

The YUKOS Affair: First Business, Then Politics

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Political battles in Russia have a reputation for being as obscure as they are vicious; thus Churchill's famous comparison of Politburo rivals to bulldogs fighting under a carpet. Churchill's saying now seems an apt description of the murky legal and political struggles over YUKOS, Russia's most valuable oil company. The YUKOS affair has unfolded in two waves. The first wave began in summer 2003. On July 2, Platon Lebedev, the company's billionaire vice president, was arrested. As of early November, he remained in pretrial detention. Lebedev was accused of fraud in a 1994 privatization auction, failing to carry out court orders to surrender the shares gained in the auction, and tax evasion. After Lebedev's arrest, it quickly emerged that two weeks earlier a top YUKOS security official was taken into custody on suspicion of ordering a double murder in late 2002. Investigations into four additional attempted or successful murders of persons with business conflicts with YUKOS, all dating from 1998, were renewed at the same time. That Russia's Procuracy (charged with investigating and prosecuting criminal cases) should have opened so many unrelated cases at one time left little doubt that YUKOS's owners, especially multibillionaire Mikhail Khodorkovsky, had come under deliberate attack. After slackening in August and September, the Procuracy attack was renewed with a vengeance in October, in a new wave of searches and charges. On October 25, Khodorkovsky himself was arrested in spectacular fashion, seized from his private airplane on a Siberian runway by Federal Security Police.

Khodorkovsky's arrest is clearly one of the signal events of the Putin era: but what does it signal? Speculation on who organized the attack, and why, has been intense. Neither Putin's long silence through the summer nor his implausible insistence in the fall that law enforcement was the only issue have silenced this speculation. Two of the most popular theories (sometimes advanced simultaneously) link the Procuracy's campaign to political conflicts or dissatisfaction over privatization.

- *Political conflicts.* Khodorkovsky had funded the parliamentary campaign of two (somewhat) oppositional liberal parties, and was widely believed to entertain ambitions to the presidency. Thus, perhaps the attack was retaliation for Khodorkovsky's violation of an agreement between Putin and the oligarchs, struck in 2000, that exchanged property stability for the oligarchs' political quiescence. Khodorkovsky himself has suggested that some in Putin's entourage view independent big business as a political threat, and claimed that the campaign was meant to block YUKOS's recent merger with Sibneft', forming one of the world's five-largest oil companies.
- *Dissatisfaction over privatization.* The YUKOS empire emerged from the legally and ethically dubious privatization deals of the mid-1990s; its assets were purchased for

around one-thirtieth of their present market value. Both in the public and in parts of the political elite, resentment over this wealth windfall is rife. Some hold that the attack against YUKOS reflects a broad effort to roll back privatization and move the economy in a statist direction. Beneficiaries of this plan would be state-owned enterprises, such as the oil firm Rosneft'. Its architects are held to be a faction composed of current and former KGB and military officers in Putin's immediate circle, the so-called *siloviki*.

In this memo, I argue that both politics and business have a place in understanding the events surrounding YUKOS, but they must be understood fairly narrowly in the context of a struggle with evolving goals and significance. In all probability, the Procuracy campaign began as a tactic to weaken YUKOS in battles over property and policy in the oil industry. The past several years have seen a number of extremely intense conflicts pitting Rosneft' against YUKOS and/or its merger partner Sibneft'. In these conflicts, as is typical of corporate disputes in Russia, all sides have made tactical use of commercial and criminal law to pressure their opponents (see PONARS memos 273 and 274). The summer's criminal cases fit this pattern. They were likely a blow designed to distract YUKOS from its high-stakes disputes with Rosneft' over eastern Siberian oil, which have continued to rage inconclusively.

However, Khodorkovsky's response to this blow fundamentally changed the nature of the conflict. He sought no compromise on the business issues at the root of the conflict, and continued to demonstrate an ability to strengthen YUKOS financially and prevail in property struggles. More important, he worked tirelessly to turn the Procuracy's campaign into a political issue, presenting it as a battle over the independence of civil society from legal arbitrariness. That the YUKOS affair took this path from business to politics reflects Khodorkovsky's choice to wage the struggle on the public stage.

