TOBACCO UNDERGROUND

The Global Trade in Smuggled Cigarettes

DIGITAL NEWSBOOK

THE CENTER FOR PUBLIC INTEGRITY
Investigative Journalism in the Public Interest

INTERNATIONAL CONSORTIUM ICIJ OF INVESTIGATIVE JOURNALISTS

SHOW CONTENTS

Table of Contents

North America

Terrorists and Insurgents

PART TWO: BIG TOBACCO'S LEGACY

About the Tobacco Underground Project

Tobacco Underground is a project of the International Consortium of Investigative Journalists. Working with reporters in more than a dozen countries, ICIJ is charting the frontlines of the illicit traffic in cigarettes.

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About ICIJ

The International Consortium of Investigative Journalists (ICIJ) was launched in 1997 as a project of the Center for Public Integrity to globally extend the Center's investigative style of journalism in the public interest. Based in 50 countries, ICIJ's global network includes 100 of the world's top investigative reporters who produce collaborative, cross-border reports on major global issues around the world.

Since its founding, ICIJ has released a series of groundbreaking reports with global impact, including stories on tobacco industry collusion with organized crime, the war profiteering of Haliburton and other contractors in Iraq and Afghanistan, the privatization of scarce water resources, and political lobbying payments by unsavory governments.

ICIJ also supports international investigative journalism by presenting the biennial Daniel Pearl Awards for Outstanding International Investigative Reporting.

About the Center

The Center for Public Integrity is a nonprofit, nonpartisan, and independent digital news organization specializing in original investigative journalism and research on significant public policy issues.

Since 1990, the Washington, D.C.-based Center has released more than 475 investigative reports and 17 books to provide greater transparency and accountability of government and other institutions. It has received the prestigious George Polk Award and more than 32 other national journalism awards and 18 finalist nominations from national organizations, including PEN USA, Investigative Reporters and Editors, Society of Environmental Journalists, Overseas Press Club, and National Press Foundation.

Overview

By Marina Walker Guevara

IT BEGAN with a basic mathematical equation: In 1995 two scholars in Europe found that almost one-third of the world's cigarette exports had simply vanished. Somehow, billions of cigarettes, once exported, had mysteriously gotten lost in transit.

Only it wasn't that mysterious. Starting in 1999, a team of reporters from the International Consortium of Investigative Journalists (ICIJ) pored over thousands of internal industry documents and uncovered how leading tobacco companies were colluding with criminal networks to divert cigarettes to the world's black markets. Big Tobacco was doing it for profit — to boost sales and gain market share — as it avoided billions of dollars in taxes while recruiting growing numbers of smokers around the globe. The tobacco industry, as it turned out, did not merely turn a blind eye to the smuggling — it managed the trade at the highest corporate levels.

Those revelations, and others that followed, helped lead to government inquiries, lawsuits, and promises of a global treaty to crack down on the illicit cigarette trade. Since 2004, two major tobacco companies, Philip Morris International and Japan Tobacco International, have agreed to pay a combined $1.65 billion to the European Community and 10 member states to settle litigation that would have further exposed their involvement in cigarette smuggling. They have also committed publicly to help fight trafficking in tobacco. Similarly, this July, Canada's two largest cigarette companies, Imperial Tobacco Canada and Rothmans Inc., pleaded guilty to aiding smuggling during the early 1990s; they are to pay a combined $1.12 billion, the largest such penalties ever levied in Canada.

Yet, despite the exposés, the lawsuits, and the settlements, the massive trade in contraband tobacco continues unabated. Indeed, with profits rivaling those of narcotics, and relatively light penalties, the business is fast reinventing itself. Once dominated by Western multinational companies, cigarette smuggling has expanded with new players, new routes, and new techniques. Today, this underground industry ranges from Chinese counterfeiters that mimic Marlboro holograms to perfection, to Russian-owned factories that mass produce brands made exclusively to be smuggled into Western Europe. In Canada, the involvement of an array of criminal gangs and Indian tribes pushed seizures of contraband tobacco up 16-fold between 2001 and 2006. "The big companies know that to some extent the golden period of smuggling is gone," observes Belgium-based sociologist Luk Joossens, a World Health Organization expert on tobacco smuggling and co-author of the 1995 study that first alerted the world that billions of exported cigarettes had gotten lost in transit. "You have still the normal small-scale smuggling, but you also have counterfeit production, illicit manufacturing… and a lot of small companies that are involved. So the whole area of illicit trade has become much more complex." Joossens also said that while Big Tobacco's participation in cigarette smuggling in Western Europe and North America has largely been curtailed, the situation remains murky in Africa and other developing areas of the world.

In late June 2009, smuggling experts, customs officials, and diplomats from an estimated 160 countries gathered in Geneva, Switzerland, to push for what has eluded governments for decades: a global crackdown on the black market in tobacco. Under the auspices of the WHO's three-year-old Framework Convention on Tobacco Control — a global treaty to curb tobacco use — delegates worked to implement a protocol to stop cigarette smuggling. But the proposed measures face plenty of challenges, with some countries showing limited concern over the issue, while others, including the United States, have so far refused to ratify the FCTC altogether.

The stakes are formidable. Experts estimate that contraband accounts for 12 percent of all cigarette sales, or about 657 billion sticks annually. The cost to governments worldwide is massive: a whopping $40 billion in lost tax revenue annually. Ironically, it is those very taxes — slapped on packs to discourage smoking — that may help fuel the smuggling, along with lax enforcement and heavy supply. (A pack of a leading Western brand that costs little more than $1 in a low-duty country like Ukraine can sell for up to $10 in the U.K.) That potential profit offers a strong incentive to smugglers.

But it is more than lost revenue that is at risk. Illicit tobacco feeds an underground economy that supports many of the most violent actors on the world stage. Organized crime syndicates and terrorist groups such as the Taliban and Hezbollah facilitate global distribution and use the profits to finance their activities. In Canada alone, police believe that 105 organized crime groups are engaged in the illicit tobacco trade, including motorcycle gangs and the Italian Mafia. Criminal organizations "are doing more than just smuggling cigarettes," notes John W. Colledge, who oversaw international tobacco smuggling programs at the U.S. Customs Service between 1999 and 2002. "They are engaged in human, drugs, and weapons trafficking."

Organized crime syndicates and terrorist groups such as the Taliban rely on cigarette smuggling to help finance their activities.

Perhaps even more troubling is the impact that smuggling has on the public health crisis caused by tobacco. Worldwide, one out of 10 adults dies prematurely from tobacco-related diseases such as lung cancer, emphysema, cardiovascular disease, and stroke. If current trends hold, tobacco will kill about 500 million people currently alive. By 2030, that figure will reach 8 million deaths a year, and with cigarettes being heavily marketed in poorer countries, 80 percent of those deaths will be in the developing world. Over the 21st century, say health experts, an estimated one billion people could die from tobacco use.

At a time when nations are increasingly trying to crack down on smoking, smugglers put cheap cigarettes into the hands of those most vulnerable — young people and the poor. In addition, the trade is pushing the supply steadily into the black market, selling cut-rate cigarettes of often dubious quality. Of special concern is the advent of a massive counterfeiting industry. Once a minor problem, today underground factories in China, Paraguay, and Eastern Europe manufacture literally billions of fake cigarettes — Marlboros, Camels, 555s, Mild

Sevens — an uncontrolled industry that law enforcement is only beginning to grapple with. Many of the smokes are made from the lowest quality tobacco, full of stem and sawdust, and spiked with unusually high levels of nicotine. Other packs contain far worse. Tests reveal that counterfeit cigarettes carry a bevy of products that could further shorten even a heavy smoker's life: metals such as cadmium, pesticides, arsenic, rat poison, and human feces.

Counterfeit cigarettes have tested positive for a range of dangerous ingredients, from arsenic to rat poison.

Despite the stakes, cigarette smuggling remains a tough crime to investigate and prosecute. Factories are set up in regions of the world with weak controls and high levels of corruption, such as the crime-ridden Russian exclave of Kaliningrad, Guangdong province in China, and South America's notorious Tri-border area between Argentina, Brazil, and Paraguay. The distribution systems are complex, the smuggling routes circuitous and hard to track.

Smugglers take advantage of an "in transit" system used in free trade zones and other shipping centers, which allows for temporary tax suspension while the tobacco is en route to a third country. As a result of lax controls, cigarettes get "lost" along the way, with huge numbers failing to arrive at their intended destination. Cigarettes, for example, may sit for weeks in free trade zones in Panama or Dubai until they are sold. Then they pass quickly through multiple buyers in a short period of time, complicating efforts to identify where "leakages" occur. On occasion, cigarettes are even illegally sold at sea, where vessels offload them to smaller boats that take them to shore. In the Balkans, they are sold by the trunk-load to smugglers who line their cars up at the borders of the European Union. And in the United States, tobacco suppliers ship millions of the tax-free smokes to Indian reservations, where they are unloaded to smugglers, bootleggers, and online merchants.

Despite its broad impact on health, crime, and taxes, tobacco smuggling receives strikingly little attention from authorities. Lenient sentences are the norm; in some countries, cigarette smuggling is not even considered a crime. Nor is it a priority for law enforcement agencies, even in the West, which spend the majority of their resources tackling drug, arms, and terrorism cases. In the United States, for example, the Bureau of Alcohol, Tobacco, Firearms and Explosives devotes a paltry two percent of its personnel and budget to tobacco programs.

Seven years after its original series on tobacco smuggling, ICIJ assembled a new team of reporters to illuminate this shadowy transnational business. Based on reporting from 15 countries, our new project looks at the influence of organized crime and terrorist groups, as well as the continued complicity of distributors, wholesalers, and tobacco companies themselves. Since 2008, the series has exposed the billion-dollar smuggling of Russian-made Jin Ling cigarettes to the European Union; the involvement of North American Indian reservations in a massive black market in Canada and the United States; and the alleged role of Montenegro Prime Minister Milo Djukanovic in a decade-long smuggling scheme with the Italian Mafia.

The response has been gratifying. Tobacco Undergound has received worldwide attention, drawing coverage in at least a dozen languages in some 30 countries. The stories have been used by law enforcement officials, tobacco control activists, and tobacco industry officials intent on cleaning up their industry. In 2009, Tobacco Underground was honored with two major journalism awards: The Tom Renner Award for Outstanding Crime Reporting from Investigative Reporters and Editors, and the Online Journalism Award for Best Web Coverage of International Affairs from the Overseas Press Club.

Our work on the issue continues, and you can help. Have a tip on the illicit tobacco trade? Send ideas to icijtobacco@icij.org. ■

Marina Walker Guevara is deputy director of the International Consortium of Investigative Journalists, a project of the Center for Public Integrity.

Made To Be Smuggled

RUSSIAN CONTRABAND CIGARETTES ‘FLOODING’ EU

By Stefan Candea, Duncan Campbell, Vlad Lavrov, and Roman Shleynov

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EUROPE is being flooded by smuggled Russian-made cigarettes worth at least $1 billion a year, an international investigation has discovered.

A network of factories and routes has been put together across Europe since 2004, following large-scale smuggling routes previously supplied by major multinational tobacco companies. The new underground smoking trade involves only one brand, Jin Ling, which is turning up in more cities and countries across Europe every month.

Jin Ling, virtually unknown to the authorities three years ago, has grown so rapidly that law enforcement officials say it now rivals Marlboro as the top smuggled brand being seized in the European Union

Jin Ling’s distinctive yellow packaging closely resembles that of Camel cigarettes. *Credit: Paul Radu.*

The organization behind this fast expanding black market, the Baltic Tobacco Factory (BTF) of Kaliningrad, Russia, has links to two of the world’s largest tobacco companies. Its factory network in Russia and Ukraine was previously owned and run by subsidiaries of Japan Tobacco International (JTI) Group, the world’s number three producer.

The investigation has identified a network of Russian and East European companies, including 5 factories believed to play roles in manufacturing the contraband cigarettes being smuggled to the West. The Russian-run factory network now claims to be able to produce more than 24 billion cigarettes annually. This would be equivalent to 7 percent of legal EU cigarette imports.

Originally imported from China, Jin Ling features a king-size packet design that closely resembles the legal Camel brand in color, typestyle, and layout. Instead of a camel, the packs are illustrated by a mountain goat.

Jin Ling cigarettes have no legal market in any European country, according to customs officials. The brand is never advertised and cannot be bought in shops. It is only sold illegally — smuggled by gangs who hope to pocket immense profits by selling unlicensed, untaxed cigarettes on black markets across Europe.

> **"Jin Ling is the most disturbing new development in the illegal tobacco trade… The cigarettes are flooding into Europe."**
> *— Luk Joossens, World Health Organization expert*

"Jin Ling is the most disturbing new development anywhere in the world in the illegal tobacco trade," according to Luk Joossens, a World Health Organization expert in tobacco smuggling. "They are flooding into Europe."

The ten-country investigation of Jin Ling was done by the International Consortium of Investigative Journalists (ICIJ), a non-profit network of independent journalists who first exposed the complicity of Big Tobacco in smuggling eight years ago. Relying on corporate records, customs data, and undercover reporting from inside the main Jin Ling production center, ICIJ's team has pieced together the unique story of the world's first ever cigarette brand designed and manufactured only for smuggling.

OPERATION BALTIC

Baltic Tobacco Factory's headquarters is in Kaliningrad, a slice of Russian territory annexed by the Soviet Union after World War II and wedged between Poland and Lithuania. The freewheeling Russian exclave is known as a hotspot for smuggling and organized crime. In the city of Kaliningrad, the regional capital, Baltic Tobacco's eight-acre complex of factories, offices and warehouses is discreetly set back from main roads. From the riverbank, an unmarked wandering track leads eventually to the company's three-story red-brick office block. No signs or nameplates mark or identify the factory or the office buildings.

From Kaliningrad, BTF's cigarettes are smuggled by the billion directly through Poland, or routed more circuitously through Lithuania, Latvia, Belarus, and Russia. Officials at Baltic Tobacco recommend sea routes to their clients, as they can deliver containers direct and tax-free to Kaliningrad's port. They also offer shipments from their Lviv factory in Ukraine, through the Black Sea port of Odessa.

Overland to Germany, and from Baltic or Black Sea ports, the cigarettes are passed to criminal networks in at least 12 countries — Germany, the United Kingdom, Poland, Latvia, Romania, Greece, Turkey, Italy, Bulgaria, the Netherlands, Belgium, and France.

None of the packs contains the correct large mandatory health warning notices now compulsory in all EU states, making their illegality clear. Some Jin Ling packs found in Europe, however, sport "duty free" stickers, or meaningless Russian tax paid stamps, apparently as a marketing tactic to confer prestige and credibility on the product. BTF is believed to print the "duty free" labels themselves, to make their black market handiwork appear as leakage to the "gray market" — as if the cigarettes are simply an unauthorized diversion of otherwise legitimate goods.

"Jin Ling cigarettes are being legally manufactured in Russian factories but are intended for the European illegal market," says smuggling expert Joossens. "It's a unique new problem."

The rise in Jin Ling traffic coincides with significant reported falls in seizures of legal but untaxed tobacco products exported from Western producers. Manufacturers such as Philip Morris, JTI-Gallaher, and Britain's Imperial Tobacco Group have come under intense international, public, and political pressure to "clean up their act" and curb sales to illegal channels and smuggling centers such as Kaliningrad.

The scale and striking growth of Jin Ling smuggling has marked it as a major new development in organized crime, prompting European customs agencies to respond by launching "Operation Baltic" early in 2008. Officials at the EU's Anti-Fraud Office (OLAF) have assigned an international task force to the Jin Ling problem. The smuggling of Jin Ling has "become a huge problem in the EU causing substantial losses to both national and EU budgets," OLAF said in response to inquiries from ICIJ.

To investigate the Baltic Tobacco Factory, ICIJ reporters went under-

Customs officials inspect a stash of contraband Jin Ling cartons in Germany. In 2007, 258 million Jin Ling cigarettes were seized throughout the European Union. *Credit: Zollkriminalamt (Customs Investigation Bureau, Germany).*

cover and visited its Kaliningrad plant in June 2008. Posing as smugglers setting up a new route to the EU, they carried concealed video and recording equipment.

BTF officials proved eager to help their prospective new clients. At the company's main factory, the undercover team was offered Jin Ling by the container — each one filled with over 10 million cigarettes. "We don't care" what happens to the cigarettes, Dmitry Gyrja, BTF's logistics manager told the reporters. "According to Russian law it doesn't matter. All the transportation arrangements are up to you…" With payment in advance, he added, a container could be ready and waiting in two weeks.

Their price per container: $102,500 (£59,000 or €73,000) — about one cent per cigarette. If the contents of one container reached Sweden or Germany and were sold at full legal price, they would be worth $3.2 million (€2.3 million). In Britain or Norway, where cigarette taxes are high, the same shipment would be worth nearly $6 million (€4 million). Even at half the price — which black market cigarettes usually sell for — the profits would be immense.

The fat profit margins rival those from narcotics and justify elaborate and costly concealments, the use of complex and circuitous routes, the payment of substantial kickbacks to corrupt police and customs officers, and the hiring of enforcers.

Since 2005, European customs agencies monitoring trade across the EU's eastern borders have seized rapidly increasing quantities of Jin Ling concealed within shipments of nearly every sort: fruit and vegetables, fish, building supplies, peat moss, timber, scrap cardboard, bakery products, paper rolls, and horse food. Lithuanian police have even found Jin Ling built into fitted furniture.

So pervasive have Jin Ling seizures become that Europe-wide, customs officials are reporting it as the "most seized" brand. Reports examined by ICIJ reveal that during 2007, 258 million cigarettes were seized — the equivalent of 25 full container loads, and an 87 percent jump in seizures over the previous year. During 2008, new seizures, routes, and locations have been discovered every week.

Far more is believed to get through, fueling black markets and funding crime across Europe. Customs agencies typically expect to uncover 5 percent to 10 percent of contraband, implying that BTF might be getting up to 5 billion cigarettes into Europe every year. But BTF claims to be making more than three times this amount.

Jin Ling from Kaliningrad started trickling into Lithuania and Poland during 2005. The first large-scale contraband shipment found entering the EU was discovered by Polish border guards patrolling the Lithuanian border on August 10, 2006. A consignment of 8 million cigarettes, worth nearly $3 million (about €2 million) in Western European black markets, was found in a truck supposedly carrying fuel. Two months later, in October 2006, British customs first reported seizing the previously unheard-of brand in the English Midlands.

Polish Customs documents obtained by ICIJ show that the country's role as smuggling route to the West has become pivotal since its accession to the E.U. The number of smuggled cigarettes seized annually on Poland's eastern border more than tripled from 243 million in 2003 to 750 million in 2007.

Since August, Jin Ling smugglers have opened a series of new routes through southern Europe. Some cigarettes have come from the Lithuanian port of Klaipeda, 120 km (70 miles) from Kaliningrad, via Cyprus. Others have been ferried to Turkey, and then taken through Greece heading for central Europe. During September, Romanian customs uncovered two containers of Jin Ling en route from Greece. The intended primary destinations for these cigarettes, say officials, are high tobacco tax Western European countries, particularly Germany and the UK.

The international scope of the business was made clear by a September 29 seizure of five million Jin Lings aboard two trucks leaving the port of Venice, Italy. According to Italy's Guardia di Finanza, the trucks had Bulgarian license plates, the arrested drivers were Greeks of Georgian and Uzbek descent, and the tobacco came from BTF's Kaliningrad factory. The cigarettes had been moved by road from Kaliningrad through Russia and Lithuania to the Baltic port of Klaipeda, then shipped to Larnaca, Cyprus, then shipped again by sea to the port of Venice.

DELIVERING 'THE KIDS'

German customs officers say they are familiar with the traffic of Jin Ling cigarettes entering and transiting Europe on the "Warsaw Alley" to Berlin and the Ruhr, and then on to the channel ports of Antwerp and Rotterdam.

Their anti-smuggling teams have extensively used mobile phone wiretaps in attempts to block shipments. Jin Ling consignments, they hear the smugglers say, are called "little goats," referring to the mountain goat on the cigarette pack design. When a consignment goes through, the smugglers are said to message each other to say "the kids have been delivered".

Cologne, Munich, and Berlin are the German cities most targeted by the Jin Ling smugglers. Berlin is served by a network of 300 black market sales points, most of which offer Jin Ling, officials say. One supply route used involves concealing contraband cigarettes within huge regular food consignments distributed to low-price German supermarket chains from mainland Europe. According to federal statistics, one in three residents of the former East Germany smokes smuggled cigarettes.

German customs and police investigators believe that Jin Ling is being distributed and sold through organized crime networks, including Vietnamese and Lithuanian gangs, and policed by local enforcers. Vietnamese sellers are ordered to sell the packs at the fixed price of €2 a pack ($2.80), or €20 ($28) per carton.

The cigarettes are generally sold by street vendors operating near underground stations. The sellers have been found to have created concealments for their supplies in nearby parks, pavements, or roadside vegetation. Some sellers in Germany carry their merchandise inside bulky clothing.

British customs reported finding the new brand with its distinctive yellow pack, first in Birmingham in 2006 and then in Derbyshire the following year.

Smuggled cigarettes are sold door to door in public housing developments, or from fast food shops or car trunks, according to tobacco control experts. They add that the same channels in Britain and Germany are used in parallel to supply narcotics.

'WE CANNOT MEET DEMAND'

In Russia, the Baltic Tobacco Factory has been a business success story. The company was officially incorporated as Baltiskaya Tabachnaya Fabrika — BTF — in August 1997. Since 2006, BTF has doubled production capacity at its Kaliningrad facility from 6.3 billion to 13 billion cigarettes a year. A second factory, in the Caucasus city of Armavir in southern Russia, was acquired in 2003 and upgraded to produce up to 1.8 billion cigarettes annually.

By April 2007, BTF had installed two new cigarette manufacturing machines in a third factory, at Lviv in Ukraine. The company said that it planned to install 6 more machines during 2007 to bring its capacity in Lviv to nearly 10 billion cigarettes a year.

The director general and apparent owner of Baltic Tobacco is Vladimir Kazakov, a Russian citizen. Kazakov told Russia's business magazine Kommersant-Dengi in October 2006 that BTF was enjoying a dramatic sales boom. "We cannot meet demand, we have no production space," he explained.

Kazakov has told the Russian press that BTF produces two dozen different brands for the mid-range domestic market in Russia, and exports 5 percent of its production to markets including the United Arab Emirates, Canada and the United States. He boasted of employing 28 regional representatives to sell his brands across the Russian Federation.

Yet ICIJ's inquiries in Russia, Europe, and worldwide raise serious questions about Baltic Tobacco's claim to be producing largely for Russian consumption. Data reported by Business Analytica, a Russian marketing research service, suggest that BTF's actual Russian retail sales are only 0.1 percent of the Russian domestic market, or about 400 million cigarettes a year. Checks of cigarette vendors in Russian cities found no evidence of Jin Ling cigarettes being sold, even in Kaliningrad. The cigarettes are rarely seen among the heavy-smoking Russians.

As for BTF's claim of exporting 5 percent of its annual production, that would equal at least 400 million cigarettes, or 40 full containers. But checks of PIERS (Port Import Export Reporting Service) — the most comprehensive source on U.S. waterborne trade data — found no records of Baltic Tobacco shipments to the United States. A check of unofficially published Russian trade data revealed only one small recorded export — to Poland, in 2005.

ICIJ repeatedly contacted the Baltic Tobacco Factory by phone and fax, seeking a response to the various issues raised by this investigation. BTF officials declined to comment.

TIES TO BIG TOBACCO

Despite Baltic Tobacco's marketing tactics, it has ties to major multinational tobacco companies, including two of the largest cigarette firms in the world — Japan Tobacco International (JTI) and British American Tobacco (BAT).

Although BAT has publicly stated its opposition to cigarette smuggling, the company has supplied Baltic Tobacco with high quality Western-style tobacco. In April 2008, BAT's Brazilian subsidiary Souza Cruz shipped 21 tons of tobacco leaf direct to BTF's Kaliningrad plant, according to PIERS. The shipment, according to BAT officials, was one of four by Souza Cruz to BTF since 2003.

In 2007, BAT Chairman Jan du Plessis pledged to "ensure that all our operations are directed only at supporting the legitimate tobacco trade. Our companies… cut off supplies to any customers knowingly or recklessly involved in illicit trade."

In an email to ICIJ, BAT spokesperson Catherine Armstrong stated that the exports had been routed through a Brazilian agent and were "an oversight" which "has immediately been put right. . . Our anti-illicit trade team is aware of allegations around the Jin Ling brand made by Baltic Tobacco Company. Regrettably, our subsidiary Souza Cruz was not aware until now… we can confirm consequently that no more tobacco will be supplied."

BAT is not alone in supplying BTF with ingredients suitable for making better quality cigarettes preferred by Western smokers. Russian customs data reveal that Baltic Tobacco has imported such products from around the world — tobacco from Brazil, Panama, Uganda, Zambia, and Zimbabwe; filters from the Baltic republics, paper from Switzerland, Germany, France, and Sweden; glue from the Czech Republic and Baltic republics; flavorings from the United States; and cigarette packs printed in Estonia. Records show that the company has also invested heavily in stock and infrastructure, including brand new machinery from Germany, France, and the Netherlands.

Jin Ling's origins date back to an obscure Chinese brand exported to Russia. Jin Ling cigarette brand was originally developed by the Chinese state-owned Nanjing Tobacco Factory. (Jin Ling is an old name for the city Nanjing.) In the last years of the Soviet regime, China bartered supplies of Jin Ling cigarettes for Russian machinery. But the trade died out until the brand was re-introduced by the first owners of the BTF factory in 1997.

BTF's director general, Kazakov, says he took over in 1999, after working with the RJR tobacco company. He told the Russian press that he was RJR's exclusive Russian distributor for its popular "Pyotr 1" (Czar Peter I) brand cigarettes. BTF's factories at Lviv and Armavir were formerly owned and operated by RJR.

But in 2004 BTF was linked to another tobacco multinational, UK-based Gallaher. In that year, BTF was owned by PRT, Ltd., a company based at the Polish headquarters of Britain's Gallaher Group, located in Poddebice near Lodz, according to the Russian company database SKRIN. Gallaher took over the Poddebice operation – Compania Tytoniowa Merkury, a privatized Polish state cigarette factory – on 5 March 2003. A spokesman for Japan Tobacco International (JTI), now owner of Gallaher, stated in an email to ICIJ that BTF and PRT "might have been third-party contractors at some point before 2003" with the Gallaher Group.

According to the Dun and Bradstreet Worldbase database, PRT, Ltd continued to be registered at Gallaher's Polish offices in Poddebice as recently as August 2008. Following the Gallaher takeover, according to the world trademark registry WIPO, ownership of the Jin Ling trademark was re-registered to BTF in Kaliningrad on 11 September 2003.

PRT Ltd in Poddebice continued to own the Baltic Tobacco Factory until

16 September 2005. Its share value was then raised from 960,000 roubles to 120 million roubles ($5 million). Ownership was transferred to a single unidentified Russian citizen.

Kazakov is now registered as the owner of all of BTF's shares, according to Russia's EGRUL information service.

Both RJR, Kazakov's former supplier, and Gallaher, BTF's former home, are now part of Japan Tobacco International (JTI). JTI acquired RJR's non-U.S. tobacco operations in 1999 and bought Gallaher in 2007. In 2004, BTF joined JTI — as well as Philip Morris — in forming the Moscow-based Tobacco Industry Development Council. The industry group's stated intent was to lobby for more favorable taxes on filtered cigarettes.

THE JIN LING ARCHIPELAGO

Although unheard of by most European consumers, the black market Jin Ling brand has grown so fast and become so successful that customs officials now believe that 10 companies are producing or marketing the cigarettes. The ICIJ investigation has independently identified five factories, located in northwestern Russia, Ukraine, and in the Krasnodar region of southern Russia, where Kazakov was born.

All but one of the companies are suspected to be run by Kazakov, who claims to have spent $45 million on new machinery. The tenth company, located in the Moldovan capital of Chisinau, may be acting as a "franchise," officials say.

Moldovan state records, however, suggest that the company is not linked by direct ownership to the Kaliningrad group. The owner of record is Tutun-CTC — which is 90 percent owned by the Moldavan government.

In March 2006, a lawyer acting for a Chisinau resident, Vsevolod Ilcenco, registered trademark rights for the identical brand name and packaging as the Russian brand Jin Ling in Macedonia, Bosnia, Serbia, Montenegro, Croatia, Greece, and Egypt. His patent lawyer, Leonid Cotruta, told an ICIJ reporter that the Moldovan Jin Ling cigarettes were made "only for exporting purposes, in countries different to the Russian manufacturer's exports." Brand trademark owner Ilcenco is also the owner of a duty free cigarette trading shop adjoining the EU border with Romania at Sculeni.

The Moldovan Jin Ling plant reportedly only began production recently, but its version of Jin Ling has already turned up in EU countries. When questions were put to Ilcenco about the export routes and methods used, a spokesperson called back and said, "I don't want to tell you how much we produce or where we export." But if the press were interested in cigarette smuggling, he added, it was best to write about Western tobacco companies. "They are also involved in contraband."

Like Baltic Tobacco's products, the Moldovan brand of Jin Ling has been found only in illegal western markets, not in the legal markets claimed by the company. The advertised retail price for Jin Ling in Moldova is 20 cents per pack.

Another Jin Ling factory uncovered by ICIJ's reporting team is located in Donetsk, in the eastern Ukraine. Operated by Subsidiary Enterprise Tobacco Company Khamaday, its products have also been found smuggled into Poland and the EU.

Production from the Armavir, Donetsk, Chisinau, and other plants is believed to be modest compared to that of Baltic Tobacco's sprawling Kaliningrad facility. But the industrial levels of black market cigarettes seen flowing out of the Russian-run factory network have alarmed EU law enforcement.

On October 20, nearly 160 governments from around the world will meet in Geneva under a World Health Organization (WHO) treaty on tobacco control. The meeting will agree on new steps to crack down on the global illicit tobacco trade. Because of the growing European concern, Jin Ling's burgeoning growth is likely to be a major issue at the conference.

Inconvenient questions may be asked of the Russian government, which has ratified the WHO treaty on tobacco control. "The WHO treaty on tobacco control requires signatories to take action against illicit tobacco trade," points out Professor Martin Raw of King's College, London and author of The Smoking Epidemic. "The Russian government must act."

But Jin Ling's extraordinary growth also raises troubling questions about the future of tobacco smuggling, which until a few years ago was dominated by big Western companies looking to gain market share. Baltic Tobacco's operations suggest how easy it may be for new players to step into channels used previously by Big Tobacco, using the same equipment, production standards and styles, and even the same recently vacated factories. ■

Going Undercover

INSIDE BALTIC TOBACCO'S SMUGGLING EMPIRE

By Stefan Candea, Duncan Campbell, Vlad Lavrov, and Roman Shleynov

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ICIJ'S REPORTERS went to Russia to uncover the truth about the billions of black market Jin Ling cigarettes turning up across Europe. They quickly learned that packets of Jin Ling could not be purchased even in the shops, markets, or street stalls of the Russian city where they are made, Kaliningrad. But Jin Ling was available to smugglers, in huge quantities, from its manufacturer, the Baltic Tobacco Factory.

Kaliningrad can be a dangerous place to ask questions about smuggling. The Russian territory, sandwiched between Poland and Lithuania, went into rapid and cataclysmic decline after the break up of the Soviet Union, but has since profited immensely from its close proximity and excellent transport to the European Union. It has also gained a reputation as a haven for smugglers and money launderers, and for a police force accommodating to smugglers' interests. The city is home to a noisy night life and frontier atmosphere, with luxury limousines a frequent sight on the streets.

Russian journalists working in Kaliningrad know that to openly ask about the cigarette contraband trade is a risky business. In 2006, after criticizing the police — including the protection they give to smugglers — the local Novye Kolesa newspaper was raided and its newspapers confiscated. The paper's co-founder, Igor Rudnikov, was then prosecuted for "beating 22 police officers."

"In Kaliningrad there were even contract killings of tobacco businessmen," says Rudnikov, a local parliamentary deputy. "But not one of those crimes was disclosed. And it is hard to imagine that law enforcement does not know what is going on."

INSIDE BALTIC TOBACCO

To investigate the Baltic Tobacco Factory company (BTF) in the high

In 2006, after criticizing police in Kaliningrad, Russia, local newspaper Novye Kolesa was raided and its newspapers confiscated. *Credit: Novye Kolesa.*

risk environment of Kaliningrad, ICIJ's reporters went undercover in June 2008, with one posing as a Romanian smuggler setting up a new route to the EU. They carried concealed video and recording equipment to witness all that they saw and heard. (Their video report is available online.)

BTF's neighborhood, Pravaya Naberejnaya, Kaliningrad ("the Right Bank"), winds along the north bank of the Pregol river past former anchorages of Soviet Baltic fleet frigates and submarines. Number 10, Pravaya Naberejnaya is a large, wooded complex of factories and warehouses adjacent to the town's distinctive elevating rail bridge, and the home of Baltic Tobacco. The company's facilities lack addresses or any identifying signs. At one end there is a busy loading pier; at the other, an entrance manned by a security guard watching surveillance monitors.

Jin Ling's manufacturers welcomed their visitors. At the company's offices, a guard ushered the reporters into an office to meet Dmitry Gyrja, BTF's logistics manager. "We haven't worked with Romania before, but we'd be really happy to do so," Gyrja said.

Gyrja got straight down to business: "We don't care" what happens to the cigarettes, the reporters were told. "According to Russian law it doesn't matter. All the transportation arrangements are up to you…" With payment in advance, he added, a container could be ready and waiting in two weeks. "We sell them for 20.5 US cents a pack, duty free."

The company's manager boasted that they could make an entire container of 10 million cigarettes or "sticks" in 8 hours, and that their production lines operated 24 hours a day, 7 days a week. The price of Jin Ling at the factory gate, he was told, was 20.5 cents or € 0.16 per pack. A case would cost $102.50; a full container, $102,500.

The director general of Baltic Tobacco, Vladimir Kazakov, advised the reporters on the quickest and best smuggling routes. Manager Gyrja also offered the would-be smugglers the services of his company's fleet of 20 brand new Volvo trucks.

The offer was genuine. ICIJ's reporters passed a transit container lorry lined up and loading as they were shown into and around the factory. BTF's logistics manager told the reporters that they were manufacturing 120 containers every month — or 1.2 billion cigarettes.

Entering the factory, the reporters were ushered into huge, brightly lit halls filled with modern and sophisticated blending, cutting, filling, rolling, and packing machines. Jin Ling packs could be seen pouring off the production lines, with one line operating at the rate of 400 packs a minute.

A container could be ready and waiting in two weeks, the undercover team was told. It could then be delivered to the Romanian free trade zone of Constanta in less than two months. Full payment had to be made in advance.

Publicly, BTF's Kazakov has boasted that his company markets a range of Russian brands for sale through a nationwide network. But during their tour of the 14,000-square-meter factory, secretly recorded on video, the reporters saw that every machine was manufacturing Jin Ling, with its distinctive yellow packaging and style. No other brand was being made.

BTF's manager boasted that that their production lines operated 24 hours a day, 7 days a week.

BTF director Kazakov was eager to discuss deals, offering to deliver cigarettes from factories in either Kaliningrad or Lviv in Ukraine.

"We work very well through the port in Kaliningrad, where we can also make the custom clearance," Kazakov explained. "Transporting the cigarettes from Lviv through Odessa would bring a gain of 3 weeks, but you might waste more time with custom formalities."

"We guarantee that delivery will be made on time," he added. "We can manufacture a container in 8 hours."

BTF, Gyrja added, sold an impressive two containers each month, or about 250 million cigarettes annually, at the two main border crossings into Poland — the same amount of smuggled Jin Lings seized in all of the E.U. last year.

THE ROAD TO EUROPE

From Kaliningrad, a team of ICIJ reporters followed the route of Jin Ling cigarettes and their containers on their journey to the west. Thirty kilometers south of Kaliningrad, at the Polish border crossing of Bagrationovsk, Jin Ling was widely available. Just outside the shabby town, parts of which have been left unrepaired since 1945, smuggling is big business. As at other border crossings between Russia and the EU nations of Poland, Latvia, and Lithuania, cigarettes are not only smuggled through in full container loads; they are also broken down into small quantities by armies of personal smugglers and their managers.

Peddlers' booths lined the roadside. Reporters observed as Russian customs officers looked on with no apparent concern while lines of Polish-registered cars and their drivers crammed their vehicles with hidden cigarettes bound for the west.

Others, in broad daylight, could be seen taping dozens of packs of Jin Ling to their arms and legs before crossing the border. Their clothing packed and bulging with cigarette packets, their appearance resembled nothing so much as fully equipped and padded American football players.

Discarded Jin Ling cases were left dumped on the street as Russian customs officers looked on. Each empty case seen at the roadside had contained 10,000 cigarettes. Each box would have cost $102.50 at the Kaliningrad factory, but would be worth at least 10 times more if smuggled successfully to Western black markets. Each abandoned box was prominently marked in red and blue with the crest and name, in Cyrillic, of the Baltic Tobacco Factory. ■

Ukraine's 'Lost' Cigarettes Flood Europe

BIG TOBACCO'S OVERPRODUCTION FUELS $2 BILLION BLACK MARKET

By Vlad Lavrov

Published Online | June 28, 2009

THE HANG GLIDER pilot insisted it was a routine flight, and that strong winds had blown him over the border from Hungary into Ukraine. But the man arrested by Ukrainian authorities last July, with his flight suit and night-vision gear, looked suspiciously like other hang-gliding smugglers along the border — smugglers who take off from Ukraine, fly into Hungary, and each drop as much as 100 cartons of contraband cigarettes.

Ukraine is home to some of the world's cheapest cigarettes — at $1.05 per pack — making the country a bonanza for smugglers, whether by glider or more mundane pathways on the ground. Cars and trucks filled with Ukrainian-made Marlboros and Viceroys get waved through border checkpoints by customs guards who seem more than eager to accommodate, for a price. Loads also move by bus and train, bound for other European countries where high taxes make packs cost as much as $5 (Germany) or $10 (United Kingdom).

The backbone of this underground commerce — the acquisition of the cigarettes themselves — is by far the easiest part of the entire operation. The world's four leading multinational tobacco companies, Philip Morris International, Japan Tobacco International (JTI), Imperial Tobacco, and British American Tobacco (BAT), have produced billions of excess cigarettes in Ukraine, fueling a teeming black market that reaches across the European Union. Today, Ukraine is rivaled only by Russia as the top source of non-counterfeit brand cigarettes smuggled to Europe, EU officials say.

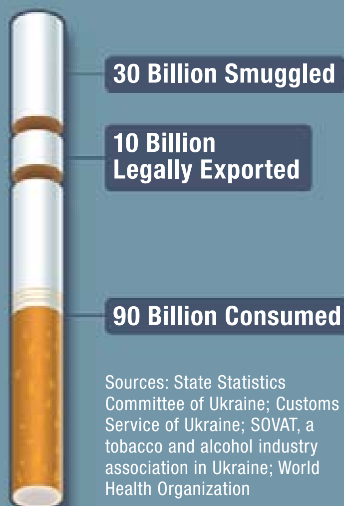
The booming trade in tobacco smuggling has major consequences, say industry experts. The growing traffic pushes huge supplies of cheap, untaxed, and unregulated cigarettes into the rest of Europe, undercutting otherwise successful attempts to curtail smoking. Worse, officials say, the trade is boosting organized crime gangs, who find the soft penalties and big profits hard to resist.

The numbers tell the story. Each year, Ukraine's cigarette consumption and legal exports top 100 billion sticks, according to Ukraine's Ministry of Health. Yet in 2008, tobacco companies manufactured and imported nearly 130 billion cigarettes — 30 percent in excess of what the local market can consume. These "extra" cigarettes disappear in the market, feeding an illicit trade that is worth, conservatively, $2.1 billion annually. Ukrainian cigarette production, meanwhile, has steadily risen since 2003, according to an analysis by ICIJ of data compiled by SOVAT, a tobacco and alcohol industry association, and Ukraine government statistics. In fact, cigarette production in Ukraine increased one-third between 2003 and 2008 — from 96.8 to 129.8 billion — with JTI and Philip Morris leading that trend.

