

# **The Yukos Affair**

## **Terminating the Implicit Contract**

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On July 2, 2003, Russian law enforcement arrested billionaire Platon Lebedev, chairman of the Board of Directors of MENATEP, the financial center of the oil giant YUKOS. A few days earlier the police had arrested Alexei Pichugin, the head of the Economic Security Department of the Security Service of YUKOS. The General Procuracy (Russia's chief law enforcement agency) charged Lebedev with financial fraud, dating back to the privatization of the phosphate-producing plant Apatit in 1993–1994, and with tax evasion by MENATEP subsidiaries in the Tomsk oblast'. Pichugin was charged with much more serious offenses: organizing five contract killings. On October 25, Mikhail Khodorkovsky, the head of YUKOS and one of Russia's leading oligarchs, was arrested and charged with fraud, tax evasion, and theft. Two days later, Vladimir Putin publicly declined to engage in any bargaining over the activities of law enforcement agencies and abruptly called for an end to all speculation and hysteria around the arrests of YUKOS management. Then, on October 30, the General Procuracy (GP) froze 44 percent of YUKOS stock (the major part of which belongs to Khodorkovsky and his closest associates). The same day Putin accepted the resignation of Alexander Voloshin, the Head of the Administration of the President (AP), and appointed Dmitri Medvedev as his successor. Finally, while still in detention, Khodorkovsky resigned as the Chairman of the Board of Directors of YUKOS.

YUKOS is Russia's largest company in terms of the market value of its assets, second largest in terms of profits, and fourth in sales. As Khodorkovsky once boasted, every sixth car in Russia is refueled by YUKOS. The criminal prosecution against its top management and the search of its offices are signs of a conflict of extraordinary scale. The causes and consequences of the conflict are not clear as the initiators of the YUKOS affair remain in the shadows. YUKOS has been seen as exemplifying Russian big business' efforts to meet international business standards, and it enjoys the reputation of being a sophisticated and transparent company that pays its taxes; it paid \$4.5 billion in taxes to the state coffers in 2002. However, the GP claims Khodorkovsky and his associates misappropriated up to \$1 billion from the state.

The detention of its management has had negative effects on YUKOS's capitalization, has increased uncertainty for the rest of the business community, and may well undermine Russia's economic growth by antagonizing foreign investors. The

reshuffling of the AP deepened the uncertainty, for it signified the end of the Yeltsin legacy in Russia's executive power and, possibly, the onset of a different type of politics.

So what are the origins of and motivating factors in the assault against YUKOS? Who are the beneficiaries, and what is the rationale for the move against YUKOS? What does it tell us about new state policies and relations between the state and the big business in Russia today?

This article, written as the YUKOS crisis was reaching its peak but was still far from conclusion, presents three possible readings of the causes of the conflict: Khodorkovsky's political ambitions; conflict within the presidential administration; and the mergers and acquisitions policy of YUKOS. It then suggests a general framework for understanding the seemingly arbitrary and risky actions of the GP and concludes that the launching of the YUKOS affair should be viewed as the strengthened state terminating the implicit and informal contract it had with the oligarchs, and proceeding to create an alternative system of relations with business in which formal rules will have more weight.

## **Political Ambitions**

The oligarchs' repeated attempts to exert direct political influence have been the source of conflicts with the Kremlin administration since 1996. In 2000 these aspirations were decisively crushed by the criminal prosecutions of Boris Berezovsky and Vladimir Gusinsky, as well as by symbolic warnings to other major companies, notably LUKOIL, whose offices were pointedly searched by the tax police. Distanced from public politics, the leaders of big business nonetheless retained informal alliances with senior Kremlin officials and continued to covertly subsidize regional governors and political parties, using regional political alliances to acquire major industrial enterprises.