Rosneft' versus YUKOS and Sibneft': The Prehistory

In 1998, it would have been hard to predict that Rosneft', one of the few remaining state-owned oil companies, would in five years become an important political and economic force. Its hold on its subsidiary businesses was weak, and its oil reserves were both more limited and less economically attractive than those in the hands of its privatized rivals. Under Sergei Bogdanchikov, however, and apparently with backing from Kremlin *siloviki*, the company rapidly grew stronger. In a struggle against Sibneft', it restored control over its subsidiaries, and it soon began to acquire new assets.

However, Rosneft' remains only about one fifth the size of pre-merger YUKOS, and its ambitions for expansion have often been frustrated. In 2002, for instance, Rosneft' and Sibneft' fought hard for control over the state-owned Slavneft' concern. The installation of a Sibneft' ally as head of the company led to a month of armed confrontation, as alternate CEOs supported by a bank close to Rosneft' twice took over the company's office with the backing of police and private security firms. Simultaneously, Sibneft's chosen head for the firm became the target of a criminal case, later dropped. Sibneft' held onto control of Slavneft', and later purchased it at a privatization auction in late 2002. Rosneft', which had hoped to participate in the auction, was barred by a last-minute injunction from a provincial court. This injunction was widely assumed to have been organized by Sibneft'.

Rosneft' has also sought to expand in eastern Siberia, where there are large undeveloped oil and gas fields. It is embroiled in a dispute with YUKOS over ownership of one of these fields. One person on Rosneft's side in this controversy is under criminal investigation, possibly at YUKOS's instigation. Meanwhile, the Procuracy initiated an investigation in response to a charge by Rosneft' that YUKOS illegitimately transferred shares in the contested company to its own account. As of October, YUKOS appeared to have the upper hand in the struggle even without the disputed shares, but the struggle continues. The two firms have also clashed over oil rights in other parts of eastern Siberia.

As important as who owns eastern Siberian oil is where it will be shipped. YUKOS has long backed a pipeline to China, which it has offered to fund, while Rosneft' advocates a far more expensive pipeline to the Russian Far East, where it has refining and transshipment assets. Frustrating YUKOS and their Chinese partners, who are eager to begin construction, the Russian government this year has repeatedly postponed, most recently until next year, a final decision on which route to embrace.

Another issue on which YUKOS and Rosneft' have been divided is the debate over production-sharing arrangements (PSAs), a form of preferential treatment for foreign investors in the oil sector. Khodorkovsky argues that PSAs are anticompetitive and unnecessary, while Bogdanchikov counters that Rosneft's inferior oil reserves cannot be developed without the incentive PSAs provide. In late May, the Duma passed a law largely in line with YUKOS's position, prodded in part by Vladimir Dubov, another billionaire YUKOS shareholder who is also an influential Duma deputy.

Before Lebedev's arrest, one of the few successful expansions Rosneft' could boast was its acquisition of a relatively small oil company in northern Russia, at a price many saw as excessive. In a February meeting with Putin, Khodorkovsky gave voice to suspicions that the premium price reflected kickbacks to Rosneft's leadership. Putin replied sharply, noting that Rosneft' was a state-owned company that needed to expand its oil reserves, whereas privately owned YUKOS had plenty of reserves already, acquired under possibly dubious circumstances.

In short, long-standing conflicts of Rosneft' against YUKOS and Sibneft' had been rife with mutual accusations of criminal activity and betrayal of Russia's interests even before Lebedev's arrest. Moreover, the merger between YUKOS and Sibneft' promised to strengthen the party to this conflict that had already proved the stronger in most struggles. In midsummer, without suggesting who had organized the attack against him, Khodorkovsky claimed that the Sibneft' - YUKOS merger was what had prompted it. Certainly it would not be surprising, on the backdrop of the impending merger, if Rosneft' and its supporters had been casting about for some new way to weaken their nemesis.

The Summer Interlude: The Procuracy on Its Own

Whether or not Rosneft' executives were behind the criminal investigations into YUKOS' shareholders, it was the Procuracy that became the investigations' public protagonist. In the face of YUKOS's high-volume public complaints, Procuracy representatives soon made sweeping public assertions about the cases that left them little room for retreat. For instance, the privatization case against Lebedev revolves around shares of the mineral producer Apatit, purchased for a pledge to make nearly \$300 million of investments in the firm. These investments were not made. After a very long dispute, Khodorkovsky's group paid around \$15 million to the government to settle the case late in 2002. Citing the difference between the investments pledged and the settlement amount, a top Procuracy official announced publicly that "highway robbery" had occurred. He went on to praise the investigator leading the case, noting that "all the cases he has supervised have been brought to court, and all of them have ended with a conviction." These strong public statements were accompanied by a number of high-profile searches of the offices of YUKOS and related entities, after which Procuracy representatives regularly asserted that they have found evidence of criminal wrongdoing. Searches took place in early July, and again in early August.