What happens to those 30 billion "lost cigarettes"? The huge surplus has reached such proportions that it has become a parallel industry, experts say, with all sides benefiting from it, from manufacturers to organized crime gangs who control the black market. In addition, hun-

Smuggled Smokes: Ukraine's 30 Billion "Missing" Cigarettes

Led by Philip Morris International, Big Tobacco in 2008 produced 130 billion cigarettes in Ukraine. Officials estimate nearly a quarter of those were smuggles abroad, fueling black markets across Europe.



Sources: State Statistics Committee of Ukraine; Customs Service of Ukraine; SOVAT, a tobacco and alcohol industry association in Ukraine; World Health Organization

Graphic by Stephen Roundtree

dreds of thousands of Ukrainians, Romanians, Hungarians, and Poles along the border rely on the trafficking of cigarettes for their livelihood, buying the cheap smokes in Ukraine and unloading them tax-free in European countries where prices are far higher.

Distribution of smuggled "discount cigarettes" with Ukrainian excise stamps is also flourishing on the Internet through numerous Moldova-based online stores, which deliver them to customers worldwide.

"Tobacco companies are benefiting from selling to smugglers," says Kostyantyn Krasovsky, head of the tobacco control unit of the Institute of Strategic Research at Ukraine's Ministry of Health. "They sell it to them at the same prices they sell to legal wholesalers." Krasovsky adds that in dealing with smugglers, tobacco companies can potentially gain extra profits when a batch is confiscated by customs and destroyed. "It's even better for them; another smuggler will come and buy the same quantity."

Even after recent hikes, cigarette taxes in Ukraine remain among the lowest in Europe. The low price of Ukrainian cigarettes means high profits for smugglers, who have pushed the product all over Europe. Enforcement is lax at best; most big seizures of smuggled Ukrainian smokes take place not in Ukraine but in neighboring Romania, Poland, and Hungary.

BLAME GAME

Attracted by high smoking rates and the potential for rapid returns on investments, multinational tobacco companies rushed to acquire the state-run cigarette factories after the Soviet regime collapsed in 1991. Today, the big four tobacco companies — Philip Morris, BAT, JTI, and Imperial — control 99 percent of the Ukrainian cigarette market.

"The former Soviet Union, particularly the most populous countries such as Russia and Ukraine, represented a massive opportunity for the tobacco companies. Men were already smoking in large numbers but the companies knew they could push many more women to smoke, and they did," said Dr. Anna Gilmore, a senior public health researcher at the University of Bath, in the UK, who has written extensively about the tobacco industry in the former Soviet Union. "As a result, Eastern Europe is now one of only two regions in the world where both numbers of cigarettes sold and profits are increasing (the other region is Asia), and this makes it extremely important to the industry."

The Tobacco Atlas, published by the American Cancer Society and the World Lung Foundation, identifies Ukraine as one of the countries with the highest annual rates of cigarette consumption per person in the world: 2,526 cigarettes.

The tobacco companies, for the most part, acknowledge that they are churning out more cigarettes than the local market can absorb, but they say they sell only to licensed distributors and periodically reduce the output of certain brands that are popular among smugglers. Beyond, that, they claim, it's up to law enforcement to prevent smuggling. "Objectively, we know that our brands produced in Ukraine are found in Europe," said Dmytro Redko, JTI's director of corporate affairs in Ukraine. "We do our best to prevent such shipments, although we can't halt them completely. That is the function of the [Ukraine] government."

JTI, which is owned in part by the Japanese government, manufactures some of the brands that smugglers cherish the most, including Ronson. Redko says his company is constantly decreasing production of Ronson, though he would not disclose the exact figures of this brand's output. In 2008, JTI manufactured roughly 37 billion cigarettes in Ukraine, roughly 30 percent of the nation's total production. According to Redko, when JTI bought British manufacturer Gallaher in 2007, it also inherited what he called Gallaher's "outflow" issue — smuggled cigarettes — and the company has since tried to correct it.

BAT also has had its share of troubles in Ukraine despite the fact that the company's output in Ukraine has declined 30 percent since 2003. In a 2007 corporate report the company acknowledged that it had to cease production of its Pall Mall brand in the country after an audit showed that "local production was not proportionate to local demand," and cigarettes were widely being smuggled to Germany. BAT stated in the report that the company's actions helped reduce the smuggling of its products from Ukraine by 3 billion cigarettes in 2005 and 2006. "It is our belief that if all manufacturers took this approach, outflows from Ukraine could be significantly reduced," BAT's chief of anti-illicit trade, Pat Heneghan, told ICIJ in an e-mail.

Philip Morris, maker of Marlboro, is the top producer of cigarettes in the Ukraine, with 44 billion sticks manufactured in 2008 — an increase in production of more than 85 percent since 2003. Marlboro, EU officials say, remains the number one brand seized in Europe. Ukrainian law enforcement officials say that Philip Morris' brand L&M is routinely seized at the border. Philip Morris International's director of brand integrity, Andrew Robinson, told ICIJ that the country does indeed have "an ongoing problem of diversion of genuine products from Ukraine into the EU," but, he stressed, the company's production is commensurate with demand. Robinson added that Philip Morris has implemented a sophisticated system of product tracking and tracing in Ukraine, and that it actively cooperates with law enforcement to prevent smuggling.

Imperial Tobacco officials declined to comment for this story. In 2008, Imperial manufactured more than 30 billion cigarettes in Ukraine, according to industry and government statistics, the third largest production after that of Philip Morris and JTI.

EVERYONE'S WINDFALL

The big tobacco multinationals in Ukraine are not strangers to the smuggling business — in the 1990s the firms colluded with criminal networks to smuggle cigarettes and gain market share around the world. Since 2004, Philip Morris and JTI have settled lawsuits brought by the EU and publicly committed to fight smuggling. The agreements require both companies to make substantial payments to the member states every time their brands are seized.

Experts say, however, that only a tiny portion of all contraband cigarettes are caught by Ukrainian customs. In 2008, customs officials seized about 66 million cigarettes — less than one percent of what they believe was smuggled out of the country.

Then there's the problem of corruption. Several of the more than 120 criminal smuggling cases prosecuted in 2008 in the picturesque region of Chernivtsi, on the border with Romania, involve customs agents who aided the smugglers, Ukrainian police say. In just the first two months of this year, three cases have been prosecuted in Chernivtsi in which customs officials "overlooked" the smuggling of 10.3 million cigarettes — more than half of them JTI's Ronsons.

Tobacco companies say they monitor their wholesalers for suspiciously large sales of cigarettes. Smugglers, in turn, have started to split large purchases into many smaller purchases to avoid detection. "We don't know really who is buying from the wholesalers, as these are small batches" said JTI's Redko.

Krasovsky, of the Ministry of Health, says tobacco companies are doing little to stop smuggling. By checking the seized packs' production dates, he said, manufacturers could monitor where cigarettes have been bought and cut off wholesalers who deal regularly with smugglers. Instead, he adds, "tobacco companies supply cigarettes to a wholesaler that has a huge warehouse in the border with Poland — it's obvious where those cigarettes are going to go."

Internet merchants are also making a windfall from Ukraine-made cigarettes. A Web search for "cheap Ukrainian cigarettes" yields about two dozen online stores, most of them located in neighboring Moldova. The sites offer all the well-known brands, from Marlboro to Winston, with Ukrainian tax stamps and health warnings. The price is $22 for a carton (10 packs) of Marlboro — about three times cheaper than prices in the EU. The sellers claim that they will skip customs inspections at the destination country. If customs does try to charge a duty tax, customers are advised to reject the package and ask for their money back. Also plentiful on Ukrainian Internet sites are classified ads offering Ukrainian cigarettes delivered to the EU "in large quantities," "on constant basis" and "without any paperwork."

One such ad, posted on January 9, 2009, offered delivery of cigarettes from Ukraine to Europe. In response to an online inquiry, a person who introduced himself as Oleh Dmytruk responded by saying that delivery of red Marlboro can be made to Germany at 18 Euros (about US$25) per carton. The minimum purchase: 1,000 cartons.

In Krasovsky's view, the only way to halt smuggling is to make the trade unprofitable for manufacturers. He and other tobacco control advocates propose that, much like in the Philip Morris-EU agreement, tobacco companies in Ukraine be forced to buy back their seized cigarettes at market prices.

But the economics of smuggling may be too sweet for at least some tobacco companies to stop. Asked whether the tobacco industry loses money to the illicit trade in Ukraine, JTI's Redko responded candidly: "What do you mean by loss? From the point of view of a company operating on the market, production of extra goods means extra profits." ■

China's Marlboro Country

A MASSIVE UNDERGROUND INDUSTRY MAKES CHINA THE WORLD LEADER IN COUNTERFEIT CIGARETTES

By Te-Ping Chen

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ON FIRST APPROACH, Yunxiao seems like any other Chinese backwater caught in uneasy industrial transition. Faded advertisements line the streets downtown, where motorcyclists wearing bamboo-frond hats determinedly vie for passengers in a riot of honking. A cheerful red banner in the city center exhorts citizens to develop the local economy — and yet the message seems ironic. After all, since the 1990s, Yunxiao has already sprouted its own league of millionaires, famous throughout China.

But you won't find their activity downtown.

Ringed by thickly forested mountains, illicit cigarette factories dot the countryside: carved deeply into caves, high into the hills, and even buried meters beneath the earth. By one tally, some 200 operations are hidden in Yunxiao, a southwestern Fujian county about twice the area of New York City. Over the past ten years, production of counterfeit cigarettes in China has soared, jumping eightfold since 1997 and making China the world leader in fake smokes. Chinese counterfeit cigarette factories now churn out an unprecedented 400 billion cigarettes a year, enough to supply every U.S. smoker with 460 packs a year. Yunxiao — once famed for its bright yellow loquat fruit — is the trade's heartland: the source of half such production, officials say.

Today, China's fake cigarettes fuel a multi-billion dollar black market and are even more hazardous for smokers, yet the industry is little-known. From New York delis to London storefronts, China's brand rip-offs are now sold in cities around the world. While a pack of fake Marlboros costs $0.20 to make in China, in the United States, it can fetch up

Officials estimate billions of fake Chinese smokes are being smuggled from ports like Xiamen to countries around the world.
Credit: Te-Ping Chen

to twenty times that amount, even when sold at cut rates. Spurred by global crime rings, the counterfeit trade has exploded, propping up addiction and robbing governments of billions in annual tax revenue. Officials can only guess at the size of the industry here in the United States, but to give a sense of scale, from 1999-2005, one ring smuggled a billion fake cigarettes into Los Angeles and New Jersey. Fully 99 percent of the U.S. counterfeit market is supplied by China, and up to 80 percent of that in the European Union. Meanwhile, Chinese government efforts to stop the trade are met by street riots, machete-armed manufacturers and retaliation killings.

"Most factories are underground," confides a Yunxiao cigarette broker in hushed tones. "They're under buildings, unimaginably well-hidden, with secret doors from the basements." Even the village temple — topped with a lilting red roof and twisting, frescoed spires — conceals a factory below, she says.

SIXTY VERSIONS OF MARLBORO

Though a nearly invisible industry, cigarette counterfeiting is an immensely lucrative one, with profits rivaling those of the narcotics trade, officials say. While one 40-foot container of cigarettes (containing 10 million sticks) can be produced in China for just $100,000, the street value of such a container smuggled into the United States is up to $2 million. And though a drug trafficker might land a life sentence if caught, a cigarette counterfeiter receives a comparative slap on the wrist — a handful of years in jail, or possibly a fine.

Interviews with law enforcement officials, tobacco industry investigators, and the smugglers themselves reveal the Chinese business is booming, with no shortage of groups vying to enter the trade. The Chinese diaspora plays a major role in distribution, with groups particularly active around New York City, Vancouver, Rotterdam, Le Havre, Valencia and Hamburg. The industry has also attracted a sprawling network of middlemen and smugglers, notably from the Middle East and Eastern Europe.

"In the last few years, pretty much every market has been targeted," says Andrew Robinson, who directs the brand integrity division for Philip Morris International (PMI). In 2001, Chinese manufacturers were producing eight different varieties of counterfeit Marlboros. As of last year, though, PMI reports, Chinese counterfeiters were manufacturing separate versions of Marlboro tailored for some 60 countries — down to the specific detail of tax stamps and regional health warnings.

"Ten years ago, [there were] almost no counterfeit cigarettes," says Austin Rowan, who heads cigarette fraud investigations for the EU's Anti-Fraud Office, known as OLAF. Last September, though, the tide of fake smokes flooding the European Union — most of them Marlboros from China — prompted OLAF to post its first-ever officer to Beijing. In the United Kingdom alone, the illicit trade costs the government nearly $5 billion a year. "People are hungry for these products," says Rowan.

Inhaling the knock-off cigarettes,

however, may do even more damage than their legitimate counterparts. Lab tests show that Chinese counterfeits emit higher levels of dangerous chemicals than brand-name cigarettes: 80 percent more nicotine and 130 percent more carbon monoxide, and contain impurities that include insect eggs and human feces. And by targeting smokers with cheap cigarettes, health authorities fear the counterfeit influx diminishes incentives to quit. (Centers for Disease Control studies show that every 10 percent increase in cigarette prices causes a 4 percent drop in consumption.)

Back in the 1990s, counterfeit packs from China often came riddled with easy giveaways: misspelled health warnings, blurred lettering. These days, OLAF reports that sophisticated industry forensics are needed to identify China's counterfeits. In the United Kingdom, where authorities in some areas report that up to one-third of all cigarettes sold are fake, mostly from China, customs officers have deployed a trained dog to try and sniff out counterfeits on the streets.

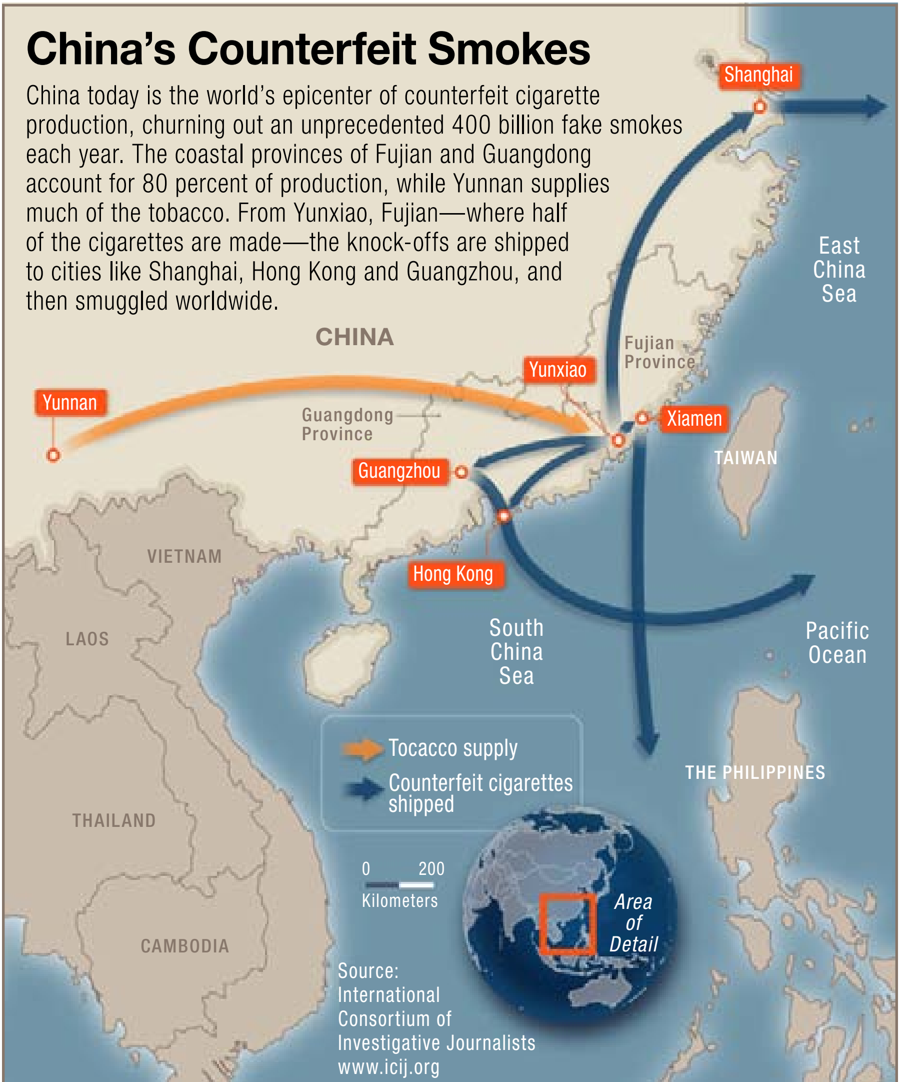
When it comes to the source of top-quality fakes like these, all roads lead back to Yunxiao. The area's cigarettes are so renowned that Yunxiao has become a watchword among China's counterfeiters, with manufacturers from other regions even claiming their cigarettes originate in the area — a kind of double-layer decoy.

Last December, China's Ministry of Public Security announced the bust of one of the largest international schemes in years, a network of 27 suspects that reportedly smuggled at least 600 million fake cigarettes around the globe. While the cigarettes — mostly counterfeit Marlboros and 555s — were shipped as far as South Africa, Greece, Indonesia and the United Kingdom, they'd all been manufactured in southwest Fujian, deep in rugged mountains.

Fujian's cigarettes also lay behind a massive U.S. smuggling network the FBI busted in 2005. Two sting operations code-named "Operation Royal Charm" and "Operation Smoking Dragon" netted a group of 62 ethnic Chinese who smuggled one billion cigarettes into the Los Angeles-Long Beach and Newark ports, using false descriptions such as "wicker furniture" and toys. The counterfeits, largely Marlboros and Newports, were in turn sold on the streets of Los Angeles, Chicago, and New York City.

China's Counterfeit Smokes

China today is the world's epicenter of counterfeit cigarette production, churning out an unprecedented 400 billion fake smokes each year. The coastal provinces of Fujian and Guangdong account for 80 percent of production, while Yunnan supplies much of the tobacco. From Yunxiao, Fujian—where half of the cigarettes are made—the knock-offs are shipped to cities like Shanghai, Hong Kong and Guangzhou, and then smuggled worldwide.



Graphic by www.stephenrountree.com

"Any brand or quality, Yunxiao can help you make it," says a former cigarette smuggler from Fujian. "You just need to name your price."

A FLOOD OF FAKES

It's hard to overstate the ubiquity of tobacco in China, a country home to one of the world's most elaborate and entrenched smoking cultures. Here, the introductory exchange of cigarettes is as ritualized as a handshake, while expensive packs moonlight as everything from wedding gifts to bribes — even offerings on ancestors' tombs.

As an official from the tobacco company Rothmans once put it, "Thinking about Chinese smoking statistics is like trying to think about the limits of space." Every year, China's smokers consume one-third of the world's tobacco: an overwhelming 2.2 trillion cigarettes. Cigarette-related mortality levels, too, are equally staggering, with fully one-third of all Chinese men under age 30 predicted to die from the pandemic.

Like anything else related to tobacco in China, the number of counterfeits flooding the domestic market is similarly off the charts. "Each of us has come up with our own strategy to deal with it by now," says one Beijing smoker, who personally refuses to buy at locations where he doesn't know the owner. The problem is so bad that on trains, conductors roam the aisles, industriously hawking 75 cent keychain lights that purportedly reveal fake packs.

After all, while the West is the most lucrative counterfeit market, for smugglers, it's also the riskiest. Inside China, local ties and protectionism afford some degree of control: a friendly $10,000 tribute, one customs official confides, has been the going rate to bribe a container out of the Xiamen ports in recent years. (And even without payment, inspection rates at China's ports are a low one to two percent) Beyond China's borders, though, containers are more vulnerable to detection by outside law enforcement, many of them newly vigilant against the fake trade.

"We're seeing seizures all the time," says PMI's Robinson. In May, UK authorities seized over 20 million counterfeit Regals (valued at $8.6 million) imported from China into Southampton. Likewise that month, Spanish authorities grabbed 20 million fake Marlboros — falsely described as mattresses — imported from the Chinese ports of Chiwan and Shekou. Also in May, French customs intercepted more than 15 million made-in-China fake Marlboros outside Paris, some bearing Vietnamese as well as Arabic and French health warnings.

In China, cigarette smoking rates are off the charts, and so are sales of counterfeits.
Credit: Te-Ping Chen

Nevertheless, says OLAF's Rowan, such seizures are just "the tip of the iceberg." Smugglers frequently ship cigarettes through an array of destinations such as Dubai and Singapore to mask a container's origin, with some spending up to three months at sea before delivery. And even if a container is seized, given exorbitant per-container profits, the loss is a slim deterrent. "With nine containers seized in ten," Rowan says, "[smugglers] still would not be losing money."

For counterfeiters, the rewards are especially prodigious. According to manufacturers, state-of-the-art cigarette machines (available online from sites like Alibaba.com) can fetch a pricey $1.5 to $3 million. "But everyone knows that the investment can be recouped in just a few months of manufacturing," says a Yunxiao broker. Some factories boast up to 500 workers and over $100 million in annual sales.

With so much profit at stake, this underground industry has cultivated a notably violent set of players. Past factory raids have yielded semi-automatic rifles and met with armed resistance, and every year, several state and private investigators are killed in their efforts to penetrate the trade. The average raid is carried out by hundreds of Chinese police. During one 2003 operation, says a security consultant at ZIC, fully 5,000 officers were deployed. (ZIC no longer takes on cigarette cases, according to the consultant, because the risks have become too great.)

In the 1990s, Chinese counterfeiters relied heavily on Macao, Taiwan, and Hong Kong for technical expertise, as well as high-quality packaging. These days, though, China's counterfeiters source the majority of their supplies from the mainland: tobacco from Yunnan province in the west, packaging from Dongguan and Shantou in nearby Guangdong province, and cast-off machines bought online from underground manufacturers or recently shuttered state facilities. (Over the past decade, China's legal cigarette industry has been consolidated, with the number of factories shrinking from 185 to 31 since 2001.) Counterfeiters have not only acquired the technology to mimic holograms used to distinguish real packs, but also the rounded-corner packaging the tobacco industry has introduced in recent years.

And as manufacturing technology has improved, so, too, has the speed with which counterfeiters respond to shifting markets. This December, when Irish authorities seized a shipment of 20 million counterfeit cigarettes, they found the made-in-China packs bore exact replicas of Ireland's latest tax stamps, which had been in circulation only a few months.

With the advent of the Internet, counterfeiters have become more brazen as well. Many openly court clients through online storefronts, touting quality guarantees and their equipment's international caliber. One Yunxiao operation, established in 1993, assures customers of its experience exporting to Asia and Africa, and says it maintains its own tobacco leaf fields in Laos. The company — which churns out some 80 million cigarettes a week—promises a six-day manufacturing turnaround, door-to-door delivery for certain overseas clients, and impeccable customer service.

The tone is reassuring and gently instructive. For tentative buyers, the owners guarantee that for the U.S. in particular, it's a "profit business." Reads their website: "We strive to build and maintain a total honesty management culture, and will appreciate the chance to do business with you."

JAMES BOND AND PIG PENS

In China, as elsewhere, a successful business relies on more than just technology — it requires serious support from investors and brokers. Men, for example, like Tony Tung.

Originally a fishmonger from Fujian, for the past 15 years, Tung — square-jawed, middle-aged, with a thick coif of black hair — has ranked among China's most notorious cigarette dealers. Tung, though, didn't start out smuggling fakes. In the early 1990s, he found gold in the genuine product: Marlboros and 555s smuggled into China from abroad.

For years, the Chinese government has worked strenuously to keep foreign cigarette companies at bay, capping imports and levying tariffs as high as 430 percent. That, though, didn't deter companies like British American Tobacco from smuggling their products into China — or Chinese enterprisers like Tung, who made millions smuggling legally produced cigarettes in the Philippines into China.

But when China cracked down on the trade in the 1990s, Tung turned his sights to the next industry bonanza: counterfeiting. Tung built up factories in Fujian, as well as in the Philippines (closed by authorities in 2005) and the free-trade zone of Rajin, North Korea. In recent years, his enterprise has reportedly shipped up to 50 containers a month — or 500 million cigarettes — to markets throughout the United States, Europe and Asia. Tung continues to elude authorities, shuttling between Singapore and nearby countries, according to a tobacco industry source familiar with Asia. Recently, his syndicate has started using fishing boats to smuggle its product around Asia, the better to dodge inquisitive customs officials.

Tung and his fellow counterfeiters employ an impressive bag of tricks to avoid scrutiny. One manufacturer (arrested in 2001) constructed a factory that masqueraded as a People's Liberation Army compound, complete with 20 laborers — dressed in cast-off military uniforms — who would conduct faux-army drills and sing the national anthem in the yard every morning. Other machines have been lodged on ships, inside concrete bunkers, and even under a lake.

"Finding these guys is like a James Bond movie," says Keith Tsang of the China Association of Industry Security Professionals. "You'd never believe it was for real."

In Yunxiao, factories are frequently hidden in dim, bricked-in facilities underground, accessible only via trapdoor and ladder. The turf masks the tobacco scent, while nearby sentries are used to monitor passersby. Workers staff production lines in teams of six or seven, feeding tobacco into large, heavy machines anchored in concrete foundations. Above ground, manufacturers use other ploys to hide the tell-tale aroma: double-paned glass and cotton quilts tacked to the walls, with pig pens sited nearby. In Yunxiao, investigators say, the easiest way to find a factory is often by searching for signs of industrial power sources.

Like many industries, China's counterfeit operations are distributed: tobacco cutting and drying at one site, cigarette rolling at another location, and packing still elsewhere. These days, the packing — usually managed outside port cities, just prior to shipment — is the only process that hasn't yet been mechanized. In major distribution centers like the city of Guangzhou, 300 miles west of Yunxiao, laborers still fill and seal the branded packs by hand. In one city corridor crammed with wholesalers, teenage girls from Fujian stroll arm-in-arm in the quiet pre-dawn darkness, awaiting their next shift.

Twenty-five years ago when multinational tobacco companies' smuggling activities took off, Chinese smokers flocked to foreign brands. Now, cigarette vendors say fake Marlboro and 555s are so common that many Chinese simply choose to avoid them altogether. As one former cigarette smuggler from Shenzhen explains, "Nobody can tell anymore whether they're real."

THE MOUNTAINS ARE HIGH

Since its accession to the World Trade Organization, China's lackluster efforts to protect intellectual property rights have attracted sharp criticism. But with regard to tobacco, Beijing has waged a more aggressive war. All legal manufacture and distribution of cigarettes is state-owned, and in a nation of 400 million smokers, that's big business. (Local governments are zealous about defending it, too: until this May, officials in Hubei were required to smoke a collective 230,000 packs of regional brands a year.) With cigarette sales accounting for nearly 8 percent of China's budget in 2007, the state has a strong motive to keep its supply counterfeit-free.

Certainly the relevant authority, the State Tobacco Monopoly Administration, has spared no resources in trying. By 1995, long before multinational tobacco companies had seriously mobilized on the issue, the STMA had already dedicated $12 million to combating counterfeiters. The agency today fields 50,000 agents to fight the fakes, according to industry sources. Meanwhile, this year, according to a police officer in the Yunxiao region, the STMA has dispatched some 150 officers directly to the region for up to year-long postings.

Last year, officials say, the STMA raided 3,312 production sites throughout China, apprehending 7,128 people in the process and seizing 8.3 billion counterfeit cigarettes. The STMA also regularly holds public "destruction ceremonies" to demolish seized cigarette equipment, hoisting the machines up into the air by crane before dashing them onto concrete below.

"China devotes a huge amount to enforcement," agrees Martin Dimitrov, a professor at Dartmouth College who has studied the issue. "The puzzle is that there seems to be little effect."

It's not that manufacturers don't feel the pressure. One manufacturer reports that local counterfeiters are losing up to $300,000 a day in seized materials, and phone calls to a handful of different counterfeiters suggest a number are currently laying low, hesitant to expose themselves to new buyers.

But when it comes to Yunxiao's factories, an old Chinese idiom seems particularly fitting: The mountains are high, and the emperor is far away. Yunxiao villagers, too, quote their own motto: "Any official can absolutely be bought within half a month." In some cases, a gift of just $1,500 can buy a counterfeiter a license to operate and some official breathing room. Last year, 28 officials werereportedly detained in connection with cigarette counterfeiting on charges such as dereliction of duty, cover-ups, or actually participating in the trade.

From another perspective, the counterfeit industry is also a boon for local employment, which some officials are loath to suppress. "The question for authorities now, with the economic slowdown, is: Do you really want to shut these places down?" says Tim Trainer, who heads the Global Intellectual Property Strategy Center in Washington, D.C.

For some, it seems, the answer is no. Last year, though China's Administration of Industry and Commerce completed 13 percent more intellectual property raids than in 2007, the number of such cases transferred for criminal prosecution dropped 40 percent. This January, the Guangdong prosecutor's office instructed prosecutors to "cautiously choose whether cases should be brought," and with less serious criminal cases, "postpone enforcement where appropriate." Likewise in December, the deputy minister of

Shandong's public security bureau (recently arrested for corruption) pressed police to avoid "aggravating" businesses' production problems, for fear of "increas[ing] the likelihood of mass protests."

No matter Beijing's intentions, national priorities can only filter down so far. One police officer based just outside Yunxiao, who asks to remain anonymous, reports that his superiors deliberately downplay fighting those in the trade, and that an arrest is an anomaly. Most workers caught will "just pay some fines," and even if arrested, their bosses will bribe or bail them out. As for catching production bosses, he says, it's "impossible." They're too deeply insulated, he says, and too adept at hiding: some hold as many as 100 fake identity cards from China's 22 different provinces.

Even if caught, the maximum sentence a cigarette counterfeiter can expect is just seven years. Three years is the minimum and more common sentence, says CAISP's Tsang. To put someone in jail for even that long, authorities have to seize over $36,800 in contracts or goods, a threshold counterfeiters try to duck by scattering storage and production efforts.

"It's impossible to root out this business," says the police officer. "Even though there are crackdowns, I don't see any long-term plan to eradicate the industry." While the STMA pays any police division up to 15 percent of the retail price of any goods seized, those incentives, he explains, are useless in nabbing those involved. "When cars [with cigarettes] are stopped, the drivers run away, but the police don't care, because they'll get a reward anyway," he says.

In the last five years, one multinational tobacco company has altered its tactics on the mainland, choosing to focus its efforts on seizing goods as they leave China, rather than on identifying production sites. "In an ideal world, we'd be able to go after them, but that became too hard," says a tobacco industry official. There are simply too many—and besides, as he asks, "At the end of the day, are we really going to convince the provincial authorities in Fujian to crack down?"

THE SHANGHAI PROFESSOR

Few in Yunxiao will talk openly about the village's main industry. One knowledgeable resident, a 30-year-old woman and sometimes cigarette broker, tried to explain why the trade flourishes so well in her community. The counterfeiting industry, she told visitors, is more than just a business, it's a brotherhood. Only those whose entire family tree can be traced to the area are permitted to work in production. Regional markets are divided by family, and once established, firmly respected — spurring others, in turn, to develop their own new markets. Unity is fierce, she says: that's why Yunxiao is so well-protected.

Surveillance is heavy in Yunxiao's narrow side streets and in its hotels, and outsiders are frequently tailed. Though authorities offer rewards of up to several thousand dollars for information, few residents dare to take them, she says. "Even if you get the money, you won't have any life left to enjoy it in afterwards."

But when it comes to production, she adds, Yunxiao people are nothing less than business-minded "professionals." She tells the story of one Shanghai chemistry professor, who manufacturers collectively enlisted five years ago to help them better mimic the popular Chinese cigarette brand Hongtashan. Counterfeiters paid him $15,000, and have rewarded him with royalties ever since. Similarly, in years past, she says, local counterfeiters have invited retired workers from the state-owned Shanghai Cigarette Factory — home to some of China's top brands — to tour Yunxiao for a month, helping fine-tune local recipes.

As they battle with Beijing, Yunxiao's manufacturers show no signs of backing down. Some have stepped up investment in new factories outside the area, including the cities of Pinghe and Zhangpu. Others are shifting production outside of China altogether, as far away as Vietnam and Burma. Meanwhile, overseas law enforcement facing the counterfeit influx is baffled by the trade: tracing a seized container to its producers, industry officials say. is "almost impossible," given that the majority of company names used on accompanying records are also fake.

Yunxiao might someday change, but such a transition would take many years, says the broker. One manufacturer she knows invested $2.5 million to start another legitimate business elsewhere, but recently quit and returned — disappointed, she reports, because "the profits could never match counterfeit."

Still, though, she hopes the industry will make a shift: "We locals hope we can work together to build up a real factory someday." ■

Patricia Chan in Hong Kong and Alain Lallemand in Brussels contributed to this report.

Smoking Dragon, Royal Charm

A TALE OF FOUR FBI AGENTS, 62 CHINESE SMUGGLERS, AND A BILLION BOGUS CIGARETTES

By Te-Ping Chen

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HERE IN CALIFORNIA, it's possible to pass within a mile of the Los Angeles-Long Beach port complex and never once suspect it's there. East of the Palos Verdes Hills, the port's surrounding warehouses easily obscure the mass of steamers that daily arrive studded with stacks of containers bearing international cargo.

Yet the complex is the busiest in America, the arrival point for nearly half the volume of all U.S. imports. And it's here that, like so many other smugglers, Charles and May Liu first struck gold.

By all accounts, the Lius were not extraordinary. After emigrating from China around 1980, the pair settled into the Washington, D.C., suburb of Gaithersburg, Maryland. Charles was quiet, a student in political science at New Jersey's Seton Hall University, where he received a master's degree. At age 67, he had a professorial look, with chinos and sweaters his preferred attire. May was a romantic, someone the agents who arrested her would later describe as a "true lady," one who loved ballroom dancing, wore pantsuits, and fastidiously watched her weight.

But the pair wasn't quite what they appeared. By the time the FBI arrested them in August 2005, the Lius had led a team of agents straight into the heart of a vast Chinese smuggling network — one that sold, among other goods, counterfeit pharmaceuticals, fake $100 bills, and weapons from North Korea. And then there was their real gold mine: cigarettes. Low-grade, brand-name counterfeits. Over a billion of them, all told — more than enough to supply every man, woman, and child in America's 50 largest cities with a pack.

Like drug trafficking, the trade in fake cigarettes is big money. While in China it costs as little as $125,000 to manufacture a 40-foot container of cigarettes (or 10 million individual sticks), here in the United States, such a container's contents can be sold for as much as $2 million. Historically, several U.S. multinational tobacco companies, notably R.J. Reynolds and Philip Morris, dominated the global cigarette smuggling trade alongside British American Tobacco. Yet since a series of exposés and multibillion-dollar lawsuits in the European Union and the U.S. clamped down on such activities after 2000, the United States has itself become a target for a new wave of smugglers who have stepped in to fill the industry's shoes.

Today, with less scrutiny from law enforcement than drug trafficking and lighter penalties for those caught, the cigarette smuggling business is a bonanza for organized crime syndicates, everyday crooks — and even terrorist cells.

As with drug smugglers, cigarette smuggling rings are difficult to penetrate, with networks insular and compartmentalized. "The person in a warehouse who's responsible for receiving the containers [of cigarettes] only knows what they need to know," said Kevin Kozak, deputy special agent in charge of the U.S. Immigration and Customs Enforcement investigations office in Los Angeles. "Try coming in with a warrant then, and you have no case."

"You have to be patient," he said.

Undercover FBI agents Lou Calvarese, Jack Garcia, and Tom Zyckowski know a lot about being patient. For six years, the trio painstakingly worked to cultivate Charles and May Liu's confidence. Over the course of some 1,000 meetings, their investigation — dubbed "Operation Royal Charm" — would pull the agents deep into a tangled Chinese underworld spanning coasts and continents. Together with a parallel California case, "Operation Smoking Dragon," the twin investigations would result in 10 indictments, with 87 individuals charged, mostly ethnic Chinese.

"We really got to see a network of cigarette smugglers up close," said Garcia — who, like the other agents, has since retired and is sharing his full story with a reporter for the first time. "It's sophisticated, the way it works. And these guys are like hookers," he said. "There's a lot of them."

Calvarese, Garcia, and Zyckowski — based out of Atlantic City, New Jersey — first heard from an Italian informant about Charles and May Liu in 1999. The informant had fingered the pair as cigarette smugglers, wheelers and dealers who'd been sneaking counterfeit smokes into the Los Angeles and Long Beach ports. But authorities had lately intercepted a few of their containers. The couple might be receptive to an offer of assistance at the ports, the informant intimated — that is, from the right kind of individuals.

At a formidable 6 feet 4 inches and 375 pounds, Zyckowski (or "Z-man," as his targets knew him) thought he could play the part. A longtime undercover agent, he was used to adopting the braggadocio needed to pose as a member of the Italian Mob. Some shiny suits, a pair of Cadillacs retrieved from the FBI's stock of impounded vehicles, and a purple Porsche Carrera — seized from a drug dealer with only 7,000 miles on it — gave him and his fellow agents all the other panache they needed.

As it turned out, the ruse was easy. The Lius, evidently, had never dealt with the Italian Mafia before. When the agents assured them that as mobsters, they knew corrupt officials at the Newark port, the couple easily absorbed the story. After their containers had been seized in California, the Lius figured they'd try their luck elsewhere. A deal was made: For $60,000 per container, the agents would guarantee delivery of their cigarettes.

And, gradually, a friendship was struck. "From the time I first met her, May actually started to kind of fall in love with me," Zyckowski said. "Well, not me, exactly. It was the Italian wise guy she liked." Those feelings, Zyckowski said, had real roots — though nothing ever came of them. "Charles was often away in China, always focused on their business," Zyckowski said. "I think she was lonely. In some ways, I think she just wanted companionship."

"CHINESE BEVERLY HILLS"

Fifteen miles east of Los Angeles lies the San Gabriel Valley: a cluster of low-slung, palm-lined suburbs variously nicknamed Little Taipei, New Chinatown, and the "Chinese

Beverly Hills." The area is heavily immigrant, its streets lined with stores bearing bleached Chinese characters advertising everything from dentists to dumplings. Around here, Chinese so heavily dominate the valley that one auto shop worker quips, "The best way to learn English is to go to jail."

Today, China is the world's biggest producer of counterfeit cigarettes.

Like his counterparts in Atlantic City, FBI agent Bob Hamer knew little about the Chinese trade in counterfeit cigarettes. But by the time he was tapped to become the West Coast undercover agent in "Smoking Dragon," he'd heard about it. Since the late 1990s, when Chinese counterfeiters first developed the ability to mimic the holograms used to indicate legitimate packs, the industry has accelerated. "In China, counterfeiters provide economic benefits [such as jobs]," said former tobacco industry consultant Tai-Ming Cheng, "so there's always been a disincentive to crack down." And greased by the generous amounts of official payoff (the cost to bribe a container out of China runs about $20,000), the trade is flourishing. Today, China is the world's biggest producer of counterfeit cigarettes, churning them out at a rate of roughly 200 billion sticks per year, according to smuggling experts.

That was mostly news to Hamer. Nevertheless, with his over 20 years of experience infiltrating groups from La Cosa Nostra to the Russian Mafia, Hamer's supervisors assured him he was the man for the job. "Asians respect age," they told him. "We need you."

"At the time, I was only 52," Hamer recalled, hardly flattered. But in September 2002, he adopted a tottering gait and a cane, and with good grace went to meet his first target: Willon Kow Szeto. A 68-year-old father from Rosemead, one of the San Gabriel Valley's majority-Asian towns, Szeto had been smuggling containers of cigarettes into the Los Angeles-Long Beach port complex along with several associates living in the San Gabriel Valley, including Dong Jie Li, 31, from China, and her 52-year-old Taiwanese boyfriend, Giashian Lin.

Apart from the occasional container customs managed to confiscate, business was good. "If they sent 10 containers over and could get half of them through, they were happy," Hamer said. "And overall [customs] really inspected so few anyway." Nationally, about 22 percent of containers entering U.S. ports undergo some level of inspection upon arrival — either an X-ray scan or a random-box search. But while port-by-port numbers aren't released to the public, one customs officer at the Los Angeles-Long Beach ports estimates the local figure is considerably lower: somewhere closer to 13 percent. After all, every day, over 15,000 containers stream into the port complex — or one every six seconds.

