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COVER STORY

Fakes!

The global counterfeit business is out of control, targeting everything from computer chips to life-saving medicines. It's so bad that even China may need to crack down

A year and a half ago, Pfizer Inc. ([PFE](#)) got a disturbing call on its customer hotline. A woman who had been taking its cholesterol-lowering drug Lipitor complained that a new bottle of tablets tasted bitter. She sent the suspicious pills to the company, which tested them at a lab in Groton, Conn. The white oblong tablets looked just like the real thing -- and even contained some of the active ingredient in Lipitor. But Pfizer soon determined that they were counterfeits. Over the next two months, distributors yanked some 16.5 million tablets from warehouses and pharmacy shelves nationwide.

An isolated case? Hardly. Last October, Brazilian police got a tip-off about a hoard of bogus Hewlett-Packard Co. ([HPQ](#)) inkjet cartridges and seized more than \$1 million worth of goods. Chinese police last year conducted raids confiscating everything from counterfeit Buick windshields to phony Viagra. In Guam, the Secret Service in July uncovered a network selling bogus North Korean-made pharmaceuticals, cigarettes, and \$100 bills. In June, French customs seized more than 11,000 fake parts for Nokia Corp. ([NOK](#)) cell phones -- batteries, covers, and more. In January, U.S. Commerce Secretary Donald Evans blasted the Chinese on a visit to Beijing, demanding they step up efforts to police intellectual-property violations. Evans singled out the case of a General Motors Corp. ([GM](#)) subsidiary that is suing Chinese carmaker Chery Automotive for ripping off the design of its Chevrolet Spark minicar. The uncanny resemblance between the two cars, said Evans, "defies innocent explanation."

Critical Mass

Kiwi shoe polish, Callaway Golf ([ELY](#)) clubs, Intel computer chips, Bosch power drills, BP ([BP](#)) oil. Pick any product from any well-known brand, and chances are there's a counterfeit version of it out there. Of course, as anyone who has combed the back alleys of Hong Kong, Rio, or Moscow knows, fakes have been around for decades. Only the greenest rube would actually believe that the \$20 Rolex watch on Silom Road in Bangkok or the \$30 Louis Vuitton bag on New York's Canal Street is genuine.

But counterfeiting has grown up -- and that's scaring the multinationals. "We've seen a massive increase in the last five years, and there is a risk it will spiral out of control," says Anthony Simon, marketing chief of Unilever Bestfoods. "It's no longer a cottage industry." The World Customs Organization estimates counterfeiting accounts for 5% to 7% of global merchandise trade, equivalent to lost sales of as much as \$512 billion last year -- though experts say this is only a guess. Seizures of fakes by U.S. customs jumped by 46% last year as counterfeiters boosted exports to Western markets. Unilever Group says knockoffs of its shampoos, soaps, and teas are growing by 30% annually. The World Health Organization says up to 10% of medicines worldwide are counterfeited -- a deadly hazard that could be costing the pharmaceutical industry \$46 billion a year. Bogus car parts add up to \$12 billion worldwide. "Counterfeiting has gone from a local nuisance to a global threat," says Hanns Glatz, DaimlerChrysler's ([DCX](#)) point man on intellectual property.

The scale of the threat is prompting new efforts by multinationals to stop, or at least curb, the spread of counterfeits. Companies are deploying detectives around the globe in greater force than ever, pressuring governments from Beijing to Brasilia to crack down, and trying everything from electronic tagging to redesigned products to aggressive pricing in order to thwart the counterfeiters. Even some Chinese companies, stung by fakes themselves, are getting into the act. "Once Chinese companies start to sue other Chinese companies, the situation will become more balanced," says Stephen Vickers, chief executive of International Risk, a Hong Kong-based brand-protection consultant.

