Corporate Governance in Yukos

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Introduction

Corporate governance, even in the established world business democracies, is still an evolutionary process. Sound corporate practices have become critical to worldwide efforts to stabilize and improve global markets, as well as to protect investors of all types. It allows for a corporation to improve its performance and attract capital. Governance is an integral part of the corporate strive to achieve its objectives, protect the rights of various stakeholders and meet the legal requirements. Yukos was a recipient of three annual "Corporate Governance in Russia" awards, which are awarded by the Investor Protection Association, representing Russian and foreign investors working in the Russian market. Receipt of such an award is a corporate achievement in and of itself. Yukos' corporate website has a Governance Charter page and it reads, as last updated on October 15, 2003:

> *Approved by the Board of Directors on April 24, 2003.*
>
> *YUKOS is committed to international standards of good corporate governance. The company will strive to continuously be a leader in implementing and promoting the highest standards of corporate governance in all aspects of its business both in Russia and in all other areas where the company conducts its operations. YUKOS recognizes that good corporate governance is essential to the continued development of the company and for the creation of long-term, stable value for its shareholders and other stakeholders.*

However, as mentioned above, what is an evolutionary process for the western business environment is still a birth-pain for the Russian corporate world. Yukos managed to eventually do it right, as is evident from the world recognition of its efforts.

Corporate Russia

To discuss the corporate governance of Yukos, it is vital to gain an understanding of the corporate governance in Russia today, as well as the history of its development. To gain such an understanding one needs to understand the post-Soviet Russia and the intertwining socio-economic, political and business processes, which took place in that country in the last 15 years.

Uniquely in world history, private property and capitalism emerged simultaneously in post-Soviet Russia. Where most of the modern capitalistic nations enjoy a rich history of reform, law and democratic attempts, modern Russia sprung to its present state in less then two decades. The chaos that emerged after Gorbachev, during the time of Yeltsin's rule, and which in some respects continues today can be attributed to the fact that Russia still shares some of the past political and social structures that date back not only to the Soviet era, but to the time of Tsars. Such history is not simply wiped out by the oppression of communism or by the wildness of capitalism that emerged in one year. The corporate enterprise fared no better than the country itself – corruption, criminal and unethical behavior and abuse were the norm for a developing business enterprise of the post-Soviet period. During the 1990's, Russian entrepreneurs routinely trampled on the rights of minority shareholders, abused their privileges, created offshore shells to siphon funds into personal holdings, and created fictitious corporate entities to invisibly acquire some of the choicest parcels of the dying Soviet economy. Of the utmost importance is the fact that all this was accomplished through the help of a well-oiled machine called bribery. Bribery of government officials can be called a Russian national pass-time and this game dates as far back to Peter the Great, who made bribery of government officials a criminal offense, punishable by jail at best. Thus, one can accuse a business of something like tax evasion during the 90's in Russia only with an understanding that corruption prevailed not only in the corporate Russia, but it dominated government structures as well.

The business obstacles facing Russia in the first half of the 1990's can be summarized as follows. First, there were large industrial complexes that were devoted to cold war efforts. With the end of the cold

* The views expressed here are those of the author and do not necessarily reflect those of the Key Bank.

war, these large, complex plants were unable to "retool" and were becoming obsolete, with ineffective management, affecting thousands of workers. Secondly, the sheer size of the country coupled with an ineffective and unproductive management of huge plants meant that large geographic regions would suffer. During the Soviet regime, entire local governments depended almost completely on the large state employers and when the production dropped during the period of hyperinflation in the early 90's, unemployment and underemployment affected huge number of people, while productive private infrastructure was just forming itself. Thirdly, there was no system of social security or welfare in post-Soviet Russia. Thus, with the absence of state control, there were severe problems in maintaining the social welfare structure of the country. All of the above coupled, with ill-equipped managers, economic depression and the lack of an entrepreneurial ambition, created a very difficult environment for corporate formation and growth.[1]

Yet, something needed to be done for the country to move forward, and the government understood that the only way to proceed was by developing and supporting the large corporate business. That understanding led to the "loans for shares" scheme and the rise of the oligarchs in Russia. Yeltsin's privatization reforms of the early 90's were full of corruption and were largely abused by those individuals who saw an opportunity to either liquidate state-owned assets and move them overseas, or use their insider positions to win exclusive government contract and licenses. Great fortunes were made almost overnight and several bright, young and well-educated managers accumulated substantial cash holdings.[2] As Yeltsin's regime auctioned off substantial packages of stock shares in Russia's most desirable enterprises in order to achieve political support and obtain funds, several of these individuals, including Mikhail Khodorkovsky, who at that time had created a small fortune of his own, became oligarchs in the true sense of the word in a matter of couple of years.[3]