Even so, one of Szeto's associates — Lin — had lately been arrested. Not because one of his containers was detected. Instead, a couple flying into the Los Angeles airport in April that year were the ones to give the tipoff. When security officials discovered that their suitcases contained 2 million phony California cigarette tax stamps from Xiamen, China — to be affixed on likewise phony packs — they also discovered the name of their intended recipient: Lin. Upon raiding Lin's apartment, they found shipping documents linking him to 16 million counterfeit cigarettes that had turned up at the ports listed as furniture and chinaware. Lin surrendered his passport and was detained that afternoon, though not for long. Much to the chagrin of his sister-in-law, Lin's brother agreed to put up $50,000 secured by their $248,000 Monterey Park home for bail.

Five months later on September 16, 2002, FBI agent Hamer sat in a posh Beverly Hills restaurant with Szeto, eating campanelli puttanesca and talking about his supposedly corrupt port "contacts." After some negotiations, Hamer promised to guarantee Szeto's shipments for $60,000 per container.

That same day, Lin strode into the gleaming Los Angeles International Airport with a substitute passport he'd obtained from the local Taiwanese Consulate. He went to the counter and bought a one-way ticket to Shanghai. He boarded a plane an hour later.

A COUNTERFEIT GOLD MINE

Meanwhile back in New Jersey, Calvarese, Garcia, and Zyckowski were getting impatient. Intent on expanding the case, the agents continued to bring in more cigarettes for the Lius — 10 shipments by September 2003, or some 100 million sticks, mostly counterfeit Marlboro and Newport. Each time, the agents helped route the cartons to the Lius' various contacts in southern California, Pennsylvania, Canada, Illinois, and New York before receiving payment (usually in paper grocery bags stuffed with $20 bills).

But at this point, the FBI wanted more. They'd met the Lius' partners, including a pair from the San Gabriel Valley, Cheng Ming Hsu and Taiwanese national Tina Huang. They'd met the Lius' buyers and distributors. Now, they wanted to know who else the Lius knew — and what else their networks could provide them.

For each shipment the Lius made, they could net over $1 million. And by the time a container crossed U.S. soil, every carton inside already had a buyer set up and distribution pre-arranged.

In particular, the FBI was interested in the Lius' rumored ties to Chinese weapons dealers. But the Lius weren't giving them up.

"The cigarettes were just such a gold mine for them," Garcia said. "That was all they were interested in." Even when customers complained about the cigarettes' poor quality, their distributors had their tricks. In run-down neighborhoods, the Lius' contacts would mix fakes with real Marlboros and sell them on the streets, three sticks for a dollar.

"The numbers were astronomical, and it was all very well-organized," remembered Calvarese, who early on became the primary agent in "Operation Royal Charm." For each shipment the Lius made, they could net over $1 million. And by the time a container crossed U.S. soil, every carton inside — usually about 900 cases of them — already had a buyer set up and distribution pre-arranged.

Finally, Garcia-the-mobster issued an ultimatum. "If you don't kick it up a notch, we said, we're out of here," Garcia said. His drug contacts in Colombia, he told them — local freedom fighters — were getting antsy, demanding that Garcia produce weapons before they moved ahead with any cocaine deals.

"It was frustrating," Garcia said. "But worth it. Because in the end, they led us to Keith."

Co Khanh Tang, or Keith, as the agents knew him, was a Vietnamese-born Chinese who immigrated to the United States in 1975 and eventually settled in the San Gabriel Valley to work the Asian tables at a local casino. An avid golfer, rarely without his Tiger Woods cap, Tang was quiet — in the words of one agent, a real "family man." Modest and discreet, even at the gambling table. When he flew out to visit with agents at casinos in Atlantic City, he'd win thousands of dollars. But when management offered him special dinners and hotel perks, he'd shake his head and simply walk away.

"He wasn't at all cocky," Garcia said. "He seemed like the kind of guy you could be friends with."

But at least according to agents, Tang also had a murkier past as a former member of a Chinese gang, with the blue-inked tattoos running down his back to prove it. At the very least, from his days working at the casino, he had all the connections he needed to draw on to make him the FBI's next primary target.

Like the Lius, Tang wanted the agents' help importing the real moneymaker: counterfeit cigarettes, which he would fly out to the southeastern city of Xiamen, China, to procure. But the agents kept pushing for other products, too, and finally he caved. Through a friend in Taiwan, he managed to obtain "green paper," or what are more commonly known as "supernotes." That is, near-perfect imitations of U.S. Treasury bills, manufactured in North Korea and delivered to the dumbfounded agents in stacks at a rate of $0.30 on the fake dollar.

"We showed them to the Secret Service and the FBI," Garcia recalled. "And suddenly, everyone was in uproar."

Still more was to come. A month later, Tang invited the agents to Phuket, Thailand, to meet with his supernotes contact, who also dealt in heroin and weapons. It would be a good time, Tang reportedly promised. Food, beaches — and girls. As many as the agents wanted, and all day if they so desired.

"At this point, I'm telling you, everything just mushroomed, out of control," Calvarese said. At home, he kept three separate phone lines: one for each of his major Chinese contacts. And every day, the phones continued to ring.

TRICKS OF THE TRADE

Three thousand miles away in California, Bob Hamer was finding himself suddenly popular. Since his initial meeting with Szeto, word of his port contacts had spread among other local Chinese eager for his assistance. Apart from Szeto, there was Dong Jie Li, a pretty 31-year-old with a penchant for yaotouwan, or what the Chinese call "shake-head-pills," ecstasy. There was John Tung Wu, a heavy-set Taiwanese who dealt in crystal methamphetamine as well as cigarettes. There was Alan Hwang, who sold counterfeit Nikes alongside fake Marlboros, and more smugglers besides. "Eventually, it was all I could do to keep them off my back," Hamer said. And the Chinese were selling to a dizzying array of characters that kept popping up, as well: Armenians from Brooklyn, Middle Easterners from southern California.

Hamer knew who the Chinese were getting cigarettes from: Giashian Lin. Since fleeing to China in late 2002, Lin had again assumed his position as a magnate of the trade, arranging for the shipment of Guangzhou-produced cigarettes out of the Ningbo, Shanghai, and Dalian ports.

The Chinese cigarette trade is powered by people like Lin: brokers who connect overseas Chinese from Los Angeles to Manila to distributors in mainland China, where illicit manufacturers churn out vast quantities to meet overseas demand. Last year alone, for example, the central Chinese government seized 9.3 billion cigarettes and rounded up 7,026 people in connection with their manufacturing, mostly in the southeastern provinces of Guangdong and Fujian.

And yet more sites continue to spring up. The cigarette counterfeiting business is something of a cottage industry in China, with mobile manufacturing sites hidden in caves, barns, or even underground. Meanwhile, since counterfeiting consists largely of "just-in-time" production, it's difficult for authorities to make substantial one-time seizures. Often, the cigarettes aren't packaged until "very late, possibly just prior to shipment," said Daniel Chow, an Ohio State University law professor whose research has focused extensively on Chinese counterfeiting. That way, counterfeiters don't run the risk of maintaining warehouses full of brand-name contraband. Once Tang placed an order, he told Hamer, it took just four days for the cigarettes to be manufactured for shipment to Los Angeles.

Over the investigation's course, Hamer learned the tricks of the smuggling trade. At the ports, smugglers relied on the names of humdrum, low-duty products for use on phony bills of lading: wicker furniture, for example, baskets, or paper products. Frequently the packers would assemble a false wall of boxes containing decoy goods to be loaded in the back end of the container, the better to dupe any inquiring port official making a cursory physical inspection of the goods.

"Cigarette smuggling functions just like a business….It's a big pie, and everyone wants a piece."
— Kevin Kozak, ICE official

He was also struck by the fierceness of the competition. "Everyone had competitors, and they were always bugging me to get their product off the ships to them faster," Hamer said.

"It functions just like a business," said Kozak, the Immigration and Customs Enforcement agent. "There are investors here in the states — street gangs or career criminals — who pool their money to purchase and contract the containers for a very calculated payoff. It's a big pie, and everyone wants a piece of it."

By this time, Hamer was enjoying himself, riding out this strange wave of smugglers anxious for his attentions. In the car as he drove with them around the San Gabriel Valley, he had a particular soundtrack he liked to play for his newly made friends. He'd turn up Charlie Daniels' "Uneasy Rider," so they could all hear the lyrics and maybe sing along: You may not know it but this man is a spy. He's an undercover agent for the FBI.

BY THE ANDAMAN SEA

There were just two Mercedes available for rent on the tiny Thai island of Phuket, and upon arrival in July 2004, Lou Calvarese's hosts had managed to procure both of them. Though Calvarese dodged Tang's offer to arrange easy female companionship by bringing along another FBI agent to pose as his girlfriend, his hosts now seemed intent on lavishing the pair with all kinds of other hospitalities. Only after a whirlwind Bangkok tour did the business meetings begin — at the extravagant resort Le Meridian, situated in a brilliantly colored cove by the Andaman Sea.

Jyimin Horng was the star of the trip, Tang's contact and the man that Calvarese had come to see. A short, stocky judo expert from the gambling enclave of Macao, China, Horng was rumored to have competed in the Olympics in the 1980s. Now he served as a go-between for the North Korean government and various clienteles, peddling supernotes and arms. There in Phuket, between bouts of swimming and beneath swaying palm fronds, Calvarese and Horng began negotiations that eventually led to the purchase of $1 million in supernotes and a contract for 1,200 AK47s, 75 antitank rockets, 50 rocket launchers, and 100 machine guns with silencers — all through Horng's North Korean contacts.

"Everything was on the table, and everything was for sale," Calvarese said.

Phuket, he remembers — with its bare stretches of beach and languid air — was a dream. It also was the beginning of the end for Operations "Royal Charm" and "Smoking Dragon." After Calvarese returned to the United States, the evidence continued to pile up: a weapons catalogue Horng sent to Calvarese, a half-inch thick, translated from the Chinese, more shipments of cigarettes, and over $3 million in supernotes that arrived into the Newark port, the bills tucked and carefully hidden in boxes of toys. Meanwhile out on the West Coast, Hamer's subjects had likewise begun to tempt him with offerings of supernotes, crystal meth, and even surface-to-air missiles.

By the time terrorists bombed the London subway in July 2005, the agents were ready to take the group down. Their targets were spooked by the attacks, afraid that law enforcement would be on heightened alert. And besides, as Zyckowski said, "It just got to a point where there was no way we could control it anymore."

After all, as he added, "How do you keep 90 people dangling on a hook?"

ABOARD THE ROYAL CHARM

The first wedding invitations were mailed out that summer. Addressed to subjects across China, the United States, and Canada in delicate script, the cards announced that Calvarese and his phony FBI girlfriend — Melissa Anderson — were to be wed on August 21. The ceremony would take place aboard a yacht off of picturesque Cape May, New Jersey: a yacht, the invitations declared, named "Royal Charm." Transportation to the wedding would be provided.

Back in Los Angeles, Bob Hamer

readied his own bait: a divorce party. He told his targets that his wife had left him, and invited them all to a massive get-together on August 22 at the Playboy Mansion for some consolatory festivities.

None of the suspects ever made it to either celebration. In Atlantic City, the agents spent the days in the run-up to the wedding with Charles Liu, Tang, and Horng, reveling at different restaurants, hamming it up. At a three-hour rehearsal dinner at Caesar's the night before the wedding, the agents and their targets ordered a $4,000 meal: shrimp cocktails, caviar, bottles of Don Perignon. Melissa flashed a 4-karat diamond engagement ring on her finger, on loan from the FBI. Garcia played best man. The room was buoyant with toasts and laughter: To you, Lou! Big man Jack: How does it feel to see him as a married man?

The next morning, two limos were ordered to arrive at the Taj Mahal hotel, where about a half-dozen smugglers awaited rides to the ceremony. Agents impersonating drivers sat behind the wheel, arrayed in full tuxedo. As the limos pulled away, the agents told the guests they had to make one more unexpected stop: to be booked.

Meanwhile, across the United States, authorities in other cities were springing into action. All in all that weekend, some 59 targets were arrested in 11 cities during the sweep, including Szeto, Li, Wu, and Chen in California. (Several other targets, including Cheng Ming Hsu and Giashian Lin — overseas in China — were never captured.)

The case had ended. But not without a certain poignancy. A few days before the arrests, Horng and Tang took Calvarese aside to present him with a gift: two gold Rolex watches for himself and his bride. As they watched his face expectantly, Calvarese tried to laugh. "Keith — these aren't counterfeit, are they?" he asked. "No," Tang replied soberly, "these are the real deal."

"It was really nice," said Calvarese, looking back. "You could see in their faces that this was something they really wanted to do for us. In a way, it was sad."

A "CLASSY, CLASSY WOMAN"

This past August, sitting in his living room in San Gabriel, Keith Tang was at first reluctant to talk. While Tang had pleaded guilty, along with many of the 87 charged on both coasts in connection with "Smoking Dragon" and "Royal Charm," his sentence had not yet been issued. But when his words finally did tumble out, they emerged in a rush.

"We didn't hurt people," he said. "We don't kill people. We just try to bring cigarettes over and make some money. Everyone was doing cigarettes to survive. We're just Asians trying to help each other, and they're calling us a gang." The tattoos on his back, he said, aren't gang-related — they were inscribed on him as a teenager by a Buddhist monk.

"All I wanted to do was cigarettes, to make a living for my kid," Tang said. Across the room, a Guitar Hero game rests on the floor, near a red-lit family shrine festooned with incense and green mangoes. "I told [the agents], 'I don't want to get involved with weapons and counterfeit money, I'm not that kind of guy,'" he said. "But they kept pushing me."

"It's a game," he said. "We're all just chips in the game. And I lost." (In September, Tang was sentenced to six years in prison.)

So far, Dong Jie Li, Jyimin Horng, and Charles Liu have also all pleaded guilty, with Li and Horng sentenced to three-and-a-half and four years, respectively. Charles will be released in 2017. Charges were dropped against May Liu, who suffered a massive stroke in 2004 that paralyzed her entire left side.

Looking back, on some level, Zyckowski said, he does feel bad about what happened to all of them. "You get to like certain people," he said. "You know, they're not monsters — they're businessmen."

For the other agents, a fondness for the smugglers likewise lingers. Garcia, in particular, recalls May as a "classy, classy woman," — gracious, always with a matching pocketbook and immaculately made up. "They were almost like someone's grandparents," he said of the Lius.

"But that's how it was with all of them," he said. "You'd never suspect that they were big-time smugglers. Not in a million years." ■

Smuggling Made Easy

LANDLOCKED PARAGUAY EMERGES AS A TOP PRODUCER OF CONTRABAND TOBACCO

By Stefan Candea, Duncan Campbell, Vlad Lavrov, and Roman Shleynov

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Smugglers have used this dock on the Paraná River, located by a Paraguayan Navy post, to move cigarettes to Brazil.
Credit: Marina Walker Guevara

GUAÍRA SITS on the edge of the sluggish, muddy, mile-wide Paraná River that cuts a natural border between Brazil and Paraguay. Here the soil is red, the terrain is flat with ample soybean and mate leaf plantations. On its face, Guaíra is a well-kept Western Brazilian city of 30,000. Men chatter among themselves sitting in small plazas and barber shops. The streets downtown are clean, the houses are freshly painted and pay phones are decorated with natural motifs — you can call from the gut of a fish or the chest of a parrot.

Beneath this surface, however, the city shows a more disturbing element.

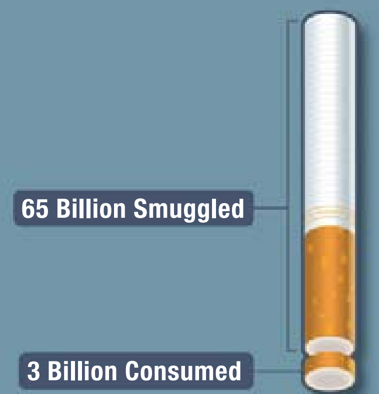
Last September, Guaíra made headlines across Brazil when 15 people were murdered at a makeshift riverside warehouse. The killings were the result of a vendetta among drug smugglers and, officials here say, they weren't all that unusual. Just 150 miles north from the notorious Tri-Border Area, where Brazil, Paraguay and Argentina meet, Guaíra is today a major weapons and drugs corridor in the region. But no product, police say, is more widely smuggled through this city, and more profitable to smugglers, than Paraguayan cigarettes.

Dozens of motor boats crammed with tobacco cross the Paraná River daily from the neighboring Paraguayan city of Salto del Guairá. The smugglers feed an illicit trade that injects billions of cigarettes into Sao Paulo, Rio de Janeiro, and other large Brazilian cities, where the cheap, untaxed Paraguayan sticks account for 20 percent of the entire cigarette market. Guaíra sits at the heart of this trade, a strategic gateway and a place where many residents — up to half its population, locals say — rely directly or indirectly on smuggling for their livelihood. A few reap millions from the illicit trade. Guaíra's most famous criminal son, Roque Fabiano Silveira, made a fortune and a name, trafficking Paraguayan cigarettes thousands of miles away.

Silveira, 44, nicknamed Zero Um ("The Kingpin"), is a larger-than-life border boss who fled to Paraguay after being charged in Guaíra with orchestrating the 1996 murder of a businessman. In Paraguay his cigarette business took off, and in 1999 he opened a sizable cigarette factory on the outskirts of the country's capital, Asunción, which soon became the operational base for a smuggling

A Runaway Tobacco Industry

Paraguay's factories produced an estimated 68 billion cigarettes in 2008, more than 20 times what the country consumes. The vast majority—$1 billion worth—is smuggled abroad, mostly to Brazil and Argentina.



Note: Paraguay also imported 3.2 billion cigarettes and legally exported 2.5 billion cigarettes in 2006.

Source:Centro de Investigación de la Epidemia de Tabaquismo

Graphic by Stephen Roundtree

network that spanned two continents and reached deep into the United States. Starting in 2003, Silveira cut deals with tobacco traders in Arizona and smoke shop owners in Indian reservations in Washington state to smuggle millions of Paraguayan-made contraband cigarettes through the ports of Miami, Norfolk, and Baltimore. The sticks were then distributed across the country and the profits were laundered to bank accounts in Paraguay and the United States. Silveira not only manufactured the cigarettes, U.S. prosecutors said, but also greased political and law enforcement hands in South America that guaranteed swift passage north for the cargoes. His former associates describe him as smart and cold, with an eye for fine suits.

The tale of Roque Silveira is emblematic of the criminal nature and global reach of the teeming Paraguayan cigarette industry, one that experts and law enforcement officials say is, largely, set up for and devoted to transnational smuggling. Fifteen years ago cigarette manufacturing was minimal in Paraguay, one of South America's poorest countries and a place notorious for corruption and trading in counterfeit goods. Today Paraguay, a landlocked, California-sized country, ranks among the world's top producers of contraband cigarettes, responsible for 10 percent of the world's contraband tobacco, experts estimate.

Paraguay's factories churned out 68 billion cigarettes in 2006, more than 20 times what the country consumes, according to a study by the Centro de Investigación de la Epidemia de Tabaquismo (CIET), a Uruguay-based NGO that tracks the economics of the region's tobacco market. The vast majority of the cigarettes — up to 90 percent of production, worth an estimated $1 billion — disappears in the black market, law enforcement officials say. The cigarettes are flooding Brazil and Argentina, where taxes are much higher than in Paraguay, and have turned up as far away as Ireland.

FIDEL, HAMLET, AND OPUS DEI

Once dominated by multinational tobacco companies, the global illicit cigarette trade today involves an array of crime syndicates which, much like the Silveira network, rob governments of billions of dollars in much-needed tax money, fuel organized crime, and help spread addiction by placing cheap cigarettes in the world's black markets. The steep growth of Paraguay's cigarette industry alarms law enforcement agencies and health officials alike, who fear that the South American nation could become be the next nightmare in global cigarette trafficking. Industry sources say manufacturing cigarettes in Paraguay today is cheaper than in China — the top producer of contraband smokes — while the quality of the product is far superior.

"There is a real danger that this situation could escalate very rapidly," says Austin Rowan, head of the anti-tobacco smuggling operations at the European Union's Anti-Fraud Office (OLAF). What's distinctive about Paraguay, investigators say, is the massive number of obscure, cheap brands its factories produce — more than 2,600 brands have been registered with the Ministry of Industry and Commerce, including the likes of "Dirty," "Fidel," "Hamlet," and "Opus Dei" — which makes it harder for investigators to track the trade. In contrast, only a handful of local brands are sold in the domestic market, where smokers pay some of the lowest cigarette taxes in the world.

Multinational tobacco firms are alarmed at the size and speed at which the Paraguayans have built up an off-the-books industry. Investigators for Big Tobacco say Paraguayan cigarettes are shipped to known Caribbean smuggling hubs like Aruba and Panama, where they believe the shipments enter the black market. In 2006 Irish customs seized a container loaded with five million Paraguayan cigarettes concealed in bales of plywood. While making inquiries about the case among his EU peers, David Godwin of Irish Customs says he was told: 'If you think you have problems with China, the Middle East, and the rest, brace yourself because you haven't seen anything. … The capacity is just endless in South America.'"

Tobacco factories in Paraguay range from sprawling, state-of-the-art manufacturing plants that boast cutting-edge technology to miniature "mobile" factories — also called submarines — which are assembled inside of trucks. Paraguayan government officials say that if all cigarette-making machines in Paraguay were to work at maximum output, the country could produce up to 100 billion sticks annually — enough to supply about two-thirds of the Brazilian market.

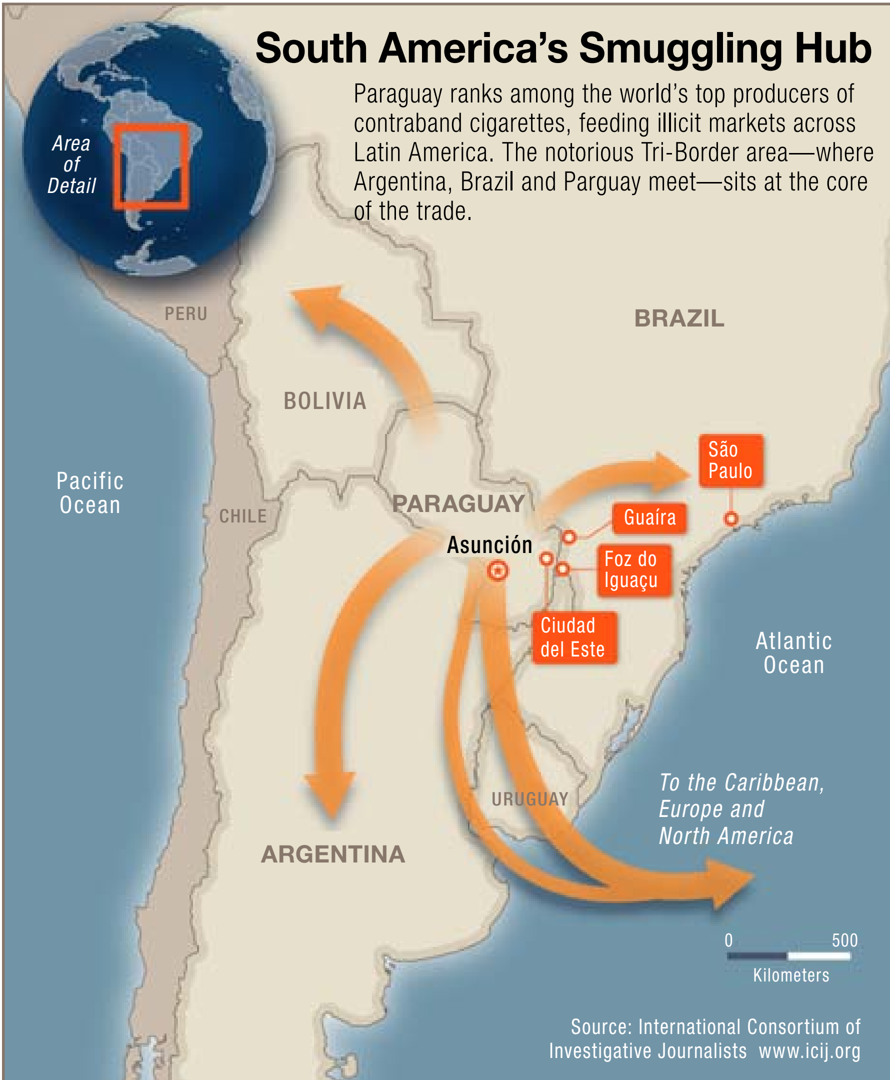
Smuggling is made easy in Paraguay, officials confide. There is virtually no industry regulation, and illegal manufacturers and traffickers are often insulated from prosecution by those in power. Bankers, politicians, and soccer club barons are themselves involved in the business and make hefty campaign contributions. Although the administration of President Fernando Lugo — a former Catholic bishop who in 2008 unseated the powerful Colorado Party after more than 60 years in power — has pledged to change the country's reputation as a smuggling haven, there already have been some mishaps. In February, the president named a convicted cigarette smuggler as his Air Force intelligence chief. Lugo later backed off amidst intense criticism.

A SMUGGLER'S PARADISE

Cigarettes are just another commodity peddled through Paraguay's decades-old underground economy, which flourished during the 35-year dictatorship of Alfredo Stroessner. Before he was forced from power in 1989 in a military coup, Stroessner made the country a sanctuary for Nazi war criminals, deposed dictators, and smugglers.

The Tri-Border Area of Paraguay, Brazil, and Argentina is the epicenter of this contraband culture. A corridor for drugs, weapons, stolen cars, and any imaginable knock-off — from CDs to Viagra — this region of thick, green rainforests and spectacular waterfalls has also become the backdrop for the booming trade in smuggled and counterfeit cigarettes made in Paraguay.

"The only thing that flourishes here is illegality," says Humberto Rosetti, a prosecutor in Ciudad del Este, the commercial center of the Tri-Border Area, often regarded as one of the most lawless places on earth. The city's downtown is a bustling labyrinth of narrow streets cluttered with thousands of street stands, money exchange houses and shops, where anything from exotic pets to AK-47s can be obtained with almost equal ease. Late-model Mercedes and BMWs sporting polarized windows rush by and scores of motor scooters, some of them transporting entire families, weave through the ubiquitous traffic jams. In the Calle de los Cigarrilleros, as locals have christened one of the city streets, boxes of Eight, Te, Rodeo, Calvert — the smugglers' favorite brands — are stacked high along the sidewalk. "Our hands are pretty much tied," says Rosetti, who has directed several cigarette seizures in recent months, only to see judges and customs officials promptly return the loads to smugglers.



Graphic by www.stephenrountree.com

Brazilian customs pulverize 500,000 packs of seized cigarettes a day. Remains of contraband cigarettes are later used in fertilizers and to build roads.
Credit: Marina Walker Guevara

U.S. officials regard Paraguay as a principal money laundering center for the proceeds of drugs, arms, and cigarette trafficking in South America — and Ciudad del Este sits at the core of that trade. Cigarette factories are often linked to money exchange houses where profits of the contraband are laundered, according to former factory managers and court records. So impenetrable is Ciudad del Este's financial system that American undercover agents who infiltrated Roque Silveira's U.S. smuggling ring were unable to find the money they helped the group launder. "We tried to track the proceeds," says Assistant U.S. Attorney James Warwick. "Did we succeed? No."

Several Paraguayan cigarette firms have conveniently built factories in Ciudad del Este and nearby Hernandarias. From there, cigarettes for years were smuggled to Brazil in vans, trucks, and buses through the shabby Friendship Bridge that connects Ciudad del Este with its Brazilian counterpart, the city of Foz do Iguaçu. Brazilians stepped up controls at the border in 2005, so smugglers switched from the road to the water. Starting at dusk, motor boats leave through any of the more than 300 makeshift piers fashioned along the nearby Lake Itaipú, formed by the dam of one of the world's largest hydrological power plants, built on the Paraná River. To reach some of these illicit piers, one must navigate a maze of tortuous and narrow red-dirt paths through dense underbrush. One afternoon in March, ICIJ reporters visiting the seemingly deserted Codorso Pier came across a government worker smoothing out the smugglers' trail with the help of his tractor. Reporters were told the smugglers were taking the day off to mourn one of their own, a former policeman, who had died in a car accident the day before.

"We close one pier, and two more pop up overnight," says Gilberto Tragancin, chief of Brazil customs service in Foz do Iguaçu. With a shoreline of nearly 1,000 miles, Lake Itaipú is almost impossible to patrol in its entirety, Tragancin explains. A few yards outside of Tragancin's office, a 'cigarette trashing' machine was in motion. The loud contraption pulverizes about 500,000 seized cigarette packs every day — the remains of which are used in fertilizers and to build roads. The flow of Paraguayan contraband cigarettes to Brazil is 20-30 billion sticks annually, experts estimate. In contrast, says Tragancin, legal exports of cigarettes to Brazil are zero.

Besides the public health threat it poses, cigarette smuggling is also bolstering violent organized crime groups that operate complex networks along the border with Brazil. Tragancin says these groups are now using the cigarette smuggling channels to supply weapons and munitions to some of Brazil's most dangerous syndicates, including the First Command of the Capital (PCC), the leading criminal gang in Sao Paulo prisons.

THE TRADE GOES GLOBAL

International smugglers quickly spotted an opportunity in the booming Paraguayan illicit tobacco trade. Washington state-based cigarette wholesaler Stormmy Paul, a Tulalip Indian, flew to Paraguay in 2003 to cut a deal. He had been buying Chinese cigarettes, including counterfeit Marlboros, and re-selling them tax-free to smoke shops in his state, but he wanted a better combination of price and quality. A business partner from Brazil offered to make some introductions south of the border.

In Paraguay, Paul visited a handful of cigarette factories. One facility stood out: the heavily guarded Tabacalera Central in the outskirts of Asunción. The visitors were greeted by owner Roque Silveira and feted with a lavish barbecue. By the time dinner was completed an agreement had been sealed. Paul would pay $2 for each carton of cigarettes manufactured at Silveira's facility and an additional $2 per carton to a middleman in Maryland who altered customs forms to avoid controls, and taxes, at U.S. ports. The deal still left Paul a $2 per-carton profit.

"I loved it down there," said Paul, an enterprising, voluble fellow who leads a weekly ritual at a sweat lodge on the Tulalip reservation, north of Seattle. He found Silveira impressive. "He is a really sharp business guy," said Paul of Silveira. "There is a certain class about him — Roque looks successful."

Starting in late 2003, the ring of 11 people, most of them American tobacco traders, smuggled into the United States more than 120 million Paraguayan cigarettes, for distribution from California to North Carolina, according to court records. The ring was brought down in spring 2005 as the smugglers convened in Las Vegas. Silveira, Paul, and the others were indicted on a total of 50 counts of conspiracy, smuggling, trafficking, and money laundering. U.S. officials jailed Silveira for two months after his arrest at the Miami airport, but the Brazilian pledged to cooperate with authorities and was handed a probationary sentence. Silveira paid a fine and, to the amazement of Paraguayans, was let go.

RIVER OF THE DEAD

Around the same time the Americans gave Silveira a slap on the wrist, Brazilian prosecutors indicted him in one of the largest-ever cigarette smuggling investigations in that country. Codenamed Operation Fireball, the sting rounded up more than 90 people in 11 Brazilian states. In the indictment for the case, Silveira was fingered as a major supplier of contraband cigarettes who allegedly controlled three different networks that delivered the sticks to the populous Rio Grande do Sul state. Silveira managed to evade the law simply by staying in Paraguay, where, Brazilian prosecutors alleged, he has "a vast network of contacts and the financial capability to live underground."

Silveira had become the top dog in the traffic of cigarettes from Paraguay to Brazil following the 2003 arrest and subsequent conviction of legendary cigarette smuggler Roberto Eleuterio "Lobão" Da Silva, a Brazilian who wore plenty of bling and looked like Mr. T, Brazilian police say. From that point on, in smuggling parlance, Silveira "owned" the routes that led to millions of smokers in Brazil's largest cities.

Two weeks after Operation Fireball, a Brazilian customs agent was murdered in a bleak, sparsely populated region of the border called Rio do Morte — River of the Dead. An anonymous caller tipped local police to a burned-out SUV on the road. So charred was the corpse in the passenger's seat that police couldn't readily identify the victim, who had been burned alive. Forensic experts eventually said the dead man was Carlos Renato Zamo, a resident of Mundo Novo, a city just north of Guaíra. He was one of thousands of customs agents working Brazil's porous borders. Throughout the years, however, Zamo reportedly had grown far richer than most on a typical border agent's salary. He accumulated real state investments in Sao Paulo and Mato Grosso do Sul. He even owned a plane.

Brazilian police discovered that Zamo had worked for Silveira and other cigarette smugglers, who allegedly paid the agent $8,000 a month to assure their cigarette cargoes passed uninspected through border checkpoints. But Zamo had begun to fear discovery and finally backed out of the ring, police said. In a meeting, the smugglers allegedly offered to raise his payment, but he refused and tipped off customs about the group's shipments, according to Brazilian police.

Four men were eventually arrested in connection to Zamo's murder, but not Silveira, who was wanted by Brazilian authorities but remained at large in Paraguay. The day police officials announced the arrests, they addressed Silveira directly, calling him "the big head" of cigarette smuggling in the region. "Everything happens under his orders," they said.

Through his attorney in Asunción, Silveira declined to comment for this article.

FILLING BIG TOBACCO'S SHOES

Paraguayan cigarette manufacturers like to point out that they are just filling a void created by large multinational tobacco companies. In the 1990s, British American Tobacco and Philip Morris ran independent schemes in which their subsidiaries in Brazil and Argentina legally exported billions of cigarettes to Paraguay. The sticks were then smuggled back to these two higher-tax countries and sold on the black market. The practice ended in 1999 when the Brazilian government raised the cigarette export taxes dramatically to discourage the illegal trade. Following the tax increase, dozens of cigarette factories opened in Paraguay, many of them owned fully or in part by Brazilians. Within three years, Paraguay was home to more than 30 cigarette manufacturing plants, some of which counterfeited well-known international brands.

Tabacalera del Este, Paraguay's top cigarette factory, features German machinery that can assemble 350 packs a minute.
Credit: Marina Walker Guevara

The local counterfeiting business has dropped markedly in recent years as cigarette makers realized that there was a market — in Brazil and around the world — for the cheap Paraguayan brands. The practice also carries less risk of being pursued by Big Tobacco companies for trademark violation. Today the number of manufacturing facilities has more than halved, but not so production.

Tabacalera del Este (Tabesa) Paraguay's top cigarette factory, a modern, sprawling 183,000 square-foot facility that can pump out up to 1.5 billion cigarettes a month — or 579 cigarettes per second. The factory, located a short drive north from Ciudad del Este in the city of Hernandarias, supplies almost half of the Paraguayan market with its two flagship brands, Kentucky and Palermo. But at the same time as it serves a legitimate market, the company allegedly supplies large quantities of cigarettes that end up smuggled to Brazil and Argentina. Customs officials in those two countries told ICIJ they seize more contraband cigarettes from Tabesa than any other Paraguayan company. In 2006, Tabesa was mentioned in Operation Fireball as one of the factories whose cigarettes were allegedly smuggled to Brazil.

Paraguayan businessman Horacio Manuel Cartes is widely reported to be the owner of Tabesa, and is listed as a top shareholder and director by Informconf, a Paraguay business database. Cartes started as a cigarette distributor two decades ago. Since then he has built an empire that includes a bank, a soccer club, and several agricultural ventures — some of these formally owned by family members and business associates.

Tabesa's CEO José Ortiz talked to ICIJ reporters about the company's business.

"We don't know where our cigarettes are consumed, and it's not our problem," said Ortiz when asked about the presence of Tabesa's cigarettes in Brazil and Argentina, two markets to which the company does not legally export. "We sell our products in Paraguay and pay all local taxes," he added, sitting in his office at Tabesa's manufacturing plant, which features high-end German cigarette machinery. What happens once the cigarettes leave the factory is not Tabesa's responsibility, said Ortiz, a view shared by other cigarette makers in Paraguay. "My job is to supply the market."

Ortiz said that Tabesa does not sell directly to vendors but rather to four or five wholesale distributors. He named two wholesale firms, one of which, Tabacos del Paraguay, is affiliated with Tabesa. "The rest, I don't remember," he said, reclining on his large black leather office chair and switching the focus to multinational tobacco companies: "They are the parents and the grandparents of the creature," said Ortiz of BAT and Philip Morris' smuggling in the 1990s. "We are replacing that market they abandoned."

Last year, the company broke into the U.S. market with its Palermo brand and is now certified to sell in at least eight states, including Maryland and California . Palermo is also available online through websites selling cigarettes from Indian reservations in New York, but Ortiz denied that Tabesa is selling to Native Americans directly. U.S. officials have identified New York reservations as major hubs for cigarette smuggling.

GUAÍRA: NO MAN'S LAND

Brazilian prosecutors and police place the Paraguayan factories at the top of the "criminal enterprise," which they say runs high-volume cigarette smuggling in the region. Érico Saconato, head of the Brazilian federal police in Guaíra, said that the factories work hand in hand with "managers" on both sides of the border who acquire trucks and boats, bribe public servants, and hire scores of youths, fishermen, and farmers to transport the cigarette loads. In one of the cases involving Silveira, prosecutors said in court documents that the ring acquired large quantities of contraband cigarettes "directly from the Paraguayan factories" for distribution in Rio Grande do Sul and border cities of Argentina.

"All the smugglers, big-time traffickers, in this region are businessmen and politicians, who have good lawyers, fancy cars, family," says

Saconato. "Some even are leaders of evangelical churches."

Roque Silveira's hometown of Guaíra gained prominence in the cigarette trade when controls tightened in the Tri-Border Area, starting in 2005. Today large portions of the population there, Guaíra officials say, rely on smuggling for their livelihood, whether it's renting space in their homes for the smugglers to store their loads, working as lookouts, or passing cigarettes across the Paraná River. The "paseros," or crossers, make about $300 a week, one and a half times the minimum monthly wage in Brazil.

Police in Guaíra say they feel overwhelmed. Saconato says 700 people were arrested in 2007 in connection with smuggling, yet only two men were convicted. When the district attorney shut down a riverside bar, Tininha's, which allegedly was widely used by smugglers to plan their business, a federal prosecutor reversed the order and sued the city. That night smugglers celebrated by launching fireworks on the riverside, officials say.

"Guaíra is practically abandoned," says Saconato, who anticipates record cigarette seizures this year due to the global financial crisis and a recent rise in cigarette taxes in Brazil. In the kiosks of Sao Paulo or Rio de Janeiro, the cheapest Brazilian cigarette pack (valued at roughly $1.50) costs three times as much as the contraband Paraguayan brands.

"A BIG DUTY FREE STORE"

No policeman in Guaíra has seen Silveira in recent years, Saconato says. He has become a mythical character of sorts, with town residents claiming from time to time to have spotted him. His 1996 murder case is still meandering through Guaíra's courts. After Operation Fireball, Silveira became a ghost, Brazilian police say, but no one believes he has retired from the cigarette trade. Some of Silveira's former associates now manage large portions of the smuggling on both sides of the border, according to Brazilian police.

The latest traces of Silveira in Paraguay's courts are from July 2007, when he beat the legal system again. On that occasion, Paraguay's Supreme Court denied an extradition request by Brazilian prosecutors who accused him of conspiracy, cigarette smuggling and money laundering.

Just the mention of Silveira's name in Paraguay's tobacco circles raises eyebrows and causes interviewees to clear their throats repeatedly before offering a noncommittal "His name sounds familiar," or "Didn't he own a cigarette factory around here?"

One man in Salto de Guairá, a Paraguayan city located just across the river from Guaíra, is not hesitant to talk about Silveira. Sidronio Talavera, a professional harpist who once played with one of Paraguay's most famous bolero bands, sits in a small office from where he manages his cigarette factory, Cosmopolita S.A. The facility is rather old and the cigarette-making machines are housed in a warehouse across a dirt yard from Talavera's office. A truck was picking up cigarettes at the factory the afternoon ICIJ reporters visited in March. Talavera says he not only knows Silveira, he is also his business associate. "He is one of the nicest people I have ever met," beams Talavera, who was convicted last year of tax evasion. Paraguayan prosecutors accused Talavera of reporting fake cigarette exports to Brazil in order to avoid paying taxes on imported cigarette manufacturing supplies. He has also been fingered by Paraguayan officials as a counterfeiter, a charge he denies.