China is key to any solution. Since the country is an economic gorilla, its counterfeiting is turning into quite the beast as well -- accounting for nearly two-thirds of all the fake and pirated goods worldwide. Daimler's Glatz figures phony Daimler parts -- from fenders to engine blocks -- have grabbed 30% of the market in China, Taiwan, and Korea. And Chinese counterfeiters make millions of motorcycles a year, with knockoffs of Honda's ([HMC](#)) workhorse CG125 -- selling for about \$300, or less than half the cost of a real Honda -- especially popular. It's tales like this that prompt some trade hawks in the U.S. to call for a World Trade Organization action against China related to counterfeits and intellectual-property rights violations in general. Such pressure is beginning to have some effect. "The Chinese government is starting to take things more seriously because of the unprecedented uniform shouting coming from the U.S., Europe, and Japan," says Joseph Simone, a lawyer specializing in IPR issues at Baker & McKenzie in Hong Kong.

Yet slowing down the counterfeiters in China and elsewhere will take heroic efforts. That's because counterfeiting thrives on the whole process of globalization itself. Globalization, after all, is the spread of capital and knowhow to new markets, which in turn contribute low-cost labor to create the ideal export machine, manufacturing first the cheap stuff, then moving up the value chain. That's the story of Southeast Asia. It's the story of China. Now it's the story of fakes. Counterfeiting packs all the punch of skilled labor, smart distribution, and product savvy without getting bogged down in costly details such as research and brand-building.

The result is a kind of global industry that is starting to rival the multinationals in speed, reach, and sophistication. Factories in China can copy a new model of golf club in less than a week, says Stu Herrington, who oversees brand protection for Callaway Golf Co ([ELY](#)). "The Chinese are extremely ingenious, inventive, and scientifically oriented, and they are becoming the world's manufacturer," he says. The company has found counterfeiters with three-dimensional design software and experience cranking out legitimate clubs for other brands, so "back-engineering a golf club is a piece of cake" for them, he says. And counterfeiters are skilled at duplicating holograms, "smart" chips, and other security devices intended to distinguish fakes from the genuine article. "We've had sophisticated technology that took years to develop knocked off in a matter of months," says Unilever marketing boss Simon.

The ambition of the counterfeiters just keeps growing. In China, recent raids have turned up everything from fake Sony ([SNE](#)) PlayStation game controllers to Cisco Systems ([CSCO](#)) router interface cards. "If you can make it, they can fake it," says David Fernyhough, director of brand protection at investigation firm Hill & Associates Ltd. in Hong Kong. Don't believe him? Shanghai Mitsubishi Elevator Co. discovered a counterfeit elevator after a building owner asked the company for a maintenance contract. "It didn't look like our product," says Wang Chung Heng, a lawyer for Shanghai Mitsubishi. "And it stopped between floors."

Many fakes, though, are getting so good that even company execs say it takes a forensic scientist to distinguish them from the real McCoy. Armed with digital technology, counterfeiters can churn out perfect packaging -- a key to duping unwitting distributors and retail customers. GM has come across fake air filters, brake pads, and batteries. "We had to cut them apart or do chemical analysis to tell" they weren't real, says Alexander Theil, director of investigations at General Motors Asia Pacific. The parts might last half as long as the real thing, but that's not apparent until long after the sale.

The counterfeiters even ape the multinationals by diversifying their sourcing and manufacturing across borders. Last August, Philippine police raided a cigarette factory in Pampanga, two hours outside of Manila. What they found was a global operation in miniature. The factory was producing fake Davidoffs and Mild Sevens for export to Taiwan. The \$6 million plant boasted a state-of-the-art German cigarette-rolling machine capable of producing some 3 billion fake smokes, worth \$600 million, annually. The top-quality packaging came from a printer in Malaysia. The machinery itself was manned by 23 Chinese brought in by a Singapore-based syndicate, says Josef Gueta, director of Business Profiles Inc., a Manila firm that tracks counterfeit rings for multinationals. "They have shipping, warehousing, and the knowledge and network to move things around easily," he says.