The core of the scheme was that Yeltsin gave huge stock packages in such industries as telecommunication, oil and energy, metallurgy and so on to banks as collateral for bank loans, with an understanding that these debts will be repaid by summer of 1996. The asset value of the collateral often was worth many times over the amount of the loan. Of course these loans were never repaid and by the end of 1996, some of Russia's largest firms were transferred to a small number of major banks, allowing a formation of a small number of holders of the major assets of the Russian industrial and development base.[4] Ergo, the birth of oligarchs, among whom was Mikhail Khodorkovsky, a major shareholder of Bank Menatep. Through his bank's loan program, he acquired over 40% of the shares of one of the largest Russian refineries, Yukos, and then completed the acquisition via the purchase of the remaining majority shares in a few months. It is true that Yeltsin's deals were effectively give-aways of a powerful state asset base to a handful of well-connected, wealthy and powerful financial groups. It is also arguably true that most of these groups did not start their wealth accumulations in the most ethical or even legal manner. Additionally, it is speculated that it was a group of these oligarchs who suggested to Yeltsin to create the "loans for shares" scheme, and that Khodorkovsky was one of the leaders of that group.[5] However, perhaps the assessment of these new corporate entities should start at the point at which they originally formed. One thing is for certain, the concept of corporate governance as we know it was virtually unknown in Russia in the mid 1990's.

Formation troubles for Russian businesses continued and came to a culminating point in 1998. The global recession that started with the Asian financial crisis in 1997, exacerbated Russia's economic crisis and led to its subsequent default. The pressure on the ruble, its very weak economy, and the drop in commodity and energy prices which Russia heavily relied on, all strained Russia's treasury to it worst levels since "perestroika". At the same time, massive tax evasion by small and large businesses continued out of control and the government found itself unable to service its debt.[6] Yeltsin was not helping by continuously changing the upper echelons of his government, including the post of the Prime Minister in the Spring of 1998, creating both internal uncertainty and instability, as well as doubt and insecurity of foreign investors. Despite the IMF's bailout attempt, Russia's monthly payments exceeded its monthly tax revenues. The Treasury found itself in a trap of borrowing foreign money to repay increasingly higher interest on its current obligations and eventually the bubble burst. In August of 1998 the central bank suspended all payments on Russia's foreign obligations, the ruble went into a free fall and western creditors and investors lost vast amounts of money.[7] A tremendous

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[1] Raymond E. Zickel, *State Department Background Notes on Russia in 1991-1995* excerpted from The Soviet Union – A Country Study, (Washington D.C.: Federal Research Division of the Library of Congress, 1989).

[2] Wikipedia - History of post-Soviet Russia, *available at* http://en.wikipedia.org/wiki/ (retrieved Feb. 28, 2004).

[3] Id.

[4] *at* http://www.pbs.org/frontlineworld/stories.moscow/billioners.html, (retrieved on March 3, 2005).

[5] Alex Cherniy Review of the Russian Oligarchs in the End of XX Century: From Developed Socialism to Wild Capitalism. Russkiy Magazin, Feb. 2005, at 21.

[6] Anastasiya Narushkina, *Delo Ukosa Glasami Rossian* ("The Yukos Affair as Viewed by the Russians") Izvestia, July 24, 2004,at 2.

number of Russian businesses disappeared, much of the foreign investment stopped and uncertainty dominated. But as commodity prices and energy costs started to rise, the Russian economic outlook became brighter, in no small part due to the efforts of the oligarchs, who managed to survive the default and reengage foreign investors overtime. Among the biggest survivors was Yukos Corporation.

Mikhail Khodorkovsky

As we proceed with the further analysis of Yukos and its reflection on the volatile surface of the evolving Russian economy, we must take a small detour and look at the man behind Yukos, who is now currently also behind bars. By his 39th birthday Mikhail Khodorkovsky was the wealthiest man in Russia and the 16th wealthiest man in the world, although most of his wealth evaporated with the fall of Yukos.[8] A product of a typical Soviet environment, he grew-up in a two-room communal apartment, worked hard, received excellent grades and, ironically, was the deputy head of the Komsomol (Communist Youth League) at his university.[9] It is under the authority of the Komsomol, which was losing funds due to the lack of the government support, that Khodorkovsky opened his first business in 1986, a private café, which was allowed under the "perestroika" program. Over the next three years he tried various import/export ventures, for-profit sales enterprises and other businesses. He proved himself a capable entrepreneur, having an unprecedented revenue base in his export/import business of R80 million (about $10 million USD) by the end of 1996. It is with that cash that he and his partners purchased a banking license from the government and opened one of the first post-Soviet privately owned banks in Russia, the Manatep Bank.