Talavera says he sells to anybody who knocks on his factory's door, and he's well aware that some of the buyers are smugglers or work with smugglers. "Good for them if they send the cigarettes to Brazil," he says slapping his hands down on his desk. "If I have too many requirements, I will starve." Talavera boasts that his Latino cigarettes have found a market as far away as Dubai. He says that wholesalers based in Panama buy from him and then ship the cigarettes overseas. "I don't know if from Panama they are smuggled elsewhere or re-sold legally, and I don't care. I care that I sell."

As for Silveira, Talavera says he is still the trade's big intermediary, the middleman who acquires large quantities of cigarettes from the Paraguayan factories and arranges the deliveries in Brazil. "He works with everybody!" he says when told that other cigarette makers seem oblivious these days to Silveira's whereabouts. "He is smart, the Mafioso. He fooled the Americans," says Talavera.

As things stand, the Paraguayan government, which says it's determined to bring the cigarette industry under compliance, has its work cut out for it. Ortiz, Tabesa's CEO, put it simply. "Paraguay is like a big duty free store," he said. "And it's a great deal."

Daniel Santoro contributed to this report.

When Cracking Down Seems Impossible

PARAGUAY'S CORRUPTION FUELS A CRIMINAL ECONOMY

By Marina Walker Guevara and Mabel Rehnfeldt

Published Online | June 28, 2009

PARAGUAY'S Customs chief, Carlos Rios, knew he would get a lot of heat from the tobacco industry, but he decided to move forward with the raid regardless. After all, he was part of a new administration that had pledged to end the country's deeply rooted smuggling culture. So on February 6, 2009, Rios coordinated the largest cigarette bust in Paraguay's history: 46 million "sticks," stored in a shabby, illegal warehouse located one block away from the border with Brazil, in the desolate area of Pindoty Porã. As officers burst onto the scene, seven cigarette-laden trucks idled, preparing to cross into Brazil. Police opened fire as one driver revved his engine and sped across the border.

It was an enforcement operation that wouldn't raise eyebrows in most countries. But the raid proved an exceptional event in Paraguay, a country that for decades has been branded paraíso de contrabandistas — a smugglers' paradise. Cigarette seizures rarely occur in Paraguay, where tobacco factories are owned by the some of the country's richest and most influential. The country produces far more than the 3 billion cigarettes its residents consume; 68 billion cigarettes were manufactured in 2006, the bulk of which ended up smuggled to neighboring countries and beyond, according to law enforcement officials. After the Pindoty Porã seizure, even President Fernando Lugo — a former Catholic bishop who in 2008 was elected on a reform platform — congratulated the customs agents who took part in it.

The celebrations did not last long. As the press coverage faded, Rios quietly replaced the core of the anti-contraband unit that had conducted the cigarette raid, a section of Paraguayan customs that receives financial assistance from the U.S. government. He scrambled to explain that the agents had not effectively stopped the influx of contraband seeping into Paraguay from neighboring countries. Meanwhile, a vociferous chorus of prominent cigarette manufacturers — whose smokes were caught in the seizure — worked behind the scenes, enlisting influential politicians to lobby for their products' return. In May, after a local wholesaler paid a bond of almost $300,000, customs returned all 46 million seized cigarettes.

UNACCOUNTABLE INDUSTRY

The raid had reaffirmed a precedent for an industry accustomed to minimal accountability. "The seizure was a media show," said José Ortiz, CEO of Tabacalera del Este (Tabesa), the top cigarette factory in Paraguay. Tabesa is reportedly owned by Horacio Manuel Cartes, a high-powered businessman whose holdings include a soccer club. The company's cigarettes are routinely seized from smugglers in Argentina and Brazil, according to customs officials in those countries. But the cigarettes in Pindoty Porã were legal, Ortiz said, as long as local cigarette taxes had been paid and the sticks were on the Paraguayan side of the border.

The investigation remains open and customs may ultimately fine the wholesaler for attempted smuggling. But the case illustrates the virtually impossible task of cracking down on crime and contraband in a country where law often takes a back seat to power and cash. Paraguay ranked near the bottom — 138th among 180 countries — of Transparency International's 2007 Corruption Perception Index.

The tobacco industry in Paraguay is virtually unregulated. Government agencies involved in its oversight cannot even seem to agree on the number of factories operating in the country. The minister of taxation, Gerónimo Bellasai, told ICIJ that tax evasion by tobacco factories is "very high," but in March his team was still trying to figure out how to track company sales. A basic step to improve traceability, officials say, is to update the country's arcane cigarette tax stamp system. Currently tax stamps — square pieces of white paper that are easily photocopied — are affixed on master cases of 10,000 cigarettes rather than on individual packs. But even this can be hard to accomplish. "When there's a lot of money on the other side, the tax authority always loses," Bellasai said.

Back in customs headquarters overlooking the Paraguay River, Rios, the customs chief, spoke of his daily “titanic fight” for resources to run his agency. Paraguay operates only 10 check-points along more than 800 miles of border with Brazil, he said. And for customs agents who earn as little as $300 a month the temptation to accept bribes is overwhelming. “We are defenseless,” he said. Rios has been criticized by the media, however, for not using the resources he does have, including a fleet of speedboats donated last year by the United States, some of them reportedly kept for months at the manufacturer’s plant while smuggling soared.

In a country where the cigarette industry carries such clout, those who actively pursue smugglers can find themselves out of a job. Prosecutor Eber Ovelar was suspended in March from his post, and he said he had no doubt the move was politically motivated, linked to his anti-contraband work. During his tenure, sentences for counterfeiting and contraband in Ciudad del Este — a commercial city at the heart of the notorious Tri-Border Area of Paraguay, Argentina and Brazil — increased six fold, Ovelar said. More often than not, the prosecutor said, customs officials refused to classify smuggling cases as a crime, opting instead for the lesser category of infraction. To Ovelar’s dismay, local judges often sided with customs when he attempted to prosecute smugglers. “Today cigarette [makers] in Ciudad del Este have become the pressure and money group,” said the prosecutor. In contrast, he added, traffickers of narcotics have never personally applied pressure to him.

NO LONE RANGERS

Former prosecutor Eduardo Petta got a taste of the politics behind cigarette smuggling back in 2005, while pursuing contraband cases in the southern city of Encarnación. One morning he saw suspects in a small plane preparing to take off from a municipal runway. Acting without police backup Petta drove his car across the airstrip and blocked the airplane’s way. Inside the plane, Petta reportedly found 8 million contraband cigarettes. Lacking equipment to search for drugs in the aircraft, he requested assistance from Argentine border agents, who provided a drug-sniffing dog. Shortly after the seizure, Petta was accused by his superiors of having violated Paraguay’s sovereignty by seeking help from the Argentine officials, and he was removed from his post by a judicial review board. He later told reporters that he had no doubt the tobacco industry had urged his dismissal. "You can't play lone ranger," Petta told the Argentine newspaper La Nueva Provincia.

José Ortiz, CEO of Tabacalera del Este. "We give them money," he said of politicians during election time. "And all we ask is to be left alone." *Credit: Marina Walker Guevara*

Brazilian and Argentine customs and police officials say they are frustrated by Paraguay's lack of commitment to stop cigarette smuggling. But they also acknowledge faults in their own governments' enforcement. Trucks loaded with Paraguayan cigarettes are supposed to pass through several Brazilian check-points along their more than 600-mile journey to Sao Paulo and other large cities. "There's no [political] will to combat this sort of crime," said Érico Saconato, the head of the Brazilian federal police in the border city of Guaíra, which in recent years has become a major corridor for the smuggling of cigarettes from Paraguay. "We know smuggling is one of the sources for campaign financing in Brazil. So, there's not much interest in messing with it," added Saconato.

Meanwhile, Paraguayan cigarette manufacturers are earning stunning profits while denying any involvement in smuggling or counterfeiting (Brazilian law enforcement officials, however, link the Paraguayan factories directly to the illicit trade). Those who pursue civil charges against factory owners face endless judicial battles. British American Tobacco has repeatedly sued a tobacco company owned by former presidential candidate Osvaldo Domínguez Dibb for counterfeiting several of its brands. Some lawsuits have slogged though courtrooms for as long as 11 years.

Tabesa's CEO Ortiz was blunt when asked about Paraguay's quid pro quo: "We give them money," he said of politicians during election time. "And all we ask is to be left alone."

Canada's Boom In Smuggled Cigarettes

INDIAN TOBACCO FACTORIES, ORGANIZED CRIME CONTROL A BILLION-DOLLAR BLACK MARKET

By William Marsden

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GARY GODELIE has been a tobacco farmer most of his life, struggling to keep alive a family farm that produces what most everyone agrees is a death crop. Whacked by global competition undercutting his prices, not to mention a dwindling number of Canadian smokers, he often thinks of getting out of the business.

Nothing brought this thought home more clearly than a series of events that began one hot July day in 2006 when two men drove up to his southern Ontario farm and offered to buy his entire crop. That surprised Godelie because anybody in the tobacco business would know that Canadian growers are part of a tightly regulated quota system. Buyers have to be federally licensed and can buy only through the marketing board.

"I said, 'Well no. I can't sell you tobacco. I have to sell it to the legal system,'" Godelie recalled. "They kind of looked at me and laughed and like said, 'Why would you want to do that when we're offering you cash money, a deal here, you know.' 'Well, no, I'm not going to do that kind of stuff.'"

The two men drove off and Godelie thought that was the end of it.

Then a few days later he had to fetch some irrigation equipment from a barn where he had stacked 169 bales that were over quota from last year's tobacco crop. He hoped to sell the surplus bales at auction that winter as part of the current year's quota. The first clue that something was wrong came when he saw his hydraulic forklift sitting on the hood of his tractor. In his mind he blamed his son-in-law. But then he thought that that wasn't typical, that his son-in-law wouldn't have done something like that. Then he switched on the light and saw why he knew in his heart that something wasn't right.

"I stood there kind of flabbergasted for a minute and then I scanned over the stacks and then it hit me, oh, no, they had cleaned out the barn completely."

It had rained the previous night so Godelie hadn't gone out to irrigate. That was the night they nailed him. He said he figured that at 40 pounds a bale it took them maybe 20 minutes to clean him out. "They stole all 169 bales, which… is (about) 8,000 pounds. It takes about 1.9 pounds to make 1,000 cigarettes. That's more than 4 million cigarettes. That's pretty significant. Now we're talking some serious coin. For me it was about a C$20,000 loss" (or roughly US$18,000 at the time).

It wasn't long before Godelie began hearing about other tobacco farmers getting hit. The thefts became so widespread that farmers began installing security systems, barring barn windows, and parking disabled tractors in front of their barn doors. But to little effect.

"Now they are so brazen they take chain saws and they cut the side walls out of the barn," said Linda Vandendriessche, chair of the Ontario Flue-Cured Tobacco Growers' Marketing Board and herself a tobacco farmer. "It's no joke. You will not believe the intimidation that is going on with our farmers."

A RUNAWAY BLACK MARKET

The thefts are the result of a new brand of tobacco smuggling that has flooded the Canadian market with contraband cigarettes and cigarillos made by clandestine manufacturers in Canada and the United States. Over the last six years, as Ottawa and provincial governments began hiking tobacco taxes to curb smoking and raise funds, the smuggling business has grown "exponentially," according to the country's national police force, the Royal Canadian Mounted Police (RCMP). At a time when a crumbling economy has forced governments into deficit financing, Canadian smugglers — dominated by members of Indian tribes and in some cases their mob partners — are pocketing hundreds of millions in profits. The cheap cigarettes not only fuel the spread of smoking, which costs Canadians more than C$4 billion annually in

Canadian Indian reservations have become hot spots for illicit tobacco manufacturing, selling, and smuggling. Among the key sites: the Akwesasne, Kahnawake, and Kanesatake reserves near the U.S.-Canada border.

health care, but also rob governments of money that otherwise would go into official coffers to pay for healthcare and other services. The federal, Quebec and Ontario governments alone claim the proliferation of untaxed cigarettes is costing them at least C$1.6 billion a year

The size of this tobacco-fueled black market is huge. Both industry and government studies indicate that, across Canada, two to three cigarettes out of every ten sold are now contraband. According to the most recent study, by Physicians for a Smoke Free Canada, contraband in 2007 made up 27 per cent of the Canadian tobacco market. In Ontario and Quebec the figure climbs as high as four out of ten. This conforms with an earlier study done by the nation's health ministry, Health Canada. "We're making more cigarettes than Imperial Tobacco [Canada's leading tobacco company]," boasted one Indian smuggler.

All those contraband cigarettes

are fueling a black market conservatively estimated at C$1.3 billion, with profit margins rivaling those of narcotics. And the market is growing rapidly. Seizures of contraband tobacco in Canada jumped a whopping 16-fold between 2001 and 2006, according to the RCMP. The off-the-books smokes range from independently-produced cigarettes sold in plastic bags to expertly counterfeited packs of leading brands. In some cases cheap Indian brands have become so popular that rival Indian manufacturers are counterfeiting them.

So vast are the profits, and so poorly are the laws enforced, that the contraband tobacco industry has attracted an unholy alliance of Canadian Indians — who say they have the right to sell untaxed cigarettes — and members of various organized crime gangs, according to law enforcement officials and the smugglers themselves. At the center of the trade are about 20 Indian-owned manufacturers that produce millions of untaxed and unregulated cigarettes a day out of small and medium-sized factories at Indian reserves in Ontario, Quebec, and across the border in New York State. An investigation by the International Consortium of Investigative Journalists has found that outlaw bikers, Italian, Irish, Russian, and Asian mobs are also now involved in the manufacturing, distribution, and retailing of the illicit tobacco products. According to Indian smugglers and police, in some cases the capital to buy the equipment and set up operations was fronted by organized crime.

Recent joint U.S.-Canadian police investigations indicate that drug money has been used to finance the tobacco business. Tobacco profits are likewise used to buy cocaine and marijuana, which are smuggled across the border using the same networks as for tobacco. Large cash seizures are common at the border and along Highway 401 in Ontario, which has become a smugglers' pipeline to Montreal and Toronto.

In March 2008, federal, provincial, and Mohawk police in three reserves — Akwesasne, Kahnawake, and Kanesatake — seized about C$2 million in cash after raiding a cigarette/marijuana smuggling operation. In just two seizures on Nov. 17 and Dec. 7 last year, Canadian Border Services agents seized C$636,467 in U.S. and Canadian funds hidden in vehicles driven by Indians from Akwesasne, the reserve that straddles the border between Ontario, Quebec, and New York. In addition, the RCMP on Feb. 19 seized US$260,000 from an Indian driving from Akwesasne to Quebec. Police believe that the cash is linked to drug sales into the United States.

MADE IN CANADA

While Canadian officials have complained to their U.S. counterparts that most of the illegal cigarettes are produced on the U.S. side of the Akwesasne reserve, the Center for Public Integrity has found that this is no longer true. According to Indian sources and visits to manufacturing plants by the Center, the operations have shifted to Canadian reserves in Quebec and Ontario.

Ironically, it was a major tobacco company, Imperial Tobacco, that supplied Kahnawake with the reserve's first cigarette making machines when the British American Tobacco subsidiary sold off surplus machines at its Montreal plant in 2003 and moved its operations to Mexico. "They not only supplied the machines, but they came on the reserve and showed us how to work them and blend the tobacco," said one smuggler who didn't want his name used. Imperial Tobacco admitted that it sold surplus machines to the Mohawks, but claimed the company later got them back. Only licensed companies can operate tobacco machines in Canada.

Some producers operate in clandestine warehouses and garages or makeshift shacks located along the back roads in Indian communities. Others are sophisticated plants sporting reconditioned British-made cigarette machines known as Mark-9s, each capable of producing 3,500 to 5,000 cigarettes a minute.

The illicit operations have in some communities become important local employers for both Indians and non-Indians alike. Workers daily earn C$100 and C$150 cash for bagging cigarettes and C$175 to C$200 a day for working the machines, several workers said.

In the Mohawk community of Kahnawake, which has a population of about 8,000 and is located just south of Montreal, Chief Rhonda Kirby, who is responsible for the Mohawk reserve's tobacco industry, estimated that the business employs more than 2,000 people in manufacturing, distribution, wholesale, and retail. Many of the workers are non-Indian.

"We have so many non-native

community members working here and then of course relationships start up, so now that's another problem," she said.

Both Kahnawake and Akwesasne are traditional Mohawk communities that bar non-Indians from living among them and jealously guard what they consider their ancient right as a sovereign people to freely cross borders, trade with whomever they want, and not collect or pay taxes.

A long history of racism against Canadian Indians — or First Nations peoples — has also played a role in hardening Mohawk attitudes and creating a climate of distrust. Kahnawake in particular has been quick to react when it believes Canada has violated these sovereign rights. The Mohawks have retaliated by blocking highways through their community as well as the Mercier Bridge, one of the main links between the island of Montreal and the mainland. Police generally won't enter the Mohawk reserves without permission from the tribal council. To a degree, this has encouraged organized criminals to use the reserves as a safe haven and a trans-border pipeline, say law enforcement officials.

The smuggling of drugs, aliens, and guns, as well as the establishment of internet gambling services, casinos and bingo halls, have all become contentious issues not only between Indian and non-Indian communities but also within the Indian communities themselves. Tobacco, however, is different. The Mohawks believe their right to trade this legal substance is sacrosanct. What's more, it brings wealth to otherwise poor communities. "The government's upset because we are punching out millions of cigarettes a day, and of course he wants his piece of the pie," said one contraband seller. "If they come in, we'll close the bridge again."

Four centuries after Europeans took control of the Indian tobacco trade, the First Nations are taking it back.

THE GANGS MOVE IN

In the early 1990s, when tobacco smuggling on Indian reserves was at record levels, the product came from the major manufacturers such as Imperial Tobacco, which is owned by British American Tobacco; RJR MacDonald, which at the time was owned by RJ Reynolds and is now owned by Japan Tobacco; and Rothmans, Benson & Hedges. The RCMP effectively shut down that pipeline by charging RJR and its executives with aiding and abetting smuggling. Rothmans and Imperial paid C$1.15 billion (US$1.12 billion) in fines and penalties to Canadian governments last year for their part in the early 1990s smuggling. RJR and some of its executives still face criminal charges.

With the major players out of the contraband game, the Indians have moved in and created a fully integrated business. The only part they don't control is tobacco farming. The success of Indian cigarettes, says tobacco farmer Godelie, reflects a sea change in market dynamics brought on by high taxes, which now make up about 75 percent of the cost of a legal cigarette.

"That really started to send a message to everyone in the world of tobacco that the consumer in Canada went from taste-sensitive to price-sensitive," he said.

But as Godelie learned three years ago, the tobacco business can be organized crime at a worrisome, reckless level. At the heart of it all is the 12-mile stretch of the U.S.-Canada border that runs through Akwesasne. It is a major security soft spot with marijuana and cocaine flowing south while tobacco and, sometimes, weapons come north. The fact that goods can pass from the Mohawk community of St. Regis on the U.S. side to Akwesasne on the Canadian side and then enter non-Indian communities unchecked is a major problem for authorities. When the St. Lawrence River ices over, smugglers take a winter road between the two communities. When the ice melts, the speedboats come out. In one February case, U.S. authorities arrested 10 people, alleging they were part of a ring that smuggled 50,000 pounds of marijuana through Akwesasne and into the United States from 2003 to January of this year. One of the ringleaders has a tobacco manufacturing license from the Canadian government.

In a 2008 report on tobacco enforcement strategy, the RCMP found that the "current trend of manufacturing, distributing and selling contraband tobacco products, which has exponentially developed over the last 5 years, involves organized crime networks exploiting Aboriginal communities." The RCMP claims there are "approximately 105 organized crime groups of varying levels of sophistication" involved in tobacco smuggling. The agency defines organized crime as three or more people conspiring to commit a serious criminal offense for financial or material benefit.

Indian leaders have taken exception to the allegation, claiming that it implies that their community members are all criminals. Yet Mohawks involved in the tobacco business told the Center said that organized crime plays a major role in the contraband tobacco. "Everybody knows we do have organized crime here," said Chief Kirby. In fact, some smoke shop owners want to get out of the business, she added, but have been forced by the gangs to stay put. "The mob is involved with some of the individuals — the Mafia and the Irish mob and the Russian mob and the Chinese mob."

The Hells Angels have financed several manufacturing operations in Kahnawake, Indian sources told the Center. This month, the RCMP ended a year-long investigation in Quebec with the arrest of 22 people, including two Hells Angels and two Mohawks from Kahnawake. They are charged with conspiracy and trafficking in contraband cigarettes and drugs, including cocaine, ecstasy, marijuana, and methamphetamine.

One prominent tobacco seller, who calls himself Splicer, agrees with the RCMP that the mob has infiltrated the illicit tobacco business. "I agree with them 100 percent that, yes, there is mafia in our community," said Splicer, who has moved contraband tobacco for 20 years. Organized crime, he explained, finances manufacturing plants and many of the retail smoke shops, most of which are little more than plywood shacks or converted shipping containers.

CONTRABAND BAGGIES

More than 150 Indian smoke shops crowd the nine-kilometer strip of Highway 138 that runs through the heart of the Kahnawake reserve. With names like Mega Butts, Get 'n' Go, and Another Dam Cigarette Store, they serve the relentless flow of commuters between Montreal and its southern suburbs. They sell predominantly re-sealable bags of no-name cigarettes and Indian brands such as Native, Montcalm, Broncos, and DK's, most of which, Splicer said, are made on the reserve.

The price of a carton of legal cigarettes in Canada varies between C$60 and C$80, depending on the province. Indian-made brands cost from C$12 to C$35, and no-name brands, which come in re-sealable bags, sell for as low as C$8 for 200 cigarettes. (Competition in Kahnawake grew so intense last year that baggy prices sank to C$6 before the Kahnawake Tobacco Association imposed price controls with a C$10 minimum. Still, the Center found some retailers selling for C$8.)

In addition to Kahnawake, police claim about 11 Indian manufacturers are operating on the Canadian and U.S. side of the border at Akwesasne. The Center tried to track down these operations but could locate only two that were still in operation. Officials say there are also manufacturers on the Six Nations Reserve near Brantford in southwestern Ontario and the Tyendinaga reserve near Belleville, Ontario.

Many of the tobacco manufacturers have their own websites on which they advertise their products and where they can be purchased. Jacobstobacco.com, the website for the Jacobs Tobacco Company on the U.S. side of Akwesasne, for example, boasts of a "state of the art facility" producing three "premium brands" under the name of "dis COUNT." The website states that the company regularly donates to community youth programs and health services.

The company's cigarettes line the shelves of Canadian smoke shops and are considered contraband by the Canadian government. Jacobs Tobacco is owned by CEO Rosalie Jacobs and her family, according to an affidavit she filed in a U.S. federal court. Her son Al Jacobs, known on the reserve as the "40-million-dollar man" and a veteran tobacco smuggler with convictions dating back to 1994, was indicted July 17, 2008, with five other men for the robbery and murder of a marijuana dealer in Stockholm, New York. Jacobs is in prison awaiting trial. His mother's business, which has addresses in both Pennsylvania and Akwesasne, still operates out of a new 47,000 square foot factory employing 72 Indians full time with a payroll of US$2 million, according to an affidavit signed by Rosalie Jacobs in U.S. federal court.

Jacobs Tobacco in 2007 opened an account at the Bank of Montreal on the Canadian side of the reserve. It is the only bank on either the Canadian or U.S. side of the reserve. In an affidavit, Jacobs said she opened the account to wire payments to her U.S. wholesale tobacco suppliers. On August 20, 2007, for example, she declared US$15,000 to border authorities and was allowed to take the cash into Canada where she deposited it at the Bank of Montreal. Three days later, she tried to take US$64,000 across the border into Canada. This time, however, when she declared the money to a U.S. border guard, he seized it and gave it to the Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF), which initiated a seizure proceeding.

Jacobs sued the U.S. government to get the money back, claiming that it was legally acquired from tobacco manufacturing and that she had at all times complied with U.S. law. The ATF, in turn, argued that Jacobs Tobacco's operations were illegal because the company had no license. The case was settled last year when Jacobs agreed, without admitting or denying guilt, to forfeit half the money — US$32,000 — while the ATF agreed to return the other half.

Rosalie Jacobs continues to deposit cash at the Bank of Montreal, according to police, and declares her funds to both U.S. and Canadian officials. Her company does not have a Canadian or U.S. license to manufacture and sell tobacco, although it says it has applied for one with U.S. authorities. It does, however, have a license from the St. Regis Mohawk Tribe. The tribal license is not recognized by Canadian or U.S. authorities.

"A BIG, COMPLEX, NASTY ISSUE"

Meanwhile, business on the Kahnawake reserve is growing so fast that the community now appears to have surpassed its cousins in Akwesasne. The Center found that Kahnawake has at least nine manufacturers. One worker, who didn't want his name used, said production varies but overall his shop processes about 5,000 pounds of tobacco each day using two Mark-9 machines — enough to make about 2.5 million cigarettes, or 125,000 packs worth.

Until recently the raw tobacco has been smuggled up through Akwesasne from North Carolina. But with the emergence of Kahnawake as a force in cigarette production, Splicer, the veteran tobacco dealer, said a lot of tobacco is coming through the Port of Montreal and the St. Lawrence Seaway, which goes right through Kahnawake. "We have all kinds of ways of getting tobacco here," Splicer explained. "We have the borders beat. We have customs beat. The international waters go right through our community… Take a ride up the riverfront and take a look, and you'll figure out how we get it in. We built our own docks. We can load and unload."

Just a few years ago, Indians hired companies in North Carolina such as the Timcorp Group of Charlotte to supply turnkey cigarette manufacturing plants, plus raw tobacco, filters and tips, say police. The company's website now says that it is out of business. A call to the firm, however, found it still operating. A receptionist said company President Dennis Makepeace would not reply to questions about his business with the Indians.

On March 14, 2006, St. Regis tribal police on the U.S. side of the Akwesasne reserve stopped three Bulgarian nationals in a vehicle owned by a prominent Akwesasne company, Mitchell Construction. According to the RCMP, one Bulgarian named Stoyan Ivanov Darzhonov, 34, told police they worked for Timcorp and had come to St. Regis to set up cigarette machines in a warehouse behind Mitchell Construction. Darzhonov also told police that two months earlier they had set up manufacturing operations for three companies, including Jacobs Tobacco and Native Trading Associates.

Native Trading's brands crowd the shelves of smoke shops in reserves in Ontario and Quebec. Its owner, Susan Jesmer of Cornwall, Ontario, has a U.S. license to manufacture her Native brand cigarettes. Through her Washington, D.C., lawyer Bill McGowan, Jesmer refused an interview. "It's a very sensitive subject. It's a big, complex, nasty issue," McGowan said in trying to explain why he didn't want his client to talk to the media. "The whole issues of Canada, etc., etc. … She just wants to follow the rules and not everybody is doing that."

Indian tobacco is mainly a cash business. During a reporter's visit to the offices of Native Trading in St. Regis, several people came in, were handed large wads of bills, and then quickly left. On February 19, 2006, St. Regis police stopped one South Carolina tobacco dealer and found a shoebox filled with US$70,000 in his car. According to the RCMP, the man said he got the money from Patrick Johnson, who is part owner of MHP Manufacturing, a St. Regis cigarette manufacturing company. Johnson's partner in the business is William Hank Cook.

Later that year, on November

20, a joint police task force arrested Johnson and Cook for tobacco and drug smuggling. Police claim they used profits from contraband cigarettes to buy Canadian-grown marijuana, which they smuggled into the United States. The drug profits were then laundered through MHP Manufacturing, police claimed. Cook pleaded guilty to charges related to drug trafficking and money laundering and was fined C$280,000. Johnson pleaded guilty to one smuggling charge and money laundering. He was fined C$350,000.

A FAILURE OF ENFORCEMENT

The RCMP strategy for combating cigarette smuggling is to target the ringleaders — those primarily responsible for manufacturing and distribution. At the same time police have tried to disrupt the flow of contraband by arresting couriers. So far, even officials admit this strategy hasn't worked.

Tribal councils won't shut down manufacturers because they don't regard them as illegal. Some have been shut down but only because their owners have also been arrested for drug smuggling. Since 2007, there have been 480 tobacco seizures in the region of Akwesasne and Valleyfield, just west of Montreal, netting 443 vehicles plus a number of firearms that include two AK-47 assault rifles, two M-16 machine guns and three grenade launchers.

In theory, penalties for smuggling tobacco in Canada can be quite severe. Federal fines range between 17 cents per cigarette and 25.5 cents, which adds up when you've got thousands of cigarettes jammed into a van. Added to that are provincial penalties that can double the fines. Failure to pay means up to 18 months in jail.

Trouble is, prosecutors say, smugglers often don't bother to show up in court, which means police have to go looking for them. And when the smugglers eventually do come to court and receive stiff fines of tens of thousands of dollars, they don't pay them. "In my four years doing these cases I have never seen anybody incarcerated for failure to pay a fine," Cornwall public prosecutor Ron Turgeon said, adding that nobody pays the fines. "Now I'm asking for prison for a second offense, but I'm still not getting it."

The province of Ontario funnels all the Akwesasne cases through a small courthouse that sits behind a beer store in the rural town of Alexandria, which is about half an hour from Cornwall. The Center tried to follow one person accused of smuggling, Oren Bigtree, through the court system, but he never showed up. “They get fined hundreds of thousands of dollars and nobody actually pays that money,” said Sergeant Michael Harvey of the Cornwall detachment of the RCMP. “They pay maybe $100 a month. It’s just crazy. We seize loads every day but there are 13 factories pumping out millions of cigarettes so it doesn’t make any dent.”

Chasing smugglers is a dangerous occupation. Last month a smuggler from Akwesasne tried to run over a Quebec police officer with his truck. The officer shot out a tire, arrested the man, and found an AK-47 in his cab. In November, an elderly couple from Massena, New York, was killed when a tobacco smuggler, chased by two Mohawk police officers, rammed their car. The smuggler also died in the collision that engulfed both vehicles in flames. In February, the police officers were charged with criminal negligence causing death and with dangerous driving.

Since the accident, tobacco seizures have declined because police are reluctant to chase smugglers, Sergeant Harvey said.

BIG PROFITS, BIG DEMAND

The weak enforcement, willing suppliers, and big demand suggest how hard it will be to change what has become a billion-dollar black market. Worse, with penalties and punishment modest at best, and profits rivaling those of narcotics, the biggest challenge may simply be the huge profits to be made. Individual smugglers, or runners, can cash in big. One 17-year-old runner testified at her bail hearing that she made three trips a day, six days a week, and earned about C$6,000 a week. She said she used the money to finance her cocaine habit.

Retailers also can make a good living. Splicer said his retail operation clears about C$130,000 a year selling contraband. Still, it’s not easy, he says. Splicer complains that he can’t hold any assets in his name or the government will seize them. He has no bank account and is forced to keep large amounts of money handy to pay his workers and suppliers in cash. “I can’t put my name up front because the government is going to come kicking my door in. That car

I own out there? It belongs to my last girl friend. I pay for the car payments but I can't own it in my name. And my business is not in my name. I burn all my stuff. We don't keep records in the stores. We burn paper. At the end of the day I log into a special computer and hide it on a chip. … The house I live in is not in my name. That's how I live. I'm nobody."

But he's someone to the Quebec government.

Tax collectors have assessed Splicer for an impressive C$25 million in unpaid taxes dating back to the early 1990s, when he ran millions of cartons of cigarettes into Kahnawake. Splicer said he reached a settlement agreeing to pay the government a mere C$150 a month against the debt. "They told me to sign an agreement to pay or go to jail for two years," he said. "I pay."

It's hard to believe that will make much of a dent in what has become a booming business. Throughout the conversation with Splicer, there is a constant flow of customers in and out of his smoke shop. They buy mostly the low-end discounted cigarettes that come in re-sealable bags. Twice during the afternoon, suppliers brought in fresh boxes each containing 50 cartons, or 10,000 cigarettes.

"I have been in this business since I was 16 years old," Splicer said, taking a drag from a premium brand cigarette. "When they rolled the first cigarettes into this community I was there on the water smuggling them in. I was armed with a machine gun in the bush to protect our loads. I remember all this. I ran the river. I did all that. Because this is what I do. This is who I am." ■

CORRECTION: The original version of this article reported that the company Brand-U Media is a tobacco manufacturer. Canadian government records, however, indicate that its activities involve publishing and combat sports. The Center also reported that Burton Rice is president of Mustang Distribution Ltd. Government records indicate that its president is his father, Peter Rice. Burton Rice is not listed as an officer or shareholder of the company. The errors arose out of a misreading of the corporate documents. The article published in this newsbook and posted on the Center's website has been revised accordingly.

Big Tobacco's New York Black Market

HOW AMERICA'S TOP CIGARETTE FIRMS FUELED A BILLION-DOLLAR UNDERGROUND TRADE

By Marina Walker Guevara and Kate Willson

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FOR NEW YORK Governor David Paterson, there was no good option. Faced with a crushing state deficit, angry American Indians, and uncooperative tobacco companies, Paterson on December 15 signed into law a bill designed to take on one of America's most lucrative black markets: the underground trade in cigarettes flowing through the state's 10 Indian reservations.

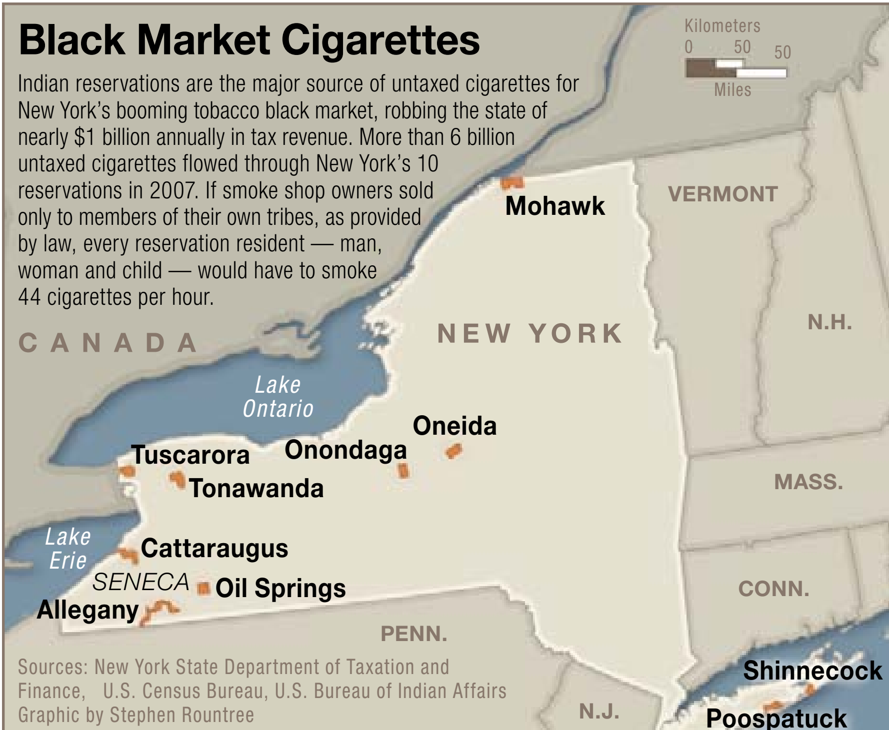
New York's 70-year-old tobacco black market exploded after 2002, as cigarette tax hikes encouraged smuggling from out of state and through reservations. The traffic is part of a nationwide boom in smuggled cigarettes, but the trade has reached a peak in New York. In 2007, one in three cigarettes sold in New York was channeled untaxed through Indian smoke shops, robbing the state and New York City of nearly $1 billion in tax revenue.

Ironically, this illicit trade has been protected in part by the state's own reluctance to enforce cigarette tax collection on reservations, a policy known as forbearance. Indians protested violently at the state's last attempt at collecting the tax in 1997, briefly shutting down the New York State Thruway. Since then, New York governors have vowed to end the black market, but ultimately have shied away from enforcing cigarette tax laws on reservation sales.

It remains unclear whether Paterson will be any different from his predecessors. If implemented, the new law will require manufacturers to supply only wholesalers that can certify that cigarettes won't be resold tax-free to reservations.

Black Market Cigarettes

Indian reservations are the major source of untaxed cigarettes for New York's booming tobacco black market, robbing the state of nearly $1 billion annually in tax revenue. More than 6 billion untaxed cigarettes flowed through New York's 10 reservations in 2007. If smoke shop owners sold only to members of their own tribes, as provided by law, every reservation resident — man, woman and child — would have to smoke 44 cigarettes per hour.



Sources: New York State Department of Taxation and Finance, U.S. Census Bureau, U.S. Bureau of Indian Affairs
Graphic by Stephen Rountree

Reservation	Population	Cigarettes purchased 2007	Cigarettes per resident per hour
Mohawk	2,699	133,062,200	6
Oneida	650	528,570,200	93
Onondaga	1,473	157,886,800	12
Poospatuck	283	2,263,354,600	913
Shinnecock	504	66,063,200	15
Tonawanda	543	400,075,200	84
Tuscarora	1,138	327,150,200	33
SENECA: Oil Springs, Allegany and Cattaraugus combined	9,227	2,511,910,800	31

The stakes are high. The law moves enforcement up the supply chain to the wholesale and manufacturing level, charging tobacco companies with ensuring that their products are not smuggled. “This means cutting off cigarettes at the factory door,” said Russell Sciandra, director of the Center for a Tobacco Free New York.

That may not be easy to do. Within hours of the bill’s enactment, Philip Morris USA, maker of Marlboro, criticized the legislation. “We applaud the government in trying to move forward with something … [but] we are not sure that is going to lead to tax collection,” said Joe Murillo, a Philip Morris counsel. Among the challenges Murillo cited: the state’s forbearance policy as well as current and possible litigation by wholesalers and Native Americans.

And then there’s the role of the big tobacco companies themselves, who in the past have shown a marked reluctance to ensure their products are not smuggled. “Cigarette manufacturers should not be expected to police the trade in untaxed cigarettes,” Lorillard, a leading tobacco firm, said in a December 9 statement.

In fact, for years, America’s three largest tobacco companies — Lorillard, Philip Morris, and R.J. Reynolds — have flooded New York Indian reservations with their untaxed cigarettes, despite ample evidence that those sales fueled a billion-dollar black market, an investigation by the International Consortium of Investigative Journalists (ICIJ) has found.

A three-month inquiry by ICIJ lays bare the role played by leading tobacco companies and their direct distributors as suppliers of the bulk of cigarettes sold untaxed on reservations. The investigation relied on internal company sales data, tax filings by cigarette wholesalers, and court documents, as well as interviews with law enforcement officials, cigarette wholesalers, and smugglers.

Consider these findings:

- As New York state struggled with a massive fiscal crisis in 2007, Lorillard, Philip Morris, and R.J. Reynolds funneled 4.3 billion tax-free cigarettes to smoke shops on New York Indian reservations — more than 25 percent of the companies’ combined total sales in the state.
- Although 43 manufacturers supplied reservations in New York last year, two-thirds of those cigarettes came from Lorillard, Philip Morris, and R.J. Reynolds, an analysis of tax data by ICIJ shows. Lorillard, maker of the popular Newport

brand, sold 40 percent of its cigarettes in New York through reservations — more than any other manufacturer.

- To distribute through the reservations, tobacco companies have relied on a handful of wholesalers who ship billions of untaxed cigarettes to Indian stores. One in three cigarettes sold in New York last year was channeled, untaxed, through these wholesalers, who are being sued by New York City for complicity in cigarette smuggling.
- Bootleggers and online vendors working with the reservations have netted, conservatively, an average of $500 million annually since 2000, according to ICIJ's analysis.

The cost of this trade is considerable: In 2007, New York state and New York City lost more than $850 million in cigarette tax revenue, according to an analysis by ICIJ. That money would have cut the state's 2008 fiscal deficit by half.

"The cigarette black market in New York is enormous, and it's brazen, and it's carried out right under the nose of the government," said Eric Proshansky, an attorney for New York City who has filed lawsuits against wholesalers and Indian vendors for their role in the illicit cigarette trade. So brazen are they, Proshansky added, that two New York smugglers are even suing each other in court over their illegal profits.

BILLION-DOLLAR BLACK MARKET

Experts say the size of New York's cigarette black market is exceeded only by the region's traffic in narcotics. And within the nation's illicit cigarette trade, New York likely ranks at the top, rivaled only by states such as California and Michigan.

