

A young American businessman in a developing country discovers that nothing gets done unless palms are greased. Should he play the game by his personal ethics—or the local rules?

HBR CASE STUDY

The Shakedown

by Phil Bodrock

"How many of them were there? Were they armed? Did they confiscate any papers or disks?"

Pavlo Zhuk suddenly realized he was shouting, though for once the telephone line to Kiev was crystal clear. Zhuk was in a state. The grandfather clock in his sprawling farmhouse in Redwoods, California, had struck 6 AM, and the young software entrepreneur had just come down to the kitchen when the telephone startled him. His friend Kostya Hnatyuk, who headed Zhuk's software development center in Kiev, was calling to say that the center had had visitors that day—and not very welcome ones.

Hnatyuk patiently repeated what he had said a moment earlier. "I'm on my way to the office, Pavlo, so I don't have all the details. Taras Borovetz called me 15 minutes ago as I was getting off the plane and said that three or four UTA agents showed up this afternoon. That's Ukraine Tax Authority. Only one of them, a

woman, entered the office. I suppose the men could have been armed, but Taras didn't say so—"

"What did the woman say, exactly?" Zhuk interrupted.

"She said that her name was Laryssa Osipivna Simonenko. She claimed to be a UTA special agent. She told Taras that she and her boss, who heads something called the Special Audits Department, want to meet with us soon," Hnatyuk replied. "She says that we haven't filed five of the 17 schedules we were supposed to last quarter and we owe the government tax arrears of 86,954 hryvnia." Zhuk quickly converted the figure in his head: close to \$16,000. "It's a shake-down," Hnatyuk concluded.

"I can't believe it!" Zhuk cried. Had his life somehow turned into a B movie? "Why are they picking on us? We did everything by the book. How much time did she give us?"

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"She said next week. Don't worry, Pavlo. Our accountant can dig out all the tax papers, and I'll keep the lawyer on call in case Simonenko drops in again. Meantime, I'll figure out who she is and whether she's really conducting an official inquiry. She could be running an extortion racket on the side..." Hnatyuk's voice trailed off; then he added: "I'll get our security guy to post two guards outside the office 24/7, starting tonight. No one else gets in unchallenged."

Zhuk was rattled by the thought of the Ukraine Tax Authority laying siege to his company's office. Standing barefoot in his kitchen, he felt powerless to deal with the situation. "Look. I'll try to get on that Lufthansa flight out of LAX this afternoon. I should be there before the weekend. Maybe it's just a misunderstanding, but if we're in the tax authority's crosshairs, this could be big trouble. I'll call you again before I head out. Tell Taras and the other guys not to panic."

After putting the telephone back in its cradle, Zhuk took a deep breath. He stared out the window toward the woods, hoping to spot the family of foxes he'd seen playing there a few days earlier. Waiting for his coffee to brew, he went out for the newspaper and scanned the headlines. He stopped again to take in the countryside. It dawned on him that for the first time in memory, he wasn't looking forward to packing his bags and heading for Kiev.

Back in the USSR

Six months earlier, Zhuk could hardly wait to land in Kiev. When the plane descended through a thin layer of clouds, he saw the setting sun reflecting off the Dnieper River and Kiev's golden domes. Without a doubt, this 1,000-year-old city was the most beautiful sight he had ever seen from the air. Sacked by the Mongols in the thirteenth century and virtually destroyed by the Nazis and the Red Army in the twentieth century, it had still clung to much of its magnificent Renaissance and Baroque architecture.

Zhuk had his own connection with Kiev's past. His parents had fled the city at the end of World War II and by 1951 had found their way to the United States. The family first settled in Cleveland but moved in 1973 when Zhuk, Sr., an engineer, accepted a job in California. Pavlo, the last of six children, was born the same year and grew up speaking English and Ukrainian at home. He was the academic star

of the family. After graduating with top honors from an engineering school on the East Coast, he worked for three years in Silicon Valley as a systems analyst and then entered an MBA program at a premier West Coast school. He hadn't even graduated when he decided to set up his company, Customer Strategy Solutions, to develop software for order-fulfillment systems. That proved to be a lucrative niche. After five years, the start-up employed 35 people, generated annual revenues of \$40 million, and reported profits.