As such counterfeiters get more entrenched and more global, they will be increasingly hard to eradicate. Financing comes from a variety of sources, including Middle East middlemen, local entrepreneurs, and organized crime. Sometimes the counterfeiters are fly-by-night operations, but just as often they're legitimate companies that have a dark side. In fact, many are licensed producers of brand-name goods that simply run an extra, unauthorized shift and sell out the back door. Or they are former licensees who have kept the molds and designs that allow them to go into business for themselves. Shoemaker New Balance Athletic Shoe Inc. is suing a former contract manufacturer in Guangdong province for selling unauthorized New Balance sneakers that have turned up as far away as Australia and Europe. In the Philippines, semiconductor distributor Sardido Industries says it has been burned by counterfeiters that have sold it microprocessors rejected by inspectors from the likes of Intel ([INTC](#)) and Advanced Micro Devices ([AMD](#)). These are doctored with logos and serial numbers to look like genuine parts and sold off cheaply as returns or production overruns. Other counterfeiters are generic manufacturers who moonlight as makers of fakes. Yamaha Corp. has licensed five plants in China to make its motorcycles, but almost 50 factories have actually produced bikes branded as Yamaha.

It's easy to find the counterfeiters, too. The Ziyuangang market in the sprawling city of Guangzhou, two hours north of Hong Kong, looks pretty much like any recently built Chinese shopping mall. But venture inside, and you'll find row upon row of shops offering bogus Gucci ([GUCC](#)), Versace, Dunhill ([BTI](#)), Longines ([SWGAF](#)), and more. Each shop has just a few dozen samples but offers vast catalogs of goods that can be made and delivered in less than a week. At one outlet, a clerk offers counterfeit Louis Vuitton ([LVMH](#)) bags in various sizes. "Even fakes have many grades of quality, and these fakes are really, really good," she boasts. Exports? She's happy to arrange shipping to the country of your choice.

Once those goods leave China, they can sneak into the legitimate supply chain just about anywhere. Sometimes, phony components get used in authentic products. Last year, for example, Kyocera Corp. ([KYO](#)), had to recall a million cell-phone batteries that turned out to be counterfeit, costing the company at least \$5 million. Unscrupulous wholesalers will fob off fakes on small auto-repair shops, office-supply stores, or independent pharmacies by saying they have bargain-priced -- but not suspiciously cheap -- oil filters, printer cartridges, or bottles of shampoo that another retailer returned, or which are close to their sell-by date. Some traders mix phonies in with authentic goods. "It's easy to slide a stack of fake Levis under the real ones," says one investigator based in Shanghai. "Most inspectors and buyers can't tell the difference."

Counterfeiters can also disguise their wares before they reach their final destination. Some ship unmarked counterfeit parts in several consignments to be assembled and labeled at their destination. And last May, Shanghai customs officials were inspecting a Dubai-bound shipment of 67 100cc motorcycles labeled with the brand name Honling. But when they peeled back stickers on the machines' crank cases, they found "Yamaha" engraved on the casting. "They are very sneaky and cunning, and that's very frustrating," laments Masayuki Hosokawa, chief representative of Yamaha Motor Co. in Beijing.

Strategic Defense

They are also making big bucks. Counterfeiting has become as profitable as trading illegal narcotics, and is a lot less risky. In most countries, convicted offenders get off with a slap on the wrist and a fine of a few thousand dollars. Counterfeiters, after all, don't have to cover research and development, marketing, and advertising costs, and most of the expense goes into making goods look convincing, not performing well. Fake Marlboros ([MO](#)) that cost just pennies a pack to make in China could end up selling for \$7.50 in Manhattan. Phony New Balance shoes can be stitched together for about \$8 a pair and retail for as much as \$80 in Australia, while real ones cost between \$11 and \$24 to make, and sell for up to \$120. Gross margins for knockoff printer cartridges are north of 60%. Counterfeiters "use low-paid employees and cut corners on safety," says Richard K. Willard, general counsel for Gillette Co. ([G](#)), which turns up hundreds of thousands of imitation Duracell batteries every week. "If they can push them off as a high-quality product, there is a big margin for them."

While the counterfeiters are piling up profits, the multinationals are spending ever more on stopping them. Luxury house LVMH Môt Hennessy Louis Vuitton spent more than \$16 million last year on investigations, busts, and legal fees. GM has seven full-time staffers sleuthing the globe, and Pfizer has five people working in Asia alone. Last September, Nokia started making batteries with holographic images and 20-digit identification codes that can be authenticated online. Cigarette maker JT International has boosted its anti-counterfeiting budget from \$200,000 to \$15 million in the past six years, spending the money on a network of investigators, lawyers, and informants in factories suspected of making fakes.

