

**The power of antibribery institutions.**

**Implementation of the Foreign Corrupt Practices Act in transition  
economies from an institutional perspective**

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# The power of antibribery institutions. Implementation of the Foreign Corrupt Practices Act in transition economies from an institutional perspective

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## Abstract

This article provides an institutional analysis of anti-bribery legislative and organizational institutions through the bribery case of Magyar Telekom in transition economies. The case shows the striking difference between the effectiveness of strong and weak institutional systems in combatting bribery of foreign public officials. The analysis gives account of factors that contribute to the effectiveness and the failure of such anti-bribery institutional systems on national, international and organizational level. While organizational culture and the general business environment contribute to the weakness of anti-bribery institutions on company and on national level, the case clearly suggests that consequent enforcement of legislative institutions on the international level can be effective ways to force companies to change their organizational culture.

## Introduction

International legal framework to punish bribery has strengthened for the last three decades and its implementation affects more and more companies worldwide. Still, many businesspeople in transition economies are not aware of the implications of the legislation and its enforcement. Businesspeople in transition economies are used to a system with relatively low level of law enforcement, especially in the field of antibribery legislation. This is due to the fact that countries that have changed communist regime into market economy all suffer from strong and opaque cooperation between politicians and businesspeople; control institutions are headed by political appointees and do not operate independently. In Russia, for example, the system of mutual favors enables their participants to gain state orders, get jobs for acquaintances, places in good schools, to stop, redirect or circumvent police, prosecution and court proceedings (Ledeneva, 2008). High-potential businesspeople rightly have the perception that in their country everything can be arranged. The same high-potential businesspeople however are rarely aware of the fact that they are subject to antibribery legislations of other countries where law enforcement is consequent and hard to influence.

This article presents the bribery case of Magyar Telekom (MT), the biggest Hungarian telecommunication provider. In 2005 MT allegedly bribed public officials in two Southern European countries, Macedonia and Montenegro. Since that time MT was listed in the US Stock Exchange it fell under the jurisdiction of the Foreign Corrupt Practices Act (FCPA). The case presents the differences in business culture, mindset and law enforcement systems of transition countries and the US from an institutional perspective.

There is strong correlation between institutions and corruption in various levels. Depending on the definition of institutions and corruption there is broad research about how institutional frameworks and systems can mitigate or increase corruption risks. Stronger and better performing institutional frameworks entail lower level of corruption risks on international, national and organizational level (Venard, 2009). The paper will present institutional setups and their corresponding risks to counter bribery through the example of Magyar Telekom's case in the Balkans. The article's structure follows the logic of the case. It starts with a short introduction of the company and follows with the analysis of national level anti-bribery institutional systems in transition economies. As the case develops the article presents the international anti-bribery legislative framework and its enforcement institutions. Organizational level institutional analysis to prevent bribery is based on the steps and actions taken by Magyar Telekom managers before and during the investigation. The last parts of the paper enlist the consequences of the case and draws conclusions.

The paper is based on and uses parts of the case study titled: *The price of regional expansion. Magyar Telekom's bribery case in the Balkans*, prepared by Noemi Alexa, Peter Hardi, Andras Hanak and Szilvia Várady in 2015.<sup>1</sup>

### *Magyar Telekom*

Magyar Telekom (MT) was a limited liability stock corporation organized under the laws of Hungary and headquartered in Budapest, Hungary. Originally called Matáv, it was the state-owned telecommunication provider of Hungary until the Hungarian government sold its shares in two phases. By the end of 1995 the consortium of Deutsche Telekom (DT) and Ameritech International acquired a majority ownership, holding 67.3% of Matáv's shares. Matáv's privatization was the biggest in Central Eastern Europe and it was the biggest foreign investment in Hungary at the time. Matáv then went public in 1997, selling its shares both on the Budapest Stock Exchange and the New York Stock Exchange. It was the first company in the region with securities publicly traded through American Depository Receipts in New York.

In 2000 Deutsche Telekom (DT), a German telecommunications provider became the company's majority owner, owning 59.01% of these shares. The remaining 40.95% was still held by the public, while a Golden Share of 0.04% was held by the Hungarian state. As part of a brand unification project throughout the whole group Matáv changed its name to Magyar Telekom (MT) in 2005. By that time MT was a prosperous company which had successfully carried out structural changes and met profit expectations.

When becoming majority owners, DT adopted a strategy of growth through regional expansion. The idea was that Matáv establish subsidiaries in the Balkans. As a first step, in 2001 Matáv acquired a majority ownership in Macedonia's national telecommunications company Makedonski Telekomunikacii (MakTel). MakTel was the first subsidiary of Magyar Telekom in the Balkans. The deal was concluded in January 2001 when Magyar Telekom bought 51% of government-owned shares in MakTel.<sup>2</sup> 45% of MakTel's shares remained with the Macedonian state and 4% of shares were held by minority shareholders.

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<sup>1</sup> The multimedia case study is available for CEU students only at [www.ceu.mcdirect.hu](http://www.ceu.mcdirect.hu).

