow director might be a significant shareholder or creditor of the company. A shadow director has been described as one who ‘lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself.’

Because a shadow director is not claimed by a company as a director, in any litigation certain elements of his status as a shadow director must be, “allege[d] and prove[n]: (1) who are the directors of the company, whether de facto or de jure; (2) that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so; (3) that those directors acted in accordance with such directions; and (4) that they were accustomed so to act.”

Bradley contrasts duties and responsibilities of a shadow director with the American concept of control person liability, which she considers much broader. She asserts that, “[c]ontrolling shareholders of corporations in the United States may be subject to a duty of fair dealing similar to the duties imposed on directors and officers of the corporation, and breach of this duty will give rise to liability in the same way. Unlike the liability imposed on shadow directors in Britain, this liability will not arise only on insolvency of the corporation. Moreover, the liability is for breach of a duty of loyalty rather than for breach of a duty of care.”

This control person liability, according to Bradley has been especially important in enforcement of federal securities statutes, "which impose liability for violations of those laws on control-persons as well as on the persons directly responsible for the violations. When a person is civilly liable under the Securities Act of 1933, the same liability applies to 'every person who, by or through stock ownership, agency or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls' the other person."

It should be noted that several Yukos minority shareholders have made an attempt to prove that certain controlling persons concealed the risk of the Russian Federation taking action against Yukos by failing to disclose: (1) that Yukos had employed an illegal tax evasion scheme since 2000; and (2) that Khodorkovsky’s political activity exposed the Company to retribution from the current Russian government, but failed to state a claim for primary liability. The Court, amongst other things, remarked: "To make out a prima facie case of control person liability under Section 20(a), 'a plaintiff must show a primary violation by the controlled person and control of the primary violator by the targeted defendant, and show that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person.'"

The diagram below shows that they have proper grounds to prove that Khodorkovsky had been the sole controlling individual for not only for Yukos and Menatep Groups, but for the Open Russia Foundation as well. By emphasizing Khodorkovsky’s controlling and managerial functions the prosecutors want to show that all the cash flows, either within or outside the Yukos Corporate Group, were ultimately under the control of Khodorkovsky, who knew of the money’s illicit origin. By
introducing this concept, the prosecutors purported to demonstrate that Khodorkovsky and other members of the organized criminal group actions were intentionally aiming at the continuous laundering of “dirty” funds and their accumulation abroad.

**Figure IV**

Khodorkovsky’s positions in the Group and outside.¹⁰³

Russian law does not directly recognize the concept of “shadow directorship” or the “controlling person” as they are recognized by the United Kingdom and the United States, respectively. Article 56 of the Civil Code and Article 3 of the Federal Law on Joint Stock Companies,

however, provide that a person who is able to give orders to a company can be held liable for the damages incurred in a course of the company’s bankruptcy if the bankruptcy arose from such orders. By describing Khodorkovsky’s position inside and outside Yukos Group in detail and stressing his actual managerial position, the investigation aims to solve the threefold problem:

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

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

3) Creating grounds for prospective civil actions against Khodorkovsky internationally by additionally confirming his role as the ultimate controlling person in the Group.

VI. THE CORE EPISODES OF THE KHODORKOVSKY/YUKOS MONEY LAUNDERING CASE

The Summary of the Charges for the Second Case represents a secondary document that summarizes the main points of the official charges in a manner that the prosecution would like to present to the public. The case, however, is extremely complicated from a legal perspective, spans over a ten-year history of several dozens of companies, and is interrelated with quite a number of other corporate, tax, and criminal cases.


105. The Summary of Charges also includes an episode on the illegal alienation of the subsidiaries shares belonging to VNK, 54 percent stock of which was acquired by Yukos on the privatization tender. However, this episode does not concern the main Yukos operational schemes and does not represent the case that needs an in-depth analysis. The Summary of the Charges, supra note 15.
Therefore, the episodes in the money laundering case should be analyzed in line with the corporate story of the Group and other significant data.

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

The prosecutors clearly see two stages in the development of the Yukos’s shell-company network. The first stage, which lasted approximately from 1997 to 2000, is characterized by using mostly shell companies registered in so-called “closed cities” or ZATOS, which were areas authorized to grant tax exemption to the companies producing something in their territory. The Summary of the Charges States:

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

... These organisations were essentially dummy legal entities, using the movement through them of petroleum, petroleum products, securities and cash as their raison d’être. On behalf of these dummy companies, which gave them the right of ownership of

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106. During this period the secretarial services to the Company were provided by Peter Bond and the holding and secretarial company Valmet Group Limited (Bermuda). See The Summary of the Charges, supra note 15.

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

108. Before Perestroika, military institutions and production units had been located in these areas, and were authorized by Government decree to grant special tax benefits to companies conducting production operations on their territory. On the problem of tax exemption policy in Rossia, see VLADIMIR SAMOYLENKO, INTERNATIONAL TAX AND INVESTMENT CENTER, GOVERNMENT POLICIES IN REGARD TO INTERNAL TAX HAVENS IN RUSSIA 7 (2003); see generally Brock, supra note 107, at 1065; Gregory Brock, The ZATO Archipelago Revisited—Is the Federal Government Loosening Its Grip? A Research Note, 52(7) EUROPE-ASIA STUDIES 1349 (2000); Maria Ponomareva & Zhuravskaya Ekaterina, Federal Tax Arrears in Russia: Liquidity problems, federal redistribution or regional resistance? 12(3) ECONOMICS OF TRANSITION 373 (2004); VADIM RADAEV, INFORMAL INSTITUTION ARRANGEMENTS AND TAX EVASION IN THE RUSSIAN ECONOMY (2001) http://www.isnie.org/ISNIE01/Papers01/radaev.pdf.
Michigan Journal of International Law

the extracted petroleum, Khodorkovsky, Lebedev and the other members of the organised group disposed of the petroleum as if it were their personal property.  

The key element of the scheme was the large-scale usage of so-called “shell” or “dummy” companies. Before the Yukos case, this term had an extremely rare application in Russian case law. The definition of a “shell” or “front” company, given in the judgment of the Khodorkovsky case, is the first comprehensive definition that sets the standards for Russian case law.  

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

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

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111. It should be noted that the same position has been expressed in the Yukos-related tax cases. See Interregional Tax Inspection N1, A40-61058/04-141-1510; Tax Inspection N5 v. ZAO “PwC,” A40-77631/06-88-185, (Moscow City Arbitration Court, 2007); Artem Aleksandrovich Rodionov, Nalogovye skhemy, za kotorye posadili Khodorkovskogo [TAX SCHEMES THAT LEAD KHODORKOVSKY TO PRISON] 58–68 (2005).  
The meaning of the term "shell company," as it is understood by the Russian court, is close to its meaning in international case law. The absence of consistent application of this definition, however, raises the question of applying the rule of law in the Russian Federation in general, and in the Yukos Case in particular.

