

“US-RUSSIA ECONOMIC RELATIONSHIP: IMPLICATIONS OF THE YUKOS
AFFAIR”

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OCTOBER 17, 2007

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY,
TRADE, AND TECHNOLOGY
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman,

I would like to thank you for this opportunity to speak on an important topic, the impact of the bankruptcy of the Yukos oil company on US shareholders. I want to discuss the US government's reaction, possible legal recourse, and plausible future remedies.¹

The Yukos Affair

In 2003, Yukos oil company was Russia's most valuable company. A majority of shares were held by a group of owners led by Mikhail Khodorkovsky, who was also CEO. Yukos had been privatized cheaply, as were most Russian companies, in 1995. It led the revival of the country's old oil fields, drawing on international technology and expertise that boosted Russia's oil production by 50 percent from 6 million to 9 million barrels a day between 2000 and 2004.

Yukos' shares were traded freely on the two main Moscow stock exchanges (RTS and MICEX), and about 15 percent of the companies stocks were traded over-the-counter (OTC) in New York as American Depository Receipts (ADRs). Most of them were held by American institutional investors, and some by individuals. Yukos was one of the greatest success stories in the Russian economy, and its stock price skyrocketed in the early 2000s. Its market capitalization peaked at \$45 billion in October 2003, which means that the US ownership might have been some \$6.7 billion. This figure is the best approximation of the total losses of American investors, because the value of these shares is now minimal.

In early July 2003, the Yukos executive Platon Lebedev was arrested and, on October 25, 2003, so was Mikhail Khodorkovsky, the CEO and main owner. The actual accusations were long nebulous, but eventually Khodorkovsky was charged with tax fraud. Yukos was the largest private taxpayer in Russia, although it minimized its profit taxes by legally registering its subsidiary companies in low-tax regions in Russia. The authorities reopened audited tax returns and denied the legality of various tax shelters. Initially, they slapped Yukos with \$3.4 billion in back taxes, penalties, and interest for 2000. Then the biased tax authorities did the same for later years as well, ending up with the startling number of \$32 billion, and the amount continues to rise, most of which represents penalties.

Although there are many possible reasons for the demise of Yukos,² two stand out. First, by jailing the wealthiest and most outspoken businessman, President Putin

¹ This testimony draws on my book *Russia's Capitalist Revolution* to be published by the Peterson Institute next month. As a matter of disclosure, I want to clarify that I am not involved in any of these legal suits. I want to thank Gary Hufbauer for helpful comments. Ivan Yuryk has contributed with research assistance. The views expressed are my own and represent none but myself.

² Khodorkovsky made high-profile charitable donations and set up the nonprofit Open Russia Foundation in 2001. He promoted civil society, democracy, transparency, the rule of law, education, and economic development in Russia. He pursued numerous campaigns. Initially, Khodorkovsky demonstrated how Yukos had increased production and efficiency, while paying its taxes. He proceeded to advocate the construction of a private oil pipeline to China and another to Murmansk at Barents Sea, which would break the state-owned Transneft's monopoly. He criticized state-dominated Gazprom for its inefficiency and advocated a bigger role for Yukos in gas, complaining that Yukos was forced to flare billions of cubic meters of associated gas because of Gazprom's refusal to grant Yukos access to its monopolized gas

consolidated his authoritarian rule. Second, the state-owned company Rosneft absorbed almost all Yukos assets, which would be worth some \$100 billion today, at a minimal cost, while Rosneft currently has a market capitalization of \$91 billion.³

While denying that he had instigated Khodorkovsky's arrest, Putin explained to Western visitors that it was necessary because Khodorkovsky was buying up Russian politics. Putin's central motive was to enhance his political control by jailing the most politically active oligarch. At the same time some of his aides wanted to seize Yukos assets.

In the ensuing process against Khodorkovsky and Yukos, Russia's legal authorities violated every rule in the book. No credible legal tax case existed to begin with. The Russian authorities dismissed the first two judges because of their impartiality. The offices of several defense counsels were raided, and they were harassed and punished. All rules regarding arrest, confiscation, and communication were violated. Khodorkovsky was denied bail, which is otherwise customary in nonviolent cases.