<sup>2</sup> [http://www.wikinvest.com/stock/Magyar\\_Telekom\\_Plc.\\_%28MTA%29/Filing/20-F/2007/F2793272#Item4aunresolvedStaffComments\\_034036](http://www.wikinvest.com/stock/Magyar_Telekom_Plc._%28MTA%29/Filing/20-F/2007/F2793272#Item4aunresolvedStaffComments_034036)

In 2004, the government of Montenegro decided to privatize its state-owned telecommunication provider, Telekom Crna Gora (TCG). Magyar Telekom won the tender in January 2005 and the acquisition took place in March. MT bought 51.12% shares from the government and bought another 15.97% of minority shares from the public in order to acquire a supermajority control in the company.

In 1995, right after the privatization of the Hungarian state-owned company, Elek Straub, a reputable Hungarian business executive was hired as Matáv's CEO and soon after became the Chair of its Board of Directors. By being able to transform a state-owned company into a successful profit-making telecommunication provider he gained the trust of DT's leadership.

## **National institutions and bribery prevention in transition economies**

Countries in the Balkan region had the characteristics of transition economies in the first decade of the 21st Century. After the fall of the communist regime in the early 90s all countries of the region aimed at introducing neo-liberal principles in their economy and setting up democratic political institutions. The dissolution of Yugoslavia however resulted in a lengthy armed conflict in the Balkans due to ethnic conflicts and territory demands of the new countries. Wars during the transition period slowed down and deviated the process of restructuring which resulted in slow economic growth, high levels of unemployment and corruption. On scale of 1-10 (with a higher score indicating a lower risk of corruption), countries in the Balkans received an average score of 3.3 in Transparency International's Corruption Perception Index in 2006.

Due to the lack of funds and transparency to finance political parties, the political and business elite became interlinked and interdependent in these countries. Firms and their CEOs, too, had good connections to get things done or paid bribes for the same purpose (Hellman et al. 2000). Business leaders were normally very well connected to the political elite, including state authorities, and had the everyday experience that the company is capable to minimize the consequences of these proceedings.

The quality of the institutional system of a country is in correlation with its development, growth (Acemoglu, Robinson, 2012) and level of corruption (Mauro, 1995, M'eaon and Sekkat, 2005). This set of research is based on theoretical assumptions as well as on the dataset provided by the World Bank (on governance, rule of law, institutions), the World Economic Forum (Global Competitiveness Report) and Transparency International (Corruption Perceptions Index, Global Corruption Barometer). Institutional weakness is considered to be one of the primary factors that perpetuate corruption (Heinemann and Heiman, 2006, Chen et al., 2008). Bribery is a form of corruption that includes an act of offering someone money, services or other valuables, in order to persuade him or her to do something in return.<sup>3</sup>

Several research confirm that liberal economic states where competition is free and markets are not highly regulated and the political system is democratic are less exposed to corruption (Goldsmith, 1999, Mauro, 1995, Johnson et al. 1998). Liberalization of markets and democratization of political institutions generate greater competition which reduces the level of corruption only after the transition period is over. During the transition period old legal, economic and political institutional structures get disassembled which results in the desinstitutionalization of the normative control

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<sup>3</sup> Glossary, U4 Anticorruption Research Center, <http://www.u4.no/glossary/>

system (Johnson and Cullen, 2009). Norms and values of a society define the type of institutions the society creates for itself (Pillay and Donasamy, 2010). Norms and values change in a transition period, which implies the change of institutions the society creates for itself. The period of normlessness or anomic conditions (Durkheim, 1951) enhances the possibilities of corrupt behavior of firms (Johnson and Cullen, 2009). That's why change in institutions should be accompanied by changes in de facto political power of the elite and reductions in the benefits of this elite when using their political power. (Acemoglu, Robinson, 2008)

Macedonia transformed its economy into a market economy during the 90s, however, significant administrative burdens as well as political instability impeded the flow of foreign direct investment to the country. Macedonia became a European Union candidate country in 2005. In spite of economic growth, the unemployment rate was 36.5% in 2005.<sup>4</sup> Corruption remained a serious problem in executive and legislative branches, as well as in the judiciary.<sup>5</sup> Macedonia ranked 103 of 159 countries in Transparency International's Corruption Perception Index in 2005.

Montenegro is a small country of 623 000 inhabitants in Southeastern Europe. Montenegro implemented a series of reforms after the Balkan wars which stabilized its legal and public administration system. Reform initiatives successfully established the foundations of a market economy, however, the economic growth of the country remained slow and did not result in enhancing living standards. Compared to its neighboring countries, Montenegro's competitiveness lagged behind.

In both countries MT won a public tender to get shares in the state-owned telecommunications provider. Privatization of state-owned real estate and companies was one of the business transactions frequently involving corruption risks. Companies bidding in the tender in Macedonia and in Montenegro might have followed the pattern of competitive isomorphism (Venard, 2009): they adjusted to local conditions of bribery because they assumed that their competitors will do the same.