According to the Arbitration court decisions, the network of onshore companies was created and used mainly for the purpose of tax evasion. Only after obtaining illegal profit derived from the tax evasion operations could the network of "shell" companies be used for its secondary purpose of laundering the illegal gains.

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

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


115. See Interregional Tax Inspection N1 v. Yukos (A40-61058/04-141-1510); Rodionov, supra note 69; RODIONOV, supra note 111.

116. This scheme sets up a perfect example of nexus between money laundering and tax evasion.

As evidence of the second stage of network development, the prosecutors point out that by 2001, Khodorkovsky and the other members of the organized group concentrated a huge amount of wealth in Russia and in foreign companies under their control. Because of the criminal nature of the accumulated capital and the intent to continue increasing that capital, the group changed the system of petroleum misappropriation and money laundering. As a result, they organized a new system of moving oil and petroleum products via companies registered in the regions that gave them tax breaks. For this purpose, the executives of the companies, controlled by the organized group, drew up appropriate agency agreements, purchase and sale agreements, commissions, and other

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118. Regions such as Evenkia and Mordovia.
documents needed for the purchase and sale between oil and petroleum products companies.\textsuperscript{119} The key principles of the system, according to the prosecutors, were, “false” publicity gained through the scheme of forced changeability:

With the aim of concealing the bogus nature of the said companies from the tax and other regulatory authorities, the plan worked out by Khodorkovsi and the other members of the organised group to misappropriate other people's wealth entrusted to them made provision for the periodic renewal of the artificial systems of sales of petroleum and petroleum products, i.e. the regular replacement in these systems of just the dummy organisations—the petroleum raiders—which were engaged in the resale of petroleum and petroleum products to other organisations, including newly founded ones.\textsuperscript{120}

The investigators say that between 2001 and 2003 Khodorkovsky and the other members of the organized group misappropriated 202,214,394 tons of petroleum from the main Yukos production subsidiaries, with a total value of 27 billion U.S. dollars.\textsuperscript{121}

B. Creation of the Off-Shore Network of Shell (dummy) Companies

The Summary of Charges provides that, for the purpose of legalizing the misappropriated petroleum, Khodorkovsky acquired dummy companies abroad and through them created a network of foreign sales organizations for oil and petroleum products based on the following pattern: Yukos (or a dummy company registered in Russia in a preferential tax assessment zone) sold oil and petroleum products to a controlled foreign company registered in Switzerland, which resold them to a controlled foreign company registered offshore, which in turn, resold them to an actual buyer at a foreign petroleum-processing plant.\textsuperscript{122} According to the Summary of the Charges,

\textsuperscript{119} See The Summary of the Charges, supra note 15.
\textsuperscript{120} See The Summary of the Charges, supra note 15.
\textsuperscript{121} See The Summary of the Charges, supra note 15.
The objective of Khodorkovski, Lebedev and the other members of the organised group was to mislead the regulatory authorities and foreign businessmen by including in the network a foreign company controlled by them and registered in Switzerland, which was enough to impart an image of reliability and trustworthiness to OAO NK YUKOS operations involving the export of petroleum and petroleum products.123

Almost all major Russian companies use the same tax optimization schemes. These schemes have never been a secret and have been addressed by several pieces of research commenting on Russian corporate governance problems.124 All Russian oil and gas corporations have networks of off-shore companies that reside primarily in the same jurisdictions as Yukos.125 It is only in the case of Yukos that the creation of several off-shore companies has been recognized as a constituent part of the criminal offence. The information about the core off-shore companies that were directly controlled by Yukos had been publicly disclosed according to the regulations of the Federal Securities and Exchange Commission. Prosecutors and the courts that considered the Yukos-related cases have not given any consideration at all to the public disclosures.126

123. The Summary of the Charges, supra note 15.
124. See generally Alexei Goriaev & Konstantin Sonon, Is Political Risk Company-Specific? The Market Side of the Yukos Affair (2005); Sergei Guriev et al, Moscow: NES-CEFIR-IET, Corporate Governance in Russian Industry (2003); Iji, supra note 1. On the problem of Sibneft and TNK-BP’s tax optimization schemes, see “Nalogosberge-
125. As an example, see the structure of Alfa Group, Konsortsium Al’fa-Grupp [Consortium Alfa-Group], http://www.alfagroup.ru/276/about.aspx.
C. Using the Auditor’s Opinion as a Shelter

According to the prosecutors, Khodorkovsky and his allies undertook several steps to conceal the illegal character of the shell companies network:

... Khodorkovsky and the members of the organised group declared the balances of these dummy companies, which they nominally referred to as operational companies, side by side with the balances of their subsidiary petroleum-extracting and petroleum-processing plants when presenting their financial statements to the international auditors. Through this deception

they convinced everybody that the dummy companies were all within the sphere of influence of OAO NK YUKOS.\textsuperscript{128}

Prosecutors argue that the auditor’s opinion allowed the criminal scheme to continue. Because the auditor provided a false opinion of no infringement with regards to the sale of petroleum products, members of the organized group continued to use a major portion of the sales funds for their personal enrichment. Only a fraction of the funds was paid to the production companies engaged in the petroleum extraction and processing.\textsuperscript{129} However, the Summary of Charges contains no evidence that the funds accumulated on the balance of the corporate group as a consolidated company were used illegally or were in violation of the appropriate corporate procedures. The absence of any significant violations has been confirmed by the consolidated accounts audits conducted by PwC since the beginning of 1997.\textsuperscript{130} Nevertheless, the charges are based on the assumption that the consolidated accounts of the Company are simply a method of concealing the embezzled and laundered funds. PwC’s opinion is considered as a tool for such concealment.\textsuperscript{131}

The role of PwC in the collapse of Yukos and the auditor’s alleged involvement in the Yukos schemes had not been assessed in any way until the Russian Ministry of Tax and Levies filed an unprecedented application with the Moscow Arbitration Court. The filing claimed that PwC’s managers and employees had actual knowledge and directly facilitated in Yukos’s fraudulent tax schemes.\textsuperscript{132} The Moscow court sided with accusations from Moscow city tax officials, who claimed that PwC had aided Yukos in perpetrating tax evasion by covering up the com-

