

# NOT EXACTLY

# COUNTDOWN

**MOST BIG BRANDS DON'T WANT TO TALK ABOUT IT, *BUT THERE'S A BUG IN THE OUTSOURCED ECONOMY*: FOREIGN CONTRACTORS MAKE MORE PRODUCTS THAN THEY'RE SUPPOSED TO, THEN SELL THE EXCESS OUT THE BACK DOOR. *NEW BALANCE* FOUND OUT JUST HOW HARD IT CAN BE TO SHUT DOWN THE "THIRD SHIFT." BY ROGER PARLOFF**

*GEE, COUNTERFEIT PRODUCTS ARE GETTING SO REALISTIC!*

Doubtless you've heard some version of that comment in recent years. Well, they *are* getting more realistic, for two reasons. One you know about, but one you might not.

The prong of the problem everyone understands is that technological advances in printing, scanning, 3-D modeling, and so on have made copying through reverse-engineering easier and cheaper than ever. And if you ask any brand owner why counterfeits are so convincing these days, that's the answer you'll get.

But there's another factor. Now that Western companies are pervasively outsourcing the manufacture of their products to factories overseas, they're entrusting their precious intellectual property—designs, molds, specifications, trade secrets—to hundreds of contractors and subcontractors all over the world.



# PERFEIT



**New Balance** ordered Chinese contractor Horace Chang to stop making and selling the "classic" shoe (far left) in 1999. He refused. It's still on sale in Shanghai.

**The Henkee** (near left) is a competing brand that Chang launched when relations with New Balance soured.

## THIRD SHIFT

It's extremely hard to police global supply chains, and IP is leaking out through 1,000 cracks.

The simplest and most dramatic form of the problem is something that Asia-based investigators jocularly refer to as the "third shift," the "midnight shift," or the "ghost shift." Say a U.S. company orders 20,000 dresses from an overseas factory. The contractor fills the order during its two day shifts but then runs off 10,000 extra at night, possibly using inferior materials. Those he sells out the back door, so to speak, trademark and all. In the case of apparel, says Vincent Volpi, the head of PICA, a brand-protection firm, third-shift products may be "substantially indistinguishable, down to the same thread count."

Daniel C.K. Chow, an IP-law professor at Ohio State University, recalls his own former employer, a multinational consumer-brands company he declines to name, having a third-shift problem at a factory in China that produced packaging and labels. The contractor "would sell the night shift to counterfeiters," says Chow. "You'd wind up discovering a counterfeit product in a genuine package."

Sometimes even brand owners can't tell whether an unauthorized product is a counterfeit (a product bearing a trademark that its maker never had authority to use) or the result of third-shift activity. In late 2001, for instance, Too Inc., which runs the Limited Too chain of clothing stores for girls, discovered that discounter TJ Maxx was selling 31 styles of Limited Too apparel at markdowns—653,000 garments. TJ Maxx was stocking many more units than Too had ever ordered from its Asian suppliers, and what Too had ordered was still being sold in its own stores. When Too sued TJ Maxx to stop sales, though, its lawyers candidly admitted that they weren't sure whether the clothes were counterfeits or third-shift goods. Though discounters can always be enjoined from selling counterfeits, some judges will let them sell third-shift goods unimpeded, viewing the latter as legally "genuine." In Too's case, the judge enjoined the sales, ruling that even third-shift goods were a form of trademark infringement, albeit less serious than counterfeiting. That seems to be the emerging view. (The case settled in 2003.)

**IN ADDITION TO** literal night-shift activity, the "third shift" is an umbrella term for any form of unauthorized production by otherwise authorized contractors. A common variant arises when a brand owner tells an overseas contractor to stop producing a line of product, and the contractor doesn't. "You've taught a company to produce something," says one China-based investigator who requested anonymity, "and perhaps that's all those people know how to do. Just because you have agreements doesn't mean those people are going to stop doing what they've learned."

Even in its wider sense, the third shift is a subset of a broader problem: the countless ways in which companies lose control of intellectual property when relying on an outsourced supply chain. IP leakage is the glitch in the ascendant paradigm for doing business.

"When you're outsourcing, you provide specifications, drawings, blueprints," says Peter Humphrey, who runs a risk-management firm in Shanghai called ChinaWhys. "What can easily happen is, someone takes it down the road to his brother or uncle, who also has a factory. 'Before you know it, there's ten or 20 factories in that county making knockoffs of your product.'" In the mid-1990s, according to Ping Deng, a professor of business administration at Maryville University in St. Louis, Yamaha set up three motorbike joint ventures in China, only to have a local part-

## BRAND RIPOFFS: A USER'S GUIDE

**COUNTERFEIT** A product that bears a trademark that its maker had no authority to use.

**KNOCKOFF** A broad term encompassing both counterfeits and items that look like branded products though they don't actually bear forged trademarks.

