

**ANALYSIS OF THE CRIMINAL CHARGES AGAINST AND THE TRIAL
OF MIKHAIL B. KHODORKOVSKY AND PLATON LEBEDEV**

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Counsel for Mikhail Khodorkovsky and Platon Lebedev have prepared the following brief statement and explanation regarding the substantive criminal charges filed against these two businessmen and the primary defenses to the charges and the procedural due process violations of Russian law that have occurred throughout the trial. It is impossible to address every pertinent detail that demonstrates why the charges are devoid of merit and rather represent a manipulation of the Russian criminal justice system to further the ulterior motives, both political and economic, of those in the Russian government. Therefore, we address below the key substantive points focused upon in our analysis and by the Russian defense lawyers during the trial. In addition, we outline the procedural violations that have occurred during the trial in order to further demonstrate why any conviction Messrs. Khodorkovsky and Lebedev should be given no currency.

As a threshold matter, the reader should understand that all of the legal defects and due process violations described below are based upon the application of Russian law, either as established in the Russian Constitution and the substantive and procedural Criminal Codes or under International laws expressly adopted by and incorporated into Russian law. The defense does not seek to exonerate Messrs. Khodorkovsky and Lebedev by changing the applicable law, but rather by attempting to secure the application of existing Russian law pursuant to the Rule of Law.

The assessment that these cases are political in origin has now been made by every independent court or government body to review this matter. In January 2005, the Council of Europe endorsed the findings of its Human Rights Rapporteur, Sabine Leutheusser-Schnarrenberger, who summarized her assessment that these prosecutions were based on politics, not criminal justice, with the following sentence:

I have come to my own conclusion, namely that the presence of an interest of the State that exceeds its normal interest in criminal justice being done and includes such elements as: to weaken an outspoken political opponent, to intimidate other wealthy individuals, and to regain control over ‘strategic’ economic assets—can hardly be denied.¹

On Friday March 15, 2005, the Bow Street Magistrates’ Court in London ruled that two former executives of Yukos should not be extradited to Russia on the basis that the prosecution of Mr. Khodorkovsky was politically motivated and that no one associated with him or Yukos could receive a fair trial in Moscow. *Between the Government of the Russian Federation v. Dmitry Maruyev and Natalia Chernysheva*. In 2004, Courts in Liechtenstein and Switzerland have rejected Russia’s requests for international legal assistance in their purported criminal investigations and prosecutions of Messrs. Khodorkovsky and Lebedev. Liechtenstein Superior Court for Civil Cases No. 12 RS. 2003.255; *Pecunia Universal Ltd. V. The Office of the Attorney General of Switzerland*, Federal Supreme Court of Switzerland, 1A.86/2004, Decree of June 8, 2004.

¹ EUR. PARL. ASS. Committee on Legal Affairs and Human Rights, *Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives*, Doc. No. 10368, Explanatory Memorandum at ¶ 57 (November 29, 2004) (text adopted by Parliamentary assembly on January 25, 2005) (Appended hereto as Exhibit 1).

Messrs. Khodorkovsky And Lebedev Never Established An “Organized Group” To Conduct Criminal Activities.

The case against Messrs. Khodorkovsky and Lebedev is rooted in what is, at best, a baseless mischaracterization and, at worst, a calculated lie: that these men are not business leaders, but kingpins of organized crime characterized in the allegations as the “Group.” In other words, the Procuracy alleges that Group Menatep Limited (“GML”) and other corporate structures are not business entities operating for profit in the stream of commerce, but components of a criminal enterprise.²

The Procuracy alleges the putative crimes were committed by an organized group for reasons associated with the application of the Russian Criminal Code to these events and for procedural and political advantage:

- Imputing to and Holding Defendants Criminally Liable for the Alleged Acts of Others in the So Called “Organized Group”;
- Extending the Statute of Limitations Periods for the Charged Offenses;
- Materially Increasing Penalties and Tightening Security Measures Such as Imposition of the Pre-Trial Detention; and
- Providing a Pretext for the Violation of the Defendants’ Fundamental Human Rights.

The Procurator General’s motivation is obvious: stigmatize these men and the companies they built, thereby destroying their reputation and establishing a thin veneer of legitimacy to a politically and economically-motivated prosecution. Stripped of this omnibus allegation, the substantive deficiencies of the charges in the individual episodes become even more apparent.

GML was established in 1997 pursuant to the laws of Gibraltar as a holding company with several wholly-owned subsidiaries through the consolidation of assets belonging to the shareholders of GML and their partners, including the major block of shares in Yukos Oil Company. GML is now an international diversified holding company that, until the unlawful auction of Yuganskneftegaz on December 19, 2004, controlled assets worth over US \$30 billion.³ Messrs. Khodorkovsky and Lebedev were two of GML’s founders.

The Procuracy charges Messrs. Khodorkovsky and Lebedev with violating Art. 33(3) of the Code as the “organizers” of an “organized group” for the commission of unlawful acts. The term is defined in Art. 35 (3) of the Code: “A crime shall be deemed to be committed by an organized group if it was committed by a stable group of persons who combined beforehand to commit one or several crimes.” The Procuracy alleges that defendants, their co-shareholders and partners in Group Menatep, along with unidentified others, conspired and acted as an organized

² For purposes of the analysis of the allegation that Defendants acted as an organized group, the term Group Menatep will be used herein to include various corporate entities that existed at different times relevant to the Procuracy’s allegations in which Defendants were associated, *i.e.* shareholders, officers and directors at, including, but not limited to, Bank “Menatep”, ZAO “Rosprom,” OAO NK “Yukos,” and GML).

³ This value was calculated prior to the Russian Federation’s attack on Yukos Oil which has artificially devalued its stock. Complete information regarding GML’s structure, finances, and business ventures can be found at www.groupmenatep.com.

group to commit these crimes, and created Group Menatep as a vehicle to coordinate a network of “false corporations” to carry out and conceal the unlawful objectives of the organized group. The Procuracy fails to demonstrate *scienter* – criminal intent – in support of its contention that Group Menatep and its various holdings were structured for the purpose of conducting criminal activities. The Procuracy does not do so because it cannot; defendants and Group Menatep were associated for the lawful purpose of engaging in legitimate business activities.

The Procuracy’s effort to cast Group Menatep as a criminal organization is not credible in view of the extraordinary efforts of Messrs. Khodorkovsky and Lebedev to introduce transparency and accepted Western business practices to the Russia’s often murky business world. In particular, GML has subjected itself, and the enterprises in which it has interests, to heightened standards of transparency and corporate governance, and has undergone rigorous audits by respected accounting firms such as Ernst & Young (GML) and PriceWaterHouseCoopers (PWC) (Yukos). In addition, although not a public company, in 2002 and 2003 GML publicly disclosed its audited financial statements, including on its website – www.groupmenatep.com. These actions refute their designation as a group of criminal racketeers. Criminals do not publish their structure or finances on the internet.

Analysis of the law concerning organized criminal groups demonstrates its inapplicability here. The commentary to the Russian Criminal Code defines an organized group as “comprise[d] of two or more individuals who have joined efforts in order to commit one or several crimes. This variety of complicity is characterized by professionalism and stability.” Complicity refers to the agreement by the members of the organized group to engage in one or more criminal acts prior to their actually taking steps to implement any criminal objective. The stability component requires the existence of “permanent ties between the member of the organized group and [choice] of particular methods of activity involved in the preparation and perpetration of their crimes. Stability of an organized group, therefore, requires prior agreement and a degree of organization.”

This definition of “organized group” simply does not comport with the true facts here. First and foremost, the Procuracy makes no credible allegation, let alone offers any evidence, of *scienter* – criminal intent – or criminal agreement to support an assertion of complicity. That several persons or corporations, conduct business together does not, without more, make them criminal co-conspirators. For example, GML is a legal entity organized for the lawful purposes of overseeing the business interests of its various holdings. The Procuracy’s mere assertion that entities with connections to Group Menatep ranging from merely holding accounts at Bank Menatep to having been founded by Bank Menatep employees does not provide any basis for allegations of criminal complicity, *i.e.*, there is no basis for the leap from the existence of a banker-client relationship to the allegation of criminal collusion.

The concept of an “enterprise” in the United States’ Federal Racketeer Influenced and Corrupt Organizations Act (“RICO”), 18 U.S.C. § 1962, *et seq.*, serves as a useful comparison to the legal concept of an organized group as defined in the Russian Criminal Code. As with 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.

In this case, however, the Procuracy alleges that virtually anyone associated with Group Menatep as far back as 1990, whether or not named as a defendant, are members of the organized group. More is required to criminalize these legally formed corporate entities and those persons associated with them. “[A RICO] enterprise must be more than simply a group of people who get together to commit crimes, or a group of associated businesses operated in concert; it must have structure and continuity, as well as ‘differentiation of the roles within it.’”⁴ Rather, structure and continuity are the hallmarks of a RICO association-in-fact enterprise. For example, a United States Court of Appeals affirmed the dismissal of a RICO claim because the alleged RICO enterprise lacked any distinct existence or structure.⁵ General allegations that defendants participated in a scheme to defraud customers are insufficient to establish a RICO violation.