Then, with the help of his friend Hnatyuk, Zhuk drew up a plan to create a software development center in Kiev. Hnatyuk, a British national of Ukrainian descent, had graduated from a Newcastle polytechnic as an electronics engineer. The two had met years before while Zhuk was summering in the UK as an exchange student. Their Ukrainian roots—and love for soccer—had kept them in touch.

Before joining Customer Strategy Solutions, Hnatyuk had been based in Kiev as the vice president of a German company that sold seeds, pesticides, and fertilizers in the Commonwealth of Independent States. His company had been doing business in Ukraine for more than six years but hadn't turned a profit there until recently. When Zhuk had called a year ago to chat about his desire to set up a software development center, Hnatyuk immediately volunteered to quit his job and help set it up.

Without discussing it much, the men both knew they were motivated by a feeling that this wasn't just about business; something more basic was at stake. Ukraine was a land where, due to two world wars, an ideology-created famine, the Holocaust, and political purges too numerous to list, 17 million people had lost their lives during the twentieth century. A tenth of Western Ukraine's population, including one of Zhuk's uncles and many of Hnatyuk's relatives, had been deported to Siberia. Zhuk and Hnatyuk's return was an assertion of resilience. They were driven by a desire to create opportunity, to bring hope, and to help build a modern society in Ukraine.

Zhuk thought he was well on his way to proving the naysayers—those who had pointed out the political turmoil and corruption in Ukraine and told him he should think twice about setting up shop there—wrong. He appreciated their concern but thought it was overblown. As he'd told his 80-year-old father

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at Thanksgiving, he felt quite at home in the country of his ancestors.

Don't Know How Lucky You Are

As Zhuk disembarked from the aircraft at Borispol Airport, he felt less at home in Kiev than ever before. Hnatyuk picked him up in his beat-up Land Rover and seemed to think that despite the extortion threat, it was business as usual. "Check it out," Hnatyuk said as he drove toward the city apartment they shared whenever Zhuk was in town. "Another McDonald's, and a new Wimpy's is going in across the plaza." He knew that Zhuk would be heartened by the sight: While most Western companies were reluctant to invest in Ukraine, fast-food restaurants were opening all over Kiev.

When he got only a weary grunt of acknowledgment from Zhuk, Hnatyuk piped up again: "By the way, I haven't had a chance to tell you about that USDA meeting." The Ukrainian Software Developers Association had held its annual meeting the week before, and Zhuk had asked Hnatyuk to check it out. "I was quite impressed," said Hnatyuk. "Do you know there are over 25 medium-sized IT companies here—not just in Kiev, but also in Lviv, Kharkiv, and Dnepropetrovsk? We're still the only development center for a multinational. Everyone there was talking about how two Ukrainian firms had beaten an Indian rival and won a contract to develop embedded systems for a big American corporation. The Association forecasts that Ukraine's exports of IT-related services will double over the next two years."

Zhuk perked up momentarily. "There's no question, we're here at the right time," he said. His business model was simple. Like India and Ireland, Ukraine offered a virtually unlimited supply of highly skilled and, by American standards, reasonably priced programmers. The country had a tradition of excellence in scientific and technical education that dated back to the formation of the Soviet Union. But most engineers and programmers had lost their jobs since the Soviet Union's demise and were looking for new openings. Meanwhile, Ukraine's schools produced 50,000 fresh technical graduates every year.

That was great for Customer Strategy Solutions because, despite an economic downturn in the U.S., the company had more work than it could handle. It had started out installing off-

the-shelf order-fulfillment systems, but its professionals increasingly consulted with clients on custom solutions and, more broadly, on innovative digital strategies. With Zhuk's top talent being pulled into strategy-related work, he needed more programmers to engineer systems.

On his previous visit, Zhuk had helped Hnatyuk recruit a core group of programmers, mostly through Hnatyuk's personal network. Later, as they made the rounds at Ukraine's universities and polytechnics, they found other institutions, such as the Institute of Cybernetics in Kiev, that were great sources of talent. "I feel like a kid in a candy store," Zhuk had said at the time. In a week, they hired 12 top-notch programmers, all in their twenties and with an average of three years' experience.