A company's regulatory compliance and integrity culture as well as the environment in doing business influence firms' bribery decisions (Chen et al., 2008). As described above, legal and institutional frameworks in the target countries were weak and full of political influence. To prevent bribery firms need to apply proper control systems (Schweitzer et al., 2004) and establish a culture of integrity. It is an open question to which extent Deutsche Telekom was aware of corruption risks that its expansion strategy meant and whether DT's leadership was confident that their control systems would prevent bribery cases. Leadership of Magyar Telekom was certainly not aware of the importance of establishing control systems that would prevent and signal such kinds of wrongdoings. As the company was listed in the New York Stock Exchange Mr. Straub was very well aware of his fiscal responsibility originating from the Sarbanes-Oxley Act. The well-functioning internal control system of Magyar Telekom focused on preventing fraud and any wrongdoings in the accounting of the company. However he has never been trained about the implications of the Foreign Corrupt Practices Act on Magyar Telekom.<sup>6</sup> Partly that's why Mr. Straub was extremely surprised that in January 2006 the auditor of MT did not sign the company's financial statement. Nick Koós, the regional head of the auditor company PwC argued that they had found two dubious contracts at MT's Montenegrin subsidiary. The contracts

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<sup>4</sup>[http://ec.europa.eu/economy\\_finance/publications/publication12460\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication12460_en.pdf)

<sup>5</sup><http://www.state.gov/j/drl/rls/hrrpt/2005/61662.htm>

<sup>6</sup> Interview with Elek Straub

might have breached the anti-bribery provisions of the Foreign Corrupt Practices Act<sup>7</sup> of the US and the auditor had to signal such instances.

## **International institutions and legislative framework to prevent bribery**

International legislation on combating bribery of foreign public officials has been strengthened in the last decades. Although Magyar Telekom's case falls under the oldest of such regulations, the Foreign Corrupt Practices Act (1977), a brief summary of the evolution of legislation gives an understanding of the current state of the art.

### *Foreign Corrupt Practices Act*

The FCPA was enacted with the purpose of protecting US taxpayers' money by prohibiting and sanctioning the bribery of foreign public official. The peculiarity of the FCPA is that it has extraterritorial effect since all companies that are listed in the US are subject to the law. The FCPA has two main parts: Anti-bribery Provision and accounting and transparency provision. The Anti-bribery Provision prohibits any individual, firm, officer, director, employee, agent of firm, stockholder acting on behalf of firm, from acting with corrupt intent, to make payment to a foreign official (regardless of rank), foreign political party or official, candidate for foreign political office and to induce the recipient to misuse his official position or wrongfully direct business. The Accounting Provision only applies to companies issuing securities registered on US stock exchanges. The Books and Records Provision requires issuers to accurately record transactions in reasonable details while the Internal Controls Provision requires public companies to maintain a system of internal policies and procedures sufficient to provide reasonable assurances that transactions are executed and recorded according to appropriate standards.

The law is enforced by the US Securities and Exchange Commission (SEC) and the Department of Justice (DoJ). The SEC focuses on the enforcement of the accounting provisions while the DoJ on the anti-bribery provisions of the Act. The SEC can bring civil charges for violations of the anti-bribery provisions and the books and records and internal controls provisions. The DoJ is responsible for criminal enforcement of the anti-bribery provisions and willful violations of the books and records and internal control provisions.

According to Section 10A of the Securities Exchange Act if there is a suspicion of the violation of the FCPA either the company commences an internal investigation and notifies the Securities and Exchange Commission within one business day or if this is not done, the auditor resigns or furnishes to the SEC a copy of its report which triggers an immediate investigation by the SEC.

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<sup>7</sup> anti-bribery provisions of the FCPA prohibit the willful use of the mails or any means of instrumentality of interstate commerce corruptly in furtherance of any offer, payment, promise to pay, or authorization of the payment of money or anything of value to any person, while knowing that all or a portion of such money or thing of value will be offered, given or promised, directly or indirectly, to a foreign official to influence the foreign official in his or her official capacity, induce the foreign official to do or omit to do an act in violation of his or her lawful duty, or to secure any improper advantage in order to assist in obtaining or retaining business for or with, or directing business to, any person.

After the auditor's notice about potential wrongdoings Magyar Telekom leadership decided within one business day to start an internal investigation. The decision was taken without knowing exactly what such kind of an investigation means in practice.<sup>8</sup> Two days after the auditor refused to sign the books for 2005 MT contracted White and Case (W&C) an international law firm headquartered in New York to investigate the case. W&C lawyers arrived to Budapest and Podgorica in a week and after three weeks of investigation concluded that a) they could not find any evidence that money from Magyar Telekom was transferred to public officials to obtain advantage and b) they could not find any evidence either that there was real performance behind the dubious contracts. Therefore W&C suggested Mr. Straub to continue the investigation and voluntarily disclose to the SEC that such an investigation is going on. Other consultants and lawyers were on the same opinion. The reasoning behind self-reporting to the SEC and the DOJ under the FCPA was that if Magyar Telekom does not do it, it would trigger the automatic investigation and procedure of US authorities. Furthermore if any wrongdoing is revealed, self-disclosure is considered as cooperation with US regulatory authorities and will be counted as a plus when negotiating the fine. Mr. Straub was not familiar with the FCPA. He did not know that the investigation would go on for years and would cost his seat soon. W&C could not find evidence to prove that MT had bribed public officials and it was strange for him to involve the US authorities without any evidence of bribery. He believed his advisors and reluctantly though, he opted for voluntary disclosure in the end of February 2005. This step automatically triggered the prolongation of the contract of W&C for an undefined period.

There is a debate whether self-reporting under the FCPA is a tool that is worth to choose for companies (Marberg, 2012, Abramovitz and Sack, 2014). On the one hand voluntary disclosure is counted as a plus when getting to a settlement agreement with US authorities and can save millions of dollars for firms. In case of Magyar Telekom cooperation with US authorities was quantified in the Deferred Prosecution Agreement as the DOJ subtracted 5 points when calculating the operative offence level.