\textsuperscript{128.} See The Summary of the Charges, supra note 15.
\textsuperscript{129.} See The Summary of the Charges, supra note 15.
\textsuperscript{131.} The position of the investigators generally complies with paragraph seven of the Resolution of the Supreme Court of the Russian Federation’s Plenary Session on 28 December 2004, which provides that people who facilitate tax crimes by providing intellectual assistance in the form of advice are criminally liable as accomplices of the offence. Postanovlenie Plenuma Verkhovnogo Suda RF ot 28 Dekabria 2006 G. N. 64: “O Praktike Primenenii Sudami Ugolovnogo Zakonodatel’stva ob Otvetstvennosti za Nalogovye Prestupleniya,” \textsuperscript{7} [The Resolution of the Supreme Court of the Russian Federation’s Plenary Session on Dec. 28 2006 No. 64: “On the Court Policy for the Application of Criminal Law in Tax Crimes,” \textsuperscript{7}] (on file with author).
pany's tax shelter schemes and drawing up two different audit reports in more than three years.\textsuperscript{133} Accordingly, the court found that the audit agreements between Yukos and PwC Audit for the years 2002–2004 were invalid because they constituted illegal and unethical deals under the Civil Code of the Russian Federation. The court awarded the government 16.8 million rubles ($480,000) in restitution.\textsuperscript{134}

This case is the first and only time when a company such as PwC was recognized as an accomplice and facilitator of the Yukos schemes.\textsuperscript{135} PwC, however, had used the same formula to describe the tax risk for all its large clients in the Russian oil sector. The formula can be seen from the table below.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{133} The court case revealed that the firm had compiled two sets of accounts—one for internal use, that warned of illegal actions taken by Yukos; and another for shareholders. See \textit{Tax Inspection N5}, A40-77631/06-88-185 (on file with the author).
\end{itemize}
\end{footnotesize}
FIGURE VII
YUKOS AND TNK-BP US GAAP TAX RISK NOTES FOR 2002

<table>
<thead>
<tr>
<th></th>
<th>Yukos</th>
<th>TNK International Limited&lt;sup&gt;36&lt;/sup&gt;</th>
</tr>
</thead>
</table>

Russian tax legislation is subject to varying interpretations and periodic changes, which may be retroactive. Further, the interpretation of tax legislation by tax authorities as applied to the transactions and activities of the Company may not coincide with that of management. As a result, certain transactions may be challenged by tax authorities and the Company may be assessed additional taxes, penalties and interest. Consolidated tax returns are not required under existing Russian tax legislation and tax audits are performed on an individual entity basis only. Tax periods remain open to review by the tax authorities for three years.<sup>36</sup>

Facing a significant threat of losing its Russian business and criminal charges against several key employees, PwC finally decided to withdraw all of its Yukos audit reports.<sup>139</sup> The auditor said that it had withdrawn Yukos’s audits from 1996 to 2004 because of the discovery of


137. YUKOS 2002, supra note 130, at 25 (emphasis added).


new information that could have influenced those reports had it come to light earlier. The firm said in a letter that was published on the firm’s Russian website that “PwC now believes that information and representations which were provided to PwC by Yukos’s former management may not have been accurate.” The letter, sent on June 15 to Yukos’s liquidator, stated that PwC believes the Yukos management lied by declaring that its main trading structures, Baltic Petroleum, South Petroleum, and Behles, were not affiliated with the company. The letter also provided three additional reasons for the unprecedented withdrawal: (1) The Yukos management failed to provide enough information on whether Russian entities later used by Yukos were in arm’s-length transactions with Yukos; (2) The management also failed to disclose information on “significant payments” the company made to entities owned by the shareholders of Menatep Bank, which collapsed during the August 1998 financial crisis; and (3) The management failed to inform the auditor about payments made by the Menatep Group to several Yukos managers. The reasons given by PwC correspond exactly with the charges recently brought against Mikhail Khodorkovsky and his allies.

Russian legislation and judicial doctrines during 1993–2003 have undergone more substantial changes than, for example, British legislation and case law have over the past two centuries. These substantial changes enable any auditor to find numerous omissions and inaccuracies in the data disclosed and repeat PwC’s tactics. PwC’s withdrawal decision has also been recognized by several experts as being driven completely by political motivations. Thus the withdrawal decision is likely to affect the Yukos case by, on the one hand, eliminating one of the

most powerful arguments of the defense and, on the other hand, providing the defense with more evidence of politically motivated influence.145

The PwC story is far from an end. Both parties will appeal to the Supreme Arbitration Court, whose final ruling will set the precedent for auditors’ liability in Russia.146

D. Accumulation of Profit on the Foreign Accounts

The key element of the charges is that, by organizing the Swiss company’s sales of oil and petroleum products to the shell offshore company, the organized group accumulated part of the money laundered through the sale of misappropriated petroleum in their off-shore bank accounts. This accumulation of funds in the off-shore bank accounts in turn reduced the tax burden on the Company’s profits obtained via illegal operations. The prosecutors claim that Khodorkovsky and the other members of the organized group transferred funds from the bank accounts of the “trading” shell companies to the bank accounts of the other “financial” shell companies controlled by them. Subsequently, the organized group manipulated these funds for its own interests.147

A number of Russian companies employed offshore schemes and fund-accumulation techniques.148 Moreover, structuring the corporate


146. PwC was “tried” under Article 169 of the Civil Code—citing “violation of the fundamental principles of law and order and morality.” However, the international auditor found an influential Russian backer in Anton Ivanov, the chairman of Russia’s Supreme Arbitration Court. “Market participants should be assured that there are basic principles which ought not to be violated. If we apply Article 169 of the Civil Code without grounds, belief in the stability of [business] contracts will be undermined,” said Ivanov in a statement which appeared in the media just a day before the Moscow Arbitration Court heard the case against PwC. Experts and print media were quick to recognize in the statement an early, hidden hint to the court regarding the PwC case’s outcome. Yelena Komarova, PwC Appeal Likely to Be Sustained at Top Level, MOSCOW NEWS WEEKLY, April 13, 2007, http://www.mnweekly.ru/business/20070413/55150034.html.

147. The Summary of the Charges, supra note 15.

group cash flow through offshore treasury companies is an internationally recognized business practice. The prosecutors’ approach to business practice erodes the line between legal business operations and illegal business practices, putting political prosecution issues on the agenda.

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

The prosecutors also charged that Khodorkovsky had redistributed the share capital of the Menatep Group under the guise of official dividend payments. The payments were made to the several members of the organized group for the purpose of concealing their “remuneration” for the crimes committed. The investigation claims that the payments had the purpose of making the members of the organized group partners and owners of shares in Yukos and other companies where the legalized funds were kept. These allegations imply that any redistribution of shares in a holding company could be taken as concealment of illegal operations inside the group.

