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# What Do the Recent Events Involving Yukos Oil Company Tell Us about Legal Institutions for Transition Economies?

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*Part One—Reconstruction: Prescriptions for Iraq, Predictions for  
Russia and Performance for China*

**What Do the Recent Events Involving Yukos Oil Company  
Tell Us About Legal Institutions for Transition Economies?**

*Sarah C. Carey\**

As a lawyer, I have more or less been a plumber; which is a low rank in society, in terms of watching how Russia has handled and is handling the transition to a market economy. I would like to make a few general comments and then I will comment on the impact of the so-called Yukos Affair.

By way of background, I should note that I have been very active in the former Soviet Union, particularly in Russia, since the late 1980s. Thus, I have watched it over a period of time and from several directions, one direction being the practice of law. I am a partner in Squire, Sanders & Dempsey, and we have had an office in Moscow for over twelve years. It is a full-service commercial firm, providing services for Russians and foreigners. I have also served on the board of the Eurasia Foundation for a decade. This Foundation is primarily funded by the U.S. government and it provides grants to small and medium-sized businesses. Its purpose, among other things, is to nurture these businesses, as they are the building blocks of a free-market economy. More recently, I have served on the board of Yukos Oil Company.

Despite all of its problems, and the second-guessing of scholars and critics, Russia has gone through an extraordinary legal revolution in the past ten to fifteen years. It has basically rewritten all of the laws that provide the infrastructure for a private market economy. Whether begrudgingly or not, the Western legal community practicing in Russia would probably agree that in most areas, Russian law currently meets international legal standards. Putting these laws in place has been a Herculean labor.

The first law to allow foreign investment in Russia was a four-page law known as the Joint Venture Law. It was very hard to get a copy. In fact, there was only one copy, and I offered to take it and make duplicates. Indeed, I became prominent in the field because I obtained the only available copy of the Joint Venture Law, which permitted foreign investment in the form of joint ventures. However, it did not change the economic infrastructure around these isolated joint ventures. It was a precursor of what was to come and new laws were passed rapidly. The original free market laws were primitively fashioned and more like exhortations about what should be done rather than clear directives. However, over the years, the laws became highly detailed and sophisticated in form.

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The Yukos case illustrates the widely discussed inadequacies of the Russian judicial system, the Achilles heel of the legal system. Although recent laws have sought to reform the judiciary—for instance, new laws on civil procedure, a new criminal code, and criminal procedure code—these laws are not yet internalized. Change has been slow, in part because of the lack of talent among the judiciary and litigators. The Russian judicial system does not have the rapid growth of new ideas and practices that exist in, for example, Russia's financial markets. The major question is how long will it take for the new laws to be internalized or as one Russian judge stated, "genetically coded."

In the early days of the commercial arena, I noted that even amidst a sparse landscape of detailed law, you can accomplish a range of fairly significant commercial transactions if contract law is clear and honored. Historically, Russia relied heavily on contractual arrangements to make up for gaps in the infrastructure law. The contracts that involved international parties were generally subject to international dispute resolution procedures, which gave the non-Russian party confidence that it would be treated fairly. Although a portfolio investor (someone who is investing funds into the Russian stock market and playing the financial game) requires certainty in regard to laws and regulations, the same level of certainty is not needed for a hands-on business venture. Often, the very behavior of creating a business and working with a partner has a major reform impact. In some cases, actually conducting business has a greater impact than writing a new law that no one quite understands.

Russia has been accused of not following the "Big Bang" approach to reform, but this is debatable.<sup>1</sup> It is hard to say what country has had a "Big Bang." A "Big Bang" in a small country is not the same thing as a "Big Bang" in a large country such as Russia. For instance, many people compare Poland and Russia, which I think are completely inapposite because Poland is geographically so much smaller than Russia. Another faulty comparison is between China and Russia, which have remarkably different economic bases. Russia has no healthy agricultural base, whereas China began its reforms with a large agriculture base. In Russia, all the talent left the farms resulting in the farms more or less producing for themselves. In terms of industry, Russia had massive interlinked dinosaurs that had to be broken into pieces. Russians needed to encourage the entrepreneurial spirit, while at the same time encouraging small business. Russia will never be the economic engine that China is becoming, partly because it does not have the population. Moreover, it does not have the topography, since half the country is not habitable or usable.

The Soviet Union was extraordinarily complex, and the central command economy reached deep into the interstices of the society. The Soviet Union's

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1. While there is some disagreement over whether Russia did a "Big Bang" or not, there is a feeling among the leadership today that Russia privatized certain assets that they probably did not need to. For instance, President Putin would probably prefer to own oil and other natural resource companies, and perhaps is trying to reclaim them now.

economic system also reached beyond Russia; the power, communications, and other sectors were closely tied into Kazakhstan, Kirghistan and elsewhere throughout the empire. The first step of the “Big Bang” was taking the economy to a stand still and dismantling it. The subsequent steps involved trying to put it together again in a new form, which was extremely complex and for which there was no model. There was literally no model for the Russians and the transition that they had to go through.

What do the Russians have at this point? They made a policy decision, which I for one applaud, that dismantling the state was essential to changing the political and the economic systems and breaking the grip of the Communist Party. Anatoly Chubais has been accused of giving the state away, giving assets to friends, not getting market value, etcetera. But, he was driven by a commitment to separate property from the state, which meant separating the Communist Party from the powers of the state, and this dramatic severing of ties may have been the only route for accomplishing the task. The outcome is still being settled, but convoluted as it has been, much has already been accomplished.