*"As such, in this case, the operative offense level is 38 for conspiring to violate the anti-bribery provisions of the FCPA, and thus the operative fine range is \$72,500,000 to \$145,000,000. Magyar Telekom agrees to pay a monetary penalty in the amount of \$59,600,000. Magyar Telekom and the Department agree that this fine is appropriate given the nature and extent of Magyar Telekom's cooperation in this matter and the remediation undertaken by Magyar Telekom."*<sup>9</sup>

On the other hand the internal investigation can be extremely long and costly. For Magyar Telekom it cost around 100 m USD and lasted 4 years. Furthermore, the internal investigation does not substitute the investigation of US authorities. Once it is completed, the SEC and the DOJ initiate their own procedures based on the report of the internal investigators. Opponents to self-disclosure under the FCPA argue that this way the enforcement of the FCPA not cost efficient.

### *International Conventions*

Since the FCPA entered into force in 1977 companies falling under its jurisdiction suffered competitive disadvantage to those firms which did not face sanctions when bribing officials in foreign countries. To level the playing field in international markets a convention prohibiting the bribery of

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<sup>8</sup> Interview with Elek Straub and the former Chair of the Audit Committee

<sup>9</sup>Deferred Prosecution Agreement p.5.<http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2012/01/24/2011-12-29-dpa-magyar.pdf>

foreign public officials was compiled under the auspices of the OECD. The Convention entered into force in 1999 and 41 countries ratified it up to 2016.

The introduction of prohibiting bribery of foreign public officials in national criminal laws of signatory countries was an important step however it is not sufficient unless accompanied by institutions that support the development of honest and effective governments (Rose-Ackerman, 2010). As this is not the case in most of the signatory countries the enforcement of the OECD Convention varies. According to Transparency International' progress report about half of the Convention countries have failed to prosecute any foreign bribery case since 1999. The report distinguishes between active, moderate, limited and little enforcement. In 2015 the US, Germany, the UK and Switzerland were the best performing countries in enforcing the regulations on national level. (Heimann et al., 2015)

The United Nations Convention against Corruption was adapted in 2005. This is the broadest anticorruption legislative framework both in terms of its geographical coverage and its content. Currently there are 140 signatory countries to this Convention which embraces mandatory and permissive preventive measures in public and private sectors, criminalization obligations, trading in influence and illicit enrichment, private rights for victims of corruption, anti-money laundering measures and cooperation in investigation and prosecution.

On the European level the Council of Europe's Group of States against Corruption (GRECO) signed a Criminal Law Convention on Corruption in 2002. This Convention covers a wide range of offences including domestic and foreign bribery, trading in influence, money laundering, accounting crimes, and even private bribery.

Countering bribery of foreign public officials on the level of international laws is mainly a voluntary system and the implementation of laws highly depends on national governments (Rose-Ackerman, 2012). National prosecution agencies in countries where corruption is rampant rarely initiate procedures against companies that are close to the political elite. According to the 2008 Global Integrity Report Macedonia's legal system was considered moderate while its actual implementation weak. In Montenegro the legal system was weak and its implementation extremely weak.<sup>10</sup>

### *UK Bribery Act*

The latest development in strengthening the legislative framework was the UK Bribery Act that entered into force in 2011. Similar to the FCPA, the strength of the UK Bribery Act lies in its extraterritorial effect on the one hand and in the independent and consequent enforcement system on the other. The UK Bribery Act applies globally for all UK registered companies and any companies operating in the territory of the UK. General offences defined include giving and receiving of a bribe, bribing a foreign public official and failing to prevent a bribe from the side of agents suppliers, subsidiaries or contractors. The Act is enforced by the Serious Fraud Office, due to its recent adaption there are only few prosecuted and closed cases.

Major differences between the FCPA and the UK Bribery Act are the following. While the FCPA punishes only active bribery (i.e. paying bribes) the UK Bribery Act sanctions those both parties, including those receiving bribes. Contrary to the FCPA the UK Bribery Act does not provide

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<sup>10</sup> Global Integrity Report, [www.globalintegrity.org](http://www.globalintegrity.org)

exemption from facilitation payments. To be sanctioned under the FCPA it has to be proven that the intention of the transaction was to obtain some kind of advantage. The UK Bribery Act focuses on the existence of improper payments with or without obtaining advantage. By reducing their fines the FCPA rewards companies that had proper preventive systems and institutions in place to prevent wrongdoings. The UK Bribery Act requires the existence of compliance systems and punishes if they are not in place.

### *Summary*

There is an ongoing debate on whether the enforcement of national legislation with extra-territorial effect (the FCPA and the UK Bribery Act) is the most efficient way to stop the bribery of foreign public officials. Main arguments against such a system are that it is extremely costly and it is maintained in such a way to feed lawyers. In the Magyar Telekom case there was a clear motivation for the internal investigator to extend the case in order to keep the assignment. According to MT's former and current employees who followed the investigation closely 90% of the data and evidence was gathered during the first year of the investigation and during the additional 3 years there hasn't been any evidence added to the case.<sup>11</sup> Still there was no institutional mechanism under the FCPA that would have stopped the investigators or could limit the time and money spent on this endeavor. Proponents of the FCPA enforcement system argue mainly with the deterrent effect of fines and procedures. Given the fact that national enforcement in most of the countries is weak still it is these two laws that have been proved to be the most effective way of sanctioning bribery of foreign public officials.