F. Laundering Operations

In the Summary of Charges, the prosecutors have separately enumerated several laundering operations allegedly conducted by the members of the organized group. The operations generally complied with the publicly known business activities of the Company and its core shareholder the Menatep Group. The bulk of these activities was respectively disclosed in the quarterly and annual audits of the company accounts. The list of “laundering” operations includes the following:


150. The Summary of the Charges, supra note 15.

151. See The Summary of the Charges, supra note 15.
FIGURE VIII
THE TABLE OF THE MONEY LAUNDERING CHARGES
AND BUSINESS OPERATIONS COMPARISON

<table>
<thead>
<tr>
<th>The Summary of Charges</th>
<th>The Business Substance of Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cancellation of the Menatep Bank's creditor indebtedness to foreign banks, restructured on Yukos, the money from which (credit) was used by Khodorkovsky to acquire shares of Yukos through the Menatep Group.</td>
<td>In 1998 the Russian ruble collapsed, taking Bank Menatep with it. Its banking license was revoked and a 32 percent holding in Yukos, pledged on security of $233 million, was taken into possession by three banks: the Standard Bank of South Africa, the Japanese Daiwa Bank and Germany’s Standard Bank. According to the Moscow News, “Khodorkovsky urged the banks to accept a three-year repayment plan that would be secured by oil exports rather than shares in Yukos, but the banks refused, taking control of their shares in Yukos. Soon afterwards, they dumped their shares, recovering only about half of their loan.” Subsequent to Bank MENATEP’s bankruptcy in 1999 and continuing into 2000, Yukos entered into a series of transactions, in which it acquired the rights to collect from Bank MENATEP from third party assignors. Through this procedure the indebtedness of the Banks was restructured and Yukos’s shares were bought back. Similar restructuring schemes were used by other Russian business groups. The transaction was fully disclosed in the Annual Report for the Year 2000 (Note 8). This voluntary buy-out scheme was quite evidently aimed at mitigation of the adverse effects incurred by the Bank MENATEP’s clients and had primarily a reputational goal.</td>
</tr>
</tbody>
</table>

153. SALTER, supra note 7, at 6.
155. YUKOS OIL CO., supra note 103, at 45.
157. YUKOS OIL CO., supra note 103, at 45.
TheSummary of Charges

The acquisition of different types of securities has always been regarded as a conventional treasury and investment operation of any corporate group, which needs to invest the temporary available funds.\(^6\) For comparison annual reports of any big Russian oil company could be taken. TNK–BP Limited Consolidated Financial Statements for 2004 provide that as of December 31, 2004 and 2003 the Group had approximately USD 700 million of Eurobonds issued and outstanding.\(^1\)

The performance of various financial exchange operations to a total amount of more than 264 billion rubles, and the laundering of this money in the bank accounts of Russian and offshore company networks. The transferring of funds of offshore "shell" companies, disguised as dividends, to a sum of more than 4.2 billion U.S. dollars, into the bank accounts.

The Business Substance of Operations

The main argument against this claim is that all operations, enlisted in the Summary of Charges, were simply transfers of funds inside a corporate group, without which it cannot function as a group.\(^6\) The funds remained properly reflected in the Consolidated Financial Statements of the Group, and all the operations with them were conducted in accordance with the centralized financial policy and relevant internal regulations. The legitimacy of intra-group transfers is recognized internationally and subject to the anti-avoidance rules.\(^6\)

For example, the Rosneft Consolidated Financial Statements for the years 2003, 2004, 2005 provide: "...the guarantee obligations of OJSC Yuganskneftegaz with respect to the loan described above have become intercompany in nature."\(^6\)

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158. Yukos Oil Co., supra note 103, at 43; Yukos 2001, supra note 130, at 6-8.
The analysis of the Summary of Charges provides some surprising results. Yukos as a corporate group has generally complied not only with international business practice, but also with the practices of comparable Russian companies. The language of the Summary does not show any corporate restructuring transactions or business operations that cannot be found in the accounts and reports of other Russian oil giants. The only assumption that may be still used by the prosecutors is that the transfer pricing schemes used by Yukos were so blatant that they may qualify as embezzlement.

<table>
<thead>
<tr>
<th>The Summary of Charges</th>
<th>The Business Substance of Operations</th>
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<tr>
<td>Transferring funds amounting to 2.8 billion U.S. dollars as credits from the offshore</td>
<td>The prosecutors aim to represent the treasury operations, i.e. intra-</td>
</tr>
<tr>
<td>&quot;shell&quot; companies to Yukos and its subsidiaries.</td>
<td>company loans common for any corporate group, as illegal activities. (*)</td>
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VI. TRANSFER PRICING ISSUES IN THE KHODORKOVSKY/YUKOS CASE

For the “Second Case,” the prosecutors chose the model of the predicate offense, which has never been used in the recent history of Russian criminal justice. According to the prosecutors, every sale of crude from Yukos’s production companies to the shell trading companies that was priced below market should be deemed as a predicate offence for the further acts of laundering. Therefore, the prosecutor argued, the transfer-pricing sales represent acts of embezzlement. As all operations had been conducted under the alleged control of Khodorkovsky and the other members of the organized criminal group, the following operations with oil and funds represent a continuous series of money laundering acts.

Initially, the investigators wanted to make their case against Yukos by arguing that the production companies had overproduced oil. (*) The

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164. The Summary of the Charges, supra note 15.

The Yukos Money Laundering Case

offense of over-production, according to Russian criminal case law, could qualify as illegal entrepreneurship that can be deemed a predicate offence for further money laundering operations. However, the investigators have declined to prosecute under this theory, as acts of illegal entrepreneurship do not amount to a serious criminal offence in Russia, and the prosecutors have obviously found them not completely suitable for such a significant criminal case. As Russian criminal law contains tax crime exception provisions with respect to money laundering offenses, the Summary of the Charges does not mention tax evasion issues, describing the schemes used for the alleged corporate tax evasion as schemes designed and used for money laundering.  

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

According to conventional understanding, “[t]ransfer pricing enables a parent company to concentrate profits, to funnel profits to foreign subsidiaries, to transfer profits to subsidiaries located in well-established tax havens, or to simply evade taxes.” The arguments of the prosecutors

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167. See Ugolovniy Kodeks RF [Criminal Code] art. 171 (Russ.). See also Guev, supra note 166, at art. 171.