Zhuk wanted the best talent and was willing to pay top dollar for it. That was another point the two men had agreed on before hiring anyone: They would pay a wage that would afford their employees a level of comfort that most Ukrainians didn't have. The typical programmer's salary in Ukraine, at \$500 a month, accounted for only 40% to 60% of his or her family's budget. Zhuk wanted his programmers to be able to afford three meals a day without having to barter, stand in queues for hours, or moonlight. He wanted their families to have good medical care when they needed it. At the end of the day, he thought, the best way to make a difference in Ukraine was to enable people to buy homes, cars, and consumer durables. Customer Strategy Solutions therefore paid its programmers a salary of 66,000 hryvnia, or \$12,000—twice as much as a programmer could normally expect to earn in Ukraine but well below the \$75,000 to \$85,000 that his American counterpart would command or the \$24,000 that a Russian programmer would earn.

"But that just isn't enough for some Ukrainians," Zhuk thought darkly, his mind returning to the reason for his current visit.

The Costs of Doing Business

It wasn't as though Zhuk's eyes were entirely shut to the difficulties of doing business in a developing economy. If they had been, they opened pretty quickly in the process of getting the development center up and running. The first lesson came the day Hnatyuk took Zhuk to Dnipro Telecom, the state-owned telecommunications utility, to get the telephone lines

Because of the current backlog of orders, Mylofienko informed them, it would take some time to install the lines in their office on Predslavynska Street—about three years, in fact.

they would need. Hnatyuk had already explained that the company didn't offer dedicated high-speed lines, and getting Dnipro Telecom to sanction even plain-vanilla telephone lines wouldn't be easy.

At precisely 9 AM, Zhuk and Hnatyuk were ushered into the office of Vasyl Feodorovych Mylofienko, a senior business manager at Dnipro Telecom. The meeting had been arranged by a former colleague of Hnatyuk's. They sat respectfully while Mylofienko detailed the costs of telephone line rentals, at ten hryvnia (\$1.85) per month, and usage rates, at 0.5 hryvnia (9 cents) per minute. The onetime installation fee that Dnipro Telecom would charge the company, 100 hryvnia (\$18.50) per line, was reasonable.

But then came an unpleasant surprise. Because of the current backlog of orders, Mylofienko informed them, it would take some time to install the lines in their office on Predslavynska Street—about three years, in fact. If Zhuk couldn't connect the center to the firm's headquarters in Silicon Valley via the Internet, the project would be dead in the water. Hnatyuk had seemed calm, though. He turned to Zhuk and remarked that they would have to approach one of the other telephone companies in the city. A smaller firm would be more expensive but would probably be able to provide the center with lines in months, not years.

Zhuk was puzzled. Why were they discussing their options out loud in Mylofienko's office? He got his answer when Mylofienko cleared his throat. "Of course," he said, "we could expedite your application."

Hnatyuk jumped on the remark. "*Tse duzhe tsikavo* [That's very interesting]," he purred. "Please tell us more, Vasyl Feodorovych. What is it that you have in mind?"

"For a onetime fee of \$300 per line"—Zhuk noted the shift to U.S. currency—"I could install the ten telephone lines in your office next month. For \$500 per line, I would be pleased to offer you service beginning next week. That would require rearranging our installation schedules in Old Kiev, but I'm sure it can be done."

For \$3,000, Zhuk's software center could be up and running next month; for \$5,000, next week. He was sorely tempted to take his business to another telecom company, where the installation charges would be more reasonable. The downside was that Hnatyuk would have to

set up fresh appointments, they'd have to visit more people, and they'd spend more time getting wired than training their programmers or scouting for customers. Zhuk felt a trifle uncomfortable but made the call: "We would like to have the lines as soon as possible," he said, as much to Hnatyuk as to Mylofienko.

That was the cue Hnatyuk had been waiting for. He asked Mylofienko to draw up a contract for ten telephone lines, then excused himself and went to the men's room, where he extracted 50 hundred-dollar bills from his security belt, placed them in an envelope, and put the envelope in his breast pocket. When Hnatyuk returned, he took his seat, carefully read the contract, and signed both copies. He ceremoniously handed one copy to Zhuk. He folded Mylofienko's copy in half. Zhuk saw Hnatyuk take the envelope filled with cash out of his pocket, discreetly insert it into the crease of the contract, and hand it to the manager. Hnatyuk wrote a check drawn on a Kiev bank for 1,000 hryvnia and handed it to Mylofienko.

Hnatyuk got up to leave.