As under RICO, the Procuracy cannot simply provide a list of persons and entities and, without more, transform their legitimate association for the lawful purpose of conducting business into a criminal organized group. Whether prosecutor or private plaintiff, a claimant “cannot meet the demands of RICO just by naming a string of entities that assertedly make up an association in fact.”⁶ The Procuracy does no more, and thus fails to convert a lawful business association into an organized criminal group. The Liechtenstein Court cited this particular flaw in the Russian criminal allegations as part of its basis for denying Russia’s request for mutual assistance. Liechtenstein Superior Court for Civil Cases No. 12 RS. 2003.255 at p. 8 (finding that the Russians had failed to identify a discernable link between the lawfully organized Bank Menatep and the alleged illegal conduct.)

Episode I – Khodorkovsky and Lebedev Committed No Crimes In Connection With The Privatization of Apatit.

At the outset of privatization, all major industrial facilities were seriously under capitalized, substantially subsidized by the state and lacking detailed accounting documents, budgets, regulatory compliance programs, codes of corporate governance, and other fundamental management tools utilized by businesses in a true market economy. Operations had never been driven by profitability and, at best, only marginally by performance. Under the Soviet regime, state owned industries existed to generate goods pursuant to centralized state plans, and to

⁴ *Carnegie v. Household International, Inc.*, 220 F.R.D. 542, 545-46 (N.D. Ill. 2004) (quoting *Richmond v. Nationwide Cassel L.P.*, 52 F.3d 640, 645 (7th Cir. 1995)).

⁵ *Stachon v. United Consumers Club, Inc.*, 229 F.3d 673, 675 (7th Cir. 2000).

⁶ *Richmond v. Nationwide Cassel L.P.*, 52 F.3d 640, 644 (7th Cir. 1995).

provide jobs and certain social benefits for their managers and workers, all without the market's disciplining imposition of economic rationality.

Rapid, mass privatization at the time was almost universally viewed by economists and political and business leaders both within and without Russia as essential for the transition from a centrally planned to a market economy. It was a sea change as for the first time since the advent of the Soviet era, businesses such as Apatit were to function in a market environment, one where success and survival were linked to performance and profitability. Privatization, in the form of investment auctions and tenders in particular, were a means to have private individuals invest capital and, by necessity, introduce performance based operating models. Increases in production levels and efficiency, rather than the satisfaction of a central plan or the personal wishes of government officials or plant managers, became a priority.

In 1994 the Property Fund of Murmansk Region (the "MRPF"), acting on behalf of the Russian Federation, invited bids for an investment auction for 20% of Apatit stock at par value (the "Auction"), which incorporated an investment plan for Apatit. Bidders submitted proposed terms of payment and sums for investment into the enterprise for the realization of an investment plan (the "Investment Plan").

Four entities bid in the Auction – Volna, Malakhit, Flora and Intermedinvest. The prevailing bidder was Volna, with an investment total of RUR 563,170 million (\$283,142,283.00). In presenting its bid, Volna submitted a Guarantee Letter from Bank Menatep guaranteeing Volna's financial performance under the Investment Plan. As finance expert Lubenchenko explained, Bank Menatep did this lawfully, because in 1994 there were no limitations on investment operations.⁷ Furthermore, Bank Menatep's role as guarantor was expressly stated and disclosed to both Apatit and MRPF prior to the Auction, and neither complained or raised any issue concerning its participation in this or two other bids. Under the terms of the Stock Purchase Agreement, Volna agreed to pay the value of the 20% shares of Apatit at par value in the amount of RUR 415,803,000.00. Volna also agreed to make a cash payment of 30% of the total amount of investments within one month of the date of the agreement, the balance to be paid by July 1, 1995.

The Procuracy has alleged three forms of fraudulent conduct in connection with the 1994 acquisition of 20% of Apatit's stock: first, that defendants conspired to create shell companies secretly controlled by Bank Menatep for purposes of the bidding, including the winner, Volna; second, that defendants knew that Volna, at the time it bid, had no intention of complying with the Investment Plan; and third, submission of false documents to the MRPF as part of the bidding process. There is no legal or factual basis for the Procuracy's leveling these criminal fraud charges. Under both the Russian Criminal Code and United States criminal law, a fraud conviction requires establishing a specific intent to defraud – *scienter*, malicious intent, or *mens rea* – at the time of the initial act. Here there is no, and can be no, evidence of any requisite malicious intent on the part of Messrs. Khordorkovsky and Lebedev.

⁷ See Expert Opinion by Konstantin Lyubenchenko, p.8.

Menatep Sufficiently Disclosed Its Role in the Apatit Privatization Auction and the Criminal Fraud Charges Fail as a Matter of Law and Fact.

The Procuracy's allegation of fraud is predicated on the false premise that material information was withheld in the bidding process. Bank Menatep owned no stock in any of the bidding companies, each of which was a separate and distinct corporate entity from the other, and had no business relationship with them beyond Volna, Flora and Malakhit being bank customers. The true facts fail to support a crime for several reasons.

As a threshold matter, Menatep's relationship to the bidding entities *was disclosed*. The Procurator's charges ignore this critical, and dispositive, fact: Volna, Malakhit and Flora each expressly disclosed their relationships with Bank Menatep in their respective submissions of Applications and Guarantee Letters: that each was a client of the bank; maintained a valid account with it; and that the bank guaranteed their financial performance of the Investment Plan. In fact, Pozdniakov the Apatit Director General and a key prosecution witness, repeatedly acknowledged that he was aware of Menatep's role in the bidding process.⁸ Thus, once the bidders identified Bank Menatep's role in their respective bids, the MRPF was on notice of Messrs. Khordorkovsky and Lebedev's potential involvement, if any. It was well known that they founded Bank Menatep and were synonymous with its business ventures, and they engaged in no effort to conceal that fact. Moreover, their affiliation with Bank Menatep does not give rise to any individual liability, particularly not criminal, for Volna's alleged non-performance.

In addition, neither Mr. Khodorkovsky nor Mr. Lebedev was under an obligation to disclose any alleged common ownership, control or business relationships between or among the bidding entities. There was no express, affirmative obligation to make any such disclosure. Then applicable law did not prohibit affiliated entities from participating in the same auction. Any business relationship among the bidders was immaterial to the award of the auction, and so cannot support criminal fraud charges. Finally, and fundamentally, the competition was not rendered non-competitive or otherwise adversely impacted by reason of allegedly affiliated entities bidding against one another. As prosecution witness and ex-Murmansk Property Fund official Polyanskaya testified, privatization would have been legal even if only one company placed a bid.⁹

Volna's Payments and Actions Demonstrate Intent to Comply with Investment Plan And Contravene an Essential Element of the Criminal Fraud Charges.

The Procuracy's allegations of short-falls in compliance with the Investment Plan do not provide the basis for a criminal fraud case. More specifically, it cannot establish that either Volna or Bank Menatep, acting as guarantor, did not actually intend to invest at the time Volna submitted the bid package. Rather, the Procuracy's position is contrary to the actual facts and applicable law, and would be dismissed by an independent judiciary on multiple grounds. At most, the Procuracy has pleaded a breach of contract case.

⁸ See Witness Testimony, Anatoly Pozdniakov (8/20/04; 8/23/04).

⁹ See Witness Testimony, Liudmila Polyanskaua (8/30/04).

First, under the narrow application of Russian law, a charge for theft by fraud (art. 159) only lies when the title to property is transferred from an owner to an alleged offender. Thus, here the alleged crime could only have occurred at the time the shares were transferred from MRPF to Volna, on July 24, 1994, when Volna paid the par value for the shares. However, many witnesses for prosecution repeatedly admitted the transaction “was done legally,”¹⁰ and “Volna paid for the shares in full.”¹¹

Subsequent performance under the Investment Plan is not an element of the purchase and therefore cannot be a predicate act for such a charge as a matter of law. However, in an attempt to avoid the narrow scope of art. 159, the Procuracy argues that performance under the Investment Plan was somehow linked to, or a precondition for, the legitimate transfer of the shares in addition to the payment of par value price. Assuming, *arguendo*, that the Procuracy is correct and the alleged failure to perform is a basis for so charging the defendants, its case still fails. The promise as to the future act of complying with the Investment Plan cannot support a charge of criminal fraud in these circumstances, where there was no fraudulent intent at the time of contracting and performance occurred. A false representation must relate to an existing or past fact. This critical distinction exists so that persons who have done no more than breached a contract are not held criminally liable. In order for there to be liability in fraud for the failure to perform a future act, as opposed to a breach of contract, there must have been an intent to defraud – *i.e.*, to not perform – at the time the promise was made.