In the end, Khodorkovsky was sentenced to eight years in jail and sent off to East Siberia. Many other Yukos employees were condemned to lengthy prison sentences on the flimsiest of grounds. Yukos' main asset, Yuganskneftegaz, was sold off in a fire sale in December 2004, to an unknown shell company, Baikal Financial Group, for an uncontested bid for \$9.35 billion. This sale was premature; noncore assets did not go first as they should in an executive auction; no real competing bids were allowed; the bidder was a temporary shell company representing Rosneft; the sale price should have been about twice as high; and state banks financed Baikal's bid. The obvious purpose was to confiscate Yukos' finest oil field, which produced two-thirds of Yukos' oil, and give it to Rosneft. After the auction, Putin was the first to clarify that he knew who the owners of the shell company Baikal were.⁴ His economic advisor Andrei Illarionov called this sale "the scam of the year," which caused his demotion.

Treatment of American Shareholders

The treatment of American shareholders in Yukos is the focus here, but naturally the confiscation of several billions of dollars of U.S. property has broader implications for U.S. investors, the U.S., and the U.S.-Russia relationship.

Trade in Yukos' stocks has continued uninhibited, and the shares are actually still traded however minimal their price, leaving the enterprise value at a speculative \$0.7 billion.

In a series of public statements throughout this process, Putin continuously denied any involvement. On October 27, 2003, two days after Khodorkovsky's arrest, he responded to protests: "But there will be no meetings and no bargaining over the law enforcement bodies and their activities, so long, of course, as these agencies are acting within the limits of Russian legislation.... Neither the executive authorities nor even the

pipeline system. In 2003, Khodorkovsky conducted extensive negotiations with both Chevron Corporation and ExxonMobil about selling a large part of Yukos.

³ The reasons why Rosneft's market capitalization is considerably less is than the value of Yukos' assets are partly its greater indebtedness, partly a lower shareholder evaluation of this less transparent and state-dominated corporation.

⁴ "President Putin's Remarks on Results of Yuganskneftegaz Auction," NTV Segodnya, December 21, 2004, Federal News Service.

Prosecutor's Office can deprive someone of their freedom, even for the period of pre-trial detention. Only the court has this power...and before the court, as before the law, all should be equal.”⁵ Yet Putin ignored the many declarations of the Moscow Collegium of Lawyers that the prosecutors violated the procedural norms in the investigation against the Yukos managers.

Before a visit to Rome in early November, Putin declared that the state did not want to destroy Yukos: “I am categorically against re-examining the results of privatization ... This is why there will not be a deprivatization or a re-examination of the results of the privatization, but everyone will have to learn to live according to laws.”⁶ In Rome, he stated with implicit reference to Khodorkovsky: “Having made their billions, they spend tens, hundreds of millions of dollars to save their billions. We know how this money is being spent —on what lawyers, PR campaigns and politicians it is going, and on getting questions like these asked.”⁷ The last words referred to the French journalist who posed the question.

On June 17, 2004, Putin told reporters: “The Russian administration, government and economic authorities are not interested in bankrupting a company like Yukos...the government will try to ensure that this company does not go bankrupt.”⁸ On September 6, he said: “I don't want to bankrupt Yukos.... Give me the names of the government officials who want to bankrupt Yukos and I'll fire them.”⁹ On September 24, he reasserted: “We shall do this in strict accordance with the law. I want to stress it— in strict accordance with the law.... The state did not set before itself the task to nationalize this company or lay hands on it. And there is no such aim now...”¹⁰

In spite of his many unequivocal declarations to the contrary, Putin disregarded the law, successfully bankrupting and confiscating Yukos. He hardly uttered a true word about the Yukos affair. He insisted that the state must not interfere in the judicial process, but all the details indicated that prosecutors and judges received daily instructions from the Kremlin to be ruthless and lawless.