The Menatep expanded rapidly, relying on export/import businesses, government contracts and various other (and at times unusual) projects. For instance, Menatep Bank was tasked with the allocation of funds for the victims of the Chernobyl nuclear accident. Mikhail learned early that in Russia having money is not enough – to succeed one must have the protection and the support of the powerful bureaucrats and he exploited that knowledge exceptionally well. Bank Menatep provided the capital for the bid under Yeltsin's scheme described above, and in 1995, an offer of approximately $350 million USD was enough to win the bid for the Yukos collateral. (The remaining balance of shares was acquired by Khodorkovsky the following year.) Yukos says that approximately $1.5 billion was spent in purchasing all of the remaining assets of Yukos, but even if that figure is accurate, when Yukos was listed two years later, it showed market capitalization (prior to the Russian Default of 1998) of $31 billion USD.[10] Not a bad deal by anyone's standards.

This two billion dollar purchase of a company that a few years later had a market value in access of $30 billion is what the Russian government and many Russian people cannot forgive – they feel cheated. Possibly so, but as Khodorkovsky stated in an interview he gave not too long after his arrest: "But then, in mid-90's when two billion was paid for Yukos that had the market value of less then $400 million, nobody said it was sold cheaply".[11]

His lessons in corporate governance however, came hard for Khodorkoysky. When the Ruble collapsed, Menatap started to collapse as well. In order to survive the default he and his team needed to forego massive obligations that Yukos secured with the western banks. Three banks, Standard of South Africa, Japanese Daiwa Bank and German West LB Bank collectively wanted almost $300 million USD back. Khodorkovsky offered them oil instead. They refused and took possession of Yukos shares held by them as collateral, which they quickly dumped collecting only half of their loan amounts. This was prompted by Khodorkovsky's public threat to massively dilute their stake with the issuance of new shares. While this technique is unlawful in most of the developed world, it was allowed by the Russian government on which Mikhail relied heavily. This behavior gave Khodorkovsky, Menatep and Yukos a terrible notoriety in the western financial circles and it took four years for the group to make peace and begin transacting with the west again.[12]

This success of regaining the trust of the western banks by Khodorkovsky and his team was accomplished largely because of their ability to show to the world that a large corporation in a developing Russia is fully capable of transparency, competent governance and the protection of its shareholders. Yukos introduced unprecedented levels of disclosure – they were the first large company to publish the list of their shareholders, something neither requi-

[7] Wikipedia – History of post-Soviet Russia, *available at* http://en.wikipedia.org/wiki/ (retrieved Feb 28, 2004).

[8] *Global 40 Richest under 40: Snapshot*, Fortune, September 16, 2003, *available at* www.fortune.com, (accessed in archives March 3, 2005).

[9] Wikipedia – Mikhail Khodorkovsy (biographical summary), *available at* http://en.wikipedia.org/wiki/Mikhail_Khadarkovsy, (retrieved Feb. 28, 2005). (This and other biographical data that follows came from this source).

[10] *Yukos 2002 Annual Report* Archives (Moscow: 2003) pg. 27, *at* http://yukos.com, (accessed March 3, 2005).

[11] *Interview with Mikhail Khodorkovsky* Moskovskiy Novosti July 2, 2004, at A3.

[12] Wikipedia – Mikhail Khodorkovsy (summary of arrest), *available at* http://en.wikipedia.org/wiki/Mikhail_Khadarkovsy, (retrieved Feb. 28, 2005).

red by the Russian Taxation Ministry at that time, nor heard of in the post-Soviet corporate Russia. Khodorkovsky also revealed that he in fact was the largest shareholder of Menatep; bringing upon himself the risk of a fall-guy should something go wrong with the company.[13] Prior to that, he and all the other oligarchs remained behind the scenes when it came to the question of ownership, hiding behind the wall of institutional investors.[14] Observed by the foreign executives and consultants, these new corporate governance principles led to a soaring share price as investors forgave past atrocities and again started buying Yukos, giving it a relatively low risk rating as compared to other foreign firms. Of great importance is that Yukos was a contagious example and other oligarchs, realizing the vital need to attract foreign capital, followed suit. Several published shareholder lists and almost all introduced GAAP and various levels of transparency in their corporations. Arguably, it was mainly because of this that Russia was able to successfully regain economic stability after its default.[15]