The Procuracy has made no specific allegations supportive of an intent to defraud, but rather relies on the bare assertion that it was financially advantageous for Volna not to meet its obligations under the Investment Plan. This is insufficient. If financial motive alone were enough to prove *scienter*, the intent to defraud could be made out in every financial dispute. Nor can imperfect or non-performance suffice to show fraudulent intent at the time of promising, lest every breach of contract support a claim of fraud. Mere failure of a promised performance does not permit a factual finding that a party never intended to perform.

The totality of the circumstances rebut any claim of specific intent to defraud at the time of the Auction or, indeed, at any time. First, Volna did not have the requisite information to form an intent to defraud through non-compliance with the Investment Plan at the time of contracting: its terms, while laid out in broad strokes, were still being defined even after Volna’s bid had been accepted, and the Investment Plan itself contemplated its later revision. Moreover, Volna, or Bank Menatep, substantially performed its obligations under the Stock Purchase Agreement by investing, by proposing revisions to the Investment Plan based upon business judgments which proved to be eminently sound, and by enhancing the management efficiency of the company. In fact, Apatit General Director Pozdniakov, admitted that Volna’s various improvements qualified as an “investment” under the plan.¹² Moreover, the fact that Volna submitted proposed revisions to the Investment Plan even *after* it sold its stock supports the contention that at the time of the Auction it had every intention to comply with the Investment

¹⁰ See Witness Testimony, Evgeniy Komarov (8/24/04) (noting that the transaction was “in accordance with legal standards of the time”). See also Grigory Rzheshesky (8/23/04); Tatiana Rashina (8/26/04); Nina Gorbunova (10/05/04).

¹¹ See Witness Testimony, Tengiz Khakhva (9/17/04)

¹² See Witness Testimony, Anatoly Pozdniakov (8/20/04; 8/23/04).

Plan. This is powerful evidence of Volna's and Menatep's good faith efforts to comply with the spirit and intent of the Investment Plan.

Second, there can be no fraud rooted in an alleged failure to adhere to the precise terms of the Investment Plan, for that document itself contemplated and provided for its own modification. According to defense expert Pleshkov, at the time the MPF drafted the investment plan, it was impossible to foresee the upcoming social, legal, and economic changes.¹³ The same conclusion was reached by experts from *Ernst & Young*.¹⁴ In the face of the myriad unknowns which attended Russia's rapid, mass privatization, such flexibility was not only prudent drafting, but a necessity. The complexity and uncertainty surrounding the transformation of a state owned entity of Apatit's scale and complexity into a viable, ongoing private concern cannot be overstated, and it was not possible to anticipate and codify in a document of less than twenty pages the thousands of possible issues with respect to this investment. The Investment Plan, incorporated by reference into the Stock Purchase Agreement between Volna and the MRPF, acknowledges the paramount goal of maintaining Apatit as a going concern, and provides presumptive terms of performance of investments toward that end, all of which are subject to revision. Volna acted consonant with the terms of the Stock Purchase Agreement in attempting to modify the Investment Plan where business prudence so dictated. Defense expert Pleshkov testified that following the plan in its entirety would have resulted in significant losses to Volna's investors.¹⁵ At most, Volna's subsequent failure to adhere to the Investment Plan is a breach, but it is not criminally fraudulent. This language of modification, present at the time of the contract's formation, precludes the imperfect performance from serving as the basis for criminal fraud charges. Perhaps the best proof of this contention is that Apatit is a going and profitable concern – the ultimate goal of the Investment Plan and Privatization.

Third, strict adherence to some terms of the Investment Plan, which was prepared prior to Volna's or Bank Menatep's ability to visit Apatit's facilities in the Murmansk region and inspect on the ground its business needs, would have been contrary to the viability of Apatit as a going concern, and entailed either or both the waste of Apatit investment assets or the commission of fraud. As Volna learned in the course of obtaining a more complete understanding of the condition of the enterprise, Apatit could not utilize the enormous influx of capital contemplated within a truncated, one-year time frame, and any transfer of the funds into Apatit accounts pending later use presented a number of potential, adverse consequences. Analyses of Apatit's operations led to the conclusion that the Investment Program was flawed in its provision for costly, unnecessary projects with not even a colorable business purpose (*e.g.*, the construction of a micro-brewery, establishment and maintenance of a resort for Apatit's employees), or projects that became legally impossible to sustain (*e.g.*, construction of housing for employees of the resort in what became a foreign jurisdiction, Ukraine). Most of these projects were relics of the planned economy era, where such remotely or non-business related expenditures were the typical means of providing incentives for workers (as opposed to raising salaries, which has been done under Volna's suggestion), and a factory's operation at a net loss was not fatal, or even necessarily relevant, to its continued existence. In the post-Soviet Russian Federation, this was

¹³ See Expert Opinion of Andrey Pleshkov, p. 88 (report was not admitted by the Court on technical grounds).

¹⁴ See Expert Opinion of *Ernst & Young*, Chapter 2, pp. 17-25 (report was not admitted by the Court on technical grounds).

¹⁵ See n. 13 *supra*, p. 89 para. 5.

no longer the case. Apatit had to be run in a rational, profit making fashion if it were to survive in the competitive, free market economy.

Fourth, and fatal to the Procuracy's allegation of fraud, Volna *has substantially complied* with the Investment Plan; to the extent it has not, any such deviation was not material. Volna satisfied the requirements for Apatit's social infrastructure and technical upgrades, and paid and secured payment of Apatit's outstanding liability including a RUR 44,000,000,000 (\$9,000,000) debt owed by Apatit to the energy company Kolenergo. In addition, Volna secured payment to other Apatit suppliers as part of its compliance with the Investment Project, and also secured approximately \$83 million in the form of loans by Bank Menatep to Apatit. Further, there is the investment value of the time, effort and expertise Volna and Bank Menatep expended to transform Apatit into a thriving, going concern. There can be no serious question but that this goal was achieved. Apatit has grown from a floundering company with a negative valuation into one of the largest and most profitable concerns in the Russian Federation. Such substantial compliance with the Investment Plan's terms cannot support a claim for civil fraud, much less criminal charges.

Fifth, and finally, the alleged conduct did not result in any harm to Apatit, and so cannot support any fraud charges. Harm resulting from the claimed fraud also is a required element, without which an action cannot be maintained. Here, the Procuracy does not allege harm to Apatit (Apatit, for its part, has *specifically denied* any harm to its interests). Rather it claims harm to the interests of the State, because it sold property (20% of the stock in Apatit) to Volna for the ultimate benefit of defendants based on a fraudulent misrepresentation.

The crux of the fraud allegation is that Volna fraudulently acquired the Apatit shares at par value price without ever intending to comply with its investment obligations. This theory is flawed for two reasons. First, Apatit, not MRPF or the State, was the beneficiary of the \$283,142,283 in investments. Even assuming for purposes of argument that Volna has not complied with the Investment Plan, which is not true, non-payment would deprive Apatit, not the MRPF. In any event, here the MRPF is only entitled to, and could only be deprived of, payment for the shares in the amount determined under the Stock Purchase Agreement, RUR 415,803,000 (415,803 shares at par value price of RUR 1,000). Since it is undisputed that Volna paid the full price for the 20% stock of Apatit RUR 415,803,000, the MRFP can hardly complain of any harm or theft, as it received the price for shares it bargained for. In its opinion, Ernst & Young pointed out that, when Volna purchased Apatit shares in 1994, there was no market for Apatit stock.¹⁶ Furthermore, even if, hypothetically, a market had existed, the price for 20% of Apatit shares could not have exceeded \$9,500,000.¹⁷ Therefore, Volna not only paid for these shares in full, it paid significantly more than they were worth. Second, even if credence is given to the Procuracy's argument, however manifestly incorrect under the law, that the price of the Apatit shares consisted of both the par value price *and* the \$283,142,283 in investments, the result would be the same – no harm to the State.

There was no harm to Apatit resulting from the alleged fraud, because the investment levels achieved resulted in a *more* productive and *more* profitable company. It was clear from

¹⁶ See n. 14 *supra*, Chapter 1, p. 35.

¹⁷ See *id.*, Chapter 2, p. 1.

the testimony of the prosecution witnesses, including the then Governor of Murmansk, that Volna played a critical role in “salvaging Apatit.”¹⁸ In 1994, Apatit had a negative capital position and was in dire financial circumstances. By 2003, Apatit had increased production levels to 8.6 million tons per year; increased personnel to 15,000 people (against 13,589 in 1994), and had received capital investments in the period of 1994 through 2003 of \$309 million – exceeding by a considerable measure the expected results under the Investment Plan. Rather than being harmed in any way, Apatit and its shareholders have benefited enormously from the transaction which the Procuracy now attempts to distort as criminally fraudulent conduct.