Patrick Fleenor, who has studied the evolution of this underground economy as chief economist at the Tax Foundation, a nonpartisan tax research group, said New York's black market dates back to the city's first cigarette tax of one cent, in 1938. While in the 1960s and '70s cigarette bootlegging in New York was controlled by a handful of organized crime groups, including the Mafia, today the trade is much more fragmented, with groups including Dominican tax-stamp counterfeiters, African-American smugglers, and Middle Eastern vendors from Jordan and Yemen competing for the profits. "The potential for volatility is much greater," Fleenor said.

The incentive to smuggle is strong. New York has the highest cigarette taxes in the nation, cashing in at $4.90 per pack when state and city excise and sales taxes are factored in. For smugglers this means they can buy a pack of untaxed cigarettes on the reservations for $3, sell it for twice as much in a Bronx "bodega" — a mom-and-pop convenience store — and still beat the price of a 7-Eleven store in Manhattan.

"This is the new crack," says a former smuggler. "The money is easy, the charges are less."

"This is the new crack," says a former smuggler. "The money is easy, the charges are less."

The problem is not exclusive to New York. Officials across the country are wrestling with cigarette smuggling from Indian reservations, as they try to strike a balance between law enforcement and tribal sovereignty. The U.S. Supreme Court ruled in 1994 that although American Indians are allowed to sell untaxed cigarettes to members of their own tribe, states have a right to collect taxes on sales to non-Indians.

Native American legal advocates say reservations are sovereign territories, and centuries-old treaties prevent interference from the U.S. government. "Tribes never really have been a part of the legal or political system," said G. William Rice, professor at University of Tulsa College of Law and co-director of the Native American Law Center. "We have a treaty that says this is our house; what we do here should be our business; It's no different than Monaco being surrounded by France." Rice said, however, that Indian nations have no choice but in the end to comply with U.S. law. "When a bigger sovereign tells a smaller sovereign, 'We're going to do something,' what choice do we have?"

Some states are entering into agreements with the tribes that provide for either the collection of taxes or establish quotas for cigarette shipments. Arizona, with the highest cigarette tax rate in the Southwest, is trying to curb smuggling from the nation's largest Indian reservation, Navajo, as well as counterfeit cigarette flows from Mexico and smuggling from lower-tax states.

Washington state estimates it has lost at least $161 million to cigarette tax evasion in 2008 even as it tries to stem the tide by signing contracts with the state's 29 tribes. Oddly enough, officials there estimate that most cigarette tax evasion by local smokers comes not from Washington state sales, but through Internet purchases from Seneca reservations in western New York.

The sparsely populated New York reservations, in particular, have embraced the tobacco trade. With fewer than 17,000 residents, the state's reservations cannot possibly absorb the huge numbers of Marlboros, Camels, and Newports, among other brands, shipped to smoke shops in their territories — 6.4 billion in 2007. Each resident — from newborn to nonagenarian — on New York's 10 reservations would have had to smoke 1,060 cigarettes per day to consume what their smoke shops purchased. The bulk end up sold over the Internet or bootlegged — largely by minivan — to New York City for sale, tax free, in bodegas and on the streets. A low-level smuggler can walk away with up to $7,000 a day.

"This is the new crack," boasted a young former New York smuggler who asked his name not be used because he is now collaborating with law enforcement. "It's better than crack. The money is easy, the charges are less. Crack, you do years. Cigarettes, you spend the night in jail and then you go through the system."

BIG TOBACCO'S SUPPLY CHAIN

A group of seven cigarette wholesalers, all but one in New York state, is responsible for supplying more than 90 percent of all cigarettes sold on Indian land, according to wholesalers' tax filings. They buy directly from the manufacturers and receive bonuses for providing the companies detailed sales information. Last spring, one longtime Philip Morris direct distributor was caught allegedly diverting Marlboros to a notorious smoke shop owner on the Long Island Poospatuck reservation. At about the same time, another distributor allegedly sold millions of cigarettes to seemingly fictitious smoke shops, also on the Poospatuck, whose listed addresses were nothing more than light posts, trees, and dumpsters.

Philip Morris terminated its relationship with both wholesalers, but critics say the big tobacco companies have shown little interest in ensuring their cigarettes are not smuggled. An April 2008 report on New York's cigarette black market by the Republican staff of the House Committee on Homeland Security noted that the tobacco industry lacks much incentive to prevent smuggling, as the illicit trade boosts the companies' bottom line. "That would explain why manufacturers and distributors continue to flood New York's Native American Indian reservations," the report said.

"Lorillard is not in a position to know where, or to whom, the product will be resold," the company responded in a statement to ICIJ. Stopping smugglers, Lorillard said, "is the responsibility of the state and law enforcement." The companies also claim that since the state hasn't enforced tax collection on reservations, they risk being sued if they cut wholesalers unilaterally

Philip Morris officials, who get higher marks from law enforcement for cracking down on the illicit trade, claim they are doing their best. "We monitor our contracts [with wholesalers], we enforce our contracts, we bring litigation when appropriate and we have ample cooperation with law enforcement particularly on this New York situation," said Murillo, the Philip Morris counsel.

R.J. Reynolds, whose brands include Camel and Doral, plans only limited action. Starting December 28, the company will cut off discounts to retailers who sell untaxed cigarettes, according to a spokeswoman.

In the 1990s, leading American and British tobacco companies were at the core of the cigarette smuggling business. An investigation by ICIJ in 2000 revealed how Philip Morris, R.J. Reynolds, and British American Tobacco colluded with criminal networks to smuggle cigarettes worldwide in an effort to increase market share. In North America, manufacturers used the Akwesasne Indian reservation, which straddles the U.S.-Canada border, to smuggle millions of cigarettes into the high-taxed Canadian market.

Today, some companies have seemingly retreated from an active role in cigarette smuggling, but the situation remains murky in duty-free shops and other untaxed venues.

New York officials say they have been reluctant to take on the tobacco companies directly for their role in supplying the reservations because of the industry's ability to put up an extended legal battle. Instead, they are going after the middlemen in hopes manufacturers will feel pressure to reform.

STOCKING THE RESERVATION

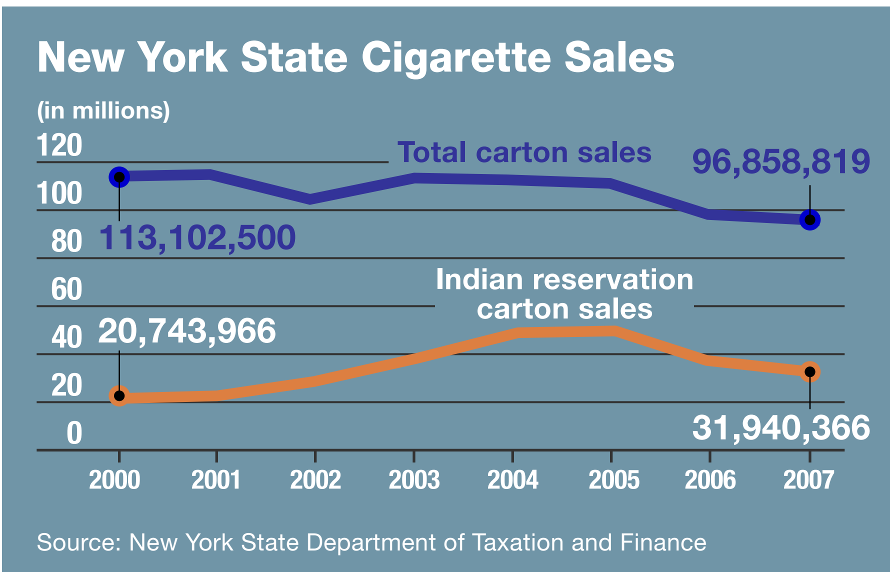
Every shop is a smoke shop on the Seneca Nation's 34-square mile Cattaraugus reservation, bordered on one side by Lake Erie, and three sides by hardwood forest and farms laden in summer with concord grapes, tomatoes, and sweet corn.

Doogie's Smoke Shop is painted bright green, boasting two lonely-looking gas pumps amid a clutter of signs announcing sales of Newports, Marlboros, and Kools. Smoke shop operators say tobacco company sales representatives visit reservation vendors like Doogie's monthly to check supply and product placement, update signs, and discuss discounts. The reps also provide price cuts in exchange for prominent shelf space.

"R.J. Reynolds, Lorillard, and Philip Morris come in monthly and change signs, check that no product is out of date, that kind of thing," said Doogie's owner Sally Snow, who heads an organization comprised of the Seneca Nation's 234 smoke shops, gas stations, and mail-order cigarette outlets.

A carton of Marlboros or Newports was selling for $32 at Doogie's this fall — a deep discount from the $60 price at the Mighty Mart off the reservation in Binghampton, or the $80 price at 7-Eleven in Manhattan.

"Lorillard and the folks who sell So-



noma and USA Gold most want their products sold," said Nikki Jimerson at the Seneca's Cloud Company Smoke Shop in Salamanca. "They talk to us more. [They ask,] 'What can we do to promote these cigarettes? What ideas do you have?'"

The marketing is not new. Over the years, manufacturers have eyed the reservations' tax-free status as a way to increase market share, according to internal industry documents uncovered by litigation in 1998. A Philip Morris presentation noted the potential "growth" to be made from "mega volume outlets" such as reservation smoke shops. "Consumers are willing to travel to get promotions and/or tax breaks in these outlets," the 1994 presentation said, noting that "changes to purchasing patterns may be accelerated by federal excise tax, state excise tax. . ." Similarly, Lorillard noted in 1996 that "Indian reservations have had a significant impact on Kent's performance."

Although reservation smoke shops have sold untaxed tobacco products for decades, their popularity among smugglers has jumped along with the tax rates. When New York raised the state tax in 2002 to $3 per pack, cigarette shipments to reservations soared, reaching 10 billion cigarettes in 2005 — enough to supply every New York smoker with 128 packs of cigarettes.

Not surprisingly, the black market exploded. Cigarette smuggling investigations have quadrupled since 2002, one New York official estimated.

When state and New York City taxes increased again last June to $4.90 per pack, off-reservation convenience stores saw their cigarette revenues drop 25 percent.

"There has been a sharp increase in demand for black market cigarettes," said James Calvin, executive director of the New York Association of Convenience Stores. "It's a huge tax evasion epidemic in New York."

PEACE PIPE AND THE POOSPATUCK

The one-square mile Poospatuck reservation on Long Island — reminiscent of a 1950s trailer park with its three sand-edged streets lined with ramshackle trailers — has become a hotbed of bootleggers and is New York City's primary source of illegal cigarettes, New York officials say. The 283-resident reservation went from purchasing less than 90 million cigarettes in 2000 to more than 2 billion last year.

Jeffrey Cohen, associate chief

counsel for the Bureau of Alcohol, Tobacco and Firearms' Northeast division, calls the illicit cigarette trade stemming from the Poospatuck "a huge problem." The tribe, he adds, has "offered no cooperation at all" with law enforcement to stop the smuggling.

"It's not a tobacco issue — it's a sovereignty issue," responded Poospatuck Chief Harry Wallace, who owns the reservation's oldest smoke shop. In 2003, Wallace himself was implicated in a government wiretap (falsely, he says) for smuggling cigarettes, but he was never charged. "Our position is if it's a bad thing, make it illegal," he said. "If you're not going to make it illegal, then we have the right to sell."

The Poospatuck gained notoriety in 2004, after Rodney Morrison — owner of the reservation's lucrative Peace Pipe Smoke Shop — was charged with firebombing a competitor's car, beating and robbing another, and financing the murder of a third. A jury found the 41-year-old Costa Rica native not guilty on everything, except for a firearms charge and conspiracy to smuggle untaxed tobacco. He is appealing the conviction, which could net him up to 30 years in prison.

Morrison — built like a brick, with a shaved head, owlish coke-bottle glasses, and plenty of bling — had for years sold millions of cigarettes to smugglers, who turned big profits on New York City streets. In the process he became a multimillionaire, with $30 million tucked away in foreign bank accounts, another $8 million in real estate, and nearly $4.5 million in jewelry, coins, pens, and watches, according to court records.

The year of Morrison's arrest, Philip Morris, Lorillard, R.J. Reynolds, and a number of smaller companies supplied him with nearly 400 million cigarettes through their distributors. But the criminal accusations didn't run Morrison out of business. In the almost four years between his arrest and cigarette smuggling conviction, more than 1.6 billion untaxed cigarettes flowed through his smoke shop, according to wholesaler tax filings to New York state.

Morrison, reached in jail, declined to comment, and his lawyer did not return calls.

Morrison's case and other court records, along with interviews with smugglers and officials, offer a revealing look inside this teeming black market. Among the smugglers' favored vehicles: Chevy Astro and Dodge Caravan minivans with their back seats pulled out. At the reserva-

tion, the shippers stuff as many as 20 cases — 12,000 packs — into black trash bags and cram them into their vans. As an added precaution, they toss a blanket over the top, then drive off the reservation, often times on the phone with a smoke shop employee who acts as a lookout for nearby law enforcement. In Suffolk County, Long Island, police arrested 81 people between March 2007 and November 2008 who later pleaded guilty to illegally purchasing untaxed cigarettes from the Poospatuck reservation. The City of New York offered evidence in court that the average person was stopped carrying more than 10,000 packs of cigarettes.

Once back in New York City, the drivers unload their stash on a ring of street-level peddlers who affix counterfeit tax stamps and sell the cigarettes to established customers at bodegas and markets in New York's poorest neighborhoods.

For each trip, smugglers easily double their investment. "We had so much money we wouldn't know what to do with it sometimes," said the former New York City smuggler. "It got to the point we would just open the glove box and throw it in. It went to casinos, cars — a lot of cars. . . . We blew a lot in the casinos. We would go in there and blow it on girls, drink the good stuff — Hennessy and Grey Goose."

GOING AFTER THE MIDDLEMEN

At the heart of the black market stand seven wholesale distributors who have for decades sold candy and cigarettes to New York vendors. They buy millions of cigarettes directly from the manufacturers, then ship them, untaxed, to smoke shops, according to distributors' sales records filed with the New York Department of Taxation. State investigators have alleged in court that, at least on one occasion, a driver for Queens-based wholesaler Gutlove & Shirvint was spotted on the Poospatuck reservation transferring cigarettes directly from a Gutlove truck into a smuggler's van.

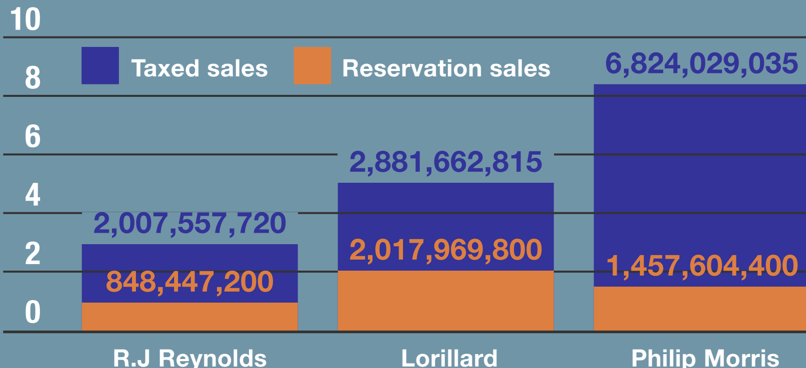
Wholesalers flooded New York reservations with 6.4 billion cigarettes in 2007. In all, 43 manufacturers supplied the reservation smoke shops, although Philip Morris, Lorillard, and R.J. Reynolds accounted for two-thirds of the amount. Lorillard brands alone comprised 2 billion of the cigarettes — or "sticks" in industry parlance — sold on reservations in 2007.

"The cigarette black market is enormous, it's brazen, and it's carried out right under the nose of the government." — Eric Proshansky, attorney for New York City.

While these wholesale distributors are licensed by the state to affix cigarette tax stamps, nearly all their business is tax-free. Untaxed reservation sales account for 90 percent of business for Long Island wholesaler Mauro Pennisi Inc., according

New York State Cigarette Sales 2007

(in billions of cigarettes)



Source: New York State Department of Taxation and Finance to wholesaler tax reports filed to the state. Buffalo-based distributor Milhelm Attea & Bros. sold 135 untaxed cigarettes for every taxed stick sold in 2007. And two other licensed tax stamp agents haven't affixed a single stamp to their millions of cigarettes shipped since at least 2004, tax data show.

Sal Pennisi, who took over the business from his father Mauro, insists that he's following the letter of the law. "We deliver the cigarettes to the reservation," he said. "Where they go from there, I couldn't tell you. I don't particularly care. Until New York state says 'stop doing it,' we'll keep doing it. When New York state says 'start taxing,' we'll start taxing."

In 2006, the office of then-New York Attorney General Eliot Spitzer sent a letter to manufacturers asking them to drop the wholesalers that supplied the Indians. "We believe that many manufacturers are aware of the legal violations of these agents, and continue to supply them," the letter read. "We are putting you on notice of this conduct and asking for your cooperation in ending it."

Lawyers in Spitzer's office were deflated by the response. Some companies shifted blame onto the state for not enforcing the law, while others failed to respond at all.

Only Philip Morris acted upon the attorney general's letter. It sent a notice to all its wholesalers saying it would drop them if they sold tax-free. The company even cut one of its distributors, Day Wholesale. But the wholesaler sued the state and the attorney general, and Philip Morris resumed the sales after the courts ruled that the cigarette tax law could not be enforced until the tax department implemented regulations. Those regulations centered on a tax exemption coupon system for reservations from which New York officials, in line with their forbearance policy, backed away.

"That was the end of it," said David Weinstein, the lawyer who signed the attorney general's letter.

At the same time the attorney general threw up its hands, the City of New York sought to stem the smuggling by filing a lawsuit against those same wholesalers. It accused them of complicity in cigarette smuggling.

Pennisi, one the wholesalers targeted in the suit along with Gutlove and five others, wonders why officials don't go after the manufacturers. "We're buying all our cigarettes from the manufacturers," he said. "And they [the manufacturers] know where it's going."

CIGARETTES SOLD TO A LIGHT POST

In December 2007, on the eve of opening statements in Rodney Morrison's high profile trial, Philip Morris ordered its distributors to stop selling to Morrison's by then notorious Peace Pipe smoke shop. But for Morrison's wholesaler, Gutlove & Shirvint, Philip Morris products made up nearly half the Peace Pipe's order, which came to more than 30 million cigarettes a month.

Gutlove continued to supply the Peace Pipe, according to state and city officials. He allegedly sought out a smoke shop seven hours away on the Seneca reservation in Gowanda, New York, to unload shipments of Philip Morris cigarettes, load them up again and ship them — often in the same day — to the Peace Pipe. The suspected scheme has sparked a federal criminal investigation into Gutlove's alleged complicity in cigarette bootlegging and money laundering, according to an October 2008 affidavit by Assistant U.S. Attorney Anthony Bruce.

Philip Morris severed its direct buyer agreement with Gutlove in April. Gutlove declined to comment on the allegations against the company.

Gutlove's alleged supplying of Morrison was only part of Philip Morris' mounting troubles on the Poospatuck reservation. At the same time, another one of the company's distributors, Mauro Pennisi Inc., was apparently delivering millions of cigarettes to benches, trees, and light posts.

Beginning in January 2008, dozens of new smoke shops registered with Suffolk County and started ordering millions of cigarettes from Pennisi's Long Island warehouse. Pennisi's drivers made the daily deliveries but investigators haven't discovered where those cigarettes wound up. Visits to the reservation by ICIJ reporters revealed the new shops were no more than small signs nailed to park benches and trees — in cases where the signs or addresses existed at all.

Pennisi began shipping upward of 50 million cigarettes a month to Smoke and Rolls Smoke Shop in January, according to industry cigarette sales data. No smoke shop by that name exists on the reservation and local residents say they have never heard of the place.

"In Native American land what do you classify as a store?" responded owner Sal Pennisi when asked about the deliveries. "On the reservation, some of these guys sell out of their trailers, which are their homes, because they don't have the revenue to build a store."

After supplying through Pennisi the seemingly fictitious shops for five months, Philip Morris sent investigators to verify the stores' existence, according to an affidavit by Philip Morris Vice President for Customer Service and Merchandising Randy Lawrence. Three months later, in September 2008, the company severed ties with Pennisi — drastically stemming the reservation's supply of Marlboros.

Today the Poospatuck smoke shops are pushing Native brands as a replacement for now-scarce Marlboros, while Lorillard and other manufacturers continue to supply the shops. Lorillard said it "does not profit from the allegedly illegal trade in cigarettes" because it charges wholesalers the same price whether or not taxes are paid." But that has not stopped the company from major shipments to smoke shop suppliers. In the first seven months of 2008, Smoke and Rolls purchased nearly 300 million cigarettes — 96 percent of which were Lorillard brands.

As pressure increases, Philip Morris continues to distance itself from its longtime reservation distributors. In December, the firm cut off Milhelm Attea, the primary supplier to the Seneca Nation.

The City of New York also responded with a September lawsuit, this time targeting the Poospatuck's biggest smoke shops. The city is seeking restitution for the loss of taxes and to have the shops shuttered. A federal judge is set to rule shortly on whether to order the shops closed while the case plays out. The tribe has requested that the suit be dismissed.

While a stream of litigation moves through New York courts, Governor Paterson's signing of the new cigarette bill on December 15 may trigger yet a new wave of lawsuits. Several New York Indian tribes reacted angrily to Paterson's move, saying that the law violates their sovereignty and threatens their livelihoods.

Proshansky, the attorney for New York City, said the big tobacco companies are keeping a close eye on all the legal maneuvering, watching to see if they are implicated. "It's a delicate game," he said. For their part, the tobacco companies insist they will be good corporate citizens and abide by New York's new legislation. "We will comply with the law," said Philip Morris' Murillo, "as best we can." ■

‘The Guy In The Wheelchair’

HOW AN EL PASO SMUGGLER MOVED A HALF-BILLION CIGARETTES ACROSS AMERICA

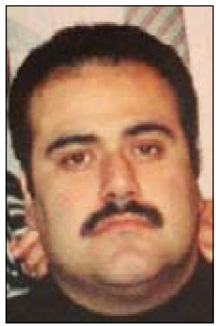
By Kate Willson

Published Online | October 19, 2008

JORGE ABRAHAM sits in his parents’ living room in a single-story rental on a rutted street in El Paso, Texas. His soft, sloping shoulders twitch involuntarily. His head and contorted right hand are the only parts of Abraham’s morbidly obese frame that move by volition — the result of a 1988 motorcycle accident that left him quadriplegic.

Behind him, the living room is stacked nearly to the ceiling with belongings — including three horse saddles — that once decorated Abraham’s former home, an expansive custom-built mansion.

Abraham, now 38, lived a luxurious life until 2004, with an ever-present entourage of bodyguards and personal assistants, and at one point owning four late-model vehicles. Not everyone believed he made his fortune legally operating his import-export businesses in El Paso and across the border in Juarez. Drug dealers in Mexico and FBI agents in Texas suspected he made his millions smuggling narcotics. But Abraham had a deal that was sweeter than dope.



Jorge Abraham

Abraham was the unlikely kingpin of one of America’s biggest ever cigarette smuggling rings — a racket that spanned three continents and six states and moved as many as a half-billion contraband cigarettes across the United States. As lucrative as narcotics, but with far less onerous penalties, tobacco smuggling is booming around the country — and around the world. Abraham, released from federal custody in June, recently talked for the first time publicly about his operation, the cheap, illegal smokes that Americans increasingly crave, and the bungled case against him that led from Chinese counterfeiters and American Indian smoke shops to a chilling Mexican house of death.

> **Law enforcement suspected Abraham was smuggling narcotics. But he had a deal that was sweeter than dope.**

"This was an extremely important case," said John W. Colledge III, former program manager for international tobacco smuggling at U.S. Customs Service. "Very sophisticated… probably one of the two most significant [federal cigarette] cases."

But Abraham's case was far from isolated. The trade in illicit tobacco today makes up 11 percent of all tobacco sales, and it has made cigarettes the world's most widely smuggled legal consumer product, according to the Framework Convention Alliance for Tobacco Control, an initiative under the auspices of the World Health Organization (WHO). The costs of this underground commerce are massive, robbing governments worldwide of an estimated $40 billion to $50 billion annually in tax revenue. The growing trade in contraband cigarettes also helps fuel an addiction estimated to cost America alone more than $167 billion annually in deaths, sickness, and lost productivity, according to data from the U.S. Centers for Disease Control and Prevention for 1997-2001. At the same time, the trade has attracted organized crime gangs and even terrorist groups, who find the mild penalties and hefty profits ideal for making money. On October 20 in Geneva, the WHO will bring together 160 nations to strengthen controls against tobacco smuggling, hoping to spark a concerted crackdown against the Jorge Abrahams of the world.

"MUST BE A DOPER"

Jorge Abraham was the youngest of three children of a Syrian immigrant father and Mexican mother. As a boy, he performed at rodeos across Mexico and sang in a children's choir — once sitting on the knee of the popular ranchero singer Vicente Fernández. He dropped out of school after the 11th grade. His parents — Nasser and Gloria — opened first one and then another successful steakhouse in El Paso and across the border in Juarez. Gloria boasts about the clientele, who she said included martial arts action actor Chuck Norris.

But the good times didn't last. While on vacation in Acapulco in 1988, 18-year-old Abraham crashed his motorcycle, fracturing three vertebrae. About the same time, his parents were struggling financially and had to shutter their restaurants.

Abraham launched an import-export business in Mexico in 1991, supporting his family and himself by importing toys, clothes, and household goods from China into Mexico. He met a woman, fell in love, and married, then built the family a 6-bedroom, 4.5-bath estate complete with elevator and pool in a gated community in nearby Santa Teresa, New Mexico. He bought two properties in Mexico, and opened an import-export business in El Paso.

Abraham's wife drove a new Jeep Cherokee. His sister drove a new BMW. He had two new handicap-accessible Ford vans at his disposal and a host of bodyguards who traveled with him between Mexico and Texas.

"When I [would cross the border] . . . I was always surrounded by a lot of people. I attracted a lot of attention," Abraham said. "The FBI hated that."

Colledge said it's a common story. "This is how border law enforcement worked at that time. Mexican-American flashing a lot of wealth — must be a doper." The FBI conducted surveillance outside Abraham's warehouse and inspected his trucks before they traveled to Mexico. But they never found drugs, and after a while they stopped coming around, Abraham said.

"So I knew back then they were checking; they kind of had a hard-on for me," Abraham said. He smiled and shook his head and was quiet. After a moment he snorted and smiled again as he considered his subsequent decision to smuggle cigarettes.

"What the hell was I thinking? Honestly, I didn't think it was such a big deal."

EASY MONEY

It started in 2000 with a woman — not his wife, from whom he had separated the year before.

"I was dating this girl, and her sister introduced me to this guy," Abraham said. "This guy from Juarez — he was kind of young, involved in bringing in cigarettes and crossing them into Mexico."

Together they bought Marlboros slated for export from warehouses in Miami and El Paso. That part was legitimate. Legally they could export them, paying taxes to the import country. Instead, Abraham and his partner smuggled them into Mexico, bypassing entrance taxes with the help of a Mexican customs agent.

Not long after they started in 2000, the Mexican customs agent was transferred; Abraham was stuck storing thousands of cigarettes in a bonded warehouse in El Paso. His partner said they had to move the cigarettes, or else the product would go stale.

"We doubled our money just like that…I thought, 'This is easy. It's cigarettes.'"
— Jorge Abraham

"I was a very well-known businessman in import-export merchandise," Abraham said. "So I told the customs broker, 'clear 'em, because I'm going to cross 'em.' And he did." But then instead of crossing the cigarettes legally into Mexico, Abraham sold them to a buyer in Los Angeles. In doing so, he avoided paying mandatory state and local taxes, instead pocketing the difference. He had invested $200,000 in the 900 cases — 9 million cigarettes — which he shipped through a cargo mail service.

"We doubled our money just like that," he mused. "I said, 'This is easy. It's cigarettes. It's not a big deal.' So we started doing it more and more often, until they seized a load." Although Abraham cannot remember for certain if he and his partner had used fake names to send the untaxed cases, Abraham said he got scared the first time Customs seized his shipment of cigarettes.

"I said, 'How are they going to react?' But nothing happened," Abraham explained. "So then we waited a little bit and did it again."

Three months into their new business, Abraham and his partner split. Abraham continued sending cigarettes to California while selling other — legal — imports to buyers in New York. During a discussion about sugar with one of those East Coast buyers — who Abraham simply called "the old man" — Abraham mentioned he could supply cheap cigarettes.

"Got any buyers for cigarettes?" Abraham asked.

"Let me find out," the old man said.

Soon after, another man called Abraham. "So they tell me you can get duty-frees," the man said, referring to cigarettes slated for export. "Can you send them to New York?"

Abraham said he could, and they decided on an initial small shipment of one master case — 50 cartons. The shipment went smoothly, with the old man acting as intermediary.

And so it began: Jorge fielded orders over the phone, then placed orders of his own for shipments of export-bound cigarettes from wholesalers in El Paso and Miami. He received those shipments at warehouses in El Paso and had them cleared for export. Instead of exporting the cigarettes, however, Jorge sent them in bulk by cargo mail service to buyers in California and New York, destined for the open market. Most in demand: Marlboros, but Newport Menthols were also popular in black communities and Camels in American Indian communities, he recalls.

The Indians became big business for Jorge. He moved truckloads of the tax-free smokes to the Cattaraugus Indian Reservation in western New York state, the largest reservation of the Seneca Nation — a wealthy tribe known for its sweetgrass woven baskets and elaborate corn husk dolls. The rural 2,400-person, 22,000-acre spread bordering Lake Erie was home to Abraham's biggest buyers, who, along with other "smoke shops," peddled millions of under-the-table cigarettes to the general public. Through the old man, Abraham's shipments went to a colorful trio of distributors there, people whom Abraham's attorney would later describe as "Broadway types."

There was Scott Snyder, who had served as police marshal and political party chairman on the Cattaraugus Reservation. Snyder lived on the reservation and ran the Iroquois Tobacco Co. out of his home. Donald "Don" Deland was a one-time professional football player (college All-American, a Buffalo Bill, and a Dallas Cowboy) turned discount cigarette salesman. Based out of the reservation, he operated Internet sites such as smokemcheap.com and dutyfreetaxfree.com, promising to sell "the same cigarettes that you are buying at the store for Outrageous Prices at the lowest Tax Free Prices you will find Anywhere!" And then there was Timothy "Tim" Farnham, with a background in marketing, who boasted that he once worked for Bill Clinton's 1992 presidential campaign. Farnham was the money-man of the three, providing upfront funds.

From the reservation, Abraham's cigarettes flooded into New York, to be sold by the city's bodegas and street vendors.

From the reservation, the contraband cigarettes flooded into New York City, eventually being sold openly by the city's bodegas and street vendors. So popular were Abraham's smokes that he became notorious among local smugglers, who referred to him simply as "the guy in the wheelchair."

ENTER "LALO"

With the New York connection in place, business boomed. But by early 2001, Customs began routinely seizing shipments of Jorge's untaxed cigarettes. Officials never seemed to know Abraham was behind the shipments, but just for safe measure, he would lay low for a few weeks after a seizure. Then the cargo shipping company transporting Abraham's cigarettes refused to handle any more. One of the company drivers "had some trouble" from Customs on his way to the Cattaraugus Reservation. Until he found another way to deliver his goods, Abraham felt he had no choice but to stop the deliveries.

"Everybody started getting desperate," Abraham recalled. His New York distributors, who until now had operated through the old man, called him and insisted on a meeting. The men flew down to El Paso, where Abraham agreed to deal directly with them. But first, he said, he needed to find an alternative mode of transportation. Fortunately, "Lalo" had a connection.

Lalo was a mustachioed Mexican from Durango, south of the California border. Jorge had met him through a well-connected figure in Mexican organized crime, and Lalo quickly became instrumental to Abraham, managing shipments and watching over the business. A former cop in Juarez, Lalo was tall and slightly overweight, with drooping eyes and jowls. He spoke with a slight stutter, Abraham recalled.

Lalo mentioned he knew truckers willing to move drugs. Abraham asked him if they would move cigarettes instead. After settling on a price, Abraham's men loaded a 53-foot truck with contraband cigarettes and stacked the final 10 feet with boxes of toilet paper. (Later he would use jalapeños — a heavier product, and thus less likely to be moved during routine searches at Customs checkpoints.) Lalo and one of the drivers he had solicited took the loads to New York. They arrived without a glitch.

"They got all excited," Abraham said. Even before the truckloads arrived, his New York distributors had a line of customers ready to buy. "If I would have sent them 10 containers a week, that wouldn't be enough."

Business was great for a while — Abraham was making shipments two or three times a week, each worth about $400,000. He opened off-shore bank accounts to store the cash. But seizures picked up, and soon, Abraham said, they couldn't get anything through.

When Abraham told Snyder, Deland, and Farnham that they had to stop for a while, the buyers balked. So Abraham tried buying contraband cigarettes from Switzerland. But those shipments were seized, too.

By then, a dozen people in El Paso were helping Abraham buy and ship contraband cigarettes. Five people in California and a half-dozen in New York bought Abraham's products, reselling the cigarettes in smoke shops and on Internet sites. Abraham says he knew one of them was "a rat." He never suspected it might be his stuttering sidekick, Lalo.

A HOUSE OF DEATH

Lalo is the reason Immigration and Customs Enforcement officials have refused to discuss this case. A dozen calls and e-mails to ICE public affairs have gone unanswered, not only because of Lalo's work as an informant, say former officials with knowledge of the case, but also because of his ties to a murderous Mexican gang and a house out of a horror flick.

Lalo's real name is Guillermo Eduardo Ramirez-Peyro. A former Mexican highway patrol officer, he left his federal post for a more lucrative job overseeing a cocaine-storage warehouse and distribution center in Guadalajara. He met Abraham in 2001, when he was 29. He had started working as an informant for Customs and the Drug Enforcement Administration the year before, according to court records.

When Customs sought approval to tap Abraham's phones in July 2002, they relied solely on information gleaned from Lalo's work. It was Lalo who introduced an undercover agent as the drug-smuggling truck driver, who informed Customs agents of Abraham's shipments, and who recorded his phone calls and meetings with Abraham. For his services, Lalo received almost $225,000 over four years.

In February 2003, Lalo began working on a high-profile case for Customs and the DEA involving Heriberto Santillan-Tabares, one of the leaders of the murderous Vicente

Carrillo Fuentes Cartel, which controls billion-dollar drug routes from Mexico into the United States. The syndicate, also known as the Juarez Cartel, was among the hemisphere's most powerful criminal organizations in the 1990s, responsible for as much as half of all drugs that entered the United States from Mexico. While its power has diminished with the suspicious death of leader Amado Carrillo Fuentes in 1997, the organization is still considered one of Mexico's four most powerful cartels, with operatives in two-thirds of Mexican states. Lalo was deeply enmeshed, so he made the perfect mole.

As a federal informant, even after supervising multiple murders, Lalo received almost $225,000.

That summer Lalo was arrested near Las Cruces, New Mexico, with 100 pounds of marijuana hidden in the tires of his Chevy pickup. The DEA dropped Lalo as an informant, said then-DEA Special Agent in Charge Sandalio Gonzalez. But ICE kept him on the payroll — even after news arrived of the grisly events at Calle Parsioneros 3633.

The house at Calle Parsioneros 3633 in Juarez is a hodgepodge middle-class cinderblock home near the city's industrial center. In August, Lalo was at the house where — allegedly on Santillan's order — he supervised the murder of a Mexican drug trafficker named Fernando Reyes. They tried strangling him with an electric cord, but it broke. So they slipped a plastic bag over his head and, after a few minutes, whacked him on the head with a shovel just for good measure. Lalo recorded the events and took the evidence that evening to his handler at ICE, which was trying to build a case against Santillan, according to court records. News of the murder reached ICE headquarters in D.C. by that night. The next day the agency's El Paso office received orders from headquarters to continue the Santillan investigation with Lalo as informant.

Yet the murders at Calle Parsioneros continued. Between August 2003 and January 2004, 11 more people were brutally slain at Calle Parsioneros 3633 — some or all of them allegedly on Santillan's order and under Lalo's supervision.

A MOVE TO COUNTERFEITS

"At the beginning I never had any trouble with him," Abraham said of Lalo. "But after a while, you know, something inside me said, 'Something is wrong with this guy.'"

One day while visiting friends at a local tire shop, Abraham said he spotted Lalo driving down from Sunland Park Drive — a road leading from a cluster of federal law enforcement offices — wearing a dress shirt and tie.

"I was inside my van and I said, 'Is that Lalo?' Every time I would see him it was boots and jeans and a shirt, just like that," Abraham said, motioning with his right hand to his own T-shirt. He couldn't figure out why the Mexican man speaking limited English would be driving away from that section of El Paso. Jorge had one of his young employees dial Lalo's number.

"Hey, turn back," Abraham said into the receiver. "I just saw you. Turn back. I'm at the tire store."

Lalo complied. But when he climbed from his car, Lalo was wearing a sweater.

"Are you hot?" Abraham asked. "It's kind of hot to have a sweater on."

Lalo's face turned a shade of pink, and he mumbled something about being cold.

"Well, take your sweater off," Abraham ordered. Lalo complied. He wore a dress shirt beneath the sweater, but had removed the tie. Abraham suffered a moment of suspicion. But Lalo seemed too well-connected to be an informant.

Abraham, meanwhile, was growing increasingly concerned about the number of shipments being seized. In 2002, he decided to stop trafficking contraband cigarettes altogether. His buyers were frantic, but he felt he had no other choice. One of his West Coast contacts — Giashian "Mike" Lin, a Taiwanese national living in California — then suggested he import counterfeits from China, Abraham recalls. Offered a sample, Abraham was surprised at the quality. The cigarettes appeared authentic. Only when the cigarette was lit, did one realize it was counterfeit — it burned unevenly.

"So I started seeing who was interested," Abraham said. "Everybody was interested."

The first containers arrived at the port of Newark, New Jersey, hidden among plastic kitchenware, teapots, and toys. The loads were stashed at Snyder's home on the Cattaraugus Indian Reservation. Abraham sold his counterfeit Marlboros to the same buyers as his duty-free smokes — in New York, California, and Kentucky.

"At that time the Chinese were so happy," Abraham said. "They wanted to move 10 to 20 containers a week." Twenty containers hold 200 million cigarettes. By then, China had emerged as the world's primary source of counterfeit cigarettes, and Abraham was a good client. So the Chinese suppliers sent California businessman Dean Miller to meet with Abraham in El Paso.

Miller launched Megafood, a successful chain of food stores, in 1987, but the firm ran into financial troubles and went bankrupt in 1994. Miller was sued for fraud in 1997 by a company that loaned him money to keep his failing business afloat. Slapped with a $2.3 million judgment in 1998, Miller filed for personal bankruptcy in 2000. He now wanted to be Abraham's sole California buyer, exclusively supplying counterfeit Marlboros to West Coast consumers.

Abraham and Miller struck a deal, and Miller agreed to travel to China with a carton each of Marlboro regulars and Lights, so the counterfeiters could update the barcodes on the cartons — because, Abraham explained, Marlboro had started updating the codes every few months to combat counterfeiting. Abraham started ordering regular shipments from China of Marlboro "Reds" and "Whites."

Abraham's cell wasn't the only one importing counterfeits from China. By 2002, bogus Chinese cigarettes were pouring into the United States, attracting a rogue's gallery of distributors — Chinese smugglers and Russian mobsters joined in, along with Abraham's Mexican-American gang. There was even a ring of Orthodox Jewish smugglers. Abraham's New York buyers — Deland, Snyder, and Farnham — were also moving contraband cigarettes from Simon and Michael Moshel, a pair of pious Jewish brothers from New York City. The Moshels started out selling fruits and vegetables when they immigrated to the United States from Israel. After selling their produce business, they launched a plastic bag manufacturing plant, and then, among other ventures, began importing goods such as jeans, counterfeit batteries, and fake Marlboros.

Although tobacco smuggling may seem tame compared to drug trafficking, it is a tough racket, and Jorge could play hard. When Farnham, the moneyman of the New York buyers, owed him $500,000, Abraham stopped shipments, sent his father to settle the account, and called Lalo. "My dad, they leave tomorrow at 6 in the morning to go see that [expletive]," Abraham told Lalo, in a February 2003 conversation recorded by law enforcement agents. "We definitely need to pick him up and take from him whatever we can get from him. . . . And then take him down."

"Then fix him up?" Lalo asked.