168. See Ugolovniy Kodeks RF [Criminal Code] art. 174 (Russ.); The Summary of the Charges, supra note 166, at art. 171.

169. See Peter Alldridge & Ann Mumford, Tax Evasion and the Proceeds of Crime Act 2002, 25 LEGAL STUD. 353, 361 (2005) (footnote omitted) (“The reasons are not difficult to guess. Schemes to avoid tax frequently depend upon complex routings of deals without apparent commercial rationale. Money movements under a tax avoidance scheme make money movements that are laundering the profits of crime less easy to detect. If the law of taxation could be altered in such a way as to discourage ‘artificial’ avoidance schemes then the laundering disposals would no longer sit amidst their camouflage. This can be used as an argument for general anti-avoidance rules.”) (emphasis in original).

170. Toshihiko Shiobara, Oversights in Russia’s Corporate Governance: The Case of the Oil and Gas Industry, in DEPENDENT ON OIL AND GAS: RUSSIA’S INTEGRATION INTO THE WORLD ECONOMY 85, 93 (Shinichiro Tabata ed., 2006).
with regards to the Yukos tax schemes are based on the following assumptions:

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

The agreements regarding the purchase and sale of petroleum were bogus because they contained the false information that OAO NK YUKOS was a purchaser of petroleum, whereas Khodorkovski, Lebedev and their friends were perfectly well aware that OAO NK YUKOS was not in fact a purchaser of petroleum, and that the products of the petroleum-extracting companies were shipped directly and independently to Russian and foreign customers.\textsuperscript{171}

2) The price of oil and petroleum products was not at market price and was determined by the members of the organized group. It represented only the cost of extracting the raw material and was on average 2–4 times lower than the market price.\textsuperscript{172}

3) The third argument was not expressly reflected in the Summary of the Charges, but it is seen from the Arbitration Court decisions on the Yukos tax claims and concerns the public auctions\textsuperscript{173} that were conducted by the company’s production subsidiaries for the oil produced. The auctions have been declared sham, since they concealed the true nature of the transaction, which was the sale of the crude to the Yukos’ shell trading companies for tax evasion purposes.\textsuperscript{174}

Combining the above arguments with the arguments concerning Khodorkovsky’s ultimate managerial position in the Yukos Corporate Group, the prosecutors came to the conclusion that the organized criminal group headed by Khodorkovsky had committed embezzlement of the oil and funds of the company’s production subsidiaries.

Two important preliminary remarks regarding structure of trading operations of Russian holding companies have to be made, since the state of the trading operations, from their creation and up until 2003, has been complicated and confusing. The first deals with the structure of Russian holding companies as business (corporate) groups functioning in

\textsuperscript{171} See The Summary of the Charges, supra note 15.

\textsuperscript{172} See The Summary of the Charges, supra note 15.

\textsuperscript{173} See infra Figure V.

\textsuperscript{174} See Interregional Tax Inspection N1, A40-61058/04-141-1510.
the transition period. The second concerns the problem of transfer pricing, the application of the “arms length” principle, and related problems of taxation, which appear to have been critical to the relationships between the emerging business groups and the state.

The corporate structures of Russian holding companies (legally termed “vertically integrated companies”) were created in the course of privatization during 1990s. These structures predetermined the design of intra-holding and external trading schemes. Almost all Russian holdings companies were incorporated as vertical corporate groups, in which the head holding company quite commonly owned 50%+1 of the ordinary voting shares.175 There were accordingly a large number of minority shareholders in the subsidiaries who quite rightly demanded dividends from the production companies where they held stock.176 The shareholders’ demand for stock dividends strongly contradicted the very idea that “virtually integrated holding companies” had to be profitable as consolidated corporate groups.177 Until 2006, there were no mechanisms for the compulsory buyout of minority stock, and the lack of these mechanisms put newly established corporate groups in an ambiguous position, where, on the one hand, they did not want to pay shareholders (or potential blackmailers) who tried to enforce their rights, and, on the other hand, they had no legal means for the effective compulsory consolidation of the minority stock at the level of the head company.178

The second observation of the trading operations of Russian holding companies is the manner in which the transfer-pricing scheme was usually realized. Large-scale oil companies first sold the oil obtained from their subsidiary oil producing companies to their affiliated companies, which were registered in domestic offshore or preferential tax zones. The sales were usually one-half to one-third lower than the international price. The affiliated companies then sold the oil to their subsidiary refineries at two-thirds the international prices. Therefore, most profits

175. Black et. al., supra note 2, at 1750–52 (discussing head holding companies’ absolute powers and how minority shareholders can have dividends taken away); Iji, supra note 1, at 9; Sprenger, supra note 4, at 11–14. For a general description of Russian legislation on holding companies, see IRENA SHITKINA, HOLDING COMPANIES: LEGAL AND CORPORATE GOVERNANCE ISSUES 132–238 (2006).
177. DMITRY GOLOLOBOV, COMPANY V. SHAREHOLDER: GREENMAIL RESISTANCE STRATEGIES 20–21 (2nd ed. 2004).
accumulated in the affiliated companies were registered in domestic off-shore or preferential tax zones.  

Transfer pricing rules were first introduced in Russia in 1999. Since then the concept of an arm’s length transaction has remained relatively unchanged. The Russian transfer pricing rules are mainly contained in Articles 20 (“related parties”) and 40 (“principles of determining prices of goods [work, services] for tax purposes”) of the Russian Tax Code. The Code provides the Ministry of Tax and Levies with a mechanism known internationally as price adjustment. The Russian Tax Code codifies an arm’s length method as the basis for determining corporate income. Although these provisions were introduced together with the First Part of the Tax Code, a lack of judicial practice, the weakness of the general tax administration, and general problems in the Russian Federation’s economic system gave birth to a confusing system of statutory willful blindness where big corporations paid taxes not on the basis of the Tax Code, but in accordance with special agreements with the Ministry of Tax and Levies. The government in turn closed its eyes to the universal application of questionable tax optimization schemes.

The weaknesses in the transfer-pricing legal framework played a huge role in the Yukos tax case. Instead of adjusting the intra-group resale prices used, the tax authorities were forced to apply and further

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179. See Shiobara, supra note 170, at 93.


182. Article 40 of the Tax Code of the Russian Federation prescribes some cases in which the tax authorities have the right to control prices used in transactions. According to clause 1, Article 40, the prices for taxes are applicable to the prices of goods, works, and services, specified by transaction parties, supposing these prices correspond to the level of market prices. In order to monitor whether this premise is fulfilled, the tax authorities are given the right to check the legitimacy of transaction prices only in the following circumstances: (1) transactions between “interdependent” persons; (2) good exchange (barter) transactions; (3) foreign trade transactions; and, (4) transactions where the level of prices used by the taxpayer for identical goods fluctuates by more than 20 percent in either direction over a relatively short period of time. Nalogovyi Kodeks [NK] [Tax Code] art. 40(1)-(2) (Russ.).

