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Introduction

Yukos is one of the largest multinational oil companies in the world. The company had a market capitalization of $40 billion before the Russian Federation engaged in a ruthless and unprecedented campaign of dubious and discriminatory taxes, illegal expropriation of property, arrests and intimidations. The attack by the Russian Federation against Yukos violates Russia's foreign investment laws, which provide for international arbitration of investment disputes, as well as Russia's obligations under its treaties and international law.

There is much at stake in how this situation is resolved: the security, reliability and price of global oil supplies; the safety and welfare of Yukos' employees and communities; the future of economic development and rule of law within Russia; and the relationship of the Russian Federation with the United States and other nations.

The United States has a direct interest in the resolution of the Yukos situation. Beyond the important political or strategic concerns, there are the vital issues of our nation's energy and economic security. There are the rights of more than 60,000 individual and institutional investors, many of them Americans, who expressed their faith in Yukos by investing in the company.

Today, the market value of Yukos has plummeted from $40 billion to $2 billion because of the Russian government's campaign of persecution and intimidation against Yukos and its officials.

The Russian government has carried out a ruthless and unprecedented campaign against Yukos by way of dubious and discriminatory taxes, illegal expropriation of property, arrests and intimidation. For reasons known only inside the Kremlin, Russia has decided to reverse its commitment to privatization and chosen instead to increase the role of the state. It has made an equally unfortunate choice to ignore the Western-style reformist laws it passed over the past several years when those laws conflict with the interests of the Kremlin. As a result, there are no guarantees of due process, no adherence to the rule of law, and no protections for the rights of shareholders or property owners.

Background

Following the collapse of the Soviet Union in the early 1990s, the Russian Federation's oil industry consisted of hundreds of stand-alone state-owned entities. The vast majority of these were inefficiently run, unprofitable and overstaffed. They survived only through continued state support. In 1993, the Russian government set out to restructure the nation's oil and gas sector. Through privatization, the government hoped to make the Russian oil and gas sector viable in a global market and, above all, attract much needed direct foreign investment into the country.

Yukos was founded by the Russian government on April 15, 1993 through the integration of state-owned producing, refining and distribution entities. Although it had become a separate legal entity, the newly created Yukos remained entirely state owned. It remained that way until December 1995 when the Russian government sold its stake in Yukos to a group of Russian investors. Thus, through a series of tenders and auctions held in 1995 and 1996, Yukos essentially became Russia's first fully privatized oil company.

Russian Success Story

Despite the arrival of private investors, Yukos continued to experience a sharp decline in production output and mounting salary arrears, and faced the technical bankruptcy of its main production unit, Yuganskneftegaz or YNG. Its debts to the Russian government had grown to more than $3.5 billion. In May 1996, Mikhail Khordokovsky stepped in as Chairman of Yukos' Executive Board, bringing with him a dynamic, professional management team. The task of this team was clear: transform the company into a multinational enterprise managed in accordance with the highest international standards of operational efficiency, transparency and corporate governance. Over the next eight years, Yukos was successfully transformed into a viable, vertically integrated, transnational oil company competing with the biggest oil industry players in the world.

The company repaid all debts owed to Russian federal and regional governments, and increased its production capacity by reinvesting its profits in drilling, capital construction and new oil field development. Further, realizing that attaining Yukos' goal of becoming a successful international energy player would require substantial foreign investment, Yukos embarked on an ambitious program to transform the company's corporate culture into that of a fully transparent, Western-style corporation. For example, Yukos became the first Russian company to switch to international accounting standards, and the first Russian-based multinational to disclose its management and ownership structure to the public.

The company's annual production output grew by 17 percent in 2001 and by 19 percent in 2002. By 2002, Yukos accounted for approximately 18 percent of Russia's total oil production, producing an average of 1.4 million barrels a day. Before the government launched its deliberate campaign to destroy the company, Yukos and its subsidiaries were the largest producers of crude oil in Russia and the largest exporters of crude oil from Russia. Together they produced slightly less than 20% of all the crude oil produced in Russia, and refined and marketed slightly less than 20% of the refined products in Russia. This made Yukos one of the largest oil and gas companies in the world.