The Russian transition taught us many lessons. First, Russia today is more privatized than many European countries and certainly more than many other countries globally, and Russia has a high percentage of privatized ownership of the economy. One thing the Yukos story shows (not the current situation - but the transformation of the business) is that instant privatization can succeed if you have a talented management team. Many companies in Russia were privatized and the same old managers continued to run them, without assistance. Thus, Russia did not add new training or value, and these companies went nowhere. Financial types were later able to assist a select few companies, but others collapsed. All of the post-Soviet countries suffered a great deficit in management talent, especially below the very top level; which can make a real difference.

A second lesson is that you may take the title to property away from the state, but it is much more difficult to get the state out of the economy. Statism remains an important tradition in Russia; the government continues to play a major role in certain sectors, such as natural resources, the media, and a few others. Privatization or transferring ownership does not, by itself, resolve the relationship between the state and business - there is much more work to be done.

Lastly, transparency has real value. This is another lesson highlighted by Yukos. Those who advocate transparency, including many of our diplomats, do not always understand what it means or how it translates into law or business practices. Transparency is a discrete set of rules.

Until recently, the Yukos experience demonstrated that by following international accounting standards, issuing regular and comprehensive financial reports, keeping the books open and so on, a company protects both its investors and itself. We do not know the final outcome in the Yukos case yet, but it helps that in regard to many of the tax allegations against the company, all of the tax minimization schemes they used were fully revealed in all of their filings. The tax authorities knew about them. Russian law authorized the activity. Given these

facts, it is going to be very difficult to maintain that this was illegal behavior. Transparent corporate behavior helps to produce a modern international, global, business sector.

I touched on the importance of checks and balances, of having an independent judiciary, and an independent press. These institutions take forever to build and they can take different forms. However, without these and other checks on the power of the state, businesses that are politically or strategically significant are ultimately at the mercy of the monarch or whoever is the current leader.

Many types of institutions ensure a free market. For example, independent regulatory agencies are of importance in making a modern economy work, but this is extraordinarily difficult to achieve with limited resources. Most regulatory agencies in Washington, D.C., have enormous budgets, in many cases larger than Russia's federal budget. It costs money to regulate effectively.

One reason the Russian Antimonopoly Ministry is a paper tiger is its very small budget. The same is true for the Environmental Enforcement Agency. Russia cannot build these agencies while it is paying off the old debts of the Soviet Union, meeting the debts that were rescheduled after the 1998 crisis, etcetera. It is going to take some time before the regulatory function matures.

What are the unanswered questions? By-and-large, as my bias reflects, Russia has come an extraordinarily long way. Today, when companies consider a transaction in Russia, they assess it the same way that they would assess a new partner in the United States, if creating a comparable kind of business. The activity, the analysis, the safeguards—the whole process, has become much more normal.

But what questions does Yukos raise? The number one question relates to the General Procurator, who has brought a series of criminal charges against the key shareholders of Yukos. Two of them are incarcerated, including the former CEO, Mikhail Khodorkovsky. Three are living in exile in Israel. One has admitted to some fairly minor tax violations. However, the General Procurator has pursued all of the key shareholders, and he has also pursued the company through nighttime raids, masked guards, and trumped up tax charges. So far, the net result for the company is a court judgment upholding tax charges in the amount of \$3.4 billion for year 2000 and slightly more in 2001. Similar rulings, also based on reinterpretation of certain tax haven laws, are expected for the years 2002 and 2003. No one is aware of the real underlying goal. What is the game plan? Where is the Procurator General going? Where are his supervisors going, and what are they looking for? Is it to take away the wealth of oligarchs who they believe got the wealth wrongfully or unfairly or do they want to participate in the same process to get their share of the wealth? Is it a trust busting plan to break up these large companies? This hardly makes sense in the oil industry where success means competing with major companies such as Exxon, Mobil, Chevron, and Texaco.

There is clearly a political and a power agenda, but it is not being debated in the legislature or even the bully pulpit. It is being worked out behind closed doors and through manipulation of the criminal and civil justice systems, which are interwoven and belong to the President.

So what are the policy issues and how should or could they be handled? In terms of the Russian experience, if a pervasive feeling exists that the oligarchs are swindlers that gained their wealth at the expense of society, then there is always the alternative of a wealth tax. Again, this would be a publicly declared policy for dealing with the issue as opposed to the Soviet style covert use of the procurator system that is being used today.

Russia must determine what the statute of limitations is with regard to the Wild West period of Russian privatization. At some point, Russia has to "legalize the squatters." These companies are in place, significant investment has been put into them, and they have been turned around. Russia needs to legitimize these companies. There is no indication that those questions are being publicly debated or even articulated. Nevertheless, they must be resolved if the market is to be effective in those sectors. These issues do not appear to exist across the board in the Russian economy; they are present only in highly sensitive sectors of great concern to the state.

Another lesson learned from the Russian experience is that the transition leaders should have communicated better about what was occurring. Russian leaders, including Yeltsin, have not adequately explained the direction in which they are headed, in terms of economic reform and social change. This is partly because the leaders themselves are unsure of their direction and much of the reforms were ad hoc. However, you cannot gain the support of the people unless you define and communicate your goals.

Finally, Russia initially made the grave error of attempting to suddenly become international, by assuming the debt of the former Soviet Union, and clambering to join all the international treaties and organizations. All of these involvements involve enormous price tags. It is a positive step that Russia is extending its negotiations over admission into the World Trade Organization ("WTO"), but at the outset, Russia had no understanding of how the WTO works.

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