**THIRD SHIFT** An unauthorized product made by an authorized contractor.



**In Shanghai** real New Balance shoes are sold alongside Henkees, a lawful knockoff made by a former supplier.

ner sell its technology to rivals. Within four months counterfeit Yamahas were being sold, Deng says, and by the early part of this decade, five of six Yamahas in China were counterfeit.

When this sort of IP theft is thrown into the mix, the boundary between third-shift goods and counterfeits begins to melt away. "When a brand owner shuts down a factory," explains Jeffrey Unger, CEO of GenuOne, a brand-protection management firm, "you'll see the same factory start up two months later making counterfeit product. They know where to buy the raw materials and know how to move product."

Variations on that theme now challenge the multinational chemical, pharmaceutical, and information technology companies that have spent billions to set up R&D facilities in China, lured by the 600,000 Chinese engineers its universities graduate each year.



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A disloyal engineer can steal a gigabyte of proprietary information by saving it to a tiny USB flash drive, according to Humphrey of ChinaWhys. In one of Humphrey's cases, he says, an employee stole a new industrial process for manufacturing a chemical and then started a competing business in collusion with his former employer's suppliers and customers. In another, research on nanotechnology was stolen. "In the cases I've dealt with, the criminals are people with Ph.D.s," says Humphrey.

Brand owners typically don't admit to having suffered from third-shift or other IP-leakage problems. "It makes you seem like you've been an idiot," explains professor Chow. "These are peo-

## IP LEAKAGE IS THE GLITCH IN THE NOW-ASCENDANT PARADIGM FOR DOING BUSINESS.



**IP chief** Ed Haddad urges companies to monitor their supply chains.

ple you've hired. You didn't exercise due diligence." Most brand owners approached for this story either declined to discuss the issue or denied experiencing the problem.

There is, nonetheless, one brave Western company that has come out of the closet about its struggles with the third shift. When New Balance thought it had been wronged by a former contractor in China, it decided to litigate in the Chinese courts. Many

companies have avoided that path for fear of either publicizing their own mistakes or alienating local officials with whom they'll be dealing. But New Balance chose to fight. Other brand owners can learn much from its eye-popping experience.

**FROM A SEVENTH-FLOOR** picture window at New Balance headquarters in Boston's Brighton section, the concrete horseshoe of Harvard Stadium looms to the northeast, while stately Baker Library of Harvard Business School commands the view due east. Yet the most noteworthy landmark lies just out of sight, about a mile to the west. There stands a rarity: a functioning American shoe factory.

Executives at New Balance, a private company celebrating its 100th anniversary this year, are proud to own that plant and four others in New England. They still produce 25% of the company's footwear. But tradition and patriotism carry a company only so far: New Balance, which reported \$1.54 billion in sales last year, competes in the same world as everyone else. About 70% of its shoes are now made in China, and the other 5% in Vietnam.

New Balance began outsourcing in the early 1980s, using factories in Japan, then South Korea, then Taiwan. In the early 1990s its Taiwanese suppliers began moving their factories to mainland China. One of those contractors was Horace Chang, now 59, a tough, keen businessman. (Chang declined to be interviewed for this article, citing New Balance's legal proceedings against him.)

In 1990, Chang built a factory in Yang Jiang City, in Guangdong province near Hong Kong. At first his factory, which can employ up to 4,000 workers, made New Balance shoes only for export. But in January 1995, at Chang's request, New Balance licensed him to also distribute its shoes to the Chinese domestic market.

Chang's sales were initially modest, according to Ed Haddad, 57, New Balance's vice president for intellectual property. But soon he had success with an inexpensive style known as a "classic." It's a colorful fashion shoe with "no technology," Haddad explains—meaning none of the fancy midsole engineering that defines a high-performance shoe. In June 1999, Chang stunned New Balance executives at a meeting in Boston by announcing that he was projecting sales of 250,000 pairs that year—quadruple what he'd sold the year before.

"We were amazed," recalls Haddad. But not pleased. New Balance executives feared that the company's name was becoming associated in China with a fashion shoe, jeopardizing its reputation as a performance brand. They told Chang to pull back from selling classics. "He was dumbfounded," Haddad recalls. "He came here thinking he was doing a great thing—like the cat that brings you the dead mouse—and we slapped him on the hand."

Chang didn't pull back. Rather, he ordered materials to produce 450,000 pairs, as the New Balance sourcing department reported to its alarmed management later that year. Soon Chang's inexpensive shoe was seeping out of China into premium markets like Japan. Licensed New Balance distributors there were furious. In August 1999, New Balance notified Chang that it was terminating his license to make and distribute classics, effective Dec. 31, 1999.