Volna’s Sales of the Apatit Shares Were Arms Length Transactions Made in Good Faith and in Reliance on Court Rulings.

The Procuracy also has charged defendants with malicious non-compliance with a court judgment ordering the return of the Apatit shares. It alleges that in response to efforts by MRPF to reclaim 20% of Apatit stock for breach of contract, the accused conspired to retain the shares through a series of illegal stock purchase agreements in 1996, as a result of which, by April 1998, when MRPF secured a final judgment terminating the Agreement and ordering the return of Apatit shares, Volna no longer owned them.

This charge is specious, predicated on the distortion and a misstatement of critical facts. Even the prosecution’s witnesses explained that “expecting Volna to return its Apatit shares was unrealistic because it had already sold them.”¹⁹ Volna’s sales of the Apatit shares to third parties in June of 1996 were made in good faith and in the wake of multiple court victories, repeatedly challenged and upheld on appeal, strongly supportive of the view that Volna was free of restrictions on the alienation of the shares. What is more, *even after having sold the shares in June of 1996, Volna continued to fulfill its investment obligations.* Based on the unsupported allegation that they controlled Volna, the Procuracy asserts that defendants criminally avoided compliance with a court order by engineering the illegal transfer of shares. However, the Procuracy’s own witness pointed out that “everything was done legally.”²⁰ Since the transfer was legal, there is no basis of this allegation. Volna, as the owner of the Apatit shares, and Bank Menatep as the financial guarantor, acted in reliance on a final court order, affirmed on appeal, that the stock could be sold without the encumbrance of any outstanding obligations under the Investment Plan. Finally, there are serious questions whether the court order on which the Procuracy so heavily relied in fact ordered Volna to return the shares to the property fund.

The Procuracy also alleges that in furtherance of their plan to retain the Apatit shares, defendants organized a settlement between the Russian Property Fund (“RPF”) and Volna by which Volna agreed to pay to the RPF RUR 478,914,197.00 (\$15,130,000.00) in damages in exchange for RPF’s release and discharge of Volna’s obligation to return the shares (the “Settlement”). The Procuracy now contends that the Settlement contradicts Russian law, and was entered into in violation of the court’s order directing the return of the shares. However, as

¹⁸ See Witness Testimony, Anatoly Pozdniakov (8/20/04; 8/23/04). See also Evgeniy Komarov (8/24/04) (noting that Apatit was on the brink of bankruptcy at the time of privatization).

¹⁹ See Witness Testimony, Tengiz Khakhva (9/17/04); See Grigory Rzheshesky (8/23/04) (noting that “Volna didn’t have the shares anymore”).

²⁰ See Witness Testimony, Tengiz Khakhva (9/17/04)

the RPF director testified, the Russian Federal Property fund also was not harmed in any way by Apatit's privatization.²¹ Volna complied with its settlement obligations and paid the settlement amount in full, in accordance with the settlement agreement.²² It should be further noted that, in complying in good faith with its settlement obligations, Volna paid nearly twice more than these shares were worth in 1994.²³

Moreover, the settlement was approved in November, 2002 by both the Moscow Court (the "Settlement Decision") and the Procuracy – which later launched the current prosecution. In 2003, the Russian Administration questioned the Settlement Decision and the Procuracy re-confirmed it to be justified and appropriate. After the Settlement Decision became a clear obstacle to the prosecution of the criminal charges, the Procuracy filed an application with the Supreme Arbitration Court arguing that the RPF had no authority to execute the Settlement, rather than challenging its reasonableness. On February 5, 2004, that Court remanded the case to the Moscow Court for reconsideration, *inter alia*, as to whether RPF had proper authority to enter into the Settlement. In July of 2004, pursuant to pressure from the Procuracy, the RPF withdrew its complaint for damages, therefore, eliminating this serious impediment to the Procuracy's pursuit of the Apatit charges.

Thus, it was not until a February 1998 that a Court ruled in the government's favor and imposed a new obligation on Volna concerning Apatit's use of the funds. This, however, came nearly two years after the shares had been sold in 1996. In 2003, having reached an agreement satisfactory to the parties and the Court, a settlement was signed, approved by the Court, and the matter was seemingly at a close. Despite the satisfaction of the direct parties to the Settlement, however, the Procurator General interjected himself into the proceedings, just as the government's campaign against Yukos and defendants ratcheted to a new intensity.

Episode II – Sales of Apatit Product Were Legally Structured.

The Procuracy alleges that defendants misappropriated Apatit profits for themselves, and caused property damage to Apatit shareholders by depriving them of the dividends on such profits they otherwise would have received. To reach this fanciful position, the Procuracy disregards fundamental economic propositions, business realities, and the facts.

The Procuracy alleges that between 1995 – 2002, defendants acted as *de facto* managers of Apatit and breached their fiduciary duty by selling Apatit concentrate ("Apatit product") at reduced prices. This allegedly was accomplished through transactions wherein "shell" entities, under their control, purchased Apatit product at a reduced price (*e.g.*, \$40 per ton) and which then resold it at market price (*e.g.*, \$63.50 per ton) with defendants retaining the resulting difference. The Procuracy alleges that in total this caused Apatit to lose in excess of \$32 million in net proceeds, representing the pricing differential between the purchase price received by Apatit from downstream entities; *e.g.* – Apatit Trade, and the ultimate sales price collected by, *e.g.*, Apatit Fertilizer, S.A.

²¹ See Witness Testimony, Tengiz Khakhva (9/17/04)

²² See Witness Testimony, Tengiz Khakhva (9/17/04)

²³ See n. 17 *supra* (noting that the price for 20% of Apatit stock in 1994 ranged between \$8,950,000 and \$9,500,000).

What the Procuracy casts as criminal conduct is the commonly used business practice of downstream sales. At least three prosecution witnesses, two of whom were ex Ministry of Fertilizer officials, admitted the legality of the structure in their respective testimonies.²⁴ The realities of the early years of privatization provide needed context here. After privatization, Apatit lost the benefit of the government's trading and distribution infrastructure as well as the government's financing and backed credits against all sales. The newly privatized Apatit, as with the rest of Russian industry, sorely lacked cash for the supplies and salaries necessary to continue production. As a result, it was forced to barter its product at a discounted price in exchange for needed inventory. One of the first decisions of the new shareholders in Apatit was to end swap sales and establish a process which would allow Apatit to sell its product at a profit and obtain funds to continue its production.

By the end of 1995, Apatit's new management with approval of its board of directors ("Apatit's Board"), including a representative of the Russian Government, established a separate operating and distribution network which replaced an old practice of barter deals on the domestic market and uncoordinated sales outside of Russia. At first, Apatit's Board delegated marketing and sales to a domestic operating company, Apatit Trade, which became responsible for delivery to the end-purchaser. In 1997, to streamline export sales, Apatit Trade stopped selling on behalf of Apatit, and instead agreed to buy annually from Apatit a substantial volume, from 50% to a 100%, of its yearly production, thus providing Apatit with guaranteed sales. Apatit Trade then resold the Apatit product during the next year to end purchasers. The wholesale price for the Apatit product was agreed by Apatit and its distributor, Apatit Trade, generally on a monthly basis.

This downstream structure is commonly used by Western fertilizer companies to provide immediate stability and enhance long term profitability. This arrangement – approved by its Board of Directors – allowed Apatit to have guaranteed sales, effectively plan its production volume, minimize and optimize its payment of taxes in Russia, and avoid the risks and additional costs with respect to the downstream sales. In the short term, it allowed the company to avoid initiation of bankruptcy proceedings by its creditors and, thus, was essential to Apatit's survival and expansion and in the best interests of its shareholders.²⁵ As a result of its implementation, Apatit achieved profitability and gained efficiencies that allowed it to increase production and expand its work force and increase wages.

Sales Proceeds Were Not Criminally Misappropriation in Violation of Art. 160.

The misappropriation charges under Art. 160 allege that defendants fraudulently caused Apatit to forego in excess of \$32 million in net proceeds from the sale of Apatit product – the

²⁴ See Witness Testimony, Vladimir Galitsky (8/30/04) (noting that "such practice was considered normal and used by many companies at the time"); Andrei Kalatin (8/30/04) (confirming that this was a normal practice at that time); Yuri Shaposhnik (10/26/04) (pointing out that the model used by Apatit was a "response to developments in the marketplace").