There is a striking difference between how executives from Western countries and from transition market economies interpret the cooperation with authorities and law enforcement agencies. In the Western model, especially under the FCPA companies and executives know that the authorities will be consistent in conducting the investigation therefore cooperation means that these companies and executives help revealing the wrongdoings so that the fine imposed is lower. In transition market economies the level of enforcement of anticorruption laws is pretty low<sup>12</sup> which is complemented with a system of mutual favors between the political and business elite. As the case indicates top managers of MT got access to decision-makers in the government and in different authorities in all the countries they operated. These relations are generally based on the culture of mutual favors among members of the political and business elite. This results in a non-transparent net of business transactions including bribery, nepotism and kickbacks. Well-connected businesspeople have the experience that they have the possibility to directly or indirectly influence authorities and law enforcement agencies and circumvent the legal system. Cooperation in this sense means misusing the connections in order to circumvent the law and stop its enforcement.

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<sup>11</sup> Interviews conducted in 2015 with former and current MT personell

<sup>12</sup> An example for that can be that both in Hungary and Germany are party to the OECD Convention on combating bribery of foreign public officials. Despite all allegations Mr. Straub has never been investigated because of the Magyar Telekom corruption case in Hungary. However the CEO of MT's mother company Deutsche Telekom was investigated and arrested German prosecutors in a rather spectacular manner at his wedding.

## Bribery cases

In this part I will go through the sequence of events during the internal investigation conducted by W&C. The investigation started in Montenegro from where some threads led to Hungary and then to Macedonia.

### *The Montenegrin case*

In 2005 the Montenegrin subsidiary, Telecom Crna Gora contracted in 2005 Sigma and Rawleigh for consultancy about an integration plan and an industry study. The auditor found suspicious that contracting parties in both cases were off-shore companies and reports submitted were plagiarized copies of documents available on the internet. Additionally, in case of the Sigma contract, one of the subcontractors was a law-firm based in Podgorica (capital of Montenegro) whose partner actually was the sister of the Montenegrin prime minister. According to MT, it was understandable that local law-firms did not want to be involved directly in, and be associated with, a politically sensitive report that recommended serious downsizing in a country where unemployment rate was 23%. Hence local firms were contracting indirectly, through off-shore companies.

The value of the contracts was not extremely high (580 000 USD and 2.3 m USD) but much higher than the performance behind their fulfillment. Even though the circumstances of these two contracts looked suspicious this would not have been sufficient to initiate a procedure under the FCPA. However there were other red flags that W&C found in the early stage of the investigation that raised their suspicion about the mother company and its Macedonian subsidiary.

Top managers of TCG tried to destroy some files from which W&C reconstructed that one of the consultants in the Rawleigh contract was also a consultant in two other contracts of the parent company, Magyar Telekom. These two contracts were signed between MT and Fiesta and Activa with the aim of assisting MT in purchasing minority shares in TCG. This was in line with TCG's strategy of acquiring majority shares in order get full control over the subsidiary. Both contracts were of the value of 2.3 m USD and were identified dubious for several reasons: Fiesta and Activa were off-shore companies; the contracts had identical terms; vaguely drafted services; and the consultancy fee was 10 times higher than the usual. To clear the suspicions about the Fiesta and Activa contracts investigators turned their attention to Magyar Telekom.

### *The Hungarian case*

It soon turned out that one year before the Director of Internal Audit had filed a whistleblower compliant about the Fiesta and Activa contracts to the CFO of MT. This compliant claimed that the contracts were not compliant with the provisions of the FCPA due to high consultancy fees, the off-shore ownership structure of the companies and the vague, but identical terms. The complaint was withdrawn in a very short time; the whistleblower supposedly understood that buying out shares from the public meant dealing with local brokerage firms and unregulated local and foreign speculators from which MT wanted to keep itself away.

When the investigation started Mr. Straub sent a letter drafted by W&C asking all of his colleagues to keep all documentation on their computers. In spite of this warning two of his high-level executives were afraid that investigators would find their internal communication about some deals in Macedonia that contained confidential information (Macedonian state was one of the owners of the

company). They wiped these confidential, Macedonia-related documents from their hard-drives. The mere fact of undisclosed shredding called the attention of W&C and extended the investigation to Macedonia.

### *The Macedonian Case*

MT had been present in Macedonia since 2001 when it acquired majority ownership in the former state owned telecommunication company, MakTel. At the beginning of 2005, the Macedonian government amended its telecommunication law in order to raise frequency fees and to open up the market to allow a new mobile provider. This was an unforeseen development with a clearly adverse impact on MakTel. In February 2005, Mr. Straub, CEO of MT decided to reach out to the highest level of the Macedonian government. MT drafted a Protocol of Cooperation according to which MakTel would make a substantial dividend payment to the government of Macedonia as shareholder. In return, the government would grant MT and MakTel certain regulatory benefits such as reductions in the frequency fees and postponing the issuance of a license to a third mobile operator.