"What happened then is when everything went crazy," Haddad recounts. Upon termination, the contract called for Chang to return to New Balance all its confidential technical, production, sales, and marketing information, including molds, specifications, signs, labels, packages, wrappers, and ads. He didn't.

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"He continued to sell," says Haddad, "and was actively trying to sell product outside the country: in Taiwan, Hong Kong, Italy, Germany." (It's unclear whether Chang continued to make classics after 1999 or sold stockpiled inventory. Chang told the *Wall Street Journal* in late 2002, when it wrote about the situation, that he still considered himself entitled to make New Balance shoes.)

At New Balance's request, the provincial divisions of China's Administration of Industry and Commerce (AIC) seized about 100,000 pairs of Chang's shoes from his stores and factories. During one raid New Balance made an alarming discovery: Chang had launched a competing line of classic-style sneakers under his own brand. These he called Henkees (a meaningless word in Chinese), and he marked them with a logo on the saddle that purported to be a distortion of "Hi." At a glance it looked a lot like New Balance's block N saddle design. Chang had obtained a Chinese trademark on the Hi logo without New Balance's noticing.

Like most Western companies doing business in Asia, New Balance had inserted arbitration clauses in its contracts so that it wouldn't have to deal with foreign courts. Disputes were to be heard by an international arbiter applying Massachusetts law. But while an arbiter could assess damages, he could not provide New Balance what it needed in this crisis: an injunction stopping Chang from selling New Balance classics. To get that, the company had to sue in the Shenzhen Intermediate People's Court for Guangdong province. In late 2000 it did.

To oversee the litigation the company retained Harley Lewin, an IP litigator at New York City's Greenberg Traurig. A barrel-chested man with a trim white beard, Lewin decorates his office with trophies from past assignments: a gorgeous leather Chloé handbag, buttery but bogus; a bottle of Pure Vodka that mimics an Absolut bottle's design; a phony Titleist golf ball. "I've tried cases in 45 countries over 30 years," he says. "I sit there next to counsel in the courtroom in Israel, Cypress, Mexico, Paraguay, Brazil. So I'm pretty ready for any hook somebody's going to throw at me."

China's intellectual-property laws are actually pretty good, Lewin explains. They were upgraded as a condition of its accession to the World Trade Organization in 2001. But the challenges of litigating in China have "nothing to do with the law as written," he says. "They have much to do with the law as applied."

China's courts are a product of some extraordinary recent history. In the late 1950s, Chinese lawyers were denounced as "rightists" and began fleeing the profession. From 1966 to 1976, during the Cultural Revolution, the nation's legal system was abolished, its law schools shuttered, and its remaining lawyers sent to the countryside for reeducation through labor. The nation's current legal system has been entirely rebuilt since 1979, and it bears some scars. Most of the older judges are not lawyers, for instance, but

former military or police officials. Judges outnumber lawyers in China 200,000 to 140,000.

More important, even legally trained judges have scant judicial independence, according to Jerome Cohen, a law professor at New York University and a renowned authority on the Chinese legal system. "They are under political control," he says. "Judges are selected locally, paid locally, promoted locally, and fired locally. A foreign company—or even a Chinese company from another part of China—going up against a locally owned enterprise has an uphill fight." Plus, Cohen adds, "corruption is a very serious problem."

Lewin understood that since New Balance was trying to enforce Chang's contract termination—potentially costing local factory



**Litigator** Harley Lewin has overseen intellectual-property suits in 45 countries over 30 years.

workers their jobs—he was up against it. Still, when the Shenzhen court handed Chang a sweeping victory in February 2002, Lewin was surprised.

The court found that while New Balance had terminated its licenses with Chang's Hong Kong operating company, it had failed to do so with respect to Chang's Yang Jiang factory. And though that factory was never licensed to distribute New Balance shoes, the court found that its license to make shoes carried an implied license to distribute—and even a right to do so without paying any royalties.

Lewin considered the court's reasoning so implausible that he suspected corruption, he admits. He appealed to the Guangdong province High Court. The High Court heard the case during the summer of 2002. Then Lewin heard nothing for many months. Eventually he hired an investigator to make inquiries. Finally word came back through two intermediaries: "For \$300,000 we could have our decision," Lewin says.