183. Nadia Havard, Comparative Analysis of Tax Incentives Provided by the United States, the United Kingdom, and Russia to Domestic and Foreign Businesses, 67 ALBANY L. REV. 1159, 1167 (2004).


185. The prospective legislative developments will drastically change the previous guidelines and bring them more in line with OECD standards. See generally Vasutin & Kosheleva, supra note 180.
develop a "bad-faith taxpayer" concept to penalize the company for tax evasions. Some commentators have made attempts to justify the application of the unprecedented concept in the Yukos case:

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

However, an analysis of existing Russian case law shows that the only legal basis for challenging the transfer pricing schemes would be for the tax authorities to challenge the pricing in the agreements between

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

1) the terms of transactions are not the most beneficial for a taxpayer;
2) accounting for transactions does not reflect their economic substance;
3) the alienation of assets and subsequent acquisition of rights to those assets.
4) transactions between related parties in connection with loans and the sale of goods, work or services with the subsequent offset of mutual liabilities, causing a decrease in tax accruals;
5) a taxpayer conducts and accounts for only those operations which are directly concerned with obtaining tax benefits, if the type of activity involved requires that other operations be conducted as well.

187. See Clateman, supra note 114, at 1–16.
the Yukos production companies and to adjust the price paid by the shell trading companies upward to market rates.\textsuperscript{188} This would result in a recomputation of the production subsidiary's taxes as if it had received market price for its products. Under this theory, the tax claims would have to be brought against the various Yukos production subsidiaries that sold products at below-market prices, and not against Yukos.\textsuperscript{189} Therefore, all the taxes of the corporate group imputed to Yukos should have been respectively recalculated. However, the complexity and unpredictable results of this method (the complete recalculation might not have given a figure sufficient for the forceful sale of the Yukos assets) excluded it from the agenda of the Russian authorities.

Russian corporate law generally demands the same arms length approach to transactions as Western and international corporate law do.\textsuperscript{190} The special procedure of approving the related parties and major transactions must be respectfully applied to all the transactions inside the corporate groups.\textsuperscript{191}

Due to the peculiarities of the Russian oil trading system, the application of the fair market price rule faced significant problems. As the export capacity of the Russian oil companies was restricted by the physical pumping capacity of the export pipeline that belongs to the state-controlled company “Transneft,” the oil companies were allowed to sell approximately one third of the produced crude to overseas consumers.\textsuperscript{192} The rest of the oil had to be sold within the internal market or refined and sold as products.\textsuperscript{193} Therefore, there was the world fair market price, fixed by the international rating agencies for overseas sales, and the internal fair market price for domestic sales.\textsuperscript{194} The internal market price did not actually exist as there was no public exchange for oil contracts, and the bulk of the oil was refined.

\begin{itemize}
  \item \textsuperscript{188} See Pepeliaev et al., supra note 111.
  \item \textsuperscript{189} See Clateman, supra note 114.
  \item \textsuperscript{190} See, e.g., Shitkina, supra note 175, at 351–54; Roswell B. Perkins, The FCSM Corporate Governance Code for Russian Companies, 16 Transnat’l. Law 75, 99-100 (2002–2003).
  \item \textsuperscript{191} The Federal Law on Joint Stock Companies, supra note 104, at arts. 78–79, 81–84.
  \item \textsuperscript{193} See Robert Corzine & John Thornhill, Oil Price Collapse Threatens Russian Economy, Fin. Times, March 19, 1998, at WORLD NEWS-EUROPE 2; Carl Mortished, Crude Oil Falls as Russia Lifts Export Curbs, The Times, May 18, 2002.
  \item \textsuperscript{194} See Shiobara, supra note 170, at 96 (“In [sic] case of Yukos, the free sale price of its subsidiary mining companies exceeded five times the transfer price of their affiliated refineries.”).
\end{itemize}
The lack of an internal market price could easily be explained by political factors: the internal price of oil was deemed a core macroeconomic factor that determined the domestic prices of other goods. If the price had not been indirectly controlled by statute, the country would have faced a tremendous shock from rising prices. Therefore, the artificial absence of an internal market price should be understood as state policy, which, of course, suppressed the internal market of oil and encouraged the application of the transfer pricing schemes.

Both tax and corporate problems made application of the intra-group tax and cash flow optimization schemes in 1996–2003 completely prevalent in the Russian Federation. The line between optimization, avoidance and evasion was unclear. The lack of clarity made the application of the transfer pricing schemes, based on the complete disregard for substance over form, a must for all big corporate groups.

One of the reasons why transfer pricing schemes have become less popular, apart from the consequences of the “Yukos Affair,” is that amendments have been made to the tax laws. The sales of mining minerals were targets of taxation until the introduction of the mining tax on mineral resources at the beginning of 2002. The mining tax integrates a user fee on underground resources, a deduction for reproducing minerals and resource bases, and excise taxes on oil and gas. The transfer pricing methods could deduct 16 percent off 24 percent of the profit tax in 2003. Shiobara points out that “the incentive to underestimate sales has also faded, because in 2002 the rate on taxable profit was reduced.”

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

Having reviewed the situation in Russia, it makes sense to take a brief look at existing international practice, which considers transfer pricing within the related groups of a corporation—one of the greatest

197. See Shiobara, supra note 170, at 97.
198. See Shiobara, supra note 170, at 93.
199. In addition, since 2004, regional preferential privileges concerned with the profit tax have been restricted within 4 percent points of 24 percent. See Shiobara, supra note 170, at 97.
problems in international tax law.\textsuperscript{200} It is widely recognised that the arm’s length principle, as embodied in the model tax treaties and OECD Guidelines, is “... almost universally accepted throughout the world.”\textsuperscript{201} This principle permits national tax authorities to adjust the accounts of enterprises under common control, if the tax authorities consider that “conditions are made or imposed between the two enterprises in their commercial or financial relations, which differ from those which would be made between independent enterprises” in order to reallocate profit which would have accrued but for those conditions.\textsuperscript{202}

By incorporating the separate entity concept, the arm’s length principle places related and unrelated enterprises on an equal footing for tax purposes, thereby theoretically “avoiding the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity.”\textsuperscript{203} In practice, however, transfer pricing disputes have “entailed negotiation and bargaining over the ‘fair’ profit allocation. . . . Both officials and business representatives have continually tended to reject the possibility of developing explicit criteria for profit allocation, and have preferred to focus on price adjustments.”\textsuperscript{204}

The experience of tax authorities reveals the difficulty of allocating profit by means of price adjustments. The British HM Revenue and Customs, which strongly advocated the separate accounting approach, uses negotiation to agree to a reasonable basis for pricing.\textsuperscript{205} U.S. transfer pricing is based on the arm’s length standard and implies the separate entity concept.\textsuperscript{206} It is recognized that “the U.S. rules against transfer-


\textsuperscript{204} Picciotto, supra note 202, at 398.