²⁵ See Witness Testimony, Yuri Shaposhnik (10/26/04). Shaposhnik, the DG of Apatit at the time in question, pointed out that "Apatit's privatization allowed the company to restart production and streamline the process of selling its product, which had been a serious problem previously."

pricing differential between purchase price received by Apatit from its downstream company and ultimate sale price collected by its downstream company. The sole basis for this is the assertion that before Apatit Trade served as Apatit's operating company, Apatit sold directly to customers outside of Russia at a higher price. The Procuracy concludes that, but for Apatit Trade, Apatit would have collected \$63.5 per ton instead of \$40. This assertion is not supported by any evidence, since the Prosecution's own witness testified that they purchased Apatit product at prices not exceeding \$43.3.²⁶

Procuracy's claim must fail for various reasons. First, the offense of misappropriation is predicated on the conversion of some *tangible property right*. If defendants misappropriated anything, which they did not, under these facts it can only be Apatit's "corporate opportunity" to sell its product directly to the end customers without sharing the proceeds with its downstream companies, conduct which does not qualify as a crime under Art. 160. The Comments to Chapter 21 (Crimes against property rights) of the Criminal Code clarify that only movable, *tangible property* with a known or non-speculative value can be the subject of crimes of theft, and that lost profits do *not* qualify as theft, as there is no transfer of possession of property from the owner to the perpetrator. The Procuracy cannot transform the alleged price differential into a *tangible* property right by pointing to transactions in which Apatit Trade successfully sold to an end user at a higher price than the one it had originally bought the Apatit product. This is too intangible interest to satisfy the element of tangible *res* or property under Art. 160.

The concept of lost corporate opportunity as alleged by the Procuracy is a matter of first impression in Russian criminal law, and reference to the United States legal authority is useful. Significantly, under United States law such a claim is a civil, not a criminal matter. This is so because the corporate opportunity doctrine flows from the duty of loyalty, and provides that a corporate fiduciary may not usurp the corporation's business opportunities without proper disclosure and consent. Courts generally limit the doctrine to those opportunities in which the corporation has at least a tangible expectancy – something less ownership, but more certain than mere desire or hope. These are expectancy interests, inchoate and not yet vested or matured into an actual, tangible property interest.

Finally, but most importantly, because Apatit's Board approved and ratified the downstream sales arrangement by Apatit Trade prior to its implementation,²⁷ this constitutes "proper consent" which defeats a claim of lost corporate opportunity at the outset, even under a less stringent civil standard.

There Was No Property Damage by Deceit or Abuse of Trust in Violation of Art. 165.

The Procuracy also asserts that defendants' conduct caused Apatit's shareholders damages in the form of lost dividends and that such conduct constitutes a criminal offense punishable under Art. 165. The Procuracy contends that the defendants' conduct resulted in RUR 6,168,043,000.00 (\$213,390,232.43) of understated net income to Apatit and related lost dividends to the State as an alleged holder of 20% of the shares. This alleged harm is no more

²⁶ See Witness Testimony, Vladimir Galitsky (8/30/04). Galitsky served as a Commercial Director of Minudobrenie.

²⁷ See Witness Testimony, Yuri Shaposhnik (10/26/04).

than sheer speculation based upon assumptions concerning potential sales of the balance of Apatit's production and fails to account for costs, normal product losses or market uncertainties.

The claim fails even under the civil standard as all material facts relating to the transactions, of which the Procuracy now complains, were fully disclosed to Apatit at the time of their occurrence, and ratified by Apatit's corporate leadership. Such ratification precludes any claim that a corporate opportunity was improperly diverted. More importantly, this full disclosure negates the Procuracy's ability to prove deceit or abuse of trust, an essential element of the crime under Art. 165. Thus ratified by Apatit, the conduct fails to constitute even a business tort or breach of contract, much less a criminal offense. As Shaposhnik testified, Apatit does not dispute the reasonableness of these actions and claims no harm.²⁸

Episode III – Privatization of the Research Institute for Fertilizers and Insecto-Fungicides.

The issues with respect to RIFIF, for present purposes, largely mirror those of Apatit's privatization, discussed in Episode I, *supra*, and in the interest of brevity are not addressed here.

Episode IV – Yukos Tax Minimization Structures Complied with Corporate Tax Laws.

The Procuracy has alleged that defendants caused Yukos to systematically evade taxes through the use of "affiliated entities" registered in the restricted access jurisdiction of Lesnoy, Nizhneturinsky District, Sverdlovsk Region ("Lesnoy"). Such restricted access jurisdictions, carry over from the Soviet-era, were remade into legislatively created internal tax havens known as ZATOs. These special administrative territories were governed by federal law, pursuant to which all taxes collected within a ZATO's territory were retained for its own budget. ZATO's were authorized to provide tax benefits, principally reductions, within its region at its own budgetary expense. The entities receiving these tax benefits, in turn, were required to transfer to a percentage of their tax savings to extra-budgetary funds of the ZATO. The ZATO's came to be viewed as a "loophole" in the tax system, and "loopholes" by definition are not illegal.

At the times in question, however, these were lawful vehicles for tax minimization, and the conduct of which the Procuracy complains cannot constitute any criminal, or even civil, tax violation. These operating companies were legal entities, compliant with applicable requirements, and their utilization in ZATOs was a lawful tax practice.

The Procuracy alleges the illegal plan allegedly occurred in two phases; first the "affiliated entities" prepaid their tax obligations with promissory notes and then, after overpaying and improperly negotiating tax reductions with the Lesnoy Department of Finance, secured tax refunds without having made good on the original notes. As with the allegations concerning Apatit, the Procuracy alleges the defendants acted with unnamed others in an organized group in perpetrating these crimes.

In connection with first phase, the charges of corporate tax evasion under Art. 199 of the Russian Criminal Code, the Procuracy alleges that, for the tax years 1999 and 2000, defendants caused Yukos Oil Company to register four "affiliated entities" – OAO Business Oil, OAO

²⁸ *See id.*

Mitra, OAO Vald-Oil, and OAO Forrest-Oil (collectively, “the ZATO registered entities”) – in the ZATO of Lesnoy to secure illegal tax reductions pursuant to law providing the local tax authorities with the authority to negotiate such reductions with companies engaged in business within the jurisdiction. According to the Procuracy, these “affiliated entities” were illegitimate front entities that did not in fact conduct business in Lesnoy and, therefore, were ineligible for any tax deductions. As part of the scheme, the defendants also allegedly caused these entities to illegally pay for those reduced taxes with promissory notes rather than cash. The Procuracy claims that this scheme resulted in an underpayment of taxes of RUR 17,395,449,282.00 (\$601,814,702.19). However, a comprehensive expert analysis disproves these allegations. For example, Denis Shchekin, an expert in tax law, demonstrated that such non-cash payments were lawful under the decrees of Russia’s Ministry of Finance and Ministry of Tax.²⁹ Furthermore, the Procuracy’s allegations are rejected by its own witness, who pointed out that neither tax authorities, which audited the companies regularly, nor Lesnoy’s administration ever raised any concerns about illegal activity of the subject companies or considered bringing legal action against these four subsidiaries.³⁰ Likewise, various defense witnesses repeatedly testified that then-existing law authorized paying taxes with promissory notes.³¹

With regard to the second phase, the putative violation of Art. 159(4), the Procuracy alleges that defendants defrauded the Federal budget by directing the “affiliated entities” not to pay on the promissory notes submitted in 1999 as advance payment for taxes due in 2000 incurred in 1999, calculating that the entities had overpaid based upon the improperly claimed reductions, and then rolling over the claimed overpayment as payment for 2000 taxes. The Procuracy alleges the theft was effectuated at the end of 2000, when, after again claiming overpayment of taxes of 1999 fiscal year, some of the “affiliated entities” were dissolved, merged them into other companies, and then sought reimbursement for the overpayments. Thus, according to the Procuracy, the merged entities received cash refunds from the Federal tax budget without the original entities ever having paid the promissory notes originally submitted to the Lesnoy tax authorities in 1998 as payment for taxes. The Procuracy claims that the improperly obtained refunds caused the Federal budget losses totaling RUR 407,120,540.28 (\$14,084,782.92).

The elements of these tax offenses under the Russian Criminal Code are comparable to United States law. In order to establish criminal tax evasion under Art. 199, the Procuracy must establish that the “affiliated entities” failed to pay taxes – in other words, that the promissory notes were not only an improper form of payment, but also that there was no intent to pay them when redeemed.

The elements of Art. 159(4), theft of tax refunds by means of deceit or abuse of trust, are: a fraudulent act for the purpose of unlawfully obtaining another person’s property; the intent to

²⁹ See Expert Opinion by Denis Shchekin, p. 26; see also Expert Opinion by Sergei Grechishkin, p. 29; Expert Opinion by Sergei Semenov, pp. 18-19; see also Expert Report by V. Bochko, Chapter A p. 1, para. 5 (the report was not admitted by the Court on technical grounds).

³⁰ See Witness Testimony, Leonid Koval (2/18/05). Koval was a founder and DG of Spetsproekt, a company that registered legal entities in special tax zone Lesnoy.