Preceding the first round of YUKOS arrests was the publication on June 9, 2003, of an analytical report entitled "The State and The Oligarchs," by the Center for the National Strategy (CNS), an allegedly independent think tank. In the opening section it bluntly stated that the oligarchs, having concluded the privatization of Russia's major economic assets, have now turned to the privatization of Russia's political space. The institution of the presidency, the report argued, was the major obstacle to the new oligarchic rule. The oligarchic scenario of regime change, according to the report, included giving the Duma additional constitutional powers at the expense of the president. This would be achieved by bringing the major political parties under oligarchic control. The 2003 Duma elections would then bring about a parliamentary majority, and thus a government, controlled by Russia's oligarchs and acquiescent to their political will. Khodorkovsky was named as the main advocate of this scenario and, accordingly, as the likely head of the new government. A widely publicized charity campaign unleashed by YUKOS in spring 2003 gave some credence to the CNS report, which the mass media occasionally quoted throughout the summer. When Khodorkovsky allegedly donated U.S.\$ 70 million to the Communist Party (made, according to media reports, through Alexei Kandaurov, one of the top managers of YUKOS), in addition to his conventional donations to Yabloko and the right-liberal Union of the Right Forces, the case of Khodorkovsky's political ambitions gained further 'proof'. The arrest of YUKOS management, including its security service, and the prospects of protracted investigations

and court hearings will certainly deprive the company of leverage during the election year and can certainly be counted on to send a clear signal to other oligarchs.

However, Putin's directive to the GP to look into the circumstances of the privatization by MENATEP of the Apatit plant (now one of the key charges in the YUKOS case) came as early as December 2002, against the background of another conflict of interest. In the end of 2002, the government and the leaders of the oil industry discussed an eastern oil pipeline route, a key issue of both economic and foreign policy. While Putin and the state-owned oil company Rosneft' opted for a route through the port of Nakhodka, supplying Russian oil to a range of possible competing consumers in southeast Asia, YUKOS lobbied for a Datsyn route leading to China and linking YUKOS oil fields directly to the single largest Asian oil market. The YUKOS option stressed the economic efficiency side of the pipeline project but left out state foreign policy interests attached, as usual, to oil pipelines. Khodorkovsky's criticism of Rosneft' and his aspiration to privatize pipeline policy antagonized both state officials and a segment of business elite.

### **Conflict Within the Presidential Administration**

The clashes between two elite groups within the presidential administration—between the Kremlin veterans and the newcomers who arrived from St. Petersburg with Putin—have become the new political myth. The arrival of people from the power ministries at key positions in the power vertical built by Putin has been documented (see, for example, PONARS Policy Memo 284). The tensions and conflicts within the presidential administration, the most influential center of power in Russia today, are, according to this scenario, kept secret. The YUKOS affair has thus been widely analyzed within the context of this internal conflict.

From 1996 to 1999, the Yeltsin administration aided the rise of YUKOS, Sibneft', Siberian Aluminum, and Alfa to dominant positions in business and protected their further expansion that proceeded through multiple enterprise takeovers during the first years of Putin's presidency. The old Kremlin part of the presidential administration, whose leading figure was Voloshin, may be regarded as the protection agency for the oligarchs and the oligarch's business interests. The oligarchs, in turn, as a source not only of taxes but also of informal rents, provided vital resources for the reproduction of the dominant political position of the presidential administration. The alliance between Russia's largest business groups and the old Kremlin element of the presidential administration may indeed be seen as the key to the endurance of Yeltsin's legacy in both the presidential administration and in the government.

The new Putin security team, comprised of the two deputy heads of the presidential administration, Igor Sechin and Viktor Ivanov, and the Federal Security Service's head of the Department for Economic Crimes Yurii Zaostrovstev (none of whom ever appear in public), and the chief of the Federal Security Service (FSB), reportedly stand behind the assault on YUKOS. Their aim then is to overpower their rival faction within the presidential administration by undermining its resource base and demonstrating to the oligarchs that the old Kremlin faction can no longer provide efficient protection. This reading makes very good sense in Russia simply because it mirrors the norms and tactics

of the wild capitalism of the 1990s, when organizations that managed coercion and offered private protection were often at war, undermining each others' credibility and competing for clients. Voloshin's resignation, then, is the sign that the old Kremlin 'roof' (*krysha*, or protection) is now defunct. This, however, does not automatically mean that the Petersburg security team has become the new 'roof' or that the 'roof' model of state-economy relations still exists.