"See how much they want," Abraham said. "If we can do it this week, let's do it this week," quite a bit later adding, "Yes, whack him, because if not, the other guys are going to say, 'Oh, he . . .'"

Abraham left the sentence unfinished. Abraham didn't pursue a hit man to carry out the murder, and his attorney said Abraham never seriously entertained the idea.

Around the same time, Abraham sent Miller to Buffalo, New York; containers had arrived at the port in Newark and been transported to a warehouse in Buffalo for dispersal. Miller was to arrange shipment for some of the containers to his warehouse in California. Abraham felt something was wrong, that law enforcement was watching. He suggested they stop shipments for a bit.

"The Chinese didn't want to stop. Deland didn't want to stop. Dean Miller didn't want to stop," Abraham said. "So I brought in 10 more. But those last shipments, people started complaining they wanted a rebate [because of poor quality]. I had a sample at home. So I told one of the guys to smoke it." The filter was half the regular size, and people were burning their fingers.

"So I stopped," Abraham said.

Meanwhile, Miller told Deland and Snyder that he could bring in containers without Abraham's help. But what no one knew was exactly how Abraham got his shipments past customs. When he tried on his own, one of Miller's shipments was seized in California. Another was seized in Newark. During the second seizure, Deland and Snyder were arrested.

Abraham's Chinese contacts urged him to continue ordering shipments in spite of the arrests and his concerns. Smuggler Mike Lin flew in to talk to him. So did another California-based smuggler, Jeffrey Liu. Abraham's direct contact in China called, trying to convince him to continue the business.

"The Chinese lady would call me almost every day from China, which I didn't understand jack [expletive] because she hardly spoke any English," Abraham said, laughing.

Abraham brought in four more containers, but felt law enforcement closing in. His subsequent decision was perhaps not logical, and he smiles today when he considers it.

"I decided, 'I'm going to see how close they are.'" Abraham said. "So I started moving duty-frees again. They started seizing everything. Nothing, nothing was getting through. I was losing money more and more, containers and containers." Over time, Customs seized 20 containers of contraband cigarettes, costing Abraham $8 million.

Abraham had ordered his buyers, movers, and sellers to call him from disposable pre-paid phones, and gave them a number for a disposable phone he had purchased.

"Did they listen? No." Abraham said. "They would call me back from their houses. . . . I guess they didn't see how bad it was going to be."

THANK YOU LETTER

The noose finally tightened around Abraham's ring in February 2004. In a SWAT team sweep by ICE and local police, authorities arrested Abraham, his father, and a dozen other men. Because the local jail lacked the proper medical facilities, Jorge spent the next six months in a hospital bed, watching TV and making friends with the U.S. marshals who acted as guards. Abraham faced 92 counts of trafficking in counterfeit cigarettes, as well as wire and mail fraud — enough charges to put him away for 300 years. Abraham initially asked the court to release him pending trial. "They denied my bond, and said I was a flight risk and I was going to leave. And I probably would have," Abraham said with a grin. "If they had given me a bond, I probably would have left, but then I only got five years. I'm glad they didn't [give me bond]. I should have written them a thank you letter."

The real thanks should have gone to Lalo, who by then was about to be exposed in the sordid, high-profile drama at the drug cartel safe house in Juarez. Tainted by the murders, he was no longer a credible witness against Abraham. Unwilling to put Lalo on the stand, prosecutors agreed to settle short of trial. Abraham pleaded guilty in April 2005 to a single count of conspiracy to smuggle cigarettes into the United States and was sentenced to five years in prison. He agreed, along with his father, to pay nearly $6 million in restitution — a seemingly insurmountable sum to the retired restaurateur now in his seventies and his quadriplegic now-unemployed son.

Abraham's New York distributors — Snyder, Deland, and Farnham —

were each sentenced to between 18 and 27 months in prison. Snyder is currently serving again as chairman of the Seneca Nation's sole political party, while his father hopes to regain the tribe's presidency. Abraham's California connection, Dean Miller, received four years and was ordered to pay a $10,000 fine. Abraham's father was sentenced to 3 years in prison. His wife faithfully visited every week.

Abraham and his pals weren't the only ones getting deals because of Lalo. Santillan, the Juarez Cartel leader, was lured into the United States in January 2004, arrested and indicted for five of the murders at the "House of Death," in addition to drug trafficking charges. But fearing their case would implode under cross-examination of their murderous informant, prosecutors agreed to drop the murder charges and all but one count of conducting a criminal enterprise. Santillan made a plea deal for 25 years in prison.

Lalo's fate remains unknown. Seemingly overnight, the former Mexican cop went from a prized informant to an undesirable illegal alien. Lalo claimed in court that ICE had promised him a green card in exchange for his work and said he feared he would be murdered by the far-reaching Juarez Cartel as soon as he returned to Mexico. But Lalo never got the promise of a green card in writing, and ICE swiftly placed him into expedited deportation proceedings. His plea for asylum is still pending in federal court while he remains in a deportation center at an undisclosed location.

Jorge Abraham was formally released from prison in June 2008 — having completed his final months on house arrest. Even before he was officially free, the telephone started to ring. Old friends wanted to know if he was back in business, he explained with a chuckle and a shake of his head.

On a recent Wednesday evening back in El Paso, he sat at his mother's dining room table. His father Nasser stood beside Abraham's wheelchair offering steaming spoonfuls of homemade chicken soup to his son. His mother Gloria bustled, roasting corn tortillas over the open burner. The kitchen smelled of jalapeños and cilantro. A string of telephone calls repeatedly broke the calm. Nasser or a young Latino man held the phone to Abraham's ear, who told each caller to ring again in 15 minutes.

Abraham plans, he said, to start another business someday, importing goods from China to Mexico.

Smoke2U

TOBACCO SALES TAKE OFF IN CYBERSPACE

By Te-Ping Chen

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THERE'S SOMETHING ODD about PO Box 365, Irving, New York. Located on the Seneca Nation — nestled just at the Empire State's southwestern tip — the box is the mailing address for at least 10 online vendors registered in far-flung locations, from New York City to Ankara, Turkey. Boasting names like BigChiefCigarettes.com, Smoke2U.com, and EZTobacco.com, the sites bear no apparent affiliation to one another, except that they all sell one product: untaxed cigarettes.

For years, tax-free cigarette sales on New York reservations have made the state among the country's top destinations for discount smokes — and not surprisingly, either. With New York City home to the nation's highest cigarette taxes, the tax-free trade offers a prodigious payoff for the enterprising cigarette vendor. (Between state and city taxes, a carton of cigarettes in New York City can cost up to $80; that same carton, untaxed, costs just $40.) There's one problem, though: The trade is illegal.

In 2007, New York's reservations — home to fewer than 17,000 people — sold a towering 6.4 billion cigarettes, leaving state revenue officials scrambling. Every year, the state loses nearly $1 billion in city and state taxes from reservation sales. While the Supreme Court has ruled that states can collect taxes on tribal sales to non-natives, ever since a violent Seneca protest beat back then-Governor Pataki's attempt to enforce such taxes in 1997, successive governors have been loath to entangle themselves in the issue.

On December 15, though, with the state facing a projected $51 billion budget shortfall over the next four years, Governor David Paterson signed a law that mandates tax collection on reservation tobacco sales. Specifically, the law requires that cigarette manufacturers supply only wholesalers that certify their products won't be resold, tax-free, to reservations (and in turn distributed through smoke shops and online vendors). But the bill's impact remains to be seen. State officials would have to overcome past reluctance to collect taxes on reservation cigarette sales; Indian leaders this week, meanwhile, expressed vigorous opposition to the new law. The law, also, does not stop tribes from selling untaxed, native-manufactured brands.

Websites catering to tax-dodging U.S. smokers jumped from just 88 in 2000 to some 772 in 2006.

The United States' patchwork of state cigarette tax laws has long spurred a brisk industry of cross-state smuggling. It's not hard to see why: While the tax in a tobacco state like South Carolina is a low 7 cents per pack, the rates in a high-tax state like New Jersey are up to 36 times higher. In the 1960s, mobsters such as John Gotti — the flamboyant "Dapper Don" of Mafia fame — were known to capitalize on the trade's vast profit margins, bootlegging cigarettes across state lines.

But these days, with the advent of the Internet, it has become a lot easier to jump into the bootlegging game: All it takes is a modem and access to a post office. Likewise for smokers, tax-free cigarettes are just a handful of clicks away.

Over the past decade, as cigarette taxes have soared throughout the United States — rising an average of nearly 90 percent between 1998 and 2002 alone — websites catering to tax-dodging smokers have proliferated. In 2006, an estimated 772 sites were selling to U.S. consumers, up from just 88 in 2000. According to Jeff Cohen, associate chief counsel for the Bureau of Alcohol, Tobacco, Firearms and Explosives' (ATF) Northeast division, it's common for entrepreneurs to maintain five or six differently branded websites to drive traffic, "even though they're just shipping from one address."

Some sites are based in low-tax states such as the Carolinas; others sell duty-free packs from overseas. Increasingly, overseas cigarette vendors drive traffic: The number of sites based overseas jumped from at least 10 percent in 2003 to over 45 percent by 2006, according to Kurt Ribisl, an associate professor at the University of North Carolina's Gillings School of Global Public Health, who has extensively studied online sale patterns.

In the United States, the real action is taking place on Indian reservations. As of 2005, nearly two-thirds of websites had some apparent affiliation with Indian reservations. For western New York's Seneca Nation, in particular, the online business has developed into the tribe's cash cow. Together, two Seneca reservations accounted for over three-quarters of all Indian websites in 2005. A 2003 tribal study found that fully 95 percent of Seneca sales were conducted over the web or phone (the rest were sold over-the-counter in reservation shops).

Increasingly, overseas cigarette vendors drive traffic: The number of non-U.S. sites jumped from at least 10 percent in 2003 to over 45 percent by 2006.

The opportunities are such that even those who cannot claim tribal heritage have allegedly sought to exploit the status it confers. This September, shopping plaza developer and former New York City bus driver Joseph Roosa was charged with using a resident of the Allegany reservation as a front for an online cigarette business that sold $4.9 million worth of tax-free cigarettes throughout New Jersey. (The case is still pending.) This July in another case, Lloyd Long pleaded guilty to using a similar ruse to purchase tax-free cigarettes for sale on two online sites, EZsmokin.com and MightySmokes.com.

Beyond lower prices, online sales also offer smokers broader options, including popular discount brands such as Seneca and Niagara. That, in part, may help account for why Philip Morris has been among online sellers' chief opponents, filing more than 20 different suits against such retailers in recent years. The company has also actively pushed model legislation to curb online sales in states around the nation. Over the past decade, about 40 states have passed laws to limit or ban the direct shipment of tobacco products to consumers, to varying effect. (In 2007, the Supreme Court, citing concern about interstate commerce interference, struck down a Maine law that required shipping companies to verify a recipient's age before delivering tobacco to a home address.)

To fight the trade, meanwhile, state officials have turned to the obscure 1949 federal Jenkins Act, which requires all vendors to report cigarette sales to the relevant state tax authorities. Failure to submit reports, though, is only a misdemeanor. Accordingly, almost no cigarette vendors bother to file, and once the packs are delivered, few consumers remit the owed taxes, either. Some do not realize they are still required to pay taxes on Internet purchases, while others take a more generally cavalier attitude toward the law. As Patrick Fleenor, chief economist at nonpartisan research group the Tax Foundation, puts it, buying untaxed cigarettes online "is still not really considered a crime, but more like a form of bargain shopping."

But opponents of the online cigarette trade charge that sales aren't so innocuous, and that they can spur addiction among underage smokers: "We spend all this time trying to stop kids from buying cigarettes at 7-Eleven, when they could more easily be at home buying cigarettes with their mom's credit card," said Marlene Trestman, special assistant to Maryland's attorney general. Few online vendors verify purchasers' ages, and one 2005 western New York study found 6.5 percent of ninth graders had made at least one cigarette purchase online. Likewise, opponents say, low online prices discourage smokers who might otherwise be pushed by high taxes to kick the habit.

And though thumbing your nose at the taxman may be a quintessential American sport, the overall tax losses add up — particularly at a time when at least 43 states are facing budget shortfalls. "There's a mad dash right now to get money into state coffers," said Timothy Quirin, an analyst at CCH, a private research group that tracks tax laws. "States are looking at any revenue stream they can tap into." In 2005, online sales cost states an estimated $2 billion in lost taxes, according to ATF's Cohen.

Virtually all online cigarette sales are illegal, for one or more reasons: Vendors do not take sufficient steps to confirm customers' ages, fail to report their shipments under federal law, or — depending where they ship — they break laws prohibiting direct cigarette shipments to individual consumers.

Questions of jurisdiction continue to hamstring state efforts to reduce sales, especially given the prominence of reservation-based vendors. While the Supreme Court has ruled states have the legal right to require that cigarette retailers on reservations collect taxes on cigarettes sold to non-tribal members — and keep records for each sale — tribal sovereign immunity bars states from directly suing tribal governments for lost revenue.

Accordingly, states have sought alternate routes, cobbling together a strategy of pressure on retailers and consumers, as well as the shippers and credit card companies that help supply them. States such as California have used outreach to vendors, encouraging them to report their sales, or — in the event that strategy fails — subpoenaing or suing them to winnow out customer information. Using data gleaned from these efforts, in recent years over a dozen states have gone so far as to bill customers directly for unpaid taxes. Alaska, for example, has sent letters to roughly 5,000 delinquent taxpayers (including some tax bills for up to $30,000). Since 2005, Pennsylvania has billed 31,000 smokers for $26.3 million in unpaid taxes, and so far has retrieved $16 million in payment. Likewise, Connecticut has recouped at least $2.48 million through such efforts; Michigan, $12.5 million (out of a total owed $36 million); Wisconsin, at least $1.4 million; Oregon over $2 million. Those amounts, too, are only the tip of what is owed, given that states are only contacting customers of sites that have given up their information. The $26.3 million Pennsylvania is currently seeking, for example, represents losses from just a half-dozen sites.

Tax bills appear to have had some deterrent effect: Oregon officials report that while in 2005, about 2,500 smokers a month were frequenting two sites sued by the state — Smartsmoker.com and Ordersmokesdirect.com — today, that figure has dropped by more than half.

Authorities say it is difficult to know if the smokers simply switched websites, so they are also targeting vendors' ability to ship and receive payment. In 2005, state attorneys general won a commitment from credit card companies and common carriers such as DHL and UPS to stop allowing their services to facilitate the trade. At the New York Department of Taxation and Finance, spokesman Thomas Bergin observes some successes from the agreement, noting that since hitting a high of 47.6 million cartons per year in 2005, overall shipments to reservations slowed to 31.9 million in 2007. One study likewise found that in the year following the agreement, the Internet purchase rate among smokers fell from 1.2 percent to 0.4 percent.

The crackdown has hit the Seneca reservation, where 1,500 people were once employed by the online business. Since 2005, though, Rick Jemison, spokesman for the Seneca Sovereign Partnership, said that many online shops have folded, leaving hundreds out of work.

Yet while credit card companies have pulled back, consumers can still pay by direct electronic banking transfer or personal check. What's more, though common carriers have agreed to stop untaxed shipments, to date, the U.S. Postal Service has refused to accede to such an agreement. (Postal officials note that Priority Mail, which handles most cigarette shipments, can't be inspected without a search warrant, and that "extraordinary resources" would be needed to enforce restrictions on tobacco mailings.)

Thus, even with states' best diligence, cigarettes continue to slip through. "They [the Internet sellers] are resourceful," said California Deputy Attorney General Laura Kaplan. "They always seem to be one step ahead of us." In the latest development, she said, California secured an agreement with First Regional Bank to stop processing unlawful cigarette purchases — to her knowledge, the first of its kind in the nation. But as Kaplan notes, there are thousands of other banks out there who have yet to sign on.

Online sites are also moving offshore, beyond the reach of effective U.S. law enforcement. In one high-profile 2004 case, the ATF raided a cargo plane that touched down at John F. Kennedy Airport bearing 60 million duty-free cigarettes from a Switzerland-based company, Otamedia. The company's original URL Yesmoke.com was shut down, but its operators simply packed up shop and today continue to do business from Italy.

"Websites used to be very clear about where their stated location was, but more and more, you can't figure out where they're from," Ribisl said. According to his research, while about 50 percent of online cigarette sites are based in the U.S., in recent years, more and more sites have been appearing abroad as part of a complicated international supply chain. "A website might say it's based in Irving, New York, and that the cigarettes come from overseas, like the British Virgin Islands. But then we'll look at the actual shipping label when it arrives, and it might say 'customs duty, Ireland.'"

U.S. authorities are hardly alone in feeling flummoxed by the trade. Canada, for example, has experienced a jump in Internet and mail-order sales, with related seizures rising by 151 percent to 1,610 from 2006-2007.

But given how one site can pop up as quickly as another is shuttered, suppressing the trade has become something of a global game of "whack-a-mole." "We see a lot of sites operating outside the country: Moldova, Israel, Russia, Ukraine," Kaplan said. Despite states' best efforts, she said, "We haven't noticed a real reduction in sales."

To that end, advocates such as Representative Anthony Weiner, Democrat of New York, and the National Association of Attorneys General are actively pushing the optimistically titled Prevent All Cigarette Trafficking (PACT) Act, which would — among other provisions — make failure to report sales under the Jenkins Act a felony, ban mailings of tobacco through the U.S. Postal Service, and codify existing agreements with credit card companies and common carriers. The bill passed the House of Representatives this September, and is expected to receive a favorable reception in the 111th Congress in 2009.

Although the spate of state actions hasn't stemmed the tide of online sales, they may be showing an impact. Jeff Kimbel, for example, a 45-year-old smoker from Long Beach, California, was accustomed to getting his untaxed Seneca-brand cigarettes in discreet brown boxes arriving from Buydiscountcigarettes.com. After the site was sued this year, though, his shipments were disrupted, and he was double-billed for his purchases. Similar consumer complaints of being fleeced online abound.

"At one point the site was based in New Mexico, and then I heard they were moving to Kentucky," Kimbel said. "Now the cigarettes come out of Irving, New York." (Kimbel — who paid by direct debit — said he never realized that he was violating state tax laws.)

With the accelerating state and federal scrutiny of Internet sales, some online cigarette purchasers figure that even with higher costs, they're better off buying in person. As one smoker recently posted online: "No online cigarettes for me. Find local store, pay cash, no trail." ■

Terrorism And Tobacco

EXTREMISTS, INSURGENTS TURN TO CIGARETTE SMUGGLING

By Kate Willson

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FOR CENTURIES, blue-turbaned nomadic Tuareg tribesmen have led caravans of camels across the expanses of the Sahara. Laden with millet and cloth from Africa's West Coast, the caravans traveled unmarked paths to trade for salt and dates in Timbuktu, across the sand plains of Niger, and into the mountain oasis of the Algerian south.

Smugglers take the same routes today — driving SUVs along paved roads or with guidance from the Tuareg and satellite phones — to move weapons, drugs, and, increasingly, humans — through the Sahara for transport across the Mediterranean Sea. The paths are no longer known as the Salt Roads of the Tuareg, but as the "Marlboro Connection," named after the most lucrative contraband along this 2,000-mile corridor.

Among those who control this underground trade is al-Qaeda in the Islamic Maghreb (AQIM), an Algeria-based terrorist organization widely believed to have been backed by Osama Bin Laden. Descended from the Salafist Group for Preaching and Combat (known by its French acronym, GSPC) the group has hundreds of members and is blamed for a bloody campaign of bombings, murders, and kidnappings across North Africa and Europe. The lead smuggler, Mokhtar Belmokhtar, 37, is blamed for the 2003 kidnappings of 32 European tourists and the 2006 murder of 13 Algerian customs officials. "They are a significant threat," says Lorenzo Vidino, author of Al Qaeda in Europe. "Of all Islamic terrorist groups, they have the most extensive and sophisticated network in Europe… And among their activities, smuggling is particularly important."

Military officials and scholars say cigarette smuggling, in fact, has provided the bulk of financing for AQIM. The money comes not directly from smuggling, but from charging protection fees to others moving the untaxed cigarettes through the Sahara. The most smuggled brand is Marlboro, followed by Gauloises and American Legend, as well as counterfeited Rym, a popular Algerian brand.

Al-Qaeda's North Africa affiliate isn't alone. After crackdowns on fundraising following the 9/11 attacks, terrorist groups worldwide have increasingly turned to criminal rackets, officials say. And smuggling cigarettes — either untaxed or counterfeit — has proved a particularly lucrative, low-risk way to fund operations.

Hezbollah, the Taliban, and al-Qaeda are involved in smuggling cigarettes; so are the Real Irish Republican Army (Real IRA) and the Kurdistan Workers' Party (PKK). Terrorist financing through cigarette smuggling is "huge," says Louise Shelley, a transnational crime expert at George Mason University and an adviser to the World Economic Forum on illicit trade. "Worldwide — it's no exaggeration… No one thinks cigarette smuggling is too serious, so law enforcement doesn't spend resources to go after it."

"Cigarettes are easy to smuggle, easy to buy, and they have a pretty good return on the investment," adds David Cid, a former FBI counterterrorism agent and deputy director of the Memorial Institute for the Prevention of Terrorism in Oklahoma City. "Drug dogs don't alert on your car if it's full of Camels." And, he notes, "The other advantage is you don't go to jail for 50 years."

Traditional terrorist networks aren't the only armed groups making money from the underground cigarette trade. Insurgents and paramilitary forces are also on the take. Many of the world's longest-running civil wars are fueled by contraband, according to a 2002 study by Stanford University's James Fearon, and tobacco is only one of the favored commodities. Cocaine smuggling has largely propelled the FARC's 40-year insurgency in Colombia. Diamonds have funded civil wars in Sierra Leone and Angola. And opium has fueled drawn-out conflicts in Burma and Afghanistan.

The increasing use of smuggled tobacco by terrorist and insurgent groups parallels the rapid growth of a multibillion-dollar trade in cigarette smuggling around the world. Huge tobacco black markets have arisen from New York State to Paraguay to Eastern Europe, as smugglers move cheap and counterfeit cigarettes to sell in lucrative high-tax regions. The illicit trade is fueling addiction, say health experts, by making inexpensive cigarettes widely available, while robbing governments of sorely needed tax revenue. At the same time, officials warn, the booming black markets are fueling not only some terrorist groups but dozens of organized crime gangs, who find the big profits and low risk hard to resist.

In addition to al-Qaeda in the Islamic Magreb, at least a half-dozen terrorist groups and insurgencies have profited from the black market in tobacco. Among the others:

THE IRA

Both the Provisional Irish Republican Army and the militant splinter group Real IRA have used cigarette smuggling to finance their operations. While both groups seek the unification of the island of Ireland, the Provisional IRA announced in 2005 that it would henceforward use only peaceful means. The Real IRA continues to employ terrorist tactics including robbery, bombings, and assassinations, most recently shooting dead two British soldiers in Northern Ireland in March.

Combined, the IRA groups reaped an estimated $100 million in proceeds from cigarette smuggling over a five-year period, according to a 2004 U.S. report.

"Cigarette smuggling has definitely been a major source of funding for the Provisional IRA — not only the Real IRA — and other terrorist groups in Northern Ireland," said Rogelio Alonso Pascual, an IRA expert teaching at Madrid's Universidad Rey Juan Carlos.

The Real IRA has flooded Ireland with contraband cigarettes and imported counterfeit versions of popular brands. Authorities say the group is responsible for nearly all the smuggled tobacco seized in Northern Ireland, and they say cigarette smuggling has emerged as a top funding source for the organization. Combined, the IRA groups reaped an estimated $100 million in proceeds from cigarette smuggling over a five-year period, according to a 2004 report by William Billingslea, an analyst for the U.S. Bureau of Alcohol, Tobacco, Firearms, and Explosives.

In March, a Miami man was indicted in connection to a cigarette smuggling ring with ties to the Real IRA. The arrest comes after a seven-year investigation stretching from the Canary Islands to Panama, through the port of Miami and on to Ireland and the UK. U.S. and European officials declined to comment, saying the case is "complex" and ongoing.

THE TALIBAN

In the restive tribal belt of Pakistan — where Osama bin Laden is thought to be hiding — some of the most hunted Taliban militias collect money from cigarette smugglers in exchange for allowing Marlboro knock-offs and cheap local brands to flow into Afghanistan and China. Cigarettes have become an increasingly important source of financing for the groups, second only to the heroin trade, according to Pakistani intelligence officials.

As NATO forces battled Taliban in Afghanistan, the insurgents increasingly sought sanctuary along the ungoverned border regions of Pakistan where both the Taliban and the vast majority of Pakistanis are Sunni Muslim and ethnic Pashtuns. The Khyber Agency, a border province boasting the most-traveled trade route between the two countries, is also the hotbed of cigarette counterfeiting in Pakistan.

THE PKK

The Kurdistan Workers' Party (PKK) long controlled the smuggling routes between Turkey and northern Iraq. Blamed for thousands of deaths since its inception in 1978, the leftist group comprised of Turkish Kurds has sought to establish a Marxist state in southeastern Turkey. The PKK has carried out bombings of Turkish governmental security forces and popular Turkish tourist sites.

The PKK funds itself through donations from sympathizers, trafficking in narcotics and arms smuggling, and by charging a fee for every container of cigarettes allowed to pass through its territory. Whereas the group controlled the flow of contraband cigarettes into Iraq during the 1990s, they now control the flood of counterfeit cigarettes streaming out of Iraq, according to Sharon Meltzer, an expert on cigarette smuggling and transnational crime at American University. "It's still going on; it's just changed direction," she said. "Now counterfeit factories are operating openly in Iraq."

HEZBOLLAH

Hezbollah, the Lebanon-based militia and political organization, is also engaged in tobacco trafficking. The radical Shiite group receives a significant percent of its financial support from Iran, but also relies on proceeds from smuggling cigarettes and other goods.

In three connected U.S. cases since 2000, defendants tied to Hezbollah have pleaded guilty to smuggling low-tax cigarettes from North Carolina and untaxed cigarettes from New York Indian reservations to the high-tax state of Michigan. Nearly 50 defendants have faced federal charges ranging from cigarette smuggling and money laundering to material support for terrorists. Investigators say the operations made millions of dollars, some of it traced back to Hezbollah leaders in Lebanon. The network's kingpin — Mohamad Hammoud — is serving time at a medium-security federal prison in Indiana. His projected release date: September 2135.

The U.S. Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) is investigating a number of cigarette smuggling cases that appear linked to terrorism, according to Associate Chief Counsel Jeffrey Cohen. "It's not because terrorists like cigarettes particularly, but because it's an easy way to finance things," Cohen says. In most U.S. cases, groups send money through hawala, a parallel banking remittance system that relies on family, ethnic, and regional ties. Because there are few records, he adds, "it's difficult to know how much of this is going to terrorists and how much is going to food and education."

The use of hawala makes it exceedingly difficult to track money in such cases, agrees Phil Awe, acting chief of ATF's alcohol and tobacco enforcement branch. "The information is anecdotal," says Awe, who investigated the U.S. Hezbollah cases. "There are a lot of small villages [in the Middle East] where Hamas, Hezbollah, and others are ruling. If you're sending money back to those small villages where extremist groups operate, there's a good chance some of that money is ending up with them."

FARC

FARC has evolved from the world's largest, strongest, Marxist-based insurgency into what is widely seen today as a criminal outfit that is the world's largest supplier of cocaine. The group began by charging taxes on coca-growers in FARC-controlled regions but has since developed into a self-sustaining cocaine trafficking organization.

To launder its money, FARC and other Colombian narcotraffickers use what is known as the black market peso exchange in which they smuggle drugs to the U.S. and sell the dollars to informal bankers called "peso brokers." The peso broker in turn sells these dollars to Colombian exporters who buy U.S. goods with the laundered funds. Those export goods are then smuggled back into Colombia.

"In Colombia, well established drug routes were easily converted into cigarette-smuggling routes," Interpol's Ralf Mutschke said in written testimony to the House Committee on the Judiciary in 2000. DEA's Alvin James said U.S.-manufactured cigarettes, "especially Marlboros, Kents, and Lucky Strikes, made up a large portion of the trade goods that were smuggled into Colombia and financed by this process."

Anyone trafficking drugs from Colombia to the United States is at least tangentially involved in smuggling cigarettes from the United States to Colombia, authorities say. Traditional drug cartels, left-wing guerrilla groups, and the equally brutal right-wing paramilitary groups jostle for market share. The players and brands have changed over the years, but investigators say the market remains the same.

The primary transit points for the cigarette black market run through Aruba and Panama. Panama customs authorities confirmed in April a seizure of cigarettes belonging to FARC, but could not provide details pending an ongoing investigation.

THE CNDP

Seven thousand miles from the coca-rich plains of Colombia, in the dense jungles of eastern Congo, rebels allegedly profit from a millionaire tobacco tycoon who recently pleaded guilty to cigarette smuggling.

A U.N. Security Council investigative body called the Group of Experts reported in December that Tribert Rujugiro Ayabatwa, a tobacco tycoon who pleaded guilty to cigarette tax evasion charges in South Africa, has been funneling money to a Congolese rebel group that has committed human rights violations including recruitment of child soldiers, mass rape, and murders.

More than five million people have died in the Congo since 1998, making it among the most lethal conflicts since World War II. The vast majority of fighting now occurs in the east between three opposing forces: the Congolese military, a Hutu-backed rebel group, and a Tutsi-backed rebel group called The Congres National Pour la Defense du Peuple (CNDP). Led by Laurent Nkunda, the CNDP has perpetuated serious human rights abuses that include mass murder, torture, rape, forced recruitment of children, and slavery, according to the U.N.'s Group of Experts.

Rujugiro owns Mastermind Tobacco Company, which produces Yes cigarettes, and Congo Tobacco Company, which produces Supermatch cigarettes, according to company filings. Rujugiro has cigarette factories across central and eastern Africa, as well as tobacco fields in many sub-Saharan countries. He also has factories and transport companies in Dubai, and has stakes in banking, oil, real estate, and construction companies across Africa. Rujugiro is also an adviser to Rwandan president Paul Kagame, according to the U.N. findings.

The Group of Experts has uncovered a series of e-mails and individuals who claim that Rujugiro has been supporting the CNDP through cash payments and supplies, and that he pays the CNDP to allow the traffic of his untaxed cigarettes. Rujugiro has denied the allegations of smuggling and CNDP ties in a post on his website and in a letter to a Rwandan newspaper.

Port authorities seized 97 million contraband Supermatch cigarettes in Ghana earlier this year, investigators say. The cigarettes were manufactured in the United Arab Emirates, stamped with fake "Sale in Ivory Coast" stamps, and destined for Mali, where they are not licensed for sale. Supermatch, meanwhile, has become the most smuggled brand into Uganda.

Rujugiro's South Africa operation was shuttered in 2006, when the South African Revenue Service froze the company's assets and filed fraud charges against him and his son. Rujugiro left the country and was arrested at Heathrow airport in London last fall. He settled the case this month before being extradited, agreeing to pay a $7 million fine and to comply with tax laws in future.

STANCHING THE FLOW

At the core of the problem, say scholars, are the high profits of tobacco smuggling, which rival those of narcotics, and the relative cheapness of conducting a terrorist operation. In many cigarette smuggling cases, millions of dollars are at stake. A shipping container containing 10 million cigarettes costs as little as $100,000 to produce in China, but can bring as much as $2 million in the United States. Cigarette smuggling bolstered the entire economy of Montenegro during the 1990s.

Contrast that with the small amounts it takes to conduct a terrorist attack. "Part of the problem is that it takes so little to finance an operation," says Gary LaFree, director of the University of Maryland's National Consortium for the Study of Terrorism and Responses to Terrorism. British authorities, for example, estimated the 2005 London subway bombing that killed 52 people succeeded on a budget of less than $15,000. Al-Qaeda's entire 9/11 operation cost between $400,000 and $500,000, according to the final report of the National Commission on Terrorist Attacks Upon the United States.

To end the flow of criminal money to terrorist groups and insurgencies, experts say, will mean cutting off the flow of contraband — whether narcotics or tobacco. Terrorism and criminal finance investigator Larry Johnson, with BERG Associates, notes that it's much easier to crack down on the flow of legal products like tobacco. "You need to ensure that the products are being sold through legitimate channels through legitimate distributors — that they're not committing willful blindness," he says. "The contraband is fairly easy to deal with because it's in the power of the distributors and producers to control the process. This is actually one of those few problems that is fixable." ■

Alain Lallemand and Aamir Latif contributed to this story.

The Taliban And Tobacco

SMUGGLED CIGARETTES GIVE BOOST TO PAKISTANI MILITANTS

By Aamir Latif and Kate Willson

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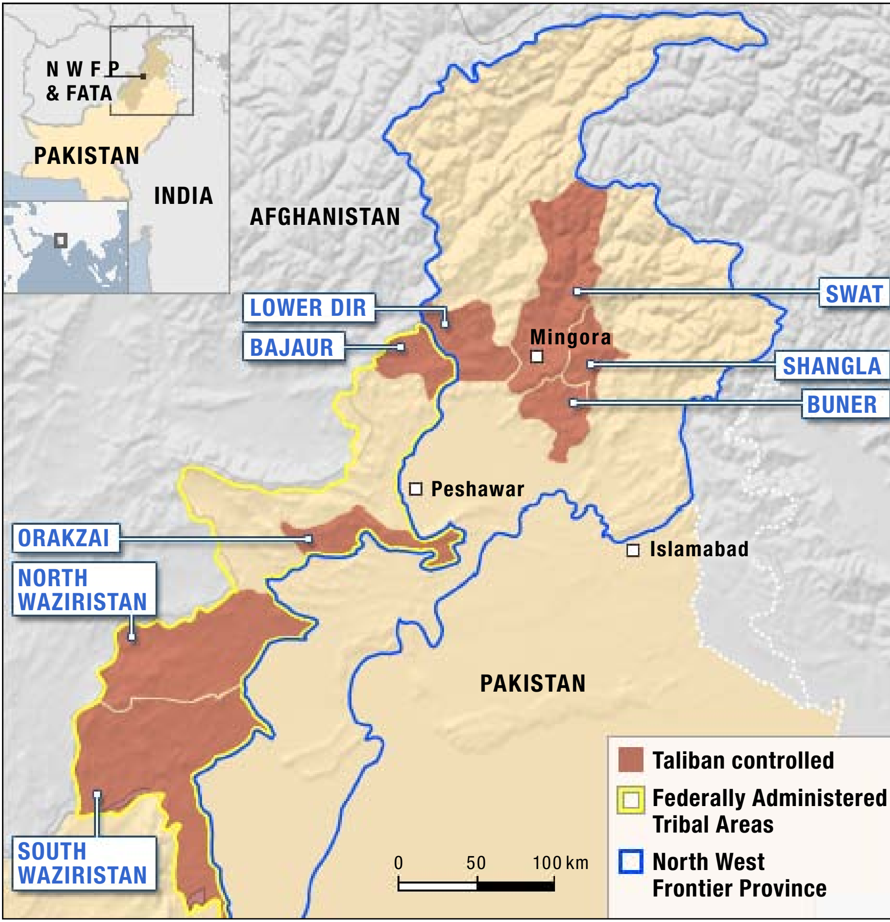
TUMMAN KHAN is a poor, aging farmer who tills another man's land in the restive northern tribal belt of Pakistan. For him and others in the Khyber Agency region, Sahib Ayub Afridi is considered an angel. The illiterate 70-year-old tribal leader finances construction of water pumps, streets and lighting, builds mosques and madrasahs, and supports the penniless and widowed.

But there's another side to Afridi.

A one-time notorious drug kingpin who in the 1980s armed the Afghan Mujahidin at the CIA's behest, Afridi churns out millions of counterfeit cigarettes to smuggle across central Asia, China, and Africa, and splits the proceeds with the pro-Taliban militants who control the swath of mountainous borderland, according to Pakistani intelligence and customs officials. The leaders of some of these militant groups are on the U.S. most-wanted list in the region — among them, Baitullah Mehsud, who has claimed responsibility for bloody attacks in Pakistan and has sworn to strike Washington, D.C. U.S. officials have responded by putting a $5 million price on Mehsud's head.

A TAX FOR TERRORISM

As government sanctions restrict traditional sources of terrorist financing, Pakistani militant groups increasingly rely on proceeds from counterfeit cigarette production and smuggling, intelligence sources say. Although income figures are rough estimates at best, profits from the illicit cigarette trade account for as much as 20 percent of funding for these militant groups, second only to heroin production, according to terrorism experts in Pakistan. "Taliban



and other militant groups do not have to do much," says Ikram Sehgal, a senior defense and security analyst who heads SMS Security, Pakistan's leading private security company. "They simply receive taxes on a regular basis from owners of illegal and legal cigarette factories and later for the safe passage they provide to the convoys."

The Afridi case is part of a broader trend of terrorism groups relying on contraband to finance their activities, experts say. Even if efforts to cut the region's booming heroin production are successful — an unlikely prospect — the lucrative tobacco trade suggests how hard it will be to stanch funding to terrorists and insurgents in areas far from government control. The world's longest-running civil wars are fueled by contraband according to a 2002 study by Stanford University's James Fearon. Cocaine smuggling has largely propelled FARC's 40-year insurgency in Colombia. Diamonds have funded civil wars in Sierra Leone and Angola. Opium has led to drawn-out conflicts in Afghanistan and Burma.

In the badlands of the Afghan-Pakistan border, the challenges are particularly daunting. U.S. President Barack Obama recently deemed the region "the most dangerous place in the world" for Americans. The growing power of the Taliban and other militant groups, combined with new waves of terrorism, has put Pakistan's weak government on the defensive. The risks are indeed high: as much as two-thirds of the nuclear-armed country is ruled not by a central government but by insurgents, militants, tribal leaders, or warlords.

Overlooked in the Pakistani Taliban's growing power is the role of tobacco smuggling.

As U.S. and NATO forces attacked the Taliban in Afghanistan, the predominantly Pashtun fighters increasingly sought sanctuary along the ungoverned border of Pakistan. The Khyber Agency — a border province boasting the most-traveled trade route between the two countries — is also the hotbed of cigarette counterfeiting in Pakistan. And its renegade factories have become the region's largest employer, according to Pakistani intelligence sources.

Fateh Mohammed, a senior Pakistani tax official, said counterfeit cigarette production is on the rise, costing the government an estimated $88 million annually in lost taxes. He said the excise department does what it can, but the factories are "out of reach."

"It's hard for us to curb the sale and production of counterfeit cigarettes as we neither have the manpower and other resources to do that," Mohammed said. "Nor do we have any reach to the tribal belt where this business is flourishing."

Illicit cigarette production in the strife-torn tribal belt, a semiautonomous region of Pashtun tribes bordering Afghanistan, accounts for an estimated 22 percent of all consumption in Pakistan, a country with cigarette taxes among the highest in the world — accounting for 87 percent of the cost per pack. Mohammad Khosa, who heads the anti-counterfeiting efforts for British American Tobacco in the region, estimated that the region's factories pump out some 15 billion cigarettes a year, a large portion of which end up smuggled to neighboring Afghanistan.

"Smuggling has long existed because of physical proximity to land routes going into Central Asia and beyond," said Sumit Ganguly, professor and Pakistan expert at Indiana University. "On top of that, there are very poor people. The two dovetail very neatly."

Trade routes between Afghanistan and Pakistan developed over thousands of years with no governmental controls. It wasn't until the British drew a 1600-mile border between the two countries, in 1893, that a culture of illicit trade flourished. Today, Pashtuns pay little attention to the poorly marked borders that separate the rugged terrain between Afghanistan and Pakistan.

Following the October 2001, U.S.-led invasion of Afghanistan, smuggling contraband goods across to Pakistan provided the Taliban with a major source of financing. In his final story published in The Wall Street Journal before his January 2002 abduction, Daniel Pearl reported on how the group "taxed" goods being smuggled across the border. The militants skimmed between $35 million and $75 million off exports of Marlboro cigarettes, Sony TVs, and Gillette shaving cream, Pearl wrote.

Today, no figure is more deeply mired in the region's contraband trade than Haji Ayub Afridi, a tribal leader of the region-ruling Afridi clan, which has long controlled trade routes into Afghanistan and whose name is synonymous with trade and transport throughout Pakistan.