³¹ See, e.g., Expert Testimony by Denis Shchekin (1/17/05-3/14/05) (noting that non-cash payments were consistent with the current Policy of Ministry of Finance and Tax Ministry); Testimony by the Procuracy’s witness Larisa Petrove (1/24/05) (stating that Russian Tax Code provided both individuals and corporations with the right to pay taxes in promissory notes); Expert Testimony by Sergei Simenov (1/25/05) (noting the same).

obtain the property of another through deception or breach of trust; and pecuniary gain to the defendant and corresponding harm to the property interest. In the context of theft by way of tax evasion, the Procuracy must show that the entities improperly reduced their tax liability by either the submission of false data regarding income or deductions, or the improper assertion of special or exempt tax status.

Thus, the Procuracy must demonstrate that the “affiliated entities” did not qualify for the tax reductions negotiated with the Lesnoy tax authorities. Furthermore, the Procuracy must establish that defendants caused the “affiliated entities” to improperly negotiate the reduced taxes with the knowledge that the entities did not qualify, *i.e.*, both defendants must be shown to have acted with the direct intent to defraud the government. Finally, the Procuracy must prove harm to the Federal budget in the form of reduced tax payments or improperly secured refunds. In order to establish the former, the Procuracy again must prove that the entities did not qualify for the special tax status in Lesnoy, and for the latter, the Procuracy must prove that the Lesnoy authorities never redeemed the promissory notes for their designated value.

Under both Russian and United States law, it is well-established that convictions for tax offenses require proof of specific intent, *i.e.*, that the defendant violated the tax laws “willfully.” A willful act is one done voluntarily and in intentional violation of a known legal duty. Thus, defendants’ actual knowledge that they were violating the statute is an element of the offense without which there can be no criminal liability. Critically, there was no intent on the part of either Khordorkovsy or Lebedev to defraud or unlawfully evade tax payments. Rather, the course taken with respect to taxes was taken in good faith reliance upon advice of counsel, and of accounting experts, generated after the full disclosure of all pertinent facts. This reasonable, good faith reliance defeats the requisite element of intent to violate the law. Even if the legal opinions given or accounting advice provided subsequently proved to be mistaken, reliance on them was reasonable, any resulted underpayments were mere mistakes, and therefore preclude criminal charges – there was by definition no intent to willfully violate the tax laws.

The Corporate Tax Payments Were Properly Negotiated and Paid.

The Procuracy’s allegation of corporate tax evasion is based on the incorrect premise that it was improper for the ZATO registered entities to pay their taxes with promissory notes in the years 1999 and 2000 for the 1999 fiscal year. Contrary to this allegation, up until the end of 1999, *it was permissible to make tax payments in non-monetary form.*³² In fact, payment with promissory notes was a widely used business practice in the years prior to 1999. The witness for the prosecution who worked for the tax authorities noted that he “never doubted the legality” of using promissory notes to pay taxes.³³

Accordingly, in 1997, the ZATO registered entities negotiated an agreement with the finance department officials in Lesnoy for these entities to register and receive tax reductions in

³² See Expert Witness Testimony, Sergei Grechishkin (2/10/05). Mr. Grechishkin, a tax expert, pointed out that both Ministry of Finance and Ministry of Taxes approved payments with promissory notes through the end of 1999.

³³ See Witness Testimony, Igor Kustov (9/09/04). During the period in question, Kustov was responsible for maintaining and enforcing tax payment agreements in the city of Tryokhorney, Cheliabinsk region.

exchange for contributions to the local economy, the initial advance payment of taxes in promissory notes for tax year 1999.³⁴

Definitive proof that the payment of the taxes with promissory notes was legal is the fact that, in 1998, effective January 1, 1999 the Russian Federation adopted a new tax code which for the first time included a provision wiping out tax payments with non-monetary forms of payment. *See* Russian Tax Code, Part I, art. 45.³⁵ Pursuant to a joint letter issued by the Ministry of Finance and the Ministry of Taxes and Levies, the tax authorities continued to accept tax payments in non-monetary form until the end of 1999. Previously, Russian law did not prohibit the payment of taxes with non-monetary promissory notes. Rather, at the time of the alleged crimes the existing tax legislation allowed for non-monetary forms of payment. Furthermore, since the taxes at issue were paid in advance, the entities paid their taxes for 1999 in the last quarter of 1999, instead of mid 2000 as required by law. Therefore, the Procuracy's claim that the 1999 taxes were improperly paid (or not paid at all as required element of crime under Art. 199) fails. With respect to the payment of taxes by promissory notes in 2000, there is no evidence which shows that the subject entities transferred any promissory notes to Lesnoy; rather the same promissory notes transferred in 1999 were redeemed by Lesnoy administration in the first part of 2000 with interest.³⁶ Experts' opinion, supported by substantial evidence, demonstrates that non-cash payments were not made in 2000.³⁷ Therefore, the Procuracy's charge of tax evasion in 2000 contradicts the facts.

Moreover, the taxpayer cannot be criminally responsible for the acts of tax authorities, such as the decision by the tax authorities in a ZATO to accept advance payments in non-monetary form, *i.e.*, promissory notes. In fact, in or about April 19, 2004, the Lesnoy Department of Finance issued a document acknowledging receipt of tax payments in non-monetary form during 1999 from fifty-five entities, not including the entities mentioned in the charges herein. Several experts, including corporate tax expert Sergei Grechishkin, opined that Lesnoy administration had independent and unconditional authority to do this.³⁸ Thus, the attempt to apply Art. 45's indirect prohibition of promissory notes to events which occurred while it was permissible to make tax payments in non-monetary form is simply wrong as a matter of law.

The Procuracy's attempt to prove tax evasion based on the failure to make payment on the promissory notes also fails. The Lesnoy Financial Department has by its actions with respect to the promissory notes refuted any allegation that harm was caused to it by payment of taxes

³⁴ Witness Myasnikova who worked at Lesnoy's Administration testified that Lesnoy implemented tax exemptions in response to the economic problems in the region; she stressed that acceptance of promissory notes was extremely profitable to Lesnoy because of the additional income that resulted from interest bearing notes. *See* Witness Testimony, Lyubov Myasnikova (3/03/05; 3/04/05).

³⁵ *See also* Expert Testimony of Vladimir Bochko, Chapter A, p. 1, para. 6.

³⁶ *See* Witness Testimony, Lyubov Myasnikova (3/03/05; 3/04/05) (noting that all promissory notes were sold, and the proceeds received by Lesnoy); *see also* Expert Testimony by Sergei Grechishkin (2/10/05) ("All promissory notes were redeemed by Lesnoy.").

³⁷ *See* Expert Opinion by Denis Shchekin, p. 27; Expert Report by Sergei Grechishkin, p. 17, para 5; Expert Opinion by Lubov Petrova, p. 4.

³⁸ *See* Expert Opinion by S. Grechishkin, p. 28, para 4; *see also* Expert Report by V. Bochko, Chapter A, p. 2, para. 1.

with promissory notes. Likewise, expert Shchekin presented sufficient evidence that no damage was caused to Lesnoy as a result on non-cash payments.³⁹ Expert Grechishkin further clarified that promissory notes in fact resulted in substantial revenues for Lesnoy.⁴⁰ The promissory notes issued and transferred to the tax authorities in 1999 were redeemed by the Finance Ministry of Lesnoy in 2000. In addition, the notes paid interest in the total amount of RUR 79,300,000. Specifically, the promissory notes accepted by the Lesnoy financial department were used as an initial capital investment by certain Lesnoy municipal entities in several joint ventures,⁴¹ which to date have been profitable and from which the municipal entities have collected millions of rubles in profits from 1999 to 2004.

Messrs. Khodorkovsky and Lebedev are not, and never have been accountants or tax planners and, obviously, did not establish the structure whereby Yukos sold or bought petroleum products through entities established in the ZATOs in order to minimize taxes. Even if the defendants had participated in any decision, or otherwise caused, Business Oil, Mitra, Vald-Oil and Forrest-Oil to enter into agreements with the local tax authorities in Lesnoy and to pay taxes with promissory notes, such participation was not made with the intent to evade taxes and was not criminal conduct. Under these facts, it is impossible for the Procuracy to prove that the defendants acted with specific intent to willfully violate the tax laws, *i.e.*, voluntarily and in intentional violation of a *known* legal duty.

Moreover, the decision to pay the taxes with promissory notes was made in good faith reliance upon, and in strict conformity with, both the advice of counsel and of accounting professionals, generated after the full disclosure of all pertinent facts of which they were aware. In 1997 Yukos hired PriceWaterHouseCoopers, and adopted GAAP. These tax regimes were reviewed by PriceWaterHouseCoopers and were covered by the unqualified audit letters issued by PWC with the consolidated financial statements. A taxpayer's good faith reliance on the advice of counsel and of a qualified accountant has long been a defense to willfulness in cases of tax fraud and evasion. Moreover, a witness for the prosecution noted that Yukos representatives actually traveled to Lesnoy to discuss the question of making tax payments using promissory notes.⁴² Thus, the Procuracy cannot establish the requisite element of any willful intent to violate applicable tax laws by the company, let alone, Messrs. Khodorkovsky and Lebedev, and, accordingly, the corporate tax evasion counts fail to state a crime.