In December 2002, Standard & Poor's rated Yukos "BB with stable outlook," and in January 2003, Moody's Investor Service assigned the company a rating of "Ba2." At the time, these were the highest long-term and foreign currency issuer ratings for any privately-held Russian multinational. Khodorkovsky himself won the 2002 "Entrepreneur of the Year" prize, awarded annually by Russia's leading business daily Vedomosti, published jointly by the Financial Times and the Wall Street Journal. The same year, the Russian government named Yukos the "Best Company for Compensation and Social Payments Programs," as well as for the "Implementation of Social Programs at Enterprises and Organizations." By 2003, Yukos had signed major joint venture and strategic alliance agreements with international companies such as Total, Schlumberger, and Microsoft. In fact, the company's success was so internationally celebrated that, in 2003, ExxonMobil expressed its interest in acquiring between 40 and 50 percent of Yukos for an estimated $25 billion — a transaction that would have been the single largest direct foreign investment in Russian history.

Not surprisingly, since 1998, the value of Yukos' shares increased more than tenfold, including a growth of 250 percent in 2001 alone. By all accounts, Yukos was the signature success story of the new Russian Federation. By October 2003, the market capitalization of Yukos' worldwide stock was estimated at more than $30 billion. As late as April 2004, Yukos' market capitalization was estimated at more than $40 billion. United States investors owned interests in Yukos that were worth approximately $4 billion in October 2003, when the Russian authorities began their persecution of Yukos' chief executive officer.

American investors (and investors from around the world) bought their interest in Yukos in the good faith belief that their investment would not be expropriated. Russia, recognizing the importance of the rule of law to international investors, adopted the Russian Foreign Investment Law which states in its preamble that it is, "aimed at . . . ensuring stable terms for operations of foreign investors and compliance of the legal order of foreign investment with the standards of the international law."

A company that had been formed from the decaying remnants of the Soviet era had become a standard bearer for the new, pro-foreign investment Russian Federation. Within a mere eight months, however, between April and December 2004, this transparent, globally-respected multinational corporation, worth an estimated $40 billion, was subjected to a series of carefully timed and politically motivated attacks by the Russian government, ultimately forcing it to seek bankruptcy protection in the United States on December 14, 2004.

Khodorkovsky Arrested

During 2002 and early 2003, Mikhail Khodorkovsky reportedly became concerned the country's upcoming general election would result in a two-thirds pro-government majority in the Russian Parliament ("Duma"). He began to contribute openly to major opposition parties, but reportedly refused requests to finance United Russia, the current governing party. He became an outspoken critic of the alleged endemic corruption in the Russian administration and advocated for progressive legislative reforms. Due to his close ties with Western business and political leaders, his words were resonating outside of Russia and his reputation growing.

In mid-2003, an election year in Russia, the Kremlin reacted. Platon Lebedev, Chairman of Menatep Limited, Yukos' largest shareholder, was arrested in July 2003 on charges of fraud and tax evasion, and Vasily Shakhanovsky, a member of Yukos' Management Board, was charged with tax evasion. In July 2003, the Russian Government raided Yukos' offices where it went through computer records for approximately 17 hours. And on October 25, 2003, Mikhail Khordokovsky was arrested at gunpoint by government agents and jailed on charges of tax evasion, theft of state property, and fraud. He remains jailed to this day. In addition, many loyal and outstanding Yukos employees have found themselves subject to intimidation by the government and threats by its agents. The Government continues to arrest Yukos' managers, intimidate its employees through illegal searches of their homes conducted by masked, armed forces, confiscate personal property of the company and its officers, and jail or threaten other company employees on trumped up criminal charges. In a recent example of this repugnant methodology, Svetlana Bakhmina, a young Deputy General Counsel of Yukos and the mother of two young children, was arrested late at night at her home in Moscow on charges relating to her legal work at Yukos. She remains incarcerated.

Despite the political activism of its largest individual shareholder, however, Yukos itself was never involved in Khordorkovsky's political activities. All his contributions to opposition parties, for example, were made from his personal funds and not from corporate accounts. Nevertheless, hand-in-hand with its criminal investigations, the government also apparently perceived that it had to move against Khordokovsky by targeting Yukos, the single most concentrated source of his wealth. In December 2003, a few weeks after Khordokovsky's arrest, the Ministry of Taxation conducted a perfunctory two-week "special" audit of Yukos' books. In April 2004, the government slapped a $3.4 billion audit report on Yukos, which it claimed Yukos owed in respect of the 2000 fiscal year. The Russian government's moves against Khordokovsky's wealth, through tax assessments against Yukos, have been numerous since then, clearly retaliatory and have involved the systematic repudiation of the rule of law.