In the renewed AP, the Petersburg security people received no new appointments or promotions. It is the liberal-economic team rather than people in the uniform that gained from the reshuffle. Dmitry Medvedev and his deputies Dmitri Kozak and Igor Shuvalov are associated with legal reform and can be seen as the administrative match to the liberal-economic wing in the government. The security team could have been instrumental in weakening the political-economic foundation of the Yeltsin legacy, but the outcome so far is that the proponents of economic, legal, and administrative reforms and not of the police state have gained strength.

## **Mergers and Acquisitions Policy of YUKOS**

The consideration of two additional issues yields a different reading of the causes of the conflict. The first is the recently completed merger between YUKOS and Sibneft', which created the world's fourth-largest oil company. Plans for the merger were first announced in early 1998, when Sibneft' was owned by Berezovsky, in preparation for the auctioning of the state oil company Rosneft' but were abandoned four months later as oil prices dropped. Since the merger, Khodorkovsky's interest in Rosneft' (along with personal accusations against Khodorkovsky by its director) has been revived.

The second issue is the prospective sale of a large share of the newborn giant to either ExxonMobil or ChevronTexaco. Furthermore, as Roman Abramovich proceeded to sell Sibneft' to YUKOS (press reports put the price between U.S.\$ 3 and U.S.\$ 10 billion), he also bought the English soccer club Chelsea. This sequence revived the familiar story of oligarchs who sought to undermine Russian national interests by selling out vital national resources abroad and investing their revenues in foreign businesses. Although the purchase of Chelsea merely insulted Russian soccer fans, the possible sale of shares of the enlarged YUKOS-Sibneft' to a U.S. company could indeed be viewed in the presidential administration as a threat to national security, thus provoking hostility and triggering the assault. In the context of negative public attitudes toward the oligarchs, the Kremlin enjoys an almost legitimate right, at least according to some, to use whatever means available to defend the national interest.

What casts some doubts on this explanation of the conflict is that the state, through the Anti-monopoly Committee, could have banned the YUKOS-Sibneft' merger, and the Kremlin and Putin personally indicated soft approval rather than hostility towards a potential deal with U.S. oil companies. The corrective explanation, then, is that, according to Kremlin's new priorities, the mergers and acquisitions should go ahead, but without Khodorkovsky.

## Terminating the Implicit Contract

Rather than unifying Russia's leading businessmen in an effort to defend their collective interests, the YUKOS affair split the Russian Union of Industrialists and Entrepreneurs (RSPP), which represents big business, into supporters of Khodorkovsky and those who silently or vocally accused Khodorkovsky of breaking the previously established rules of the game. A survey conducted by the business journal *Kompaniya* in August 2003 of the heads of 83 companies showed that respondents were split as to whether the YUKOS affair threatened the institution of private property. But when asked whether the YUKOS affair would affect the future of their business and whether they felt any change in attitude toward them from state-supervising organizations, an absolute majority answered "no."

Arkady Volsky, head of the RSPP, delivered a letter from the union asking Putin to step into the fracas over YUKOS. After meeting with Putin, Volsky commented that "the issue is not persons or structures [particular companies], but general rules of the game," and the outcome depends on how well YUKOS plays by these rules. Even though a number of businessmen and leading officials, including the prime minister, expressed public doubt about the appropriateness of keeping Lebedev behind bars, there is a tendency on the part of the business community to blame Khodorkovsky for breaking rules of the game and to see the YUKOS affair as a private conflict.