Finally, the corporate tax evasion charges fail as a matter of law because the payment of the taxes with promissory notes caused no *harm*. As noted, the Lesnoy Financial Department refuted the Procuracy's efforts to establish this element of the criminal tax evasion. Rather, based upon the evidence, depending upon ongoing performance of the joint ventures, the allegedly criminal activity may result in long term monetary benefits to the residents of Lesnoy.

³⁹ See Expert Opinion by Denis Shchekin, p. 27; see also Expert Report by V. Bochko, Chapter A, p. 2, para. 2.

⁴⁰ See Expert Opinion by S. Grechishkin, p. 12, para 4; see also Expert Report by S. Semenov, p. 20, para 4.2 (noting that Lesnoy received an additional 28% interest).

⁴¹ See Expert Opinion by D. Shchekin, p. 27.

⁴² See Witness Testimony, Leonid Koval (2/18/05).

The ZATO Registered Entities Qualified for Tax Benefits Negotiated with the Finance Administration in Lesnoy.

The Procuracy also incorrectly alleges that the ZATO registered entities illegally secured tax benefits under the ZATO Legislation on the grounds that each was not actually conducting business within Lesnoy. These allegations too, fail to state a claim.

In Russia, tax breaks are lawful and are encouraged as means of promoting economic progress in urban areas.⁴³ According to expert Bochko, ZATO has been offering tax benefits to companies since 1997, to further its goal of improving local economy.⁴⁴ Even the Procuracy does not challenge that the entities Business Oil, Mitra, Vald-Oil and Forrest-Oil entered into agreements with the finance authorities of Lesnoy as provided for in the ZATO Legislation. Rather, the Procuracy alleges they were merely shell companies that did not operate in Lesnoy, and thus did not qualify for reduced taxes.

In fact, each of the entities served as an operating company that provided downstream services to Yukos by marketing and reselling crude oil to third party purchasers or arranging for the crude oil to be processed into refined petroleum products. Expert Bochko determined that activities of these entities were in conformity with the requirements of Russian law.⁴⁵ Furthermore, tax law expert Simenov explained that administration that registers a corporation for tax breaks undertakes an obligation to ensure that the corporation meets the minimum capital and employment requirements.⁴⁶ The ZATO registered entities' tax payments and subsequent claims for tax deductions were disclosed and audited. The Federal Tax Authorities conducted regular audits for compliance with the requirements of the ZATO law. For example, in 2000 it audited the tax filings for Business Oil, and the Tax Authorities did not allege any violations at that time.

The ZATO Registered Entities Properly Secured Tax Refunds and Thus the Art. 159(4) Charge of Theft of Tax Refunds by Deceit or Abuse of Trust Fails.

The last part of the Procuracy's allegations of theft in connection with corporate tax payments relates to the tax refunds secured by the ZATO registered entities. The Procuracy asserts that these entities illegally received tax refunds for fictitious overpayments calculated on the illegal payments with promissory notes and reduced by the terms of the agreement with the finance authorities in Lesnoy. In order to establish this charge, the Procuracy must prove the allegations set forth in the prior two sections. Since the Procuracy has failed to identify criminal conduct there, its allegations here necessarily fail as well. Importantly, expert Shchekin agrees that refunds were lawfully issued due to an overpayment by Yukos in a previous tax year.⁴⁷

⁴³ See Expert Opinion by S. Simenov, p. 4.

⁴⁴ See Expert Opinion by V. Bochko, Chapter C, p. 17, para. 1.2.1.

⁴⁵ See *id.* at p. 21, para. 1.2.3.

⁴⁶ See Expert Opinion by S. Simenov, p. 4. Simenov explained that, to be eligible for tax breaks, ZATO registered companies had to conduct 70% of its business in the area and employ 70% of workers from the area. *Id.* Importantly, ZATO companies don't have to have 70% of its oil in the area: rather they must merely conduct oil trade operations on ZATO territory. *Id.* at 7.

⁴⁷ See Expert Opinion by D. Shchekin, p. 27.

Expert Petrova explained that the amount overpaid in tax must be indicated on the appropriate tax form and is subsequently refunded by the government.⁴⁸

The Procuracy shamelessly re-writes history to support its unfounded criminal corporate tax charges in what amounts to a breathtaking *ex post facto* law violation, held universally repugnant in all legal systems as contrary to fundamental fairness. As the Parliamentary Assembly Council of Europe (“PACE”)’s resolution notes, “the allegedly abusive practices used by Yukos to minimise taxes were also used by other oil and resource companies operating in the Russian Federation which have not been subjected to a similar tax reassessment, or its forced execution, and whose leading executives have not been criminally prosecuted. Whilst the law was changed in 2004 and the alleged ‘loophole’ thus closed, the incriminated acts date back to 2000 and retrospective prosecution started in 2003.”

Episode V – Alleged Personal Criminal Tax Evasion.

The Procuracy also has leveled charges of personal tax evasion against Messrs. Khodorkovsky and Lebedev, alleging that they unlawfully evaded taxes by submitting false tax declarations claiming certain income as private entrepreneurial revenues rather than as salary. Once again, the Procuracy distorts the facts in order to transform what was no more than the use of a lawful, permissible and widely employed tax minimization regime into criminal tax evasion.

Pursuant to Article 198 of the Russian Criminal Code it is a crime, *inter alia*, to submit a tax declaration containing information known to be false. Tax evasion may be predicated, therefore, on acts such as the international failure to record assets, the concealment of transactions, or the falsification of documents in order to qualify for more favorable tax treatment than that to which one is legally entitled. Critically, under Russian law, direct, or specific intent is required in order to support criminal charges of personal tax evasion. Thus, under Russian law, as in the United States, criminal tax evasion must be a willful and intentional act – a voluntary and intentional violation of a known legal duty.

In connection with their allegedly unlawful securing of tax status as private entrepreneurs, the Procuracy claims that defendants submitted tax declarations falsely claiming that they provided consulting and managerial services worth millions of dollars to one or more offshore companies. In particular, the Procuracy alleges that no such services were provided by either man, and that Mr. Khodorkovsky’s conduct resulted in RUR 54,532,186.00 (\$1,886,600.96) in unpaid personal taxes 1998-1999. Similarly, Mr. Lebedev’s alleged conduct is claimed to have cost the Russian government RUR 7,269,276.00 (\$251,488.60) in unpaid taxes for the 1998-2000 time period.

Defendants, Lawfully and Duly Licensed as Private Entrepreneurs, Provided Services for Which They Were Compensated and Paid Taxes Accordingly.

The defendants were lawfully and duly licensed as private entrepreneurs under the law in effect at the time of the alleged conduct, and entitled to the tax treatment that followed from that designation. Accordingly, the sums which the defendants received as compensation for their

⁴⁸ See Expert Opinion by Lubov Petrova, p. 3.

consulting services in their capacities as private entrepreneurs appropriately were subject to the applicable simplified tax.

Under Russian law at the time of the alleged conduct, a private entrepreneur could elect to pay an annual fee in exchange for a tax license, which constituted full satisfaction of taxes on earnings derived from the licensed, entrepreneurial services. Thus, pursuant to this law, a licensed entrepreneur's tax liability for sums earned in connection with the provision of licensed services was subject to no more, and no less, than the advance tax payment. Such licensure encouraged entrepreneurship by providing incentives in the form of a simplified and fixed advance tax payment for individuals engaged in providing services as independent contractors. To qualify for this licensing, an applicant had to file with the local tax authority an application stating his intention to provide specified services as a private entrepreneur and receive approval. Tax Deputy Chief Kuchinskaya testified that Mr. Khodorkovsky lawfully obtained and paid for this license between 1998-2000, and that he was allowed to do so by tax authorities.⁴⁹ Deputy Chief Rodnina similarly testified that there were "no concerns" regarding the veracity of information provided by Mr. Lebedev.⁵⁰

Following then existing law, Messrs. Khodorkovsky and Lebedev applied to and were approved by their local taxing authority for licensing as private entrepreneurs. Both men paid their annual fee for such license status, and in all other respects acted in compliance with the law, and were in good standing as private entrepreneurs. Representative of the tax authority confirmed this point testifying that both men presented all necessary documents, paid the appropriate taxes, and were never required to produce additional documents.⁵¹ Furthermore, there were "no concerns" regarding the validity of their actions which is reinforced by the fact that the tax authorities never included Messrs. Khodorkovsky and Lebedev.⁵²

Under then-governing law, as duly licensed private entrepreneurs, the tax obligations of both men for their consulting fees were limited to the above noted, prepaid tax amount associated with their licensing. Defendants owed no tax on these consulting fees beyond these amounts – amounts which the Procuracy nowhere contends were not paid. There simply is no crime here.