Foreign investors' belief in Putin's declarations was so great that the Yukos stock price held up well for half a year after Khodorkovsky's arrest until April 2004, and thereafter the ensuing decline was gradual. The stock price vacillated sharply with prosecutors' public statements, suggesting that insiders speculated on the basis of these allegations. Foreign investors, who were naïve enough to believe in Putin's words, lost billions of dollars, but the biggest losers kept quiet so as not to reveal their folly to their shareholders. Russia's stock market took a break in 2004, but then it surged again.

At least three well-known major American fund management companies made big bets on Yukos stocks and held on to them, reassured by Russian declarations that Yukos would not be bankrupted. Nobody doubted the value of the real assets. According to well-informed American investment bankers, one of these US fund made a major loss

⁵ Vladimir V. Putin. Remarks by President Vladimir Putin on Yukos Affair at Government Meeting. RTR Vesti Program, October 27, 2003, Federal News Service.

⁶ Vladimir V. Putin. Interview with the ANSA Italian news agency, Corriere della sera newspaper and the RAI Television Company, November 3, 2003. www.kremlin.ru.

⁷ Vladimir V. Putin, Introductory Words and Answers to Questions from Journalists at Press Conference about the Results of the Russia-EU Summit. Rome, November 6, 2003. www.kremlin.ru.

⁸ Interfax, Tashkent, June 17, 2004.

⁹ Catherine Belton, Putin: Tell Me Who Wants Yukos Broke. *The Moscow Times*, September 9, 2004.

¹⁰ Vladimir V. Putin, Speech at the World Congress of News Agencies, September 24. www.kremlin.ru.

of a few billion dollars on Yukos, while two other US funds lost about half a billion dollars each. Thus, the total losses to US institutional and individual shareholders amounted to several billion dollars, and a reasonable guess is \$6-7 billion. None of the really big losers from Yukos has publicized its losses, because they do not want to scare off their investors. The many shareholders who have complained tend to be individual investors with much smaller holdings.

US Government Reactions

When American shareholders lose billions of dollars because of miscarriage of justice in a major country, one might have expected that the US government would protest. Although the Yukos affair attracted considerable and daily international publicity, no major government tried to defend its shareholders. A scrutiny of major US statements on this and related topics is bewildering.

On September 27, 2003, three months after the arrest of the Yukos executive Lebedev, President George W. Bush had the following warm words to say about President Putin, after having hosted him at Camp David: “I respect President Putin’s vision for Russia: a country at peace within its borders, with its neighbors and with the world, a country in which democracy and freedom and rule of law thrive.”¹¹ Not surprisingly, Mr. Putin felt reassured and went ahead with the arrest of Khodorkovsky four weeks later.

Several senior US officials intervened once—in October 2004—but only to express in private messages to Russian counterparts their fears that Russia’s oil production would decline during the then expected Russian confiscation of Yugansk. Instead of condemnation, on October 18, 2004, US Secretary of State Colin Powell uttered his forceful support for Putin: “The Russian people came out of the post-Soviet Union era in a state of total chaos—a great deal of freedom, but it was freedom to steal from the state and President Putin took over and restored a sense of order in the country and moved in a democratic way.”¹² It is difficult to read this statement issued just before the Yugansk confiscation as anything but a tacit approval of the confiscation of billions of dollars of assets, partly held by US funds and individuals.

In the end, President Putin let Yukos be confiscated through arbitrary taxation and kangaroo courts. All the remaining assets of Yukos were sold off last summer in auctions that were biased in favor of Rosneft, which acquired most of the assets cheaply.

The Yukos affair also changed Russia’s economic policy. After all, the accusation against Yukos was that it followed the letter of the new tax code and utilized one of its loopholes. Putin’s program of structural reform came to a screeching halt. The Yukos affair showed the KGB men around Putin that they could seize Russia’s biggest private companies if they just lied. The road to large-scale renationalization through lawless government interference lay open.

US President George W. Bush, however, has not wavered in his publicly expressed confidence in Putin. On July 1–2, 2007, Bush honored Putin by inviting him to his father’s summer house in Kennebunkport, Maine. At the ensuing press conference,

¹¹ The White House website, www.whitehouse.gov. (accessed July 3, 2007).

¹² “Interview with the USA Today Editorial Board,” October 18, 2004, US Department of State website www.state.gov (accessed July 15, 2007).