Following Hnatyuk's lead, Zhuk got up and bid the telecom manager good day. Mylofienko smiled and assured Zhuk that his telephone lines would be installed early the following week.

The kicker came at the very end. As Mylofienko shook hands with Hnatyuk, he presented him with two receipts: one for \$5,000, the other for 1,000 hryvnia. Zhuk was no longer sure what was going on. Had they or had they not just bribed Mylofienko?

As Zhuk and Hnatyuk walked down the steps of the Dnipro Telecom building, Hnatyuk burst out laughing at the expression on his friend's face. He explained that so many people had complained about the demands for extra charges in hard currency that the telephone company had taken to issuing receipts. Paying extra in U.S. dollars or euros for a service had become standard practice in Ukraine. In fact, Hnatyuk warned Zhuk, bureaucrats in most offices followed the same procedure. When they registered the company, got the fire inspector to visit the premises, and listed with the tax authorities, they might have to pay official fees in local currency and quasi-official charges in dollars or euros.

"Crazy as that sounds, I'm relieved," said Zhuk. "I knew that because of different laws, European firms could pay bribes more easily

than American firms, but I'd never have guessed that paying bribes could be official." He asked Hnatyuk to check, in any case, with the firm's CFO in California about how to account for such payments on the company's books. "I realize you have a local accountant," he added, "but let's just make sure there won't be any trouble with the IRS."

By the end of the week, Zhuk was convinced that incorporating a business in Kiev was no more burdensome than setting up a company in California. They had to register with only six bureaucracies: the Kiev city administration, an ecology office, a statistics bureau, the local social security office, the local police, and the Ukraine Tax Authority. Zhuk and Hnatyuk had to visit the police twice—first to obtain a permit to open a business, then again to get the permit stamped, since the part of the office that stamped permits was open only two days a week. But all that was hardly insurmountable. In the end, Zhuk got back to the United States just two days later than he had originally planned, secure in the knowledge that the Kiev software development center would be up and running the very next week.

A Matter of Principle

Hnatyuk's Land Rover pulled into the parking area behind the apartment building. Zhuk sneezed and said he might be catching a cold. As they entered the apartment, they discussed what they should attempt to accomplish—and be prepared to accept—in the days to come.

"So we don't know anything more, do we?" asked Zhuk. "We only know that Simonenko told Taras that if payment was not forthcoming within a week, there could be some serious consequences."

Hnatyuk nodded. "She also said that in such cases, it was not uncommon for the parties to reach an agreement," he said. "That sounded like an invitation to me."

"Look, Kostya, I'm way outside my comfort zone on this," Zhuk massaged his forehead. "I was willing to go along with all those so-called facilitation payments to get bureaucrats to do their jobs, especially if that's what everyone else does. But let's assume this is really an extortion racket. What happens when word gets out that we're a soft target? I don't have the stomach or

the capital to pay off every thug in town. Also, we're doing something good for this country. We shouldn't have to put up with this."

"No question," Hnatyuk said. "We shouldn't pay them too much." Zhuk could tell his colleague was trying to hold him to a pragmatic line of thought. Why waste time wishing reality were other than what it is?

But reality was different where Zhuk came from, and it could be different here. Strike that "could," Zhuk thought. It *will* be different here. It's only a matter of time. And Ukraine was where he wanted his company to be. A couple of days ago, he had gone to lunch with a merchant banker who felt that Zhuk should take Customer Strategy Solutions public. "You'll get a bigger premium for your shares because you have a development center in Kiev," the banker had said. "People are crazy nowadays over firms that outsource."

Maybe it wasn't a comfortable time to be doing business here. But which was better: to pack up and go home with one's personal ethics unsullied or to live to fight another day and commit to being part of the solution? Perhaps he could lead a double life, abiding by the local rules of the game while investing in initiatives led by local NGOs that wanted to battle corruption in the country.

Zhuk glanced at Hnatyuk and realized it wasn't that straightforward. What about his friend's well-being? Hnatyuk would never leave Kiev, and hadn't Zhuk encouraged him to quit his job and work for Customer Strategy Solutions? For that matter, what about the programmers they'd hired? He knew each of them by name and knew how grateful they were for the opportunity he'd given them. How could he let them down at the first sign of trouble?

In his heart, Zhuk knew he wasn't ready to pull out of Ukraine; he would have to bargain with the bullies. But what actions would constitute the high ground?

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