Defendants' Reliance on Advice of Counsel Precludes Criminal Intent.

Even if, for the sake of argument only, it were assumed that the licensure of the defendants as private entrepreneurs was in error, the defendants' actions do not constitute crimes where, as here, their conduct was predicated on the advice of their counsel. There can be no crime for the simple reason that there was no requisite criminal intent.

A violation of Art.198(2) may only be found where the actions were willfully done. Tax expert Larisa Petrova explained that an individual has a right to rely on the written explanation from competent authorities that his or her actions were lawful.⁵³ Importantly, no criminal

⁴⁹ See Witness Testimony, Svetlana Kuchinskaya (10/14/04).

⁵⁰ See Witness Testimony, Marina Rodnina (10/15/04).

⁵¹ See Witness Testimony, Svetlana Kuchinskaya (10/14/04); Marina Rodnina (10/15/04).

⁵² See *id.*

⁵³ See Expert Opinion by Larisa Petrova, p. 5.

liability may arise for acts resulting from such good-faith reliance.⁵⁴ Such willfulness is necessarily lacking, and prosecution necessarily precluded, where the taxpayer successfully interposes an advice of counsel defense. Here, the defendants' obtained licensure as entrepreneurs in good-faith reliance upon and in strict conformity with the advice of counsel generated after the full disclosure of all pertinent facts of which they were aware. Messrs. Khodorkovsky and Lebedev appropriately relied on the advice of counsel that their conduct was lawful, and accordingly they did not willfully violate applicable tax laws. It follows, of course, that the personal tax evasion counts fail to state a crime.

Episode VI – Yukos Funds Were Legally Invested in Media Most Corporation.

The Procuracy alleges that Mr. Khodorkovsky engaged in a scheme to funnel money from Yukos Oil Company to Vladimir Gusinsky and in doing so caused the “organized group, illegally and gratuitously [to] remove[] and put into the hands of V.A. Gusinsky” monies belonging to Yukos and its shareholders, therefore committing a crime of misappropriation under Article 160 (3)(a) and (b). Specifically, Khodorkovsky allegedly caused Yukos to loan RUR 2,649,906,620.00 (\$ 91,676,434.42) to Media Most Corporation and related companies (“Media Most”) for the benefit of its largest shareholder, Gusinsky, in exchange for certain corporate notes and then forgave the debt.

By 2000, Media Most was the dominant private media outlet in Russia, and an increasingly vocal critic of the government administration. The Procuracy quickly retaliated with a series of raids of Media Most's headquarters followed by Gusinsky's arrest on charges of fraud and embezzlement and the company's forced bankruptcy. The European Court of Human Rights (“ECHR”) last year held the Russian government, *inter alia*, had used the criminal justice system not to enforce the law but to further its economic priorities. *Case of Gusinskiy v. Russia*, App. No. 70276/01 (Eur. Ct. H.R. May 19, 2004). It concluded that the Russian government's attack on Media Most and Gusinsky constituted extortion, with the criminal justice system implementing the scheme.

The Procuracy's allegations against Mr. Khodorkovsky focus on two series of transactions which occurred in 1999-2000 time period involving acquisition of certain commercial paper issued by Media Most. At all relevant times, Mr. Khodorkovsky served as a member of Yukos' Board of Directors and had no management position or authority within the company.

The first set of transactions involve three loans by Yukos to Media Most whereby Yukos agreed to loan RUR 635,450,000 and received as a collateral four promissory notes from Media Most with a nominal value of \$25 million. These transactions were neither illegal nor gratuitous. By April 28, 2000, Yukos had redeemed the notes and received their full nominal value with profit as a result of the differences between the exchange rates. Yukos then reinvested the full amount in four promissory notes, issued by MetaMedia, a Media Most related entity, with a nominal value of \$25 million. Again, this transaction was neither illegal or gratuitous and was fully disclosed and approved by Yukos' Board of Directors. Despite the 2000 events which led

⁵⁴ *See id.*

Media Most into a forced bankruptcy proceedings, Yukos managed to recover the full value of its investments by April 19, 2002.

Similarly, the second set of transactions involve a purchase of Most-Bank promissory notes by Yukos related entities “Grace” and “Mitra” for RUR 1,014,434,620. In addition to full disclosure and approval of Yukos’ Board of Directors, these investments indisputably were commercially reasonable at the time made. These transactions were properly reflected in Yukos’ accounting system. In 2000, as a result of the Government’s persecution of Mr. Gusinsky and his businesses, Yukos wrote off the value of the notes, and disclosed the write-off in its consolidated financial statements.

In his closing arguments, Mr. Khodorkovsky stressed that his defense team submitted numerous documents to the Court showing legitimacy of the subject transactions. The Procuracy deliberately withheld these documents from the Court despite of its knowledge of the documents.⁵⁵ Accordingly, the Procuracy’s attempt to convert a business decision to invest in a thriving company into a scheme to divert Yukos assets to Media Most is disingenuous. Yukos’ purchase of Media Most commercial paper was lawful and reasonable. Yukos was able to recover portion of its investments, but it had to write off the remaining amounts. It was unforeseeable at the time Yukos made the investments that the Russian government would render them worthless through what was found by the ECHR to be an act of extortion and the abuse of the criminal process. Hence, if anyone committed a criminal act that resulted in Yukos’ shareholders suffering losses in connection with the purchase of Media Most notes, it is the Russian government. Accordingly, the Russian government should be liable to Yukos and its shareholder, including Group Menatep, for their losses.

Violations of Due Process in the Prosecution of Messrs. Khodorkovsky and Lebedev

Much has written about the due process abuses committed by the Russian Procuracy during the investigation and prior to the trial, *e.g.*, the illegal search of defense counsel and the improper pretrial detention of Messrs. Khodorkovsky and Lebedev and the litany of violations will not be repeated here. Predictably, the due process abuses did not end with the commencement of the trial. The trial is replete with instances where the court violated the criminal procedure code. Moreover, the Procuracy and the defense have not been treated equally by the court. For example, the defense has been provided with less time to present their case and the overwhelming majority of defendants’ motions and requests to court are denied. The court repeatedly has made thinly-reasoned decisions that simply parroted the Procuracy’s self-serving and unsubstantiated assertions and completely ignored the Procuracy’s violations of Russian law and the defense’s arguments.⁵⁶

Specifically, the Court, both upon the request of the Procuracy and *sua sponte*, has interfered with defense counsel and the manner in which evidence is present against the accused,

⁵⁵ See Khodorkovsky’s Closing Statement (4/11/05).

⁵⁶ *Id.*

have all been declared by PACE as corroborated and serious shortcomings of the Russian proceedings.⁵⁷ The list of other violations include:

- Impermissible introduction of evidence by the Procuracy
 - evidence obtained through illegal searches and seizure
 - unauthenticated documents;
- Defendants denied the opportunity to introduce exculpatory evidence, including key expert reports;
- Restriction on scope of direct questions of defense witnesses and of defense cross examination of prosecution witnesses, including denial to cross examine Prosecution experts;
- Defendants denied requests to subpoena prosecution key expert witnesses;
- Harassment and improper influencing of witnesses:
 - continued investigation and interrogation of trial witnesses;
 - threats of searches, arrests and prosecution;
 - improper questioning during trial concerning witnesses' personal life and work unrelated to the case;
- The Court's making motions on behalf of the Procuracy;
- The Court questioning witnesses on behalf of the Procuracy;
- Denial of effective assistance of counsel in the form of:
 - interference with access;
 - interference with confidential communications;
 - harassment of defense counsel;
- Failure to disclose exculpatory evidence.

CONCLUSION

The Russian Procuracy has presented an extensive and what appears to be, an impressive list of charges against the defendants. During the trial it took numerous isolated, random, and often immaterial facts, many of which have been known to the public and public officials for years, and attempted to create the appearance of wide spread criminal activity among the defendants. The result is a verdict unsupported by evidence on the law.

⁵⁷ EUR. PARL. ASS., *Circumstances Surrounding the arrest and Prosecution of Leading Yukos Executives*, Res. No. 1418 at ¶ * (January 25, 2005)

In a criminal justice system with an independent judiciary following the rule of law, this case would not have been indicted. Rather, the matter would have been resolved in the civil courts or before administrative panels, as the Apatit case was in 2002.

The above is a mere thumbnail sketch of the total perversion of the Russian criminal justice system in the Khodorkovsky/Yukos Affair. It requires far greater detail to demonstrate all of the complexities and nuances of the abuses that have occurred during the past 18 months. Counsel is available to provide additional information for use in further investigation of the matter.