Parallel to drafting the Protocol of Cooperation MT signed three advisory contracts with Chaptex, an off-shore company to lobby with the Macedonian government to establish favorable conditions for MT's operations. Suspicions about the Chaptex contracts were: unclear ownership structure of the company; some dubious e-mails; fast payment without real performance; bypassing internal regulations and shredding some data related to these contracts. Investigators assumed that the Chaptex contracts were to cover illegal payments to Macedonian government officials to ensure that the legislative environment favored MakTel. In fact, after Mr. Straub met the prime minister of Macedonia in May and in June 2005, frequency fees were reduced and the issuance of a license for a third mobile provider was postponed by several years. MT's calculations suggested that they saved roughly 4 million EUR with the postponed liberalization of the market.

## **Company Institutions and Culture to Prevent Bribery**

Unethical decisions in a company are due to a complex set of factors such as individual moral standards, organizational environment and business environment (Kish-Gephart et al., 2010). The fact that MT's integrity culture was decoupled from its formal institutional system can be explained by at least three factors: the business environment, the company's formal and informal institutional system and the organizational culture.

### *Business Environment*

The business environment in which MT operated in Hungary lacked transparency, interests of political and business decision-makers were interdependent and control institutions were not independent enough to operate as deterrent factors for the political and business elite.

After the fall of communist regimes at the end of the 80s CEE countries underwent significant economic and political restructuring and sought to adhere to neo-liberal principles. Privatization of state owned real estate and companies, dominance of foreign capital as well as growing number of undercapitalized SMEs characterized the economy during the transition period. The structural reforms implemented

during the 90s were followed by a strengthening the legislative framework by 2004, when CEE countries joined the European Union. The institutional system of these countries was not strengthened enough to ensure proper enforcement in respect of anticorruption and business laws hence corruption remained a significant problem for doing business in the region. The CEE region's perceived level of corruption was lower with an average of 5.<sup>13</sup>

Corporate culture in Hungary was defined by the legacy of communist culture. Due to the lack of funds and transparency to finance political parties, the political and business elite became interlinked and interdependent in these countries. Firms and their CEOs, too, had good connections to get things done or paid bribes for the same purpose.<sup>14</sup> Business leaders were normally very well connected to the political elite, including state authorities, and had the everyday experience that the company is capable to minimize the consequences of these proceedings.

Corruption cases of bribery of public officials are rarely investigated and almost never sentenced in transition market economies. Investigating authorities and law enforcement agencies are not independent and strong enough to reveal high-level corruption cases. In transition economies such as Hungary, those having close connections to political leaders got better access to information about privatization (Hellmann et al., 2000). Magyar Telekom was one of the privatized companies and become the exemplary Western-type multinational in some years. However, due to the strong cooperation of political and business elite, the leadership of MT had good connections to high-level political leaders and state institutions including regulatory and control institutions.

Firms cope more easily with structural changes caused by market equilibrium than with unpredictability due to industrial policies (Tool, 1993). Once such a policy change occurs, the policy maker's exposure to corruption, the transparency of the business environment and the firm's willingness to bribery will influence whether the policy change is influenced through unlawful actions. According to the principal-agent model the accountability of public officials and the monopoly held by this official determine corruption (Klitgaard, 1988).

### *Organizational systems*

The behavior of employees is affected by formal and informal systems (Trevino et al. 2001) Formal systems consist of rules, structures, processes while informal systems are based on values, assumptions and meanings. These elements influence and form each other through an iterative process and change the culture, structures and procedures, time to time. Whether formal systems get implemented in practice highly depends on company culture which is influenced by values defined by top leadership. And vice versa, whether ethical commitment of top leadership is reflected in practice depends on well-designed structures and processes. For example if performance evaluation focuses only on reaching ambitious business goals employees are not encouraged to take into account ethical aspects in their work. In this case formal systems such as performance evaluation get detached from the commitment of top leadership and there is a discrepancy between formal and informal daily life of the organization. An example for good processes without real ethical

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<sup>13</sup>Corruption Perceptions Index, Transparency International, 2006,  
[http://www.transparency.org/research/cpi/cpi\\_2006/0/](http://www.transparency.org/research/cpi/cpi_2006/0/)

<sup>14</sup>Hellman, Kaufmann, Jones: Seize the state, seize the day: state capture and influence in transition economies, Policy Research Working paper 2444, The World Bank and European Bank of Reconstruction and Development, September 2000

commitment can be that there are codes of conduct and due diligence processes set up to screen suppliers and business partners but if nobody cares about controlling the implementation of such norms they will not become the DNA of the company i.e. company culture. These organizations can take up the “check” approach” (Weaver, 2006) and feel comfortable checking the boxes of codes, trainings and other compliance institutions. And although such formal systems can prevent unethical behavior as little attention is paid to their implementation they get decoupled from the organization’s daily life (Weaver et al. 1999).

To ensure that an organization prevents such instances that happened at Magyar Telekom both formal and informal systems to ensure integrity of the company must be in place.