Pfizer will soon introduce radio-frequency ID tags on all Viagra sold in the U.S., which will enable it to track drugs all the way from the laboratory to the medicine cabinet. Other companies simply try to make life as difficult as possible for manufacturers and distributors by raiding factories and warehouses or by slightly altering the look of products, making it tough for counterfeiters to keep up with the changes. JT International -- which sells Camels and Winstons outside the U.S. -- sometimes digs through dumpsters at suspect factories looking for counterfeit packaging. Callaway patrols the Web looking for suspiciously cheap clubs bearing its brand -- though as soon as it shuts one dealer down, another is sure to pop up. "Getting rid of the problem altogether is too much to ask," says Callaway's Herrington. "We just try to do our best and give the counterfeiters a really bad day."

One tactic is to outwit the counterfeiters in the marketplace. Anheuser-Busch Cos. ([BUD](#)), for instance, was plagued by knockoff Budweiser in China. A big problem was that counterfeiters were refilling old Bud bottles, so the company started using expensive imported foil on the bottles that was very hard to find in China. The company also added a temperature-sensitive label that turned red when cold. The result: "We've been able to keep [counterfeiting] at a pretty low level," says Stephen J. Burrows, chief executive and president of Anheuser-Busch International. Yamaha, meanwhile, overhauled the way it manufactures and designs motorcycles to lower costs. Now it charges \$725 for its cheapest bikes in China, down from about \$1,800. To stay competitive, counterfeiters have since lowered their prices from around \$1,000 to roughly half that.

The biggest challenge is getting cooperation from China. For years, Chinese authorities turned a blind eye to the problem, largely because most of the harm was inflicted on foreign brand owners and most counterfeiting was seen as a victimless offense. The only time China got tough on counterfeiters was when there was a clear danger to Chinese. Last year, for example, 15 infants died from phony milk powder. The ringleader was sentenced to eight years in prison. But when the victim is a company not an individual, the courts are far less severe. Last June, a Guangdong businessman was found guilty of producing fake windshields under 15 different brand names, including General Motors, DaimlerChrysler ([DCX](#)), and Mitsubishi Motors. He was fined just \$97,000 and given a suspended sentence. It's unclear just how much he made selling fakes, but GM gumshoe Theil says "there is no way the fine is commensurate with the profits he made."

But more Chinese corporate interests have seen profits hit because of counterfeiting -- which may lead to a tougher response from Beijing. Li-Ning Co., China's No. 1 homegrown athletic footwear and apparel company, has gotten the ultimate compliment from counterfeiters: They're faking its shoes. So today, Li-Ning has three full-time employees who track counterfeiters. The state tobacco monopoly is conducting joint raids with big international tobacco companies, since counterfeiters have started cranking out Double Happiness, Chungwa, and other Chinese smokes. The crackdown, investigators believe, has forced some cigarette counterfeiters to decamp to Vietnam and Burma. And the government is finally realizing that piracy -- which accounts for 92% of all software used in the mainland -- isn't just setting back the likes of Microsoft Corp. ([MSFT](#)) "Piracy is a big problem for the development of the local software industry," says Victor Zhang, senior representative for China of the Business Software Alliance, an industry group. Some fear that Western companies may cut research spending in China if the mainland doesn't crack down.

Now, China is toughening its legal sanctions. In December, Beijing lowered the threshold for criminal prosecution of counterfeiters. Prior to the changes, an individual needed to have \$12,000 worth of goods on hand before police could prosecute. It was easy to skirt that rule by spreading the wares around. Today, that threshold stands at \$6,000 for counterfeiters caught with one brand and \$3,600 for those with two or more. And in late January, Beijing began the trial of two Americans who are accused of selling \$840,000 in knockoff CDs and DVDs made in China over the Internet. The two could face up to 15 years in jail if convicted.