What are these rules of the game? In short, they can be viewed as an implicit contract whereby the state does not revise the outcome of the privatization of the Russian economy while the main beneficiaries of the privatization (i.e., the oligarchs), in turn, fulfill several key obligations, such as not interfering in public politics, paying informal rents to the political elite, and taking on responsibility for the economic and social development of the country. In 1993–1997, some of the country's most lucrative assets (oil-mining, ferrous and non-ferrous metals) were sold to select individuals and business groups at low prices. Having thus "appointed" the oligarchs and by contributing to their dramatic expansion in 1998–2001, the AP set the terms of the informal contract and then enforced it through the expulsion of Gusinsky and Berezovsky as well as periodic assaults on other companies. Now on the eve of the Duma elections, the oligarchs, notably Khodorkovsky, have undertaken activities that might be interpreted as threatening the implicit contract. They were accused of directly buying political parties instead of sponsoring them through the presidential administration, in investing abroad, and ignoring their domestic responsibilities. In response, the central authorities proceeded to enforce the implicit contract.

The biggest problem with this perception of the nature of the conflict is that it did not presuppose the detention of Khodorkovsky or the resignation of Voloshin and new appointments in the AP. By giving the GP and the newly reformed court system the freedom to prosecute, which led to the arrest of Khodorkovsky et al, by refusing to negotiate with the business community, and by removing Voloshin (the key figure of the Yeltsin informal patronage system), Putin simply eliminated the main parties to the implicit contract, its key 'signatories', so to speak, and with this the contract itself.

The key feature of the system of relations between the state and big business, which Putin inherited from Yeltsin's weak state, is that rules, rents, and responsibilities were

agreed upon personally and informally. This was an intricate system whereby taxes and rents were exchanged for exemptions, quotas, and licenses; electoral victories for industrial enterprises; personal loyalties for competitive advantages. Voloshin was the key broker in this multiple exchange system and YUKOS was one of its primary beneficiaries. Located within the AP, this system of governance, ironically, was the major limit to presidential power itself, although it ensured post-Yeltsin succession and stability. As Minister of Finance Alexei Kudrin commented on the pages of a major newspaper, the resignation of Voloshin coincided with the end of the Yeltsin epoch. “That’s it, the Byzantine Empire is over! ... I know that this will be better for Russia’s economy.” He also stressed the inadequacy of the old rhetoric of the ‘equal distancing’ of the oligarchs (one of the terms of the implicit contract of the 2000): “They were not equally distanced, they were returned into their native business environment where one can gain exclusive rights only by means of fair competition”.

As the new segment of state power consisting of the liberal economists and jurists backed by loyal law enforcement and security has grown stronger, its representatives preferred to tear apart the old contract rather than to reproduce it and enforce it as before. This indicates a decisive shift in the balance of powers sufficient to change the nature of Russian politics as well as its agents. Such a shift was long feared or long awaited (depending upon one’s affiliation). It would have been naïve to expect that no interests would suffer, yet few predicted an offensive of such a scale. Certainly someone had to be sacrificed. It could have been another company and another oligarch, possibly Roman Abramovich (Sibneft’) or Oleg Deripaska (Russian Aluminum), but Khodorkovsky did a much better job of advertising himself for this role. After the initial shock is gone, the real interests will come back – foreign investors and the Russian business community will continue dealing with YUKOS that will, as most great creations, outlive its creators.

The question that remains open is whether the declared new type of politics—the rule of law that should, according to Putin’s statement, equalize big businessmen, state officials, and ordinary citizens—will indeed replace the old one. Much will now depend upon the way this and other major cases, such as the trial of the former Railway Minister Nikolai Aksenenko and a dozen other corruption cases, will be handled. Thus far the GP has not succeeded in winning in court cases of the Khodorkovsky variant. Given the legal capacities of YUKOS, every legal aspect of the investigation and proceedings will be closely controlled by lawyers and the media. The success of this operation then is highly dependent on the existence of real evidence, reliable proof of alleged crimes, and the GP’s ability to at least reach the court if not win the case. If legal procedure is properly observed—and Putin has publicly insisted that it will—then it might indeed form a new precedent, even if the GP loses. If, as in the past, the cases are dropped and the detainees freed as a result of informal negotiations, the rule of law will lose no matter what the state gains from yet another deal.