<u>The Tax Assessments</u>

Following the first assessment against Yukos, the government levied additional tax assessments against Yukos and certain of its subsidiaries. Including massive penalties, fines and interest, these assessments eventually totaled approximately $27.5 billion. They were based on government audits of Yukos' books, which had already been audited by PriceWaterhouseCoopers, formally audited and confirmed as correct by Russian tax authorities, and made as transparent as possible as part of the company's corporate philosophy. Further, in light of the fact that Yukos was one of Russia's largest taxpayers, it was in constant communication with the regional Russian tax authorities, which had approved all of Yukos' previous filings following similar audits. Yukos has always maintained that the company, like many other companies in Russia, used legal and government-approved tax reduction provisions. Allegations that Yukos had acted illegally could only be made under a selective and retroactive reinterpretation of Russian tax law that could not reasonably have been anticipated when the transactions took place.

In addition, the amount of the taxes has been swelled by usurious default interest, penalties, and fines. This exponential rate of increase jeopardized Yukos' ability to conduct business and decimated its net equity. In a blatant example, tax assessments for 2001 and 2002 have been in excess of 100% of Yukos' annual consolidated gross revenue; for 2003 the assessments have been in excess of 80% of Yukos' consolidated gross annual revenue. Indeed, the assessments levied against Yukos for 2001 were in excess of four times the consolidated gross industry average taxes; for 2002, in excess of 3½ times the industry average; and for 2003, in excess of 2½ times the industry average.

Kremlin Moves To Bankrupt Yukos

Despite the government's insupportable tax claims, Yukos acted in a responsible manner. Even while challenging the tax claims through all available legal, political and diplomatic channels, as a matter of good faith and as a signal of our interest in finding a reasonable resolution, Yukos began to pay some of the taxes. But it became clear this was not really about taxes. It was about an illegal and politically motivated campaign to expropriate valuable oil assets and return them to the close control of the government. Having ignored any number of settlement proposals by Yukos, or other reasonable proposals to pay the entire amount of the tax assessments over time, the Russian government instead intensified its collection efforts against Yukos by utilizing the full apparatus of the state.

On April 15, 2004, the government obtained an injunction forbidding the disposal, encumbrancing or other dealing with any of the assets of the company. On June 30, 2004, a further freezing order forbade any disposals of assets while at the same time requiring an additional tax payment of more than $3.4 billion to be made within 5 working days on pain of a penalty surcharge of 7% of the total debt ($241 million).

Because of the injunction and the freezing order, the company was prohibited from making that additional tax payment. Its formal application on July 2, 2004 that sufficient assets to meet the liability should be released for that purpose was rejected. The surcharge was duly applied. The government's ultimate resolution to this contrived situation was to declare that because Yukos could not pay its fictitious taxes, the bailiffs would have to seize Yuganskneftegas, the company's most valuable asset, and sell it at auction to satisfy the tax charges.

On August 31, 2004 the bank accounts of Yuganskneftegas were frozen and on September 9, 2004, following a further additional tax assessment of $2.7 billion, thirteen further freezing orders were imposed on Yukos' bank accounts forbidding all transactions. As a result, the company had no access to cash to reinvest in their operations, operate their businesses, disburse company expenses, pay salaries to employees, satisfy any amounts levied under the tax assessments, and most importantly, pay current taxes. In essence, by forcing the company to operate with no money, the Russian government left Yukos incapacitated and unable to function.

Having rendered Yukos cash-flow insolvent, the Russian government through its bailiffs conducted an auction of Yuganskneftegas on December 19, 2004, allegedly to raise money to pay a portion of Yukos' tax bill. In violation of a restraining order from a U.S. Bankruptcy Court, the auction proceeded as scheduled, with the assets being sold for half their appraised value. The buyer in this sham auction was an unheard of company of no certain address that sold its prize almost immediately to Rosneft, a front for the Kremlin, whose chairman had led the attack on Yukos in the first place.

By forcing down the value of YNG stock at the auction, the subsequent set-off against Yukos' tax bill still left a significant tax liability, potentially putting other assets in jeopardy. At the Russian government's request, Dresdner Kleinwort Wasserstein valued the shares of YNG in preparation for the auction. It gave a valuation of between $15-18 billion. Despite that valuation by an independent bank, the Russian government set the auction to start at significantly under $9 billion, less than half the valued amount.

In recent comments, Andrei Illarionov, a close and long-term economic adviser to the Russian president, said Yuganskneftegas should be returned to Yukos. "There are certain common human commandments," Mr. Illarionov said. "Such as 'thou shalt not steal.'" Not surprisingly, this once influential adviser has reportedly been stripped of many of his duties following his comments.

The Kremlin's deliberate campaign against Yukos has serious implications for the United States. Americans should be concerned about a Russian government still willing to unleash its agents in a ruthless campaign against companies or individuals. Likewise, we should be wary of a retreat from democratic values in Russia and a seeming level of instability, especially given Russia's strategic location and nuclear capability.