WHO'S WHO OF MILITANTS

Afridi's sweeping luxury estate near the Afghan border is enclosed by 20-foot high walls topped with concertina wire, guarded by a private army and protected by an anti-aircraft battery. Authorities point to a pair of lucrative, yet nameless, cigarette factories that Afridi owns, known locally as "One More Cigarette," and to a number of cigarette-filled warehouses he is said to own near Peshawar — the region's largest city, 25 miles east of his home. Because most of his business is in the names of associates, the full extent of Afridi's assets is unknown, but officials believe he operates as many as six factories.

Afridi churns out copies of an array of Western brands — Marlboros, Camels, Benson & Hedges, and 555s, among them, officials say. The Marlboros and Camels are smuggled into Afghanistan and the central Asian countries of Turkmenistan, Uzbekistan and Tajikistan. Benson & Hedges is favored for shipment to South Africa, while counterfeit 555s are moved through the Khunjarab pass into China. Afridi also produces low-quality local brands One-Touch and Datchi, which are popular in Afghanistan.

Afridi pays protection money to a Who's Who of the region's militant leaders, according to Pakistani intelligence. In exchange for operating his factories in the Khyber Agency, sources say, Afridi pays $36,000 a month — the average combined annual income of 47 Pakistanis — to Mangal Bagh, leader of the area's ruling pro-Taliban militia.

A former bus token taker and fellow member of the Afridi clan, warlord Bagh commands thousands of heavily-armed Islamist militants through his group Lashkar-i-Islam (Army of Islam). In addition to collecting taxes from the likes of Afridi, the pro-Taliban group specializes in kidnapping for ransom. Early in his smuggling racket, Afridi refused to cut Bagh a percentage of his proceeds, instead paying protection taxes to a rival Taliban group, officials say. The two groups clashed in 2008, leaving 19 dead. Following the battle, Afridi agreed to pay Bagh.

Bagh may be the most moderate militant leader on Afridi's payoff list. Afridi also pays a pair of rival Taliban factions in the neighboring tribal region of Waziristan, along the Afghan border to the south, who are actively fighting U.S. and NATO troops in Afghanistan. One of the men, Mullah Nazir, opposes fighting against Pakistan security forces. But his rival, Baitullah Mehsud — leader of Pakistan's Taliban movement — has advocated attacks against the Pakistani government and is blamed by Islamabad for ordering the assassination of Benazir Bhutto.

Mehsud's troops also provide a safe haven for al-Qaeda forces fighting in Afghanistan, and his militancy has made him a prime target for the Americans. But that has not deterred the Taliban leader; he recently joined forces with Nazir and a third warlord who, together, now control much of the region. The rival groups agreed to "fight the U.S. together, because we are concerned over the surge in

American troops in Afghanistan," Nazir told local tribal chiefs, according to the Daily Times, an English-language newspaper in the region.

Afridi isn't the only counterfeit cigarette producer in the tribal belt. Smugglers also transport cigarettes from illegal factories in neighboring provinces of Kohat and Bannu into Afghanistan through the border town of Miramshah. The area is in the grip of an al-Qaeda militia of ethnic Uzbeks loyal to Mehsud. Pakistani intelligence sources say cigarette smugglers pay the militant groups up to 20 percent commission for each convoy. American and Japanese model trucks leave the sprawling, high-walls cigarette factories almost daily, while bigger convoys of five to seven trucks leave twice a week, local residents say.

ON THE LAM

Afridi is no stranger to the black market. During the 1960s he drove truckloads of smuggled gold through the Khyber Pass. His partner was a slightly older gold smuggler named Iqbal Baig. The two prominent tribal members would remain close business partners as they expanded into currency, hashish, and heroin smuggling.

In the 1980s, Afridi is credited with orchestrating the heroin trade between eastern Afghanistan, through the Khyber Pass, to the Afridi clan in Pakistan. Pakistani and Belgian authorities first sought his arrest in 1983, after tying the smuggler to 17 tons of hashish in a southwest Pakistan warehouse and another 6.5 tons in Antwerp, Belgium. But when 50 Pakistani police sought to arrest Afridi in 1990, they were met by an armed militia and quickly retreated, according to U.S. court records.

Despite his record as a narcotics trafficker, the CIA had its own uses for Afridi. In the 1980s, he was one of many Pashtun tribal leaders tapped by the agency to help finance and arm the Mujahidin struggle against the Soviet invasion of Afghanistan, according to The New Dimension of International Terrorism by former Harvard University fellow and U.S. Army Colonel Stefan M. Aubrey. After the Soviets pulled out of Afghanistan, Afridi turned his attention homeward. He was elected to Parliament in 1990 — reportedly after paying up to $600 per vote to represent the Federally Administered Tribal Areas.

Through it all, Afridi never stopped dealing drugs, according to U.S. court records. He ordered subordinates to truck hashish to Karachi in Bedford trucks and old tanker trucks. Meanwhile, he and his partners made millions smuggling tons of heroin and hashish across the globe — through India to London, Paris, and Amsterdam, packed amid frozen fish into the Netherlands, through Singapore and Hong Kong, and across the Atlantic to the United States and Canada.

Afridi, through his longstanding contacts in the drug world, became the key supplier to the biggest narcotics ring in Pakistan, according to the U.S. Drug Enforcement Administration. The DEA branded Afridi's syndicate "the single most prolific heroin and hashish drug trafficking organization in Pakistan." The amounts were indeed impressive: 57 tons of hashish into the Netherlands in a single shipment; 30 tons of hashish to California; and massive amounts of heroin around the world.

At the center of the operation was the notorious Iqbal Baig–a respected, well-known businessman whose assets included cinemas, textile factories, commercial property, and a pizzeria. And at Baig's side was Tarik Butt, his brother-in-law. Butt took over a battery manufacturing plant in 1986 after its owner — smuggling heroin into Vienna on Butt's behalf — died from a drug-filled balloon exploding in his stomach. The factory became "a social club of misfits, thugs, murderers and dope dealers," said a New Delhi-based agent with the Drug Enforcement Administration.

By the 1990s, however, Afridi's criminal past was catching up with him. With authorities threatening prosecution, he went into hiding and was soon splitting his time between Pakistani tribal areas, Afghanistan, and the United Arab Emirates.

It was a trio of hash shipments — 58 tons in all — that finally led to Afridi's undoing.

Hidden amid fish, tires and sacks of rice, the drugs were sent to Long Island, New York, and Newport News, Virginia, and led to the arrest of one Stewart Newton, Afridi's U.S. connection. Arrested in 1988, Newton was sentenced to 47 years in prison, but served only eight after agreeing to cooperate with prosecutors in the case against the Pakistani smugglers. Also indicted were Butt and Baig, whom Pakistan extradited to the United States in 1995.

Afridi stayed out of reach, hiding in the tribal zone. But fearful of arrest by Pakistani officials and concerned his now-arrested co-conspirators would turn against him, he negotiated with the DEA for a year before finally turning himself in.

Now-retired DEA agent Gregory D. Lee recalls fielding odd questions from Afridi's go-between during that time.

"He would ask crazy questions like, 'how many times a day will I be beaten by the Marshals?' and 'will I be able to stay at the Waldorf Astoria in Manhattan," Lee said during a recent phone interview. If he wasn't permitted to serve out his sentence at the four-star hotel, Afridi wanted to know if he could employ a personal cook at the prison. "He had no idea what to expect."

In 1997, Afridi pleaded guilty to smuggling hashish and was sentenced to five years in prison and a $100,000 fine. But the Pakistani godfather served only two years in U.S. jail, paid just $425, and in 1999 he was deported to Pakistan, where officials promptly arrested him for an earlier smuggling case.

Although sentenced in Pakistan to seven years in prison, Afridi was released without explanation shortly after 9/11. Soon after his release, he traveled to Afghanistan to unite anti-Taliban warlords, according to senior Pakistani intelligence and anti-narcotics officials. His attempts failed, they say, and the aging Afridi returned home.

It is back home, in the Khyber Agency, where Ayub Afridi has refocused his attentions. Gone are the hashish and heroin shipments, officials say. The old smuggler has found an easier racket to ply, with few penalties and easy profits — the untaxed cigarette trade. Reached by telephone, in English and Urdu, an elderly man at Afridi's home denied he was Afridi and declined to comment further.

Nor will others talk openly about Afridi in his native land. Journalists do not write about the man, and even law enforcement officials speak about him in hushed tones. But the poor of the Khyber Agency are not so reticent. Despite his years in Afghanistan, in jails and throughout his smuggling exploits, Afridi didn't forget the poor who surrounded him, farmer Tumman Khan told a visiting reporter. Even when Afridi was locked away in an American prison cell, the poor and widowed continued to receive monthly checks on his behalf.

"Haji Sahib is an angel for poor people like us," Khan said. "We don't know much about his business, whether legal or illegal. What we know is that he has helped us when no one was there to do that." ■

The Montenegro Connection

LOVE, TOBACCO, AND THE MAFIA

By Leo Sisti

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"**MY LITTLE CAT** … I'm going crazy without you …. You have repeatedly betrayed me, I think …. Little cat, when are you coming? ... I love you, little cat." On Jan. 4, 2001, Dusanka Pesic Jeknic, representative of the Montenegrin trade mission in Milan, Italy, was speaking on the phone at her home in the southwest of the city. Milo Djukanovic, at that time president of Montenegro, was calling from the capital Podgorica. Billions of people around the world had just hailed the New Millennium. Dusanka, nicknamed "Duska," the beautiful 41-year-old widow of the late foreign minister of Montenegro, was alone, far from her country. And she spoke out freely about everything: love, tobacco, and crime.

Eight years after Jeknic's loving conversation with her president, transcripts of her phone calls, wiretapped by the Italian police for 20 months, are attached to hundreds of thousands of court records filed by the prosecutor's office in Bari, in southern Italy. Here, in the Apulia region's capital, facing Montenegro across the Adriatic Sea, prosecutors Giuseppe Scelsi and Eugenia Pontassuglia have at last wrapped up their long-running investigation of Djukanovic, Jeknic, and six other Montenegrins and Serbs, as well as seven Italians allegedly tied to organized crime. Their indictment charged the group with, among other offenses, mafia association aimed at illicit trafficking of tobacco, a serious crime in Italy. The indictment and an accompanying 409-page report by Italy's anti-mafia unit, the DIA, which have not before been made public, provide an extraordinary look inside what may be one of Europe's biggest smuggling operations in recent years — a tale of corruption, murdered witnesses, and a billion dollars in money laundered through Swiss banks.

TORTUGA OF THE ADRIATIC

At the center of this case is a hidden bit of history, say prosecutors, of how tobacco smuggling became a state enterprise in Montenegro, a Balkan republic in southeastern Europe bordering Serbia and the Adriatic Sea. Home to just 600,000 people, the country is smaller than Israel and is known for its scenic coastline. But it is also known for its smuggling routes through the heart of the Balkans, which, during the breakup of the former Yugoslavia, allowed organized crime to thrive. Italian authorities noted as much in the DIA report. "Montenegro, for a decade, was the real Tortuga of the Adriatic sea," they wrote, comparing the Balkan state to a Caribbean island notorious for its pirates. "A heaven for illicit trafficking; impunity granted to mobsters … a place where authorities guaranteed the passage of illicitly traded goods." And investigators left no doubt who they thought was behind the billion-dollar racket: "Milo Djukanovic ruled this Tortuga."

Djukanovic is now prime minister of that "Tortuga." Re-elected in March, he leads a country where for nearly 17 of the past 18 years he has served as either prime minister or president. And he is pushing hard for Montenegro to join the European Union, which is now considering the country's membership. To that end Djukanovic counts on his main supporter, Italy's premier Silvio Berlusconi, who in March lauded him during a state-visit in Podgorica.

Affiliated with Serbia until 2006, Montenegro is now fully independent, but some EU nations, notably Belgium and Germany, remain skeptical that the country is ready to join the West. Djukanovic has said that the smuggling is a thing of the past, done, to earn cash during a time of international sanctions against the former Yugoslavia, and that he did not personally profit from the trade. Law enforcement officials broadly agree that Montenegro's era of state-sponsored smuggling is over. But the prime minister's controversial history has dogged him for 15 years, and whether he can convince the EU that he — and his government — have cleaned up Montenegro may depend on what happens in Italian and Swiss courts this summer.

According to the Italian indictment, from 1994 to 2002, during Djukanovic's long tenure, Montenegro was a haven for cigarette smuggling by two of Italy's mafia syndicates: the Neapolitan mafia, known as the Camorra; and the crime family of the Apulia region, in Italy's boot heel — the Sacra Corona Unita. Both syndicates set up shop in Montenegro. Almost every night dozens of pilots steered a fleet of large speedboats crammed with cigarettes across the Adriatic from the Montenegrin port of Bar to the Italian city of Bari and nearby. According to court records, during those eight years an extraordinary one billion cigarettes per month — 100,000 cases — were smuggled out of Montenegro, most of them Marlboro and Marlboro Light. Once in Italy, the untaxed cigarettes were sold by the mafia on the black market.

The judicial papers originally named 15 people. Among them: Djukanovic himself; Dusanka Jeknic; a former Montenegrin finance minister; managers of the Montenegrin company MTT, allegedly set up to control the smuggling; reputed Balkan and Italian mobsters; and a Serbian businessman. In March, noting that Djukanovic is protected by diplomatic immunity, prosecutors dropped him from the indictment.

Starting June 3, Bari Judge Rosa Calia Di Pinto will hold a preliminary hearing to decide whether or not the evidence gathered by prosecutors is enough to put the indicted on trial. The judge will hear a story of a "mafia war" stretching into 10 countries: not only Italy and Montenegro, but also Serbia, Croatia, Greece, Germany, Switzerland, Cyprus, the Netherlands, Liechtenstein, Aruba, and the United States. So far, two key witnesses and five others mentioned in the case have been murdered.

OPERATION MONTECRISTO

In Switzerland, meanwhile, a second trial has been underway since early April, also bearing on the Montenegro connection. Codenamed "Montecristo," after the classic book The Count of Montecristo, the case stems from the Swiss leg of an investigation started as an offshoot of the Bari prosecution. In what is reportedly the largest organized crime case ever in Swiss courts, authorities maintain that over a decade — from the early 1990s until 2001 — more than US$1 billion from the tobacco smuggling were laundered by Italian organized crime. The mafia allegedly washed its dirty cash from Montenegro through brokers and money changers based in Lugano, Switzerland, and deposited it in Swiss banks. The trial of nine people, including Swiss, Italians, a Frenchman, and a Spaniard, is expected to end in June, with a possible ruling June 19 in Bellinzona, just across the border from Italy.

Both sets of hearings are sure to interest Brussels officials in charge of EU enlargement, who are reviewing Montenegro's bid for membership. Djukanovic's diplomatic immunity cannot stop the proceedings from shedding light on a country that for years, critics say, has been governed outside the rule of law. Today, law enforcement officials believe Montenegro's tobacco smuggling has largely been replaced with new routes from Russia, China, Poland, and Ukraine. But the years of black market activity, allegedly presided over by Djukanovic himself, raise uncomfortable questions about crime and corruption in Montenegro.

Ratko Knezevic, a long-time Montenegro government insider who once lobbied Washington on behalf of Djukanovic, described the extent of the old smuggling in his 2006 thesis for the London Business School. Knezevic reported estimates "that by the end of [the] 1990s, the Montenegrin government was earning as much as $700 million annually from the clandestine cigarette trade." Knezevic was a teenage friend of Djukanovic, who served as a witness at Knezevic's wedding. But Knezevic now lives in London and has had a falling out with the prime minister. He relates that Djukanovic once told him that while Montenegro faced international economic sanctions in the 1990s, the country reaped $300 million annually from the illicit trade in cigarettes and oil. Whatever the black market amount, law enforcement officials are convinced the contraband trade was a prime earner of hard currency for Djukanovic's government, which slapped a so-called "transit tax" on shipments by the smugglers. Knezevic described it as a stream of contraband cash "flowing into a parallel government budget, which was then used to support the official budget."

This much is clear: Milo Djukanovic is a seasoned and savvy politician. The son of a well-connected judge, he enrolled in the Yugoslav Communist League while still in high school. He later became secretary of the League of Communists of Montenegro and allied himself with Yugoslavia strongman Slobodan Milosevic. Djukanovic's own bid for power succeeded in February 1991, when he was elected prime minister of Montenegro. He was only 29, and at that time few people in the world had even heard of Montenegro. That changed quickly with Yugoslavia's bloody collapse in 1991 and '92, as Slovenia, Croatia, Bosnia Herzegovina and Macedonia all seceded. Montenegro remained in a federated state with Serbia, and in 2006, it became independent through a referendum. Through all this, Djukanovic dominated the political life of Montenegro, serving six terms as prime minister (1991-1998, 2003-2006, 2008-present) and one term as president (1998-2002).

THE BARI INVESTIGATION

In 2001, a special commission set up by the Italian Parliament released a 130-page report focused on Montenegro and the mafia. For years, the mafia had moved mountains of contraband cigarettes through the ports and warehouses of Montenegro's southern neighbor Albania, but these had become unreliable due to the Balkan war. By the mid-1990s, Montenegro had taken over the illicit trade, and was pouring billions of untaxed smokes into Italy.

One of the investigators summoned by the Rome Parliament to testify on Montenegro's new role was the Bari prosecutor, Giuseppe Scelsi. He and other colleagues testified that Montenegro was the main operational base for smuggling in the Mediterranean, a place where a great number of fugitive criminals set up shop to trade cigarettes as well as drugs and arms. In the north, they noted, the port of Zelenica was controlled by members of the Bari and Naples mafia, while in the south the port of Bar was run by the mob from Bari and Brindisi, another Apulia town. The gangs in effect operated their own navy — about 70 speedboats — able to cross the Adriatic in a mere two hours.

The lucrative trade was also a bloody one. Wars between rival mafia factions left more than a few mobsters dead in both Italy and Montenegro, along with several agents of the Guardia di Finanza, the Italian tax and customs police. In Rome, the Parliament reacted quickly: just 13 days after releasing its report on the mafia, it approved a tough new law making tobacco smuggling a crime tied to mafia association with prison terms of up to 15 years. Two years later — in 2003 — the prosecutor's office in Naples aimed their sights at the very top, seeking to arrest Djukanovic himself on "association of mafia-type" charges. The warrant, however, was initially rejected by a judge, on the grounds that Djukanovic was shielded by diplomatic immunity. The judge did grant a warrant for the arrest of Duska Jeknic, but by then Djukanovic's lover had already fled Italy.

Prosecutors in Bari were also investigating the same case. With authorities in both cities conducting investigations on Montenegro, often involving the same people, in summer 2003 the Bari prosecutor's office was chosen as the sole investigative magistrate and the cases were merged. From that point on, Scelsi worked alone with the Bari unit of the DIA, the anti-mafia agency. He spent years collecting testimony and documents, which he requested from several countries, mainly tax havens, like Cyprus and Switzerland, as well as the Netherlands, Croatia, Serbia, Slovenia, and the United States.

The court records have been sealed until now. The report produced by the DIA, in particular, includes a fascinating set of statements made by mobsters from the Apulia "cartel"; smugglers turned informants; the reputed "kingpin of Swiss contraband"; Croatian journalist Ivo Pukanic, editor of the Zagreb-based weekly Nacional, murdered in October 2008; and two Montenegrin officials.

FOLLOWING THE MONEY

Italian investigators set out to follow the money behind the "Montenegro Connection" — where it went, who touched it, who laundered it, and who owns it today. There was money for everybody, they found, in a multi-billion-dollar business. Money for smugglers. Money for organized crime. And, according to court records, money for Montenegrins in high places. "Djukanovic, together with his inner circle," noted the DIA report, "had huge amounts of money illicitly earned and lodged in Swiss, Monte Carlo and Cyprus banks."

Scelsi, the prosecutor, zeroed in on the man who allegedly masterminded the smuggling scheme with Montenegro authorities. He was Franco Della Torre, a Swiss citizen well known to Italian and U.S. officials. Della Torre was implicated in laundering mafia money in the notorious "Pizza Connection" case of the 1980s. The Pizza Connection had reunited the Sicilian mob with its American cousins, pouring a flood of heroin into America's East Coast through pizzerias. It looked to Scelsi as if Della Torre was up to his old tricks, but this time using not drugs but tobacco. Swiss prosecutors agree and have indicted della Torre as part of the Montecristo case. Authorities allege that della Torre built a complex operation that involves a 1996 deal he negotiated using a Panamanian company, Santa Monica, with an exclusive license to transfer 100,000 cases per month of Philip Morris, British American Tobacco, and R.J. Reynolds cigarettes. Della Torre, Scelsi says, then subcontracted with four distributors: Italian, French, and Spanish smugglers.

Della Torre's de facto partner in Montenegro was allegedly MTT (Montenegro Tabak Transit), a state company set up to control smuggling operations and run by two of Djukanovic's friends, according to court records. MTT in turn was said to manage another Montenegrin company, Zeta Trans, which operated a warehouse based in the Montenegrin port of Bar, where smugglers stored the tobacco before moving it each night into the hands of Italian organized crime.

Scelsi charges that Della Torre, on behalf of MTT, was entitled to import and store cigarettes, as well as to collect duties (the so-called "transit tax") from his four distributors. Della Torre then made payments to MTT from Santa Monica, working through three Irish companies owned by MTT and an account with the Intercambi company, owned by a Swiss money changer. Under instructions from Montenegro, Della Torre allegedly made payments to Zeta Trans and others, including "Yugoslav politicians." How much money went to Zeta Trans? According to testimony summarized in the DIA report, the Italians paid US$63 a case; $30 ended up on Zeta Trans accounts and the rest in private accounts. Elsewhere, the report cites testimony that "part of the transit tax, at first three Deutsche marks per case … went onto the books of the National Security Service, without any authorization, in violation of Montenegro laws and regulations."

Who was behind the smuggling scheme? Court records allege that Djukanovic himself was deeply implicated. Scelsi accused the Montenegrin leader of "having promoted, run, set up, and participated in a mafia-type association." His investigators wrote: "Milo Djukanovic was absolutely aware of what was going on in Montenegro, as well as of the repercussions on the Italian State and the other EU members. He was aware since he was involved in it and had a direct interest in it. He himself was conscious of the huge amount of money, in hard currency, drawn from illicit tobacco trafficking handled by Italian organized crime. His greed for riches made him so unprincipled that he fit in with the association. He went so far as to assure protection to fugitives wanted in Italy, disregarding the most basic legal norms. He did that through the state security apparatus."

The racket was, in effect, a giant ATM machine, producing as much as $2 million each week. Court records from the Italian and Switzerland investigations suggest that the mafia's profits from the trade were cleaned up by Swiss money launderers. According to an indictment by Switzerland's attorney general:

"Criminal funds of the Camorra and Sacra Corona Unita were infiltrated into the Swiss banking system through Ticino-based money changers. The money runners crossed the border into Switzerland carrying huge amounts of cash. In Lugano, mafia funds were deposited in bank accounts of individuals and brokerage companies …. Thanks to exclusive licenses and the collection of transit taxes on contraband cigarettes, Montenegro rulers were presented with another income stream and the possibility of obtaining profits from illicit trafficking in cigarettes …. Starting in the early 1990s until the beginning of 2001, almost the whole flow of funds stemming from Montenegro's cigarette smuggling trade, managed by the Camorra and Sacra Corona Unita, went through the Swiss financial market. During this time, more than one billion dollars were laundered."

Italian investigators have reconstructed what they say is the "money trail" behind the Montenegro Connection. From 1997 to 2000 the smugglers flew planeloads, literally, of banknotes in foreign currencies: 1.2 billion German Deutsche marks, 726,000 U.S. dollars, 136,000 Swiss Francs, and some 65,000 Austrian Shillings. The man who allegedly engineered all this was Stanko "Cane" Subotic, a Serbian businessman close to Djukanovic. "Through his company, Dulwich," alleged Italian prosecutors, Subotic "laundered the proceeds of the criminal association. He assured the availability of aircraft to transfer money from Montenegro, where the money arrived from Switzerland, to Cyprus." He used three airplanes, "one of them bought with profits from Montenegro's tobacco transit tax and with Subotic's own money," and 15 couriers who flew 178 times from Montenegro to Cyprus, according to investigators. Once deposited in the Bank of Cyprus, some of the funds were used to pay tobacco makers (for example R.J.Reynolds, Austria Tabak Scandinavia, which later became Gallaher Sweden, and Seita, the French maker of Gauloises). But the bulk of it allegedly disappeared in at least two obscure companies with accounts in Liechtenstein banks.

"I'M HOME, LITTLE CAT"

At 10:13 pm on Feb. 24, 2001, Milo Djukanovic made a phone call to his lover Duska Jeknic, the Montenegrin business attaché in Milan, who had just turned 42. "Where are you, little cat?" Jeknic: "I'm home, little cat." She was accompanied by Paolo Savino, an Italian living in Switzerland, who had become the group's new cigarette broker, according to the investigative report. Savino's predecessor, Della Torre, was being investigated in Bari and in Switzerland.

Duska didn't know that she was being tailed and wiretapped by Italian agents. Two days later, news broke that Della Torre had been arrested. On the phone, according to the investigative report, Duska and Savino worried that Djukanovic's role in issuing Della Torre's cigarette license could tie him to the smuggling network, according to court records. Both allegedly feared Della Torre could show that he was acting as a representative of the Montenegro government. Worse news came the same evening, that a reputed boss of the Sacra Corona Unita, known as the king of contraband in Montenegro, had been extradited to Italy after his arrest in Greece. He, too, could open his mouth.

More bad news followed. In May that year, the Croatian magazine Nacional published an interview with Sretko Kestner, a local tobacco trader. Kestner was a former partner of Subotic, the man behind the airlifted cash from Montenegro to Cyprus, and he knew plenty. Djukanovic, he told the world, was behind the Montenegro cigarette trafficking through MTT's directors.

Scelsi's DIA investigators searched Jeknic's Milan apartment in July 2003. By then Jeknic had fled Italy, fearing the worst. But she left behind a goldmine: personal organizers, notes, and telephone books with the numbers of Milo Djukanovic, his brother Azo, and a certain "Cane" — the nickname of suspected smuggling mastermind Stanko Subotic. Also among the notes: the codes of two airplanes used to channel black cash into Cyprus, with "Cane" written aside it with a Greek phone number and the name of a courier.

A DEADLY TRAIL

The Montenegro Connection is surrounded by murder. Investigators have been struck by the large number of people linked to the "Montenegro Connection" who have met untimely deaths in recent years:

Goran Zugic, security advisor to then-President Djukanovic, was shot and killed on May 31, 2000.

Vladimir Bokan. A Serbian businessman murdered in Athens on Oct. 7, 2000. During the 1980s, Bokan owned retail shops, including a Belgrade boutique where "Cane" Subotic was a tailor before becoming a contraband kingpin and working for Djukanovic. According to the Italian investigators, Bokan had been tied to tobacco smuggling in Montenegro for some time.

Darko Raspopovic. A senior member of the Montenegro police directorate, Raspopovic was shot dead on Jan. 8, 2001, in Podgorica. He had run investigations into white collar crime and in 2000 was nearly assassinated when a bomb blew up his car.

Baja Sekulic. A former bodyguard and aide to "Cane" Subotic, he was murdered on May 30, 2001, in Budva, Montenegro, on the Adriatic coast.

Orazio Porro, murdered on March 25, 2009. Porro, arrested in 1998 in Montenegro, where he was one of the bosses of the cigarette traffic, became an informant and for a time was in a witness protection program.

Zugic, Bokan, Raspopovic, and Sekulic were mentioned in the Bari investigation but were never summoned by Scelsi's team. The case is different for two other key murdered witnesses, both of them journalists:

Dusko Jovanovic. Editor of Dan, a pro-Milosevic Montenegrin daily newspaper, he was gunned down on May 27, 2004, while getting in his Peugeot 406. His newspaper had reported stories first broken by the weekly Croatian magazine Nacional. Through his investigators, Scelsi approached Jovanovic and asked if would testify in the Italian investigation. Jovanovic agreed but never made it to Bari.

Ivo Pukanic. Editor of Nacional, he was questioned by Scelsi on July 18, 2002. But "Puki," his nickname, will never get to the witness stand. He was murdered on Oct. 23, 2008, killed by a car bomb in Zagreb, near Nacional's offices. His deposition, however, can be used in court, and prosecutors found his statements an invaluable starting point in tracing the money out of Montenegro to Cyprus .

Another important witness questioned by Italian investigators is Vuksan Simonovic, a Socialist People's Party representative in the Montenegrin Parliament. Simonovic chaired a Montenegro parliamentary committee set up in 2001 to investigate the tobacco smuggling allegations. According to Simonovic, the Bar port authority reaped $7 million in five years, from 1996 to 2001, from cigarette smuggling, just by loading and unloading tobacco from ships to warehouses. Simonovic also confirmed the roles of MTT and Zeta Trans, the Montenegrin companies allegedly tied to the smuggling. And the committee, he said, had questioned Djukanovic about three Swiss bank accounts allegedly tied to him, with some $3.2 million, mentioned in an article published by Pukanic's Nacional. Djukanovic denied everything.

Djukanovic has denied everything in Italy, as well, and he has declined to comment on this report. In March 2008, he agreed to submit to questioning by Scelsi and another magistrate in Bari. After more than six hours, Djukanovic left the court. Outside, his Naples attorney told the press how as prime minister, Djukanovic could have refused to answer the court's questions, but that he had in fact asked to be questioned. "A year ago Prime Minister Djukanovic had asked to be interrogated to clear up all the lies told by people who, obviously, love neither Italy nor Montenegro," the attorney explained. "Now everything has been cleared up."

Well, not quite. That will be up to judges in Italy and Switzerland this year, who will be looking at the law, a decade of smuggled cigarettes and laundered money, and the legacy of a certain prime minister.

Djukanovic's Montenegro A Family Business

AS EU MEMBERSHIP LOOMS, SO DO TROUBLING QUESTIONS

By Miranda Patrucic, Mirsad Brkic, and Svjetlana Celic

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MONTENEGRINS may have been surprised late last year to learn that the global financial crisis had arrived in their tiny Balkan country. Newspapers, the Internet, and even a James Bond film painted Montenegro as the Monte Carlo of Eastern Europe. The nation's mountainous, tree-lined coast, medieval walled cities, and stone ruins set the scene for a boom in luxury hotels and private villas.

In December, the administration of Prime Minister Milo Djukanovic announced that Montenegro would bail out First Bank (Prva banka), one of the country's largest financial institutions and a major investor in the Montenegrin boom. First Bank is majority owned by Djukanovic, two siblings, and a close friend.

Members of local watchdog groups, opposition parties, and journalists say this is just another example of the government's interests aligning with the financial interests of the first family. They say their small country — fewer than 700,000 people in less space than the U.S. state of Connecticut — seems at times like the private corporation of the prime minister and his family. With Djukanovic's political party handily winning elections at the end of March, the prime minister is expected to remain in power for another two years.

"Montenegro is a lawless country," charges Milka Tadic, editor of the country's influential Monitor magazine. "And if you are part of the government or close to its circles you can do whatever you want."

Djukanovic has amassed a level of wealth that is hard to explain given his meager government salary over the years. Some believe his wealth stems from his days in the tobacco smuggling business. Italian prosecutors place the prime minister at the center of a conspiracy by Montenegrin officials and the Italian Mafia that allegedly smuggled huge quantities of cigarettes for about 10 years starting in the 1990s, although prosecutors did not specifically allege that Djukanovic profited personally from smuggling.

Allegations of corruption are attracting interest outside Montenegro these days, as the country is making a bid to join the European Union. Although the EU is satisfied Montenegro is making progress, EU Enlargement Commissioner Olli Rehn told a Montenegrin television station in December that corruption and organized crime are the primary obstacles to the country joining the EU.

Djukanovic declined to comment for this story, and has said little beyond cursory denials when various allegations of wrongdoing have surfaced over the years. Instead he has vigorously confronted his accusers in court, filing and winning defamation lawsuits against media in his homeland, Serbia, and Croatia. Last year he won a €20,000 judgment against Vijesti, the country's largest independent newspaper, and its publisher Zeljko Ivanovic, who was badly beaten and had suggested that Djukanovic and his family were behind the attack. When the Croatian weekly Nacional published an unflattering article in 2001, Djukanovic countered by suing not only that publication, but also media outlets that reprinted the story, according to Reporters Without Borders.

FAMILY OF MILLIONAIRES

In 1991, on the day he turned 29, Milo Djukanovic came to power, the youngest prime minister in Europe. Shortly after, Yugoslavia split apart in war. Djukanovic was one of a trio of Montenegrin leaders at the time, led by then-President Momir Bulatovic, a close ally of Serbian strongman Slobodan Milosevic. In 1991 and 1992, Montenegro drew international outrage for shelling Dubrovnik — a UNESCO heritage site — in neighboring Croatia. Ethnically targeted Bosnian Muslims who sought refuge in Montenegro were deported back into Bosnian Serb-held areas, a fact Montenegro has acknowledged in recent years by awarding compensation to survivors. In 1992, for example, some 80 Bosnians were sent back; some of them were kept in prison camps, but most were later executed. Opposition parties unsuccessfully called for an investigation into whether Djukanovic should be tried for war crimes.

Djukanovic dominated political life in Montenegro. Except for 16 months he spent in Parliament, he has served continuously since 1991 as prime minister or president. As president, he became the darling of the West when he turned his back on Milosevic. After Milosevic's 2000 defeat in Serbia, Djukanovic began a national push for independence from Serbia. His efforts succeeded in 2006.

During the war years, Montenegro relied on cigarette smuggling revenue to keep the country afloat.

During the war years, Montenegro relied on cigarette smuggling revenue to keep the country afloat. Bulatovic and Djukanovic have admitted that smuggling helped fill government coffers, but maintain that they never personally benefited from the trade, which they say complied with Montenegrin laws.

Whatever the source of his wealth, Milo Djukanovic today is a rich man. Reporters for the International Consortium of Investigative Reporters (ICIJ) found that he owns or controls properties and company shares worth at least US$14.7 million. That stands in contrast to Djukanovic's government salary, which has never topped $1,700 per month. Djukanovic's income declaration forms, dating back to 2005, do not list earnings from other sources. His wife Lidija earns a salary slightly higher than his, according to the most recent filing.

Other members of the Djukanovic family also fare well financially. Djukanovic's brother Aleksandar (known as "Aco"), a concert promoter before the Balkans war, has accumulated at least $167 million, according to an ICIJ estimate of his assets. His sister Ana, a high-profile lawyer, has more than $3.5 million worth of stocks and real estate. And the prime minister's son Blazo, a university student, earns about $15,000 monthly leasing an office that was a gift from his uncle.

"What is obvious is that Mr. Djukanovic and a number of government officials amassed enormous riches during the 1990s, and now with that money they are unabashedly buying Montenegrin companies," said Alexander Damjonovic, a member of Parliament for the opposition Socialist People's Party of Montenegro (SNP). "They are investing money in the capital markets. They are buying real estate."

How the family accumulated its wealth is not clear. Critics say the Djukanovics made a series of lucrative business deals, and that the prime minister has been involved in repeated conflicts of interests. The privatization of a bank in his hometown of Niksic is the prime example, they say, of how Djukanovic's family makes these business deals bear fruit.

THE NIKSIC BANK GOES PRIVATE

In 2006, the Niksic Bank was slated for privatization, and Djukanovic was deeply involved. As prime minister he established a council to oversee the transfer of public companies into private hands, and he appointed himself president of that council. The council set up odd rules for the bank privatization by which a 30 percent stake in the bank would be sold on the Montenegrin stock exchange. The shares, held by the Republic of Montenegro and two government agencies, had to be sold to one bidder, the rules stated, and they set a minimum acceptable price, about $3 million, for the package. Only one bid came in. It was from Monte Nova, a company owned by Djukanovic's brother Aco.

Monte Nova, which already owned 12 percent of the bank, didn't actually pay even the minimum asking price. It covered about half of its bid in cash and the rest in bonds of old foreign exchange funds, a form of payment that the council's unusual rules for the bank deal allowed. The bonds could be bought at the time for a fraction of their face value.

After the purchase, the name was changed to First Bank and its headquarters were moved to the capital, Podgorica. Monte Nova appointed four of the seven members of the board, effectively taking control of the bank. A corporate disclosure filed with the stock exchange showed that over the next two years, the board approved a series of recapitalizations, issuing additional stock that was sold again at a minimal price of $187 per share (the market price ranged between $250 and $1500). Djukanovic, through his company Capital Invest, bought nearly seven percent of the low-priced shares with a $2 million loan from the London office of Piraeus Bank of Greece. Djukanovic used the stock that he was buying as collateral. Ana Kolarevic, Djukanovic's sister, bought what is now a 0.5 percent share of the bank.

Aco Djukanovic's shares jumped 100-fold in value and by September 2008 were worth more than $141 million. The prime minister's investment had grown to nearly $8.7 million by then, while sister Kolarevic's shares increased to about $1.6 million. (Their current value may be different, but no shares have publicly traded since then.)

> **Within one year of the purchase of his first shares, Djukanovic repaid a $2 million loan with stock that was worth four times what he paid for it.**

Within one year of the purchase of his first shares, Djukanovic repaid the loan with stock that was worth four times what he paid for it.

Immediately after the Djukanovic family invested in the bank, the amount of assets deposited there by governmental bodies skyrocketed. At the end of 2006, about the time Monte Nova took over the board, the Montenegrin government and agencies, various municipalities, and state companies had $23 million in the bank, according to bank audits. By the end of 2007, government deposits totaled $127 million. Overall deposits soared from more than $104 million in 2006 to more than $579 million in 2007, making it one of Montenegro's most important banks overnight.

Djukanovic's government announced in December that due to the international financial crisis, the government would bail out the family's bank. First Bank showed a profit of $5.8 million for the nine months ending September 2008, but end of the year figures just three months later revealed a loss of $35 million. Djukanovic's government helped with a loan of $64.7 million and by paying off some $19 million in loans the bank had given to state companies or companies working on state projects. By March, the bank had paid back $14.5 million of the loan.

Auditors found that while under the family's control, the bank regularly loaned to insiders and connected parties. For example, in 2007, Aco Djukanovic borrowed more than $2 million and Milo Djukanovic's business partner, Vuk Rajkovic, borrowed $856,500. Stanko Subotic, a friend of Djukanovic who is under indictment in Serbia on charges of tobacco smuggling, took out a loan from the bank to buy nearly $33 million of land on exclusive St. Nikola Island, a resort property so stunning it is known as "Hawaii." He never repaid the loans and the bank is liquidating his properties.

Aco Djukanovic and his sister Ana Kolarevic declined to comment. "I would gladly talk about everything else, but not about First Bank," said Kolarevic. "I'm a small stakeholder, with a very, very small percentage. … I'm not authorized to talk about it."

Ranka Carapic, Montenegro's chief state prosecutor, issued a statement in January saying that the Central Bank suspected that First Bank's management had "taken illegal actions" that had endangered depositors' accounts. Prosecutors and Central Bank officials refused to provide ICIJ with details about the alleged irregularities. Meanwhile, press accounts quoted depositors who complained that the bank took three weeks to honor wire requests. The case is being investigated by the Montenegrin Special Department for Combating Organized Crime.

The Network for Affirmation of the NGO Sector (MANS), a Montenegrin nonprofit watchdog group, complained to the state Commission for Determining Conflict of Interest in 2006, asking it to suspend Djukanovic and several other ministers from membership in the privatization council. MANS argued that the Montenegrin Constitution prohibits government officials from performing other duties. The commission, appointed by the assembly controlled by Djukanovic's party, disagreed, finding that the board was a government body and Djukanovic could serve in any governmental function he wanted.

CONFLICTS OF INTEREST?

In the fall of 2006 Djukanovic withdrew from the top level of government in favor of serving as a member of Parliament. Montenegro's independence, he said, represented the achievement of his major political goal and it was time to dedicate himself to business.

Over the next two years, he opened five companies. Three are still active, including Capital Invest, a consulting and management firm that owns his shares in First Bank. He co-founded and owns one-quarter interest in a firm that operates the University of

Donja Gorica, a four-acre, 4,500-student private institution in Podgorica that his son Blazo attends. He also co-founded Global Montenegro, a tourism consulting and management firm, which owns acreage along the coast in the tourist town of Budva, according to Montenegrin corporate registration records.

A large part of the growth has been due to an influx of capital from Russian businessmen, some of them clients of the prime minister's sister.