\textsuperscript{205} Picciotto, supra note 202, at 398.

\textsuperscript{206} There are three traditional specified transactional methods set forth in the U.S. transfer pricing regulations: comparable uncontrolled price (CUP) (or, in the case of intangibles transfers, comparable uncontrolled transaction (CUT)), cost-plus, and resale price. The CUP method uses prices in comparable transactions between or with unrelated third parties.
pricing are inconsistent with modern business models, which organize by process rather than by function.\textsuperscript{207} In contrast with the U.K. approach, in the United States the procedures have become increasingly juridified\textsuperscript{208} since the politicization of the problem in the 1960s.\textsuperscript{209} Approved in 1968, the regulations on transfer pricing defined five categories of transaction (loans, services, leasing, intangibles, and tangibles), and specified rules for determining prices for each.\textsuperscript{210} In addition, "for each of the five categories of transactions the primary test of price should be the 'comparable uncontrolled price' (CUP), which is the price that would have been charged by uncontrolled parties dealing at arm's length."\textsuperscript{211} Regardless of the sophisticated legislative efforts, the problem of transfer pricing remains problematic in the United States.\textsuperscript{212} Proposals have been raised to use criminal legislation for ensuring effective enforcement.\textsuperscript{213}

In sum, although the existing international practice shows the importance and actual incontestability of the arm's length principle, the legislative and political history in the United Kingdom and the United States rules against transfer pricing clearly demonstrate that the rules need a comprehensive and balanced approach that will inevitably include element of negotiation between a taxpayer and the tax authorities. The Yukos case does not set up an example of such approach.

Regardless of the legal, economic, and political arguments justifying either the application of the Yukos transfer pricing schemes, or declaring

\begin{thebibliography}{9}
\bibitem{207} Ackerman & Chorvat, supra note 201, at 637.
\bibitem{208} See Picciotto, supra note 202, at 403 (The procedure "also initiated by the US authorities and on which considerable stress is being placed, is for 'advanced pricing agreement' (APAs). This allows, at the taxpayer's initiative, the negotiation of an agreed transfer pricing method which the tax authorities would accept, and which might remain valid, providing there is no change in the key parameters identified in the agreement, for several years. Since the procedure requires the same effort and level of disclosure as a contested audit, it is likely to be initiated only by firms at high risk of tax scrutiny. However, political pressure has led to a much more active programme of examination of TNCs, especially of foreign firms entering the US market which are popularly suspected of not playing fair.").
\bibitem{210} Id. at 52-58.
\bibitem{211} Picciotto, supra note 202, at 399.
\bibitem{212} See Durst & Culbertson, supra note 209, at 134-35; Steven Harris & Paul B. Burns, Transfer Pricing in the Post-Enron World, 13 Int'l Tax Rev. 30, 30-31 (2002).
\end{thebibliography}
them an essential element of blatant tax evasion, qualification of these
schemes as a form of embezzlement raises significant questions. Russian
legislation and case law consider embezzlement as an act of personal
misappropriation or transfer to a third person without any compensation
of the assets that have been entrusted to the offender. The assets may
also be under his control due to other legitimate reasons (agreement, or-
der, etc.) and he could exercise the rights of possession, management,
or delivery of these assets. The replacement of assets for less valuable ones
shall also be considered as embezzlement. According to commentators,
the corpus delicti in the offense of embezzlement should involve the fol-
lowing characteristics:

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

2) The offender has a legal right to alienate the assets to himself
or transfer assets to a third party.

Therefore, this legislative and case law approach in application of
the Khodorkovsky/Yukos case raises two important questions. The first
is whether a chief executive officer, a “shadow director,” or an actual
controlling person of a managing company can be considered as a “con-
trolling person” as defined by Article 160 of the Russian Criminal Code
and Russian Case Law. Taking into consideration the language of the
Summary of the Charges, the position of commentators, and the judg-
ments in the First Khodorkovsky case, this question could well be

214. Embezzlement by means of the large-scale misappropriation. The Summary of the
Charges, supra note 15.

Cudebenoi Prakthe po Delam o Khshcheniakh Gosudarstvennogo i Obshchestvennyh
Imushchestva” [The Resolution of the Supreme Court Plenum of the U.S.S.R. on July 11,
1972 No. 4: “On the Court Policy on the embezzlement of governmental and public property”

216. DUYN EV ETAL., supra note 166, at art. 160.

217. Guev, supra note 166, at art. 160; V.M. Zhukov & E.N. Renov, Vlast i Biznes:
Vzaimnaia Otvetstvennost’—Kommentarii k Zakonodatel’stvu [Law and Business:
Mutual Responsibilities—Comments to the Legislation] art. 160 (2004); V.D. Larichev
& D.V. Kudriavtsev, Osobennosti Prestuplenii, Soveshchaemykh Prkovoditeliam Bankov,
Advokat, Mart 2005 G [Characteristics of the Offenses Committed by Chief Bank Officers,
Advocat, Mar. 2005], at 2–3 (on file with author); Valerii Belik, Za Chto Finansovogo Direk-
tora Mogut Privilech’ k Ugodlovnoi Otvetstvennosti, FINANSOVYI DIREKTOR No. 7–8, Tiul’-
Avgusti 2006 [What Criminal Responsibilities Can They Call Financial Directors into Ac-

218. That time he was sentenced for “embezzlement of other people’s property entrusted
to the guilty party in large scale” regarding the Apatit trading scheme. Judgment, supra note
35, at 14. However, later, the Moscow City Court stated in its cassation decision that “the
The Yukos Money Laundering Case

answered in the affirmative. However, this decision will set a precedent for other Russian corporate groups and may urge them to make their management structures more complex and opaque.

The second question is more important as potentially having a significant impact on all the Russian business (corporate) groups. It can be formulated as follows: Can transfer pricing transactions that are conducted for the benefit of a parent company be considered as damaging for a subsidiary that is fully owned by the parent?