As the world's largest oil consumer, America's energy security -- and by extension its economic security -- depends on the stability and reliability of global oil supplies. Yukos had made significant investment in technology, equipment and talented staff, and was playing a growing role in stabilizing world supplies.

Today, industry analysts note that the Russian government is tightening its grip on the energy sector. Christopher Weafer, chief strategist for Alfa Bank, said this move "is not unexpected and is part of the government's efforts to exercise greater control over the energy sector." Just last week, the Russian Federation announced a ban on US and other foreign-owned companies from bidding for new permits to develop several large oil fields. This action will further slow the growth of Russian oil production by discouraging needed investment capital and expertise.

Roland Nash, chief strategist for Renaissance Capital, a Moscow-based investment bank, called the ban "a dramatic step down the road of state intervention, which Russia has been following for some time." Mr. Nash concluded: "The ban could dissuade foreign companies from investing in Russia."

As the Wall Street Journal reported recently, slowing growth in Russian oil production has helped drive up world oil prices. Production has fallen for four straight months. The International Energy Agency cut its forecast of Russian oil output growth this year to 3.8 percent, citing higher taxes and a worsening regulatory climate. These circumstances run counter to the energy and economic security of the United States.

Uncertain Future

In July 1999 the Russian Federation adopted the Russian Foreign Investment Law in order to attract and encourage foreign investment on its territory. According to its preamble: "This Federal Law determines the basic guarantees of foreign investors' rights to the investments, and to the income and profits obtained from such investments, and the terms of business activities of foreign investors in the Russian Federation." The legislation's preamble declares its purposes to be: "attracting foreign material and financial resources, advanced engineering and technologies, managerial experience and efficient application thereof in the economy of the Russian Federation, and ensuring that the legal regime of foreign investments is in compliance with the norms of international law and the international practice of investment co-operation."

The Yukos matter puts the eyes of the world squarely on the Russian Federation to judge whether it is living up to that commitment. Yukos is protected by the investment guarantees set forth in the Russian Foreign Investment Law because foreign investors own at least 10% of Yukos' capital stock and because Yukos reinvests its income and profits in oil production and related activities on the territory of the Russian Federation.

By any measure, the Russian government tax claim is not in keeping with international norms or even Russian law. It was imposed without substantive due process by retroactive application of substantive law that was different from what had been applied to Yukos in the past and different from what was applied to other similar companies. It involved an interpretation of law that could not reasonably have been anticipated. It was also imposed without procedural due process involving a fair opportunity to be heard, in many cases imposing taxes for prior years in which the Russian government had previously said no more tax was due.

This has resulted in a discriminatory taxation of Yukos as compared to other oil and gas companies operating in Russia, many of which are not foreign-owned corporations, and at $27.5 billion, it was so grotesquely large that it equaled between 80%-111% of Yukos' US GAAP consolidated **gross revenues** (before expenses are taken into account) for the years 2001, 2002 and 2003, and about 70% in 2000.

The inequitable and illegal actions surrounding these extraordinary tax claims substantially impaired Yukos' ability to pay its more than $1.5 billion of debt to over 150 legitimate lenders and trade creditors, and caused the value of Yukos' common stock, owned by over 60,000 shareholders, to plummet from over $40 billion to less than $2 billion.

These actions also focus attention on Russia as it attempts to gain full membership in the global economic community. Would-be investors might well be wary of doing business in a country where international norms and the rule of law can be so easily violated, and where property and shareholder rights cannot be guaranteed. The Kremlin may feel it has license to tear up the Russian rule book, but international rules are another matter. The rights of international investors can only be protected in a legal system that is fair and unbiased, not one where the Russian government picks winners and losers before it ever decides to hear the case. As long as that system exists, Yukos will not be the last company to find its rights violated and its assets seized by the Kremlin.

The actions of the Russian government have bankrupted a company that once seemed destined to serve as a model for Russia's economic future. The European Union has condemned the actions against Yukos as a politically motivated, coordinated attack by the Russian government designed to regain control of strategic economic assets. The Senate Foreign Relations Committee has also added its influential voice through a resolution of disapproval which the Committee passed on a unanimous vote.

Sadly, the Russian people will bear much of the burden as well. At its peak, Yukos employed more than 100,000 people, paid billions of dollars in taxes and invested generously in local communities. A modern, globally-respected company has been dismantled by a series of carefully timed and politically motivated attacks by the Russian government. As a litmus test for future investors, adherence to the rule of law and compliance with international norms, the Yukos experience is not encouraging.