Bush revealed: “But one thing I've found about Vladimir Putin is that he is consistent, transparent, honest and is an easy man to discuss our opportunities and problems with.” “I know he's always telling me the truth.”¹³

In no way has the US government expressed public concern about the confiscation of billions of dollars of bona fide American investments in Yukos shares. No protest against this multi-billion dollar confiscation has been apparent.

Possible Legal Recourse

What legal recourse against Russian government confiscation of US private property in Yukos shares could the US administration have provided?

In current international law, a number of possibilities exist. Yukos shareholders live in many countries, and they are now investigating their legal options. A large number of legal suits are under way in many countries, but it is difficult to gain an overview because many shareholders hope to achieve beneficial settlements out of court by keeping quiet. Predominantly, these legal cases are instigated by relatively small individual investors, while the big institutional investors do not want to reveal how much they have lost.

The most direct remedy is through a bilateral investment treaty, which many countries have concluded with one another. The United States and the Russian Federation signed such a treaty on June 17, 1992. This treaty was supposed to guarantee “prompt, adequate and effective compensation in the event of expropriation,” and provide “the right to third party international arbitration in the event of a dispute between a U.S. investor and the Russian government.” The U.S. Senate ratified this treaty on August 11, 1993, but the United States has failed to persuade Russia to ratify this treaty, so it lacks legal force. The main reason for this failure of ratification was that a parliamentary majority long opposed President Boris Yeltsin, but that was no longer true from December 1999.

By contrast, 38 countries, including Belgium, France, Germany, Ireland, Italy, Luxemburg, the Netherlands, Norway, Spain, Sweden and the United Kingdom, have concluded bilateral investment treaties with Russia that have also been ratified, allowing Yukos shareholders in those countries to sue the Russian government, but that venue is not open to American shareholders.

After 1998, the United States has almost stopped concluding bilateral investment treaties. The U.S. has tried to make them more ambitious, but the consequence has been that only one has been concluded (Uruguay in 2006). The U.S. has instead tried to include investment guarantees in free trade agreements, but no free trade agreement can be concluded with Russia until that country has become a member of the World Trade Organization. Thus, a free trade agreement is not an option.

In 1994, a multilateral treaty, the Energy Charter Treaty, was signed by most European countries, the former Soviet countries and some other countries. A total of 51 countries signed it and 46 of them have also ratified this treaty, which also contained substantial clauses against confiscation. The treaty came into force in 1997. The United States, however, abandoned these negotiations early on in 1991 and has never signed this

¹³ “President Bush Meets with President Putin of Russian Federation,” White House press release, July 2, 2007, available at www.whitehouse.gov (accessed July 13, 2007).

treaty. Russia signed the Energy Charter Treaty, but although it has not ratified the treaty, it has committed itself to abide by this treaty, and major suits in Europe are under way on this basis, but again this option is not open to U.S. shareholders.

Citizens in European countries have a third legal opportunity, namely to appeal to the European Court of Human Rights in Strassbourg. It is attached to the Council of Europe, an organization of which Russia but not the U.S. is a member. The verdicts of the European Court of Human Rights are formally accepted by the Russian government, which renders them potent in commercial cases. Thousands of cases concerning Russia have been raised there, and the Russian government regularly loses. One prominent case that the Russian government lost was raised against Vladimir Gusinsky. The European court established that the Russian state had forced him to give his media empire to a state-dominated company. However, U.S. citizens have no legal recourse to this international court.

At present, a number of legal cases have been raised against the relevant Russian companies and individuals in the United States. In the absence of any binding bilateral treaty, sundry legal cases focus on assertions that the defendants committed securities crimes in the United States, including insider trading and racketeering. It is too early to judge the eventual success of these legal suits.

Other Legal Ramifications: Possible Money-Laundering

Another issue that naturally arises in this context is possible money-laundering. If, as appears to be the case, current Russian top officials illegally appropriate large state assets for their personal benefits, they are likely to transfer substantial assets abroad, which may pass through the American banking system. Money-laundering might not be apparent in the Yukos affair, but it is in other cases of illicit enrichment by Russian state officials.