One big problem: Too many scammers have ties to local officials, who see counterfeit operations as a major source of employment and pillars of the local economy. "Two or three of our raids have failed because of local protection," says Joseph Tsang, chairman of Marksman Consultants Ltd., a Hong Kong-based company that has helped conduct raids on behalf of Titleist and Nike ([NKE](#)) Golf. Take the example of a raid last August in Fujian province. The police found a dirt-covered hatch hiding a stairway that led into a pitch-black cave. Inside was a rolling machine, cigarette paper, and a die for stamping Marlboros and Double Happiness packaging. But the counterfeiters themselves had cleared out and taken the smokes with them. "They knew we were coming," sighs a Hong Kong-based investigator who participated in the raid.

Embattled Beijing

Beijing says it's doing what it can. The government has raised intellectual-property issues to the highest levels: Trade czar and Vice-Premier Wu Yi, for instance, has held regular meetings with the Quality Brands Protection Committee since 2003. "China customs is taking the fight seriously," says Meng Yang, director general for the Policy & Legal Affairs Dept. of the General Administration of Chinese Customs. The agency in November held a conference in Shanghai with brand owners and customs officers from around the world to map out strategies. But delegates acknowledged their biggest challenge is finding the funds to fight counterfeiting, as most governments are more concerned with preventing the smuggling of drugs and arms.

Could the U.S. apply stronger pressure to get China to crack down? "The answer is for the Administration to bring a WTO case against the Chinese," says one leader of the intellectual-property bar in Washington. The challenge is to secure evidence from U.S. companies, which desperately want relief but don't want to anger Beijing. More calls for a WTO action may come soon, after the U.S. Trade Representative's office finishes a review of IPR in China in March.

Hard as it is, there's every reason to try to keep up the fight to stop counterfeiting. One is safety. Novartis ([NVS](#)) says counterfeiters have used yellow highway paint to get the right color match for fake painkillers. And in some African countries, counterfeit or illegal medicines account for as much as 40% of the drugs on the market. "You even have antibiotics without the ingredients," says Daniel L. Vasella, chairman of Novartis. Pfizer says police and regulators in Asia uncovered more than 1.5 million counterfeit doses of its hypertension drug Norvasc in 2003. "You are seeing counterfeiters exploit a loose supply chain and moving from lifestyle drugs to life-saving drugs," says Pfizer's vice-president for global security, John Theriault. "That should make people

nervous."

The other reason to mount an offensive against the counterfeits is, obviously, the hit to corporate profits -- and the likelihood developed markets will one day be seriously contaminated. It's already happening. In June, 2003, Tommy Hilfiger Corp. ([TOM](#)) successfully sued Goody's Family Clothing Inc. ([GDYS](#)) for \$11 million for carrying fake shirts. The incidence of fake prescription drugs in the U.S., though small, is rising sharply. The U.S. Food & Drug Administration began 58 investigations of counterfeit drugs in its fiscal 2004, up from 22 in 2003.

More alarming, say police, is counterfeiting's connection to the underworld. "Organized crime thrives on counterfeiting," says Ronald K. Noble, Secretary General of Interpol. So does terrorism. Noble says profits from pirated CDs sold in Central America have funded Hezbollah in the Middle East. One cigarette executive estimates North Korea earns \$100 million per year in fees from pirates producing there. That kind of activity proves that buying fakes "isn't innocent, and it's not a game," says Bernard Arnault, chairman of luxury goods maker LVMH.

The counterfeiting scourge, meanwhile, continues to spread. Pakistan and Russia are huge producers of fake pharmaceuticals, while in Italy an estimated 10% of all designer clothing is fake, much of it produced domestically. Gangs in Paraguay funnel phony cosmetics, designer jeans, and toys from China to the rest of South America. Bulgarians are masters at bootlegging U.S. liquor brands. This is one fight that will take years to win.

By Frederik Balfour in Guangzhou, with Carol Matlack in Paris, Amy Barrett in Philadelphia, Kerry Capell in London, Dexter Roberts in Beijing, Jonathan Wheatley in Sao Paulo, William C. Symonds in Boston, Paul Magnusson in Washington and Diane Brady in NY

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