A long hiatus followed before a new round of searches in early October. During this period, the political backing within the Russian leadership for the anti-YUKOS campaign appeared thin. No other part of the government appears to have taken any actions against the firm. The fiscal authorities were passive after the Procuracy requested they investigate YUKOS's tax affairs, and new tax accusations emerged only from within the Procuracy itself. In July, Prime Minister Mikhail Kasyanov declared that he found Lebedev's pretrial detention excessive, leading to a sharp rebuke from the Procuracy for political interference. In early August, Russia's antitrust regulator approved the merger with Sibneft'.

One of the mysteries of the summer was Vladimir Putin's attitude toward the campaign. The Putin-Khodorkovsky exchange over Rosneft', alongside some threatening Putin remarks in mid-June about the fate awaiting big businessmen with excessive political ambitions, lent credence to theories that the president himself was blessing the Procuracy's actions. Through the summer, it was plausible that this was not so. Former Putin political adviser Gleb Pavlovsky suggested in July that Putin would have rejected the anti-YUKOS campaign if he had been asked about it in advance. Later, Khodorkovsky accused the Procuracy of deceiving Putin, and said Putin had not decided on this course of action. Most significantly, in a late-July meeting with foreign journalists, Putin's chief of staff Alexander Voloshin agreed that the cases represented a campaign against YUKOS, but claimed that Putin had not known about it in advance. He suggested instead that a business rival had arranged for the cases to be brought. Once the cases had been launched, Putin was officially unable to interfere, Voloshin said, but Putin had "sent signals" about the damage the affair was causing to Russia.

Putin finally spoke about the matter himself in late August, in remarks to foreign journalists. He rejected the idea that politics or an attack on privatization were involved. Although it was clear that Putin had questioned the Procuracy about the basis for their actions, he purported to accept their explanation that purely criminal investigations were at stake, and said he could not intervene.

Of course, few people believe that the limits of Putin's influence on the Procuracy are those established by the constitutional separation of powers. Still, failure to squelch the Procuracy campaign was something less than endorsement of it. A very public admission that prosecutorial services were available for hire would be embarrassing (even Voloshin, when he said as much, spoke under what proved a very thin shield of anonymity).

YUKOS's Defense

Much of the public prominence the anti-YUKOS campaign achieved resulted from the company's aggressive public relations efforts in its own defense. Both television (until October; see below) and the print media have given extensive, at times even dominant, coverage to YUKOS's complaints about the actions against it. YUKOS lawyers have also challenged, with maximum publicity, the legality of virtually every move the Procuracy made, though their protests met no success in court. Khodorkovsky greeted each search with scorn, suggesting in early October that the widening circle of investigations reflected Procuracy officials' lack of evidence and fear that they would lose their jobs if they could not justify their actions. Meanwhile, Khodorkovsky was careful to explicitly absolve Putin of involvement, and evidently worked to secure the Procuracy's political isolation from other government agencies. The Procuracy campaign brought no visible reduction in Khodorkovsky's political activism. Indeed, if anything, Khodorkovsky's political visibility and outspokenness increased. A charity he funds purchased the famous *Moscow News* newspaper in September, and a journalist who has often clashed with Putin was installed as its head. And Khodorkovsky continued to assert that he and other shareholders are free to support whichever political parties they choose.

In extensive interviews in the Russian media, and in travels both to the U.S. and to Russia's provinces, Khodorkovsky sounded the theme that his was a struggle on behalf of the rule of law and the freedom of business from arbitrary prosecutorial activity. YUKOS's strength, he suggested, made it the best possible candidate for a test case of what standing up for oneself can accomplish.

While Khodorkovsky did what he could to politicize the conflict, YUKOS did not back down on any of its business disputes with Rosneft'. And it continued to build financial strength. In early September the firm borrowed a billion dollars at an exceptionally attractive rate (over 2% per annum below analogous borrowing by Rosneft'.) It also made successful efforts to manage investor sentiment. From the outset, Khodorkovsky stressed that the attack targeted the firm's largest shareholders, but not the firm itself. The successful completion of the Sibneft' merger, predictions of large dividend payouts, and rumors of the sale of a stake to a major foreign investor all helped stoke investor confidence. After YUKOS stock and the stock market dropped in response to Lebedev's arrest, both recovered, setting new record highs.