In an interview several months prior to his arrest, Khodorkovsky stated:

> "*Using methods that violate the chief aims that big business was made for and that violate the laws of the government are inadmissible for business. For a very simple reason – big business functions on existing laws, even if they are wrong. Our country has a history of serfdom and slavery and unfortunately the psychology of society is psychology of serfdom. In this situation, the responsibility of a successful businessman is to support the democratic process, regardless of its potential problems.*"[16]

In his final statement in Meshansky Court, when he was given an opportunity to speak in his defense, Khodorkovsky stated in the end of his speech:

> "*I was a wrong oligarch… I honestly tried to work to benefit my country, not my pocket. All I have left, is my knowledge of my truth, my business reputation and will-power. I am guilty of nothing that violated any laws. … I believe in the future of Russia as the country of law and justice.*"[17]

Realizing that they are fighting a losing battle and being on the verge of having their main oil-producing subsidiary, Yuganskneftegas, auctioned off, Yukos decided in December of 2004 to file a claim against the Russian government and to seek equity through an injunction of the auction in the US Bankruptcy court in Texas. Their request was to force the Russian government into arbitration, claiming that auctioning off the main business unit means the collapse of the company. Their connection to the United States was the fact that Yukos' CEO, Steven Thede was an American and had an office in Houston.[18]

Around the same time, three foreign members of the Yukos' Board, Sarah Carey, Raj Kumar Gupta and Jacques Kosciusko-Morizet resigned. They claimed they were unable to act in the interest of shareholders in a situation where Russian authorities were seeking to collapse the company. Their resignation produced an immediate reaction by the market – Yukos shares dropped more then 10% in less then four hours.[19]

Unfortunately, on February 24, 2005, U.S. Judge Letitia Clark dismissed Yukos' case, stating that the case belonged in a forum that included the participation of the Russian government. All subsequent attempts by Yukos to motion for a stay while it seeks remedial options were not successful.[20] The subsidiary was ultimately sold to a shell company, which later resold it to a state-owned oil-producing firm, Rosneft. In the opinion of this writer, what took place was a de-privatization of a company, camouflaged by a legal proceeding and an open-bid auction forum, placing it and its resources in the hands of the State.

Conclusion

While not arguing either for or against the position of the Russian government with regard to Yukos Company, it can be objectively stated that Yukos was one of the best examples of a developing Russian company fully capable of transparency, competent governance and the protection of its shareholders. Yukos introduced unprecedented levels of disclosure, and other progressive corporate governance practices. Arguably, it was mainly because of this precedent, followed by other large corporate entities, that Russia was able to successfully regain economic stability after its default.☐

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13 *Yukos Corporation: History / About Us*, as appears *at* http://www.yukos.com/Aboutus/management/biogrophies.asp, (retrieved March 3,2005).

14 Yelena Levina, *Russia Takes 3rd Place in the World in the Number of Billionaires*, Russkiy Magazin, May 2005, at 41.

15 In my opinion, had it not been for the oligarch's ability to convince foreign investors that Russian environment is stabilizing after the default, and that the increases in commodity prices will be very favorable for Russia, a country of natural resources wealth, the economic recovery, which Russia enjoyed from 2000 to present would not be as strong as it is.

16 *Interview with Mikhail Khodorkovsky,* Moskovskiy Novosti July 2, 2003, at A3.

17 *Last Word of Khodorkovsky, at* http://www.rambler.ru/db/news, (retrieved April 11, 2005), (direct translation).

18 Information regarding the filing with US Bankruptcy Courts, Court's disposition of the case and subsequent auctioning of the Yuganskneftegas subsidiary was gathered from various Internet media sources and was retrieved at various times during February and March of 2005. Main sources of information include www.CNN.com, www.Rambler.ru/db/news, www.yukos.com/vpo/, http://news.yahoo.com//news. For a detailed chronological event summary, see http://www.platts.com/Oil/Resources/News%20Features/yukos/.

19 *Available at* http://www.platts.com/Oil/Resources/News%20Features/yukos/, (retrieved March 21, 2005) (chronology of events as reflection on market).

20 Market Watch, *Yukos asks court to revive case*, Feb. 25 2005, *at* http://www.marketwatch.com/news (retrieved March 21, 2005).