In Magyar Telekom formal compliance institutions were mostly in place, top leadership communicated to be a compliant and transparent company. However this formal commitment to compliance was not reflected in the performance evaluation system and in the company’s culture. Deutsche Telekom’s expansion strategy to the Balkans entailed inherent corruption risks due to the fact that the institutional system of transition economies was not strong enough to operate independently and efficiently. Given the characteristics of the business environment the expansion strategy defined by DT can be considered as an excessive goal that is hard to reach without cutting corners. Higher institutional pressures such as opaqueness, loose enforcement and injustice as well as higher task pressures lead to increased level of corruption (Luo, 2005). Opaque environment in the Balkans was accompanied by a very ambitious goal to be fulfilled by Mr. Straub. Goal-setting is constructively motivating (Schweitzer et al., 2004) however too high pressure on the value of performance might lead to unethical practices (Schweitzer et al., 2004, Beenen and Pinto, 2009, Pinto et al., 2008). As described by Schweitzer et al. overambitious goals involving corruption risks might justify unethical behavior of businesspeople (Schweitzer et al., 2004).

Magyar Telekom at the early 2000s had probably the best compliance systems among Hungarian enterprises. Because of being listed in the NY Stock Exchange the leadership was aware of the consequences of the Sarbanes-Oxley Act. They had a strong internal control department, they also operated a whistleblowing system and managers were trained on their fiscal responsibility and liability. Even though their compliance system was not perfect it was able to signal and filter wrongdoings. Company culture though was not always in line with formal procedures. The report of the whistleblower is a good example of how formal structures and systems identified red flags in a contract and how company culture disregarded them. The whistleblower’s claim was based on exactly the same issues that later on substantiated the indictment. However the CFO didn’t take them seriously for two reasons. First, he wasn’t aware of the robustness of an FCPA procedure and its potential consequences. Second, and most importantly because the aim of expansion in the Balkans and buying minority shares from the public was such a strong motivating factor that overwrote any reasonable argument that indicated that these contracts might be unlawful tools to conceal corrupt deals. Another example of weak integrity culture at Magyar Telekom is the fact that top executives felt that they can disregard the explicit order of the CEO and wiped files from their hard drives. This happened both in Montenegro and in Hungary, in the latter case with the justification of protecting the confidential information about the Macedonian government. Again, most probably they were not aware the severe consequences of wiping under an FCPA investigation. At the same time this instance shows that observance to norms was not a must at the company. If

leadership felt that the norms imposed contradicted their or to company's interest they easily disregarded the regulations.

The whistleblower report and shredding by executives were turning points of the case. Should the whistleblower's complaint taken seriously, those contracts might have been cancelled. Should high-executives keep to the non-shredding policy W&C might have stayed with investigating in Montenegro.

### *Organizational culture*

Tone at the top is considered as a key factor in forming the culture of an organization. Mr. Straub had the reputation of being impeccable and a person who cares for his company and his country. According to his colleagues Mr. Straub was an excellent business leader. He knew how to motivate people, how to hold the company together. MT's working culture was innovative and competitive. At the same time he was a hands-on and strong leader. He knew about all contracts and things that happened in the company.

Schein considers organizational culture "a set of shared meanings, assumptions, values, and norms that guide employees' behavior within an organization via explicit structures and implicit conventions" (Schein 1992). The ethical dimension of organizational culture is captured by Trevino et al. stating that the "ethical climate... is reflected in the normative controls systems, ethical cultural norms and values of the organization" (Treviño et al., 2006). By introducing 'norms' in both definitions authors make reference to the influence of formal structures on the organizational culture. As discussed above formal institutions of Magyar Telekom were mostly but not entirely in place to prevent bribery cases.

Besides formal systems the ethical culture of the company plays important role in encouraging employees to correct observed wrongdoing if 1. standards for ethical behavior are clear, 2. employees are committed to the ethics of organization, 3. ethical dilemmas and issues are open for discussion and 4. transgressors are punished. (Kaptein, 2011). In Magyar Telekom the picture of the operation of these four dimensions was mixed. Standards for ethical behavior were not clear since formal rules contradicted to actual daily practices. Without clear system of norms and values employees adherence to ethical values could not be expected. As the whistleblower complaint shows, there was space for discussing even delicate issues and due to the strong internal audit team transgressors were usually punished.

An analysis of Magyar Telekom's organizational culture based on the literature of corrupt organizations reveals that even though it was a company with outstanding formal systems in the Hungarian market its norms and values corresponded to some extent to the characteristics of corrupt organizations. Campbell and Göritz conducted interviews with experts who have extensive knowledge about corrupt organizations. They found that "managers perceive a corrupt organizational culture in terms of performance values" (p. 14). Corrupt companies perceive themselves in a war where their major goal is to fight for contracts. In this fight unethical behavior is justified by the leadership to preserve the workplace for employees. In this way corruption is perceived as an external pressure over which the company does not have control. Obeying this pressure ensures the survival and growth of the company which in this way wins in a war to ensure employment. (Campbell and Göritz, 2014). In corrupt organizations employees commit wrongdoings

in the interest of the company and not to enrich themselves (Pinto, 2008). The aggressive growth strategy and the pressure on MT leadership to implement it match to this argument (however, we have to admit that salary level of top leadership normally depends on their performance therefore fulfilling ambitious and excessive goals serves their personal interests too). As corrupt activities serve the organization's goal employees cooperate in exercising these practices (Palmer and Maher, 2006). Fulfilling organizational goals that ensure the survival of the company and preserves the workplace of many people justifies the uses of corrupt practices (Campbell and Göritz, 2014, Sims and Brinkmann 2003). The cooperation between employees necessary for reaching these goals through maybe unlawful practices legitimizes corrupt behavior within the organization (Ashforth and Anand, 2003).