This question is rather complicated, since in Russian case law the responsibility of the parent company for the damages caused to its fully owned subsidiary as a member of a multi-level corporate group is not clear. Nevertheless, Article 71 of the Law on Joint Stock Companies points out that either an individual manager or a managing company owes the same general fiduciary duties of loyalty and care to the company they manage as they owe under U.K. and U.S. law. Article 6 of the Law also fixes the responsibility of the parent company whose instructions have led to the insolvency of its subsidiary. The U.S. law would give a similar answer to this question by using “separate entity,” “limited liability,” and “piercing veil” doctrines.

Concluding the part on the Yukos transfer-pricing problem, it is important to stress that all Russian oil companies used different transfer

apatit concentrate has not been entrusted to Khodorkovsky and Lebedev.” Lebedev’s Legal Team Supervisory appeal to the Presidium of the Moscow City Court of December 26, 2005, available at http://www.platonlebedev.ru/docs/default.asp?sid=2&mid=1478&open=1#doc. This decision may create certain problems for the second case, but it is evident that this inconvenience precedent can be easily overruled.

219. In the “Apatit episode” in the First Case the court used the formula “Mr. M. B. Khodorkovsky, Mr. P. L. Lebedev acting as members of the organized group fraudulently misappropriated shares in OAO ‘Apatit’ and, holding the major equity of the above company, acquired the right to strategic and day to day management thereof by electing their subordinates to the leading positions with DAO ‘Apatit,’ i.e. the Board of Directors and Director General.” Taking into consideration the language, used in the Summary of the Chargers, the similar approach will be used in the second “Khodorkovsky case.” Judgment, supra note 35, at 14. See also infra Figure IV on the managing position of Khodorkovsky.

220. See Shitkina, supra note 175, at 328, 412.

221. See The Federal Law on Joint Stock Companies, supra note 104, at art. 74. See also E. Makeeva, Pravovye Kollizii Bnutri Kholdinga [Legal Collisions Inside Holding Companies], Konsul’tant No. 5, (Mar. 2005); Perkins, supra note 190, at 96–97.


223. Shitkina, supra note 175, at 316–329.

pricing schemes which varied in the level of prices, types of shell companies, etc. The new precedent, which is likely to be set in the new Khodorkovsky/Yukos case, is sure to create a new legal threat for all Russian production majors that will last at least for seven years. The new precedent could also be used as an effective tool in a new wave of politically motivated redistribution of big property and industry in Russia.

**CONCLUSION**

A brief comparison of the Yukos corporate structure and business operations with the recently brought money laundering charges shows that similar allegations based on the creative application of the money laundering legislation could be effectively brought against any corporate group in Russia. The important point is that it could be done in full compliance with the current Russian anti-money laundering legislation, which is regarded by the international experts to be a consistent part of the international anti-money laundering framework.

This situation simultaneously raises several problems. The problem stemming from applying national anti-money laundering legislation that was adopted in compliance with international guidelines can be seen in the context of countries with transitional economies. Multinational business groups from such countries aim to conquer the international securities markets and showed an unprecedented level of production and capital growth. The majority of such corporations, acting primarily in the oil, gas, and metal sectors, demonstrate a high level of compliance with the most advanced international corporate governance and accounting standards. They retain the best consultants, lawyers and auditors available in the market, who in turn assist the companies’ stocks to become blue chip shares.\(^\text{225}\) However, the Yukos case shows the general vulnerability of such compliance. The company, known in the international business community as a leader that sets standards for a Russian corporate governance in transition, within months became an example of the most outrageous corporate collapse in recent Russian history. This case puts on the international agenda the question of whether advanced international corporate standards, even when meticulously complied with by companies from countries with transitional economies, can protect international investors from unexpected scandals and losses. It also raises the

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question of what role of the anti-money laundering legislation may play in the promotion of such scandals.\footnote{226}

The Yukos case has already given birth to a number of unprecedented decisions and is still creating precedents for international case law.\footnote{227} More news is expected from the ECHR, where at least six Yukos-related applications have been filed. There are two main questions which are still outstanding and have to be addressed in the Yukos case: 1) The role of the gatekeepers, including primarily the international auditors, in the collapse of Yukos; and 2) the Russian government’s political motivation and its significance for corporate cases where the criminal and corporate tax evasion allegations were interrelated and used not only as an attack on individuals, but also as an attack on their economic wealth, which represented a danger for the existing political regime.

The battle unfolding in Russian courts surrounding PwC’s involvement and role in the Yukos case, even after its formal “surrender” to the state, shows that the definite answer to the first question is likely to be obtained only in a couple of years.\footnote{228} The answer to the second question does not seem as evident as some experts are eager to represent it. The position of Amnesty International, which has refused to declare Khodorkovsky as a political prisoner, leaves a lot of room for further discussion and stresses the importance of the ECHR position. The judicial battles unfolding around PwC’s role in the Yukos case in Russia are unlikely to come to an end for at least a couple of years and have a good chance of migrating to the US courts. Nevertheless, answers to these two

\footnotetext{226}{Taking into consideration the growing number of Russian companies’ IPOs, especially in London, the problem is now how to protect international investors from new corporate disasters. Overregulation and overwhelming control may lead to not only to the uncontrollable migration of issuers from one stock exchange to another, as has already happened with New York and London, but to de-listings as has happened with Tatneft. Press Release, Tatneft, O.A.O. Tatneft Announces Notice to NYSE Re Delisting (Aug. 18, 2006), available at http://www.marketwire.com/mw/release.do?id=695859&k=O.A.O.%20Tatneft. In this situation, while the Russian Government makes attempts to promote Russian IPOs for Russian companies, the choice for the western regulators will be a difficult one: whether to introduce new regulatory regime or lose Russian issuers. See, e.g., Maria Ermakova, London and Moscow Exchanges to Cooperate on IPOs, HERALD TRIB., Mar. 1, 2006, at 20; Mosnews.com, 150 Russian Companies to Hold IPO over Two Years—Stock Market Specialist, Apr. 4, 2007, available at http://www.huliq.com/19466/150-russian-companies-to-hold-ipo-over-two-years-stock-market-specialist; Posting of Charles Ganske to http://www.russiablog.org/2007/04/russian_ipos_week_15_of_2007_r.php (Apr. 16, 2007).}


questions would permit a full stop to the Yukos story and answer a principal political question: What did Yukos and its shareholders actually represent? An organized corporate criminal group of tremendous complexity and power, or an extremely powerful group of individuals who were regarded as a danger to the interests of Putin's ruling elite?

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