The best documented recent case is Minister of Communications Leonid Reiman, a friend of Putin from foreign intelligence in St. Petersburg. In May 2006, Reiman lost a civil case in Zurich, Switzerland. The court established that he had committed major crimes in Russia, that he owned large chunks of Russia's telecommunications, which he oversaw as minister, and that he created a vast international money-laundering scheme to conceal his diversion of state assets.¹⁴ The countries involved were primarily Luxemburg and Bermuda, and the main bank used was German Commerzbank.

The news was suppressed in Russian media and Reiman remains on his post also after the last government changes. In July 2007, his apparent assets were assessed at \$5.9 billion, when Reiman apparently capitalized his assets by selling them to a friendly businessman.¹⁵ Reiman has continuously been a state employee while amassing this fortune through privatizations and preferential licenses.

¹⁴ Gregory L. White, David Crawford, and Glenn R. Simpson, "Why Putin's Telecom Minister is in Investigators' Sights Abroad; German and Swiss Probes Tag Leonid Reiman as Owner of Businesses he Oversees; Commerzbank's Unusual Role," *Wall Street Journal*, October 17, 2006.

¹⁵ Neil Buckley, "Russian Phone Feud Is Settled," *Financial Times*, July 30, 2007.

Conclusions

The outcome of a large number of ongoing court cases is not clear as yet, and my testimony is by no means intended to prejudge their outcome. However, a number of major conclusions can be drawn.

First, in the last couple of decades, the confiscation of the Yukos oil company is one of the biggest confiscations that has hit U.S. shareholders, probably in the order of \$6-7 billion. It is all the more remarkable, because at the time of the confiscation Russia was enjoying a prolonged economic boom.

Second, in their public statements the leading representatives of the U.S. administration, the President and the Secretary of State, have not protested against this confiscation but on the contrary expressed general support for President Putin's actions.

Third, a little noticed fact is that American shareholders of Russian companies have considerably weaker legal protection than European shareholders against confiscation by the Russian government, because the U.S. has not bothered to establish binding treaties with Russia that would safeguard its citizens. European investors benefit from a safer legal environment in this regard.

It is difficult to escape the impression that the current US administration has done nothing to establish appropriate legal defenses for American shareholders of Russian companies. Unfortunately, Yukos is not likely to be the single case, because a wave of renationalization is currently under way in Russia.

How can this situation be remedied? To begin with, one would expect US top officials to protest against the confiscation of billions of dollars bona fide investment by American citizens. In several cases, Putin has moderated his actions after loud, public, and concerted Western protests. The easiest legal option is probably to persuade Russia to ratify the bilateral investment treaty of 1992, which should not be that difficult, but it does not appear to be on the U.S. agenda.

In the longer term, adequate legal guarantees can be best accomplished through the conclusion of a bilateral free trade agreement between the United States and Russia, but that presupposes that Russia becomes a member of the World Trade Organization. During President Putin's first term, Russia's accession to the WTO was an important goal. In November 2006, Russia concluded a substantial bilateral protocol with the U.S. on Russia's accession to the WTO. Unfortunately, President Putin has increasingly downplayed the significance of the WTO. Last June, he went as far as to call the WTO "obsolete;" Russia's progress toward accession has slowed down; and German Gref, the Minister for Economic Development and Trade, who has been Russia's foremost advocate of WTO membership, was dismissed from the government last month. Russia's government still professes its aim to join the WTO, but its determination has waned.

The absence of any legal safeguard for American investment in Russia can nothing but harm and hold them back. The Russian state officials that carried out the confiscation of Yukos have by no means been punished but have only had their appetite vetted. This is apparent from the current wave of renationalization in Russia, which further deters Americans from investment in Russia. My conclusion is that the United States has an interest in stronger mutual treaty obligations between the U.S. and Russia safeguarding investments. Also bona fide Russian businessmen have an interest in such treaty obligations. Although a WTO accession does not have direct bearing on

investment, it can serve as a useful tool, providing a basis for a bilateral free trade agreement, which would contain guarantees for the protection of investment.