The above categorization of corrupt and ethical organization is misleading in the sense that organizational culture changes by time and the culture of corruption in an organization needs time to develop. It would be misleading to assume that all employees at Magyar Telekom were corrupt individuals. If the allegations are right these bribery schemes happened through the cooperation of different managers and as in corrupt organizations usually each of them was involved only in one part of the corrupt behavior (Sims and Brinkmann).

Even though it sounds rational managers committing corruption rarely make cost-benefit analysis of bribery. These actions are much more impulsive that give answer to everyday business challenges than deliberative calculated choices of bribery (Kish-Gepart et al., 2010). Especially in a business environment of transition economies where integrity norms and standards are not very clear small departures from written norms are well tolerated and rarely have severe consequences. For example 49% of shares in MakTel were held by the Macedonian state which at the same time acted as a regulator and was going to raise frequency fees and allow a new competitor to the market. Even though for an outsider there is a clear conflict of interests involving corruption risks in negotiating with the prime minister in his double role, MT leadership did not consider these negotiations as departing from ethical standards. As top managers provide rationalization for their minor wrongdoings these acts build the commitment of employees to the wrongful course of behavior (Palmer and Maher, 2006, p.3-4). Since enforcement of antibribery rules in Macedonia was weak the accountability of public officials and politicians drafting the new regulation was not weak too.

## Consequences

By the fall of 2006 the pressure on Mr. Straub was enormous. A number of his colleagues had left the company during the summer and he could not see when and how the investigation would finally come to an end. The resignation of Karl-Uwe Rietzke, CEO of Deutsche Telekom in November was a sign that Mr. Straub's chair as CEO of Magyar Telekom was becoming tenuous. Even though he was certain that he committed no crime, he decided to resign on 5th December 2006, two years before the expiry of his contract. Christopher Mattheisen, former deputy CEO and director of Landline Division of Magyar Telekom, was appointed as CEO of Magyar Telekom the next day and elected as chair of the Board on the 21st of December.

The final report of W&C of 300 pages was released in December 2009 four years after they had been hired. The internal investigation cost roughly \$100 Million; in Hungary this was an unprecedented amount of money paid to a law firm. After W&C released its report, the company management took over the driver's seat from the audit committee and negotiated with the US authorities through their

law firm. On top of the four years of internal investigation the external investigation culminating in a settlement lasted for two years.

The SEC and the DOJ used the content of the White and Case final report, but they needed to obtain admissible evidence in a DOJ and potential court proceedings. Therefore the SEC and the DOJ examined the same witnesses so that they would have legal grounds for including their statements in the documents of the record. The investigation revealed enough evidence to start two procedures: one against Magyar Telekom (and Deutsche Telekom) and the other one against three former MT executives, including Mr. Straub. As time passed, the Department of Justice dropped the allegations about bribery in Montenegro. This meant that the DOJ could not prove beyond any reason that MT would have bribed public officials in Montenegro.

The procedure against the companies concluded in a settlement with the SEC and a Deferred Prosecution Agreement with the DOJ on the 29th of December 2011. This was almost 6 years after the case has started and two years after W&C has published its final report. Magyar Telekom agreed to settle the SEC's charges by paying \$31.2 million in disgorgement and pre-judgment interest. Furthermore Magyar Telekom agreed to pay a criminal penalty of \$59.6 million to the DOJ as part of the deferred prosecution agreement.

As a consequence of the scandal, the company strengthened its internal control and risk management mechanisms. In 2006, Magyar Telekom improved the control system of consultancy contracts; introduced a new model of governance and approved the future introduction of a rectification program. Furthermore the company decided to amend the structure and procedures of acquisitions and other procurements, as well as introducing a new internal control system. In 2008, Magyar Telekom launched a robust compliance program that has become the best practice in Hungary.

## Conclusions

Magyar Telekom's bribery case in the Balkans shows the effectiveness of strict enforcement institutions of international anti-bribery legislation. Lack of proper institutions preventing bribery at organizational and national level enables and justifies corrupt behavior of businesspeople in transition economies that might face strikingly different enforcement systems if US or UK authorities investigate them. The international legal framework combatting bribery of foreign public officials is subject of criticism because it maintains an extremely costly legal system. However the deterrent effect of such framework lies in its strong institutions that transition economies and companies operating in these countries many cases lack. Magyar Telekom was an exemplary company for its transparency within the Hungarian market because of being listed in the NY Stock Exchange. However its institutional framework preventing wrongdoings was not accompanied by an organizational culture focusing on integrity. Compared to the value of the allegedly bogus contracts the investigation took extremely long since it was extended from Montenegro to Macedonia. The extension of the case was due to mainly two factors. One, the imperfectness of the enforcement system of the FCPA: had W&C not found anything else besides the Montenegrin contracts the accusations could not have been substantiated. This would have been a shame on the auditor and would have resulted in much less revenue for W&C. Second, the imperfectness of MT's integrity system: even though formal institutions to prevent wrongdoings were more or less in place,

company culture allowed circumventing the rules should this circumvention serve the company's interest. To prevent similar wrongdoings and their escalations ethical values of the organization have to be reinforced in the daily practices so that they strengthen the enforcement of the institutional system.

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