October: The Winds Change

In October, the conflict intensified sharply. New Procuracy raids seeking evidence led to a tax evasion case against Vasilii Shakhnovskii, another billionaire YUKOS shareholder. More telling, however, were signs that the Procuracy was no longer working alone. Oil officials refused to renew YUKOS' license to work a Far East oil field that Rosneft' had hoped to acquire. A

broader review of YUKOS' oil extraction licenses was also launched. At mid-month, the tone of television reporting on stations close to the government made a sudden tilt toward the Procuracy.

Khodorkovsky continued to react defiantly, indeed with deliberate provocation: early in the month, he challenged the Procuracy in so many words to arrest him. After they did not, Khodorkovsky began a campaign-style tour of the provinces, handing out contributions to local universities, stressing his charitable works, and putting out his version of the conflict to local reporters. Accusing prosecutors of being nothing more than shakedown artists, he mocked their confiscation of old YUKOS computers, saying they were too naïve to realize that all the data had been scrubbed from them first. In slashing public statements, Procuracy officials gave as good as they got. On October 25, Khodorkovsky was arrested in spectacular fashion.

The pattern of events in October strongly suggest something had changed behind the scenes: Putin had thrown his full weight behind the anti-YUKOS campaign. There is much evidence for this position, especially the resignation of Putin's chief of staff Alexander Voloshin after the arrest, which is hard to understand except as a protest against a decision made by his superior. After the arrest, Khodorkovsky partner Vladimir Dubov was dropped from the electoral list of United Russia, a party close to the president. Putin's public statements about the arrest also leave little doubt about his role: while noting with obvious relish the equality of even the richest before the law, he immediately devalued this statement by insisting that this was a special case from which no generalizations should be drawn. As of early November, it appeared that international investors were ready to believe that Khodorkovsky's arrest was an isolated matter. Although YUKOS stock initially plunged, it soon recovered, and still remained far above the level of the beginning of 2003.

Conclusion

As of early November, claims that the YUKOS affair presaged a reversal of privatization or a major redistribution of property appeared implausible. In late October, the Procuracy impounded YUKOS shares held by offshore holding companies in which Khodorkovsky has a major stake. But this measure merely prohibits the sale of the YUKOS shares, not those of the offshore holdings, so it is of little effectiveness. Moreover, the Procuracy was clearly reprimanded over the impounding, not only by the prime minister but also by Putin's new chief of staff, Dmitri Medvedev. Nationalization of the company does not appear to be on the agenda. After Khodorkovsky, from jail, resigned his position in YUKOS (without surrendering his ownership), the minister of Energy emphasized that he welcomed foreign oil firms' interest in buying the company. Putin stated that YUKOS oil licenses should not be revoked. Against this backdrop, Putin's repeated implication that the problem is YUKOS, and clear statements that no broader, general assault on privatization will be allowed, are at least temporarily credible.

The most interesting question about the YUKOS affair is not what the Kremlin's purposes are, for it is not the Kremlin that has had the initiative. Rather, the most interesting question is why Khodorkovsky chose to behave so provocatively, escalating what could have been a business struggle into a political one and forcing the issue of whether the authorities were ready to arrest him. YUKOS and other Russian corporate titans became large by being specialists not just in the acquisition, but also the retention of corporate property in an environment where tactical use of

commercial and criminal law is extremely common. Ordinarily, the legal cases quietly lapse once a deal is reached. By failing to negotiate, Khodorkovsky broke the rules of a system he had done much to create, and one under which he had flourished. Absent a profound personal conversion to liberal values—inconsistent with YUKOS's own tactical use of the Procuracy against its enemies—the only plausible reason for this step was Khodorkovsky's desire to build his political reputation. The Putin-Khodorkovsky showdown incontestably raises the latter's stature, shifting attention from the dubious origins of his fortune. Khodorkovsky's communications from jail have been filled with heart-tugging appeals for his partners to continue funding of his charitable works and stirring assertions of his devotion to Russia. Last summer, Khodorkovsky told a Russian interviewer, "We need no sympathy. We are strong people, and we will be strong in jail too." Such sentiments are certainly bold. Whether they are also foolhardy remains to be seen.