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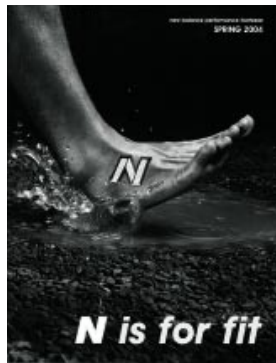
## THIRD SHIFT

"We were on the head of a pin," he recalls. "Clearly we weren't going to do it. But you're being asked directly by the tribunal hearing your case." As politely as he could, he responded that, no, New Balance really couldn't do anything like that.

More weeks passed. Lewin made more inquiries. Word came back again. "The price was down to a hundred grand," he says. "As God is my witness." New Balance again refused.

Still more time passed. In September 2003 the lead judge on the three-judge panel contacted New Balance through a different intermediary. He asked for \$100,000 again, and then came down to \$50,000, according to Lewin. This time New Balance

## "TO INTERPRET AN AMERICAN COMPANY—HOW WE THINK, HOW WE OPERATE—THAT'S REALLY DISTURBING."



**Next-generation knockoff** New Barlun, introduced in 2005, even mimics New Balance marketing: genuine article (left) and takeoff.

reported the request to the province's supervisory bureau for courts. In April 2004, after no action had been taken, New Balance formally petitioned the court to replace the judge, though without stating the reason. A few days later the judge was removed from the case (but not from the bench). No explanation was given. (Asked about Lewin's allegations by phone, the replaced judge told FORTUNE, "That's impossible. Are you interviewing me? You cannot interview me like this," and hung up. In response to a letter outlining the accusations, a court public affairs staffer said foreign media had to direct inquiries to the Foreign Ministry.)

We don't need to speculate about the way a Western judge might have viewed the same facts, because in 2004 one did. After New Balance invoked its arbitration clause, international arbitrator Natasha Lisman, an American litigator in Boston, found the evidence "clear and persuasive" that Chang had sold at least 200,000 pairs of New Balance shoes after termination of his contracts. (Chang's marketing of Henkees also violated a noncompetition clause in the contract, Lisman ruled.) In December 2004 she awarded New Balance \$9.9 million. So far, New Balance hasn't

collected a penny; it's still hunting for assets in Chang's name.

In January 2005 the Guangdong High Court finally ruled. It affirmed Chang's victory. The court did throw New Balance one bone, finding that the company had terminated the Yang Jiang factory's license as of July 27, 2001—19 months after it thought it had. (The termination had been effected, the court said, by a letter to the factory to which New Balance had attached no legal significance at the time.) But the belated termination afforded New Balance no real benefit. The Chinese IP authorities interpreted the ruling as permitting shoes made before that date to still be sold. Accordingly, they released tens of thousands of pairs of previously seized shoes to Chang, who dumped them on the market—to the chagrin of New Balance's new licensed Chinese distributor.

In late spring 2005, New Balance petitioned for a rehearing. It heard nothing for almost a year. Then, on March 28, 2006, out of the blue, the court granted the petition. The reargument was scheduled for April 24.

The case is almost moot at this point, since only a small number of Chang's New Balance shoes are still on sale. Haddad believes that Chang no longer makes them and that he's focused on his Henkee brand instead. New Balance has petitioned China's trademark office to cancel Chang's distorted-Hi logo, but otherwise it left that brand alone.

Today the company has a more pressing concern: a competitor that launched in 2005 under the brand name New Barlun. New Barlun uses packaging, logos, store displays, and slick advertising brochures that by Western standards are audacious ripoffs of New Balance's. "We have counterfeits all the time," comments Haddad. "That's not anything new. But to interpret an American company—how we think, how we operate—that's what's really disturbing us." However, as often happens once a company has experienced an IP leak, New Balance executives don't know whether the New Barlun knockoff has any relationship to its earlier problems or is a completely reverse-engineered operation—albeit a diabolically sophisticated one. Some New Balance officials have their suspicions. "They know our company so well," Haddad marvels.

Despite all the challenges, New Balance has never considered withdrawing its factories from China. The economic allure is too compelling, and as Haddad points out, its products would have been counterfeited in China to some degree no matter where the company made them. Like others with experience in Asia, New Balance monitors its supply chain to the extent it can, checks out contractors in advance, writes tough audit clauses into contracts, and enforces them. It now embeds encrypted information in security tags and monitors the number of tags it issues to combat third shifts. Other companies use invisible inks and dyes both to authenticate their products and to trace diversions from authorized distribution channels. The GenuOne company in Boston even sells software that lets brand owners discreetly monitor how many tagged components a contractor orders: If too few, the contractor may be substituting inferior parts; if too many, there might be a third shift.

"If you don't do your upfront due diligence in managing the supply chain," advises Haddad, "you're just going to be subject to problems." But after a pause, he adds a weary coda: "Not that you won't be even then." ■

*With additional reporting by Clay Chandler and Alice Fung*