The wealthiest members of the Djukanovic family are the prime minister's brother and sister. According to Montenegrin property records, Aco Djukanovic or his firms own at least 22 business properties and four apartments, several in downtown Podgorica and, along the coast, and an acre in tourist haven Herceg Novi. Montenegrin corporate registration records show he closed Monte Nova but still co-owns two construction companies, Urbis Nova and Invest Nova, which are involved in coastal real estate development.

Aco Djukanovic has a knack for making money. In 2005, he bought shares of the Montenegrin Commercial Bank for more than $1.7 million at about $636 per share, according to bank records. He sold them the next year to OTP Bank of Hungary, which bought out all shareholders for a premium of about $3,767 per share — leaving Aco a six-fold return on his investment.

Djukanovic's sister, Ana Kolarevic, owns four apartments in downtown Podgorica. A former supreme court justice appointed during Djukanovic's tenure, Kolarevic specializes in business law. She owns a legal firm and Edu Cons, a consulting and management company. Her 25-year-old son Edin is also an entrepreneur who owns and operates three design, consulting, and building firms.

The first family's heavy investment in tourism and coastal development is another conflict of interest for Djukanovic, say local critics, given the government's strong backing of development. Property on the Montenegrin shoreline has risen in value dramatically over the past four years before pulling back this year, and the government has stated a desire to turn Montenegro into an upscale resort area. A large part of the growth has been due to an influx of capital from Russian businessmen, some of them clients of the prime minister's sister.

In July 2008, Parliament, controlled by Djukanovic's party, passed a law declaring five-star hotels to be in the national interest of Montenegro. The law allows these private companies to confiscate surrounding land using eminent domain. The new law also loosens the rules for large developments and can even force small landowners to give up land to neighbors with bigger lots and houses. At the same time, Montenegro has embarked on an international, state-funded advertising campaign to lure upscale tourists to the country.

The Djukanovic government has also moved to make the prime minister the president of the board of the Montenegrin Investment Promotion Agency. The position allows him to control and negotiate foreign investment deals. Djukanovic has traveled extensively to Russia and last year to Dubai looking for investment along Montenegro's coastline.

In 2006, MANS, the watchdog group, again complained about the prime minister, arguing to the Constitutional Court that Djukanovic's seat on the investment board was a conflict of interest. This time MANS won, with the court ruling it unconstitutional for the prime minister to sit on the board of an independent public institution. But such matters are never that simple in Montenegro. Another body, the Djukanovic-friendly Commission for Determining Conflicts of Interest, ruled that the prime minister's membership was not a conflict because he receives no pay.

Djukanovic has so far ignored the constitutional court's decision and still holds his position. In 2008 when Djukanovic, prompted by the sudden illness of his successor, moved back into the top level of government, he promised to distance himself from his private enterprises. "As long as I am in a state function I don't want to do business," Djukanovic was quoted as saying in Vijesti, the Montenegrin daily. But the prime minister has not acted quickly on that promise. Records show that Djukanovic recently re-registered three of his firms, which will keep them operating through at least 2010. ■

Blame The Distributor

HOW GALLAHER STAYED IN THE SMUGGLING GAME

By Drew Sullivan and Paul Radu

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IN **2004,** Cyprus-based tobacco distributor Tlais Enterprises Limited (TEL) was told it had received a "red card" from British customs, a warning that the company was suspected of cigarette smuggling.

TEL's owner, Ptolomeos Tlais, was surprised. Born in Lebanon to a wealthy trading family, Tlais was doing, he said, exactly what his supplier, Gallaher Tobacco, had told him to do: quickly dumping large amounts of cigarettes onto developing countries. Everyone involved, he insists, knew that some of these smokes — especially their low-end Sovereign brand — would find their way back to the U.K., where avoidance of high tobacco taxes guaranteed smugglers a windfall.

In fact, Tlais had even signed a unique deal with both Gallaher — the U.K.'s largest cigarette manufacturer — and the U.K. customs service, giving them unprecedented access to his shipping records. In the deal, Tlais agreed to unload tens of millions of moldy cigarettes by mixing them with new cigarettes and selling them overseas. If anyone deserved a red card, Tlais felt, it was Gallaher for coming up with the plan.

Yet just a few months later, in January 2005, Gallaher told Tlais that it could no longer send his company cigarettes because he was involved in smuggling. Each sued the other in the U.K. for breach of contract, with Gallaher claiming it was still owed $3.2 million for cigarettes purchased and Tlais seeking $675 million in lost profits and other damages. Tlais is also pursuing Gallaher — now owned by Japan Tobacco International — in his native Lebanon, where a criminal court case is about to begin against three Gallaher managers and Gallaher itself for fraud. In addition, Tlais has sued U.K. customs in Cyprus for allegedly assisting in smuggling, misrepresentation, and damaging his reputation, a case that started this month.

These actions, borne of pique, have opened a crack in the usually insular community of tobacco manufacturers and distributors. From the U.K. lawsuit have come some 13,000 internal documents on the inner workings of Gallaher and Tlais, revealing how a major tobacco company got others to do its dirty work, and how customs officials shrugged this off. Not since litigation during the 1990s forced millions of documents out of the tobacco industry has such an inside look been available at the seamy underside of a major cigarette company.

Tlais's dealings with Gallaher date from 2000 and continued through 2005 — a time of major upheaval in the tobacco industry, when it came under heavy pressure around the world for contributing to smuggling. The smuggling by Big Tobacco is widely thought to have subsided since a series of press exposés in 2000-01 helped prompt government crackdowns and billion-dollar settlements. But the Tlais case suggests that, at least in the case of Gallaher, the smuggling continued for years, and indeed was business as usual.

Tlais and his co-workers today make a litany of charges against Gallaher. Among the claims: that TEL was made the scapegoat for practices by Gallaher which included dumping billions of cigarettes in markets where they could not possibly hope to sell them legally; that Gallaher dealt with companies known to be smugglers while publicly speaking out against the practice; that the company sold cigarettes through duty-free channels meant for airports and border shops, knowing that those cigarettes often ended up in the hands of organized crime; that Gallaher sold substandard cigarettes that were expired, damaged, and moldy to developing countries such as Iran and war-torn Iraq; and that the U.K. customs service, rather than being a barrier to smuggling, was complicit as long as the U.K.-made cigarettes went to other countries.

Gallaher has denied any impropriety. Last April, in fact, the company prevailed in its U.K. legal dispute with TEL when Judge Christopher Clarke ruled that Gallaher had sufficient cause to cancel its contract with the distributor, and had, in fact, attempted to clean up its record on smuggling. Indeed, the judge fingered TEL, not Gallaher, for indiscriminately selling cigarettes to known smugglers.

Judge Clarke, however, did not let Gallaher off the hook. In his 326-page ruling, he took the company to task for its past involvement in smuggling, and noted that the company's later practices "gave rise to a risk of smuggling" — including Gallaher's supplying of a distributor without "any due diligence," goods that "were shipped to Cyprus and not to their ultimate destination," and export of cigarette packs with health warnings only in English, not in local languages.

Gallaher did not respond to ICIJ's request for an interview.

Documents released during the various legal disputes, as well as interviews with industry insiders, similarly depict an unseemly record for Gallaher. Among Gallaher's critics is Heiko Arjes, a veteran tobacco businessman and brand integrity consultant who worked with Gallaher and Philip Morris in the Middle East and Africa. Arjes stated in a deposition for the U.K. case that Gallaher was deeply implicated in the "transit" and "duty not paid" cigarette trade — longstanding industry euphemisms for smuggling, according to the court ruling and various industry records. "My direct experience with Gallaher," Arjes stated, "confirmed that they were still more interested in pursuing transit, non-duty-paid business than the other manufacturers who had cleaned up their act."

Tlais's allegations are also supported, in part, by an unlikely source: a top Gallaher manager who said he was in charge of the trade. Norman Jack, a longtime Gallaher insider, stated in an affidavit in the Lebanon case that the company set up a smuggling system using distributors to shield the company and give it deniability.

GALLAHER'S RESCUE PLAN

Gallaher's problems date to 1998, when, like other big tobacco firms, the company was reaping huge rewards from selling cigarettes that routinely ended up on black markets abroad. Gallaher and U.K.-based Imperial, for example, were selling so many cigarettes to Andorra, a small European principality in the Pyrenees mountains between France and Spain, that every man, woman, and child would have had to smoke seven packs a day to account for the trade.

Gallaher's attitude at the time was summed up by Peter Wilson, then its chairman and chief executive, who told the BBC: "We will sell legally to our distributors. . . . If those distributors subsequently sell those products on to other people who are going to illegally bring them back into this country, that is something totally outside our control."

Despite the big profits, 1998 turned into a rough year for Gallaher, according to trial records. Across the

EU, as borders disappeared, so did the duty free shops that ran a brisk business in tax-free cigarettes. Taxes on cigarettes — especially in the U.K., its home market — had soared, leading to decreased sales. Then the company sales in Russia, its largest foreign market, nosedived after the ruble was devalued.

At the same time, Gallaher had just upgraded a plant in Northern Ireland with new high-speed cigarette-making equipment that would allow the company to benefit from large-scale production. But the drop in sales threatened the plant's profitability if it could not be kept operating near capacity.

In response, Gallaher officials embarked on a bold plan to dramatically bolster their sales worldwide. To implement the strategy, Gallaher brought in Jack, a trusted, long-time manager, in the spring of 1999. Jack, according to his sworn statement in Tlais's lawsuit in Lebanon, was asked to flood markets in developing countries with Gallaher brands — to "sell billions rather than millions." Jack said the strategy was directly overseen by Gallaher chief executive Wilson himself. There was no plan to support the brands with advertising as is customary in opening new markets.

In his statement, Jack said he prepared a presentation for the Gallaher board explaining how this was to be done, clearly pointing out that the procedures would involve "trading and transit" — the industry code for smuggling. Jack felt he needed to protect himself and communicated regularly with top management because "we were all aware that we were embarking on business that was potentially extremely risky." To avoid prosecution, Jack said he was told not to put anything in writing, to avoid knowing too much about where cigarettes were destined, and to avoid meetings on the topic.

"By following this course of action," Jack stated, "we could never be accused of conspiring to smuggle . . . and it was always possible to deny knowledge of everything and blame the distributor."

DUBIOUS DISTRIBUTORS

To help distribute the cigarettes, Jack signed up Namelex, a Cyprus-based company run by a former Gallaher executive. Tlais was an investor in Namelex and would fund a large number of the company's tobacco sales, according to court records.

Business at first was great. Over time, Gallaher shipped tens of billions of cigarettes to Namelex's warehouses in Cyprus and Dubai.

But among Namelex's staff was a British manager named Michael Clarke (no relation to Judge Clarke, who heard the Tlais case in London). Namelex's Clarke began to wonder if the plan they were following was legal. He asked Jack, who told him to follow the same rules he was using, according to Jack's statement. The idea was to look the other way and avoid asking questions.

Under Namelex, there seemed to be no shortage of suspicious shipments. U.K. customs would later say a hefty amount of the company's cigarettes were eventually smuggled back into the U.K.

From 2000 to 2002, Namelex also sold Gallaher cigarettes to an array of questionable distributors, including a Cypriot-based company named CT Tobacco owned by one Christos Tornarides. A playboy scion of a wealthy, politically-connected family, Tornarides had worked extensively with Imperial and had a reputation for diverting cigarettes, the U.K. court decision said.

Namelex and CT Tobacco got into trouble right from the start. In August 2000, the "Marina," a Cambodian-registered ship, was stopped by Greek authorities near Crete, packed with more than 11,000 cases (110 million cigarettes) of Gallaher's Sovereign and Mayfair brands, most of which had been sold or traded to CT Tobacco by Namelex. British and Greek law enforcement reportedly suspected the cargo was to be diverted in Latvia to a paper company run by a former KGB officer from Kazakhstan and then smuggled into the U.K. The ship, according to press reports at the time, attempted to ram Greek customs boats.

One month after the Marina was seized, Namelex sold 65,000 more cases to CT Tobacco for export to Albania, according to testimony and Namelex records. Albania, then a smuggling haven, seemed an odd choice for such a shipment, as no market existed there for Mayfair and Sovereign brands. Jack and Clarke, according to the U.K. judgment, "discussed the risk of diversion in the light of Mr. Tornarides' reputation, [and] that senior members of the [Gallaher] board . . . were very pleased with the deal which should proceed immediately."

Gallaher cigarettes were even sold to Iraq and to the regime of Saddam Hussein, then under U.N. sanctions. In an interview, Clarke said he and Jack did business with Hussein's sadistic son Uday on his yacht in Baghdad, just months before U.S. troops invaded (although he said he and Jack believed their actions were legal at the time).

MOLDY CIGARETTES

In 2001, U.K. customs officials issued a red card to Namelex, and Gallaher used the action as a basis for cancelling its contract with the company. Despite Tlais's close ties to Namelex, Gallaher replaced the distributor with TEL, Tlais's own company. TEL agreed to sign a new contract and take over vast quantities of Gallaher cigarettes waiting to be sold by Namelex — more than 400,000 cases of them, or 4 billion cigarettes in all. The cigarettes ranged in age from 9 months to two years old, well past the expiration date, according to Tlais. They had been stored in warehouses in Dubai and Cyprus, and some of the packs were discolored and the cigarettes themselves were molding. Mold in tobacco, if smoked, can add to cigarettes' harmful effect.

The solution was an unusual agreement signed in 2002 between U.K. customs, Gallaher, and TEL. In it, Tlais agreed to provide documentation of future shipments to Gallaher and U.K. customs, and customs officials agreed to supply TEL with real time information on seizures of Gallaher brands, so that TEL could avoid smugglers. Perhaps more importantly, customs also "acknowledged" Gallaher and Tlais's plan to dispose of their mountain of aging cigarettes: They would mix the old stock into batches of new cigarettes — for export.

"If you look at the industry, it's unheard of to mix old goods with new goods," said Clarke, the former Namelex manager who by then had gone to work for Tlais. "If you're importing old goods through duty paid (channels), you can't get away with it."

But as long as the old smokes stayed away from British shores, apparently U.K. customs officials were satisfied. It was an extraordinary deal. The expired cigarettes had no legitimate market overseas, said tobacco experts. They lacked freshness certificates required in many countries, their English-only warning labels were not allowed in many countries, and they lacked proper tax stamps.

U.K. customs did not respond to questions from ICIJ on the agreement or any matter.

Distributors soon began complaining about the moldy cigarettes Tlais was pushing, and a shipment to Iran was turned back. Tlais repeatedly warned Gallaher that the cigarettes were garbage and unsellable, but Gallaher continued to insist the cigarettes be sold. Tlais said he even paid for destruction of the Iranian shipment and asked Gallaher to destroy more of the old stock.

While acknowledging the problem, Gallaher officials still insisted that much of it be sold by mixing it with fresh stock, according to Gallaher records. A handwritten note on the inspection report is clear about what to do next: "Sell [to] Iraq."

"These goods in the condition that they have been since the first inspection can never be sold in a duty-paid market without problems," Tlais wrote to Gallaher chief executive Nigel Northridge in 2004 after almost two years of trying to sell the bad cigarettes. "Gallaher has placed me in a very bad position by following their instructions to sell against my own advice."

Gallaher defended the company's actions in testimony in the U.K. cases by Nigel Espin, then a Gallaher manager. "I would see a market like Iraq, which was just opening up after the release of sanctions or the relief of sanctions, would be a more suitable market to sell these into rather than a more sophisticated market at that time," Espin testified. "I would not want to be smoking moldy cigarettes. [But] if I did not have a cigarette at all, then I probably would be quite happy to smoke a moldy cigarette. . . . I do not think that is necessarily bad, that they are sold into Iraq."

Tlais, who now expresses remorse over the deal, sees it differently. "Gallaher was poisoning people," he said. "I shouldn't have allowed myself to sell the cigarettes. I didn't sell them because I wanted to, but because I had a [U.K. customs] agreement." Michael Clarke said the implications of the deal should have been obvious. "Everyone knew [the old goods] would be smuggled," Clarke said. "If you're selling moldy meat, you're going to sell it to dodgy people."

GETTING RED-CARDED

As Tlais worked on unloading Gallaher's moldy cigarettes, the smuggling game was changing. Gallaher and other cigarette companies were under growing pressure by authorities to clean up their act. Still, TEL proved just as ineffective as Namelex at keeping goods out of the U.K., according to the U.K. court summary.

TEL used a Dubai-based company as its major distributor. The goods were soon diverted to Africa and across Eastern Europe, including to smuggling havens in Latvia, Ukraine, and Montenegro. When U.K. customs officials asked to see documentation, Gallaher said much of the company's papers were either missing, incomplete, or suspected by Gallaher of being forged, according to the judge's summary.

Tlais and Clarke dispute this, but Tlais's reputation was beginning to suffer. There was evidence that CT Tobacco and other companies given red cards were still getting supplies of cigarettes indirectly through TEL.

By 2004, three out of every four genuine cigarettes seized by U.K. customs were made by Gallaher — and Tlais was a prime suspect. In his ruling against Tlais, Judge Clarke found it likely that "well over 50 percent of the cigarettes supplied to TEL ended up being smuggled."

Tlais disputes the judge's assumptions, but it was clear that TEL was becoming a liability to Gallaher. "Gallaher never trusted me," Tlais now recalls. "I kept asking, 'Do you want to work with me?' and they said, 'Yes we do.'"

Tlais said he tried to clean up his business — that TEL stopped working with five suspect distributors, but that his distributors were dumping the old cigarettes wherever they could and he rarely received information from customs to help him avoid known smugglers. He claimed he repeatedly warned Gallaher about other companies, but said officials there were not only uninterested but had originally brought him some of the distributors who later got him into trouble.

TEL was finally red-carded by U.K. customs in 2004. Gallaher cancelled its agreement with the company, citing TEL's red card, its poor documentation, its closeness to distributors suspected of smuggling, and its failure to investigate seizures. Gallaher brought suit in British court and, furious over the betrayal, Tlais countersued.

Gallaher's contract with TEL allowed it to break their contract if TEL received a red card. But red cards are unusual administrative actions — a kind of blacklist with no formal hearing or appeal process. Tlais has never seen the documentation of his company's red card and cannot verify that it even exists. In fact, customs makes the documents available only to U.K. manufacturers, and bases the information primarily on seizures and the opinions of manufacturers themselves. To Tlais, this is far too chummy a relationship and speaks to a "blame the distributor" system that allows big companies to escape accountability.

"Gallaher should have been red-carded, not me," he said. "They made me sell this [expletive] under their agreement and then they complain about smuggling."

"THE WHOLE CONVERSATION"

Tlais's own problems continued. His company soon attracted the attention of investigators of the European Anti-Fraud Office (OLAF), an arm of the European Commission. In 2005, he was charged with smuggling in Greece after an OLAF investigation found that transit cigarettes sold by Tlais for Bulgaria were instead being sold off in Greece. Tlais was considered an accessory to the crime because he had sold the cigarettes to known smugglers. At first convicted and sentenced to four years in prison, Tlais won on appeal and the case was dismissed.

Tlais fared less well in British court, when, in April, Judge Clarke ruled that the company was within the law when it cancelled the TEL contract over concerns about smuggling.

As for Gallaher, the 150-year-old company was bought in 2007 by Japan Tobacco International (JTI), a $50 billion behemoth half-owned by the Japanese government. In December 2007, OLAF and JTI struck a deal to avoid litigation by the European Commission and its member states over smuggling. To atone for Gallaher's past, JTI agreed to pay a €400 million fine. JTI, for its part, promised to clean up the mess it had inherited. In exchange, JTI got a two-year moratorium on enforcement of smuggling statutes against Gallaher.

Tlais said the whole episode cost him a heavy price both in terms of money and trauma to his family. Everyone involved, he said, ultimately lost. Gallaher's point man on smuggling, Norman Jack, was considered by some managers to be "too close to Tlais," according to the court's judgment, and eventually left Gallaher. Most of the Gallaher executives, meanwhile, have been replaced by JTI.

Michael Clarke, the Namelex manager, is still out of a job. Clarke, for his part, thinks there is plenty of blame to go around, from the dubious distributors to Gallaher and the U.K. customs service. "They always say it's the distributor's fault," he reflected, "but you don't see the whole conversation." ■

How To Get Away With Smuggling

CANADA'S BILLION-DOLLAR DEAL FOR BIG TOBACCO

By William Marsden
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THE INVESTIGATIONS had gone on for so long that most Canadians probably wrote them off as another victory for big corporations.

Then suddenly on July 31, after a year of secret negotiations, Canada's two largest tobacco companies — Imperial Tobacco Canada and Rothmans Inc. — pleaded guilty to aiding and abetting tobacco smuggling from 1989 to 1994, defrauding Canadian governments of more than a billion dollars in unpaid taxes.

The two companies agreed to pay an unprecedented C$1.15 billion (US$1.12 billion) to Canadian governments and to plead to one count of "aiding persons to sell or be in possession of tobacco products manufactured in Canada that were not packaged and were not stamped in conformity with the Excise Act and its amendments and the ministerial regulations."

Imperial Tobacco, maker of 16 cigarette brands including Canada's top sellers Players and du Maurier, agreed to pay US$582 million. Rothmans, parent of Rothmans, Benson & Hedges Inc. and maker of 16 cigarette brands, agreed to US$534 million.

Key to the settlement was the government's readiness to release all former and present executives, employees, directors and officers from civil or criminal prosecution. Also released were the companies' foreign owners and affiliates. Tobacco bosses who oversaw the smuggling could now live out their retirements without fear they might be interrupted by a spell in prison. It wasn't an idle fear. Two former executives with Canada's third largest tobacco company, RJR Macdonald, have been convicted. One served four years in jail. Six others are awaiting trial or procedures that could eventually send them to trial.

The settlement has left RJR out in the cold. The company, now called JTI Macdonald after its 2000 purchase by Japan Tobacco, faces about $10 billion in claims from various Canadian governments.

That figure was not lost on Rothmans. Pressure to settle came from Philip Morris International, which in May 2008 offered to buy out the shares in Rothmans it did not already control. A stipulation of Philip Morris's C$2 billion offer was the settlement of all outstanding liabilities. This included the ongoing investigation by the Canadians into the company's smuggling activities.

The Canadian settlement rivals a 2004 settlement in which Philip Morris agreed to pay the European Commission US$1.25 billion over 12 years. In return, the Commission agreed to drop smuggling-related litigation against the company.

Even though the fines and penalties set records in the annals of Canadian white-collar crime, they were a pale reflection of the staggering amounts that smugglers had defrauded governments during the early 1990s, when as many as one in every three cigarettes sold in Canada was contraband. After the Canadian government doubled tobacco taxes in 1991, Imperial alone earned annually C$600 million to C$700 million in net profits "lubricating" the smuggling through its supply of cigarettes, according to Paul Finlayson, a former executive with Imperial's holding company Imasco Inc.

The Imperial settlement "is chump change. It's just peanuts. It means nothing."
— Paul Finlayson

Because of the nature of smuggling and its fluctuating market, it's difficult to calculate precisely how much revenue Canadian governments lost to tobacco smuggling during this period or exactly how much of the smuggling was aided and abetted by Big Tobacco. The federal government is said to have lost at least C$3 billion from 1990 to February 1994, according to a study by the Canadian anti-smoking group, the Non-Smokers' Rights Association. But this is a conservative estimate given the C$10-billion claim against JTI Macdonald. As former executive Finlayson said of the Imperial settlement: "This is chump change. We used to spend C$50 million on a sponsorship. It's nothing. It's just peanuts. It means nothing."

Government officials refused to comment on the settlement other than to note that it was a record penalty, agreed to by all sides. In reality, the government likely had very little choice but to settle for a relatively small amount, since Canada's three major manufacturers had successfully used their global reach to insulate their assets from seizure.

Corporate and court records show that over the last 10 years, the companies sold off or transferred assets, rendering them out of reach to Canadian tax collectors. By the time Canadian governments got around to pursuing Big Tobacco, the companies were little more than shells with rights to a few popular tobacco brands, owned by offshore companies. This reduced government leverage to the threat of criminal prosecution and the seizure of future revenues.

CHUMP CHANGE

For years there has been little doubt about the involvement of Imperial and Rothmans in smuggling when the companies vigorously vied for market share while hoping that their cigarettes would not be featured in front photos of major police seizures. Corporate documents in the public record show Imperial and Rothman executives intentionally exported enormous amounts of brand named cigarettes into the United States so they could be smuggled back into Canada to supply the black market.

Finlayson recalled that after the Royal Canadian Mounted Police (RCMP) raided Imperial Tobacco's head office in Montreal in November 2004, they contacted him because his name was on some critical documents. "Don [Brown, president of Imperial] should have ordered that stuff destroyed," he said. "I mean that should have been for your eyes only. . . It was not ever intended to be stored or kept after presentation."

One of those documents, he added, was a planning document for exporting Imperial brands into the United States to be sold to smugglers. Finlayson said he drew up the plan: "They [the police] could have walked in and just handcuffed everybody at Imperial. But the government did not have the guts of a field mouse to go after the executives of the company."

Imperial's role in the illicit Canadian market is detailed in documents publicly available at the Guildford Depository near London, England (an archive of 6 million to 7 million British American Tobacco Company papers that resulted from U.S. litigation against the industry). Imperial, the record shows, set up distribution networks to smugglers as far afield as Florida and Louisiana. In a memo dated June 3, 1993, for example, Imperial Tobacco president Don Brown told a BAT executive that "until the smuggling issue is resolved, an increasing volume of our domestic sales in Canada will be exported, then smuggled back for sale here."

"The police could've walked in and handcuffed everybody at Imperial Tobacco. But the government didn't have the guts of a field mouse."
— Paul Finlayson, former Imasco executive

The evidence was overwhelming. Why, then, did the government settle for "chump change"? It was public knowledge by at least 1997 that Big Tobacco was involved in supplying smugglers. Yet federal revenue officials failed to take timely action to seize or freeze assets before they were sold off or shifted offshore. Ottawa has never explained its tardiness.

The result greatly played to the advantage of Imperial and its executives, who obtained large compensation packages when Imperial's assets were sold. In the end, Imperial's C$600 million settlement only marginally benefited the taxpayer, who remains the ultimate victim of what may have ended up as a multibillion-dollar crime.

Consider this: At the height of the smuggling, Imperial, Rothmans, and RJR were selling an estimated 10 billion cigarettes a year into the illicit market, or about 20 percent of their total production. This means that the three companies were supplying at least 66 percent of the illicit market. This amounted to a tax loss for Canadian governments of more than $1 billion during the peak year in 1993.

The companies, meanwhile, made out like bandits. Finlayson said that while Imperial obtained its full manufacturer's price in advance of shipments, its costs were lower in the illicit market because it didn't have to pay promotional costs to retailers.

THE SCRAMBLE TO DIVEST

When the smuggling finally ended in February 1994 — after the government caved in to industry demands by reducing taxes to pre-smuggling levels — Imperial was probably the most exposed of the big three. Its holding company, Imasco Inc. (Imperial and Associated Companies), owned a multibillion-dollar string of high-profit companies that could theoretically be seized for payment of back taxes, interest, and penalties. These assets included a trust company, a drug store chain, fast food restaurants, an insurance company, and a real estate developer.

Initially, Imperial and Imasco executives didn't believe the government would take action against big tobacco. "We didn't think the government would have the balls to come after us," Finlayson said. News reports in 1997, however, indicated that both the U.S. and the Canadian governments were investigating tobacco companies for their part in the early 1990s smuggling.

By 1997, U.S. authorities were chasing RJR Macdonald's parent company RJ Reynolds Tobacco, which in 1992 had set up Northern Brands International, based in Winston-Salem, North Carolina. The company and its Canadian executive Les Thompson managed a smuggling network that stretched from a Canadian manufacturing plant in Puerto Rico to Aruba, then onto Buffalo, NY, and into Canada. Northern Brands and RJ Reynolds pleaded guilty and were fined US$15 million. Les Thompson in 2000 was sentenced to four years in prison.

When both Canada and its provinces pummeled JTI Macdonald with tax claims, the company filed for protection under Canada's bankruptcy laws.

JTI Macdonald, however, was far from insolvent. Over the past four years it had transferred more than $100 million in dividends to its parent company JT Canada LLC II Inc., of Halifax, Nova Scotia, which is owned by JT Canada LLC Inc., which in turn is owned by JT International Holding B.V. of the Netherlands.

Japan Tobacco had carried out a series of transactions that its auditors, Deloitte & Touche, admitted were designed to make it difficult if not impossible for governments to attack its assets, according to the Canadian government's statement of claim against RJR. The company had transferred in 1999 assets to a network of firms that ultimately lead offshore to companies based in the Netherlands, Switzerland, and the British Virgin Islands and which are owned by Japan Tobacco, according to the court filings.

The company also created a sort of circle of debt, burdening its assets with $2.24 billion in debts to related companies using the trade marks as collateral. Both the federal and Quebec governments have petitioned the court to have these transactions reversed, claiming they were designed to "reduce the value of its assets and to try to fraudulently shelter its shares" against seizure.

At the same time, Imperial's holding company, Imasco, also began divesting itself of its assets and moving the proceeds offshore. It auctioned all of its non-tobacco assets for more than C$11 billion. British American Tobacco, which already owned 42 percent of Imasco, used the proceeds to buy out the 58 percent held by the public — leaving BAT, through its subsidiary BAT Acquisitionco, with 100 percent ownership of the only company left standing, Imperial Tobacco.

This occurred after BAT merged with Rothmans International in 1999 to become the world's second largest tobacco company, with a 16 percent market share and an annual production of more than 900 billion cigarettes. BAT then sold off the Canadian Rothmans in compliance with an order under the Canadian Competition Act.

Imperial Tobacco moved its manufacturing to Mexico and was reduced to little more than a shell in Canada with a head office in Montreal. Its only real assets were Canada's two most popular cigarette brands, Players and du Maurier, which were owned by another company, BAT.

Imperial executives, some of whom were directly implicated in the smuggling, according to company documents, earned more than C$39 million in cash compensation plus stock options as a result of these sales. Imperial President Don Brown, for instance, got C$2.5 million in addition to his 100,000 in shares worth C$4.2 million.

Imasco's proxy statement on the BAT buyout made no mention of smuggling, tax liability, or possible police investigations into the activities of Imperial or Imasco executives relating to the smuggling. The circular's stated reason for the sale of Imasco assets was that BAT wanted to restrict its operations to tobacco.

Rothmans had reason for concern, as well. The RCMP notified the company in 2002 that it was under criminal investigation for smuggling-related charges. Secret negotiations for a settlement began in 2007 after the RCMP and federal and provincial prosecutors informed Rothmans that they were "contemplating laying charges."

With Rothmans ready to plead guilty, Imperial followed suit, since both companies employed identical structures to feed the smuggling networks. The amount of the settlements, parts of which will be paid over 15 years, did not seem to harm the companies' bottom lines. On July 31, the day of the public announcement of the settlement, Imperial executives called a meeting of head office employees to assure them that despite the settlement it would not affect salaries or bonuses, one source said.

FILLING BIG TOBACCO'S SHOES

Ironically, the belated crackdown has not affected the flood of smuggled cigarettes pouring into Canada, which, in fact, has grown larger since the government's case began. The major route remains largely the same — a tiny 5-mile section of the St. Lawrence river near Cornwall, Ontario, where the Akwesasne Indian Reservation straddles the U.S.-Canada border. The billions of brand named cigarettes that Big Tobacco helped push through this funnel in the early '90s no longer are in the game. But with taxes back up to 1990 levels, dozens of small, unlicensed companies have sprung up on the reservation. They are making vast numbers of illicit cigarettes with impunity.

The government's crackdown hasn't affected the flow of smuggled cigarettes. Today, it's just a new set of players reaping the profits.

Today, those reaping huge profits off the smuggling are no longer the executives of cigarette companies, but renegade firms with distributors that range from biker gangs to the Italian Mafia. Even as Big Tobacco pays a billion-dollar settlement to the citizens of Canada, the wealth that once flowed into its hands is now staying with organized crime. But that is another story. ■

Tobacco Companies Linked To Criminal Organizations In Lucrative Cigarette Smuggling

Editor's Note: *During 2000 and 2001, a team of reporters from the International Consortium of Investigative Journalists broke a series of landmark stories exposing how leading tobacco companies worked with criminal networks to smuggle cigarettes around the world. Relying on interviews with insiders and thousands of internal industry documents, the unique team — based in six countries — pieced together how smuggling played a key role in big tobacco's strategy to boost sales and increase market share. Those revelations, and others that followed, helped prompt lawsuits and government inquiries, and led to promises of a global crackdown on the illegal trade in tobacco.*

The series was reprinted or written about in more than 40 publications in 10 countries, including Australia, Brazil, Colombia, Denmark, the U.K., and the United States. The complete ICIJ series, from its first stories in 2000 on industry involvement in smuggling to the exposés of 2001 revealing big tobacco's collusion with Colombian drug cartels, the Italian Mafia, and North American motorcycle gangs, can be found online at ***http://projects.publicintegrity.org/Content.aspx?context=article&id=351.***

WHEN TOMMY CHUI failed to show up at the grand opening of his wife's new boutique in downtown Singapore, alarm bells rang 1,600 miles away in the offices of Hong Kong's Independent Commission Against Corruption. It was March 29, 1995, and the news that Chui was missing devastated the commission's assistant director, Tony Godfrey. He immediately sent two investigators to Singapore. Three days later, on April 1, his worst fears were realized. Dockworkers found Chui's bloated body floating in Singapore

Harbor. A former director of British American Tobacco's biggest distributor of contraband cigarettes to China and Taiwan, the 38-year-old Chui had been abducted, ritually tortured, gagged, suffocated, and thrown into the harbor just weeks before he was to testify against his ex-associates. Chui was the star prosecution witness in an international tobacco smuggling investigation launched in 1993 by Hong Kong's Independent Commission Against Corruption. He was about to blow the lid off a $1.2 billion smuggling operation to China and Taiwan and implicate three former British American Tobacco executives in a HK$100 million bribery scandal. In addition, his testimony was key to the prosecution of his two former business associates, several corrupt customs officers, and various members of Asia's most notorious criminal gang, the Triad.

The case of Chui and the massive BAT-fed smuggling network into China reveals the dark underbelly of a billion-dollar business fed by international corporations and operated by organized crime. While it is among the more sensational examples of corporate tobacco's implication in international smuggling and its links to organized crime, it is far from an isolated instance.

Tobacco manufacturers have often blamed the international smuggling of their products on organized crime. But a year-long investigation by the Center for Public Integrity shows that tobacco company officials at BAT, Philip Morris, and R.J. Reynolds have worked closely with companies and individuals directly connected to organized crime in Hong Kong, Canada, Colombia, Italy, and the United States. In fact, one Italian government report obtained by the Center states that Philip Morris and R.J. Reynolds licensed agents in Switzerland were high-level criminals who ran a vast smuggling operation into Italy in the 1980s that was directly linked to the Sicilian Mafia. Corporate documents, court records, and internal government reports — some going back to the 1970s — also show that BAT, Philip Morris, and R.J. Reynolds have orchestrated smuggling networks variously in Canada, Colombia, China, Southeast Asia, Europe, the Middle East, Africa, and the United States as a major part of their marketing strategy to increase profits. The corporate documents refer to this black market business as "duty not paid," "parallel" markets, "general trade," or "transit." But these same documents often clearly delineate between this aspect of the business and legal trade. For example, one BAT official, in a 1989 letter to associates in Taiwan, said, "With regard to the definition of transit, it is essentially the illegal import of brands from Hong Kong, Singapore, Japan, etc., upon which no duty has been paid."

The companies have sought to undercut rising government taxes, which studies show are the main reason most smokers quit, as well as to gain market share on their competitors or on government-controlled tobacco monopolies by offering competitively priced popular international brands on the black market. The result has been tax evasion on a global scale that has greatly depleted government treasuries, especially in Third World countries. Cigarette smuggling has also fostered international crime and money laundering and alarmed growing numbers of law enforcement officials worldwide. Attracted by huge profits, quick turnovers, a captive market, and relatively light penalties if caught, organized crime now controls large sectors of the smuggling.

"Organized criminals, who have traditionally been involved in smuggling illicit narcotics, are suddenly realizing that tobacco is a good thing to get into, as you make just as much money, and it's perhaps not quite as anti-social," Douglas Tweddle, the outgoing director for compliance and facilitation at the World Customs Organization in Brussels, told the Center. "The public generally aren't against you if you're selling smuggled cigarettes; in fact, they rather appreciate you. And if you get caught, in virtually all countries, the penalties for smuggling tobacco are a great deal less than smuggling heroin or cocaine." In the United States, cigarette imports have risen so dramatically that investigators are looking into whether the country is being used as a way station in the global smuggling trade. "Profits from cigarette smuggling rival those of narcotic trafficking," then-U.S. Customs Commissioner Raymond Kelly told Congress last year. "The United States plays an important role as a source and transshipment country."

The investigation by the Center's International Consortium of Investigative Journalists is based on a review of thousands of pages of corporate and government documents and dozens of interviews with law enforcement officials, smugglers, and other sources worldwide. It indicates that tobacco smuggling is increasingly dominated — often with the knowledge and consent of the tobacco companies — by a handful of criminal organizations that in some cases have links to organized crime. The Italian Mafia in Western Europe, East European gangs, Triads in Asia, drug cartels in Colombia, and motorcycle gangs and the American mafia in North America all have become entrenched in the game. Licensed distributors for the manufacturers feed these organized crime syndicates billions of cigarettes worldwide, often with corporate knowledge. "A primary driving force behind the proliferation of cigarette smuggling in both Colombia and Europe is the need of narcotics traffickers, Colombian, Russian, and others, to launder enormous amounts of money that can no longer be laundered through banks," said one recent court filing in a cigarette smuggling case.

THE BLACK MARKET TRADE

It's estimated that about one in every three cigarettes exported worldwide is sold on the black market. This enormous business is operated through a web of offshore companies and banking institutions that often employ the same routes and distributors. Russian and Italian mafia use Cyprus and Montenegro. The drug cartels and U.S. mafia use Aruba and Panama. The same names turn up in smuggling networks into Colombia, Canada, and Europe. In Southeast Asia, the same distributors who smuggle out of Hong Kong to China also control distribution out of the Philippines and Singapore. The Center investigation shows that the manufacturers funnel massive amounts of their brand name cigarettes into these smuggling networks, often employing circuitous routes in an apparent attempt to shield themselves from accusations of wrongdoing. Distributors and manufacturers work hand-in-hand to feed this market.

But, in some cases, the manufacturers have worked directly with organized crime figures. In Colombia, tobacco companies are alleged to have helped launder drug money and to have worked closely with distributors who are involved in drug trafficking. A Colombian lawsuit against Philip Morris and BAT accuses them of involvement in drug-money laundering through what is known as the "black market peso exchange," a circuitous system by which drug dollars are laundered for clean pesos through the purchase and importation of such goods as cigarettes and alcohol. In a federal civil racketeering lawsuit launched in 2000, Colombia's governors accused tobacco company executives of illegally entering the country to organize smuggling networks and retrieve cash payments, which were then smuggled out for deposit in offshore banks. Company employees are also alleged in the lawsuit to have bribed border guards. And their agents have been implicated in illegal cash campaign contributions to Colombia's former president Ernesto Samper.

In Italy, court cases and police and government reports reveal an intricate web of Mafia families that through bribery, intimidation, and murder control the smuggling of billions of Philip Morris and R.J. Reynolds cigarettes into Europe through Cyprus, Albania, and Montenegro. In Spain, at least one major distributor for RJR is allegedly a black market distributor linked to illegal drug trafficking. In Canada, RJR sales executives dealt directly with smugglers linked to the American and Canadian mafia. In some cases, tobacco industry executives actively played various gangs off against each other and solicited and received millions of dollars in kickbacks or bribes in return for selling to preferred criminal syndicates, according to court records and sources.

The Center investigation also shows that when senior or mid-level executives have been charged criminally with aiding and abetting smuggling, tobacco companies often don't cooperate with investigators. In a Louisiana case, for example, lawyers for one tobacco company used their connections in the administration of former President Bill Clinton to force the removal of a prosecutor pursuing a Brown & Williamson sales executive for smuggling into Canada. The major tobacco companies all vigorously deny any involvement in the smuggling of their products. In a statement to the Center, BAT also said it knew of no evidence "to substantiate allegations that some of our employees or distributors have worked with criminal organisations and/or organised crime." Companies such as BAT have stated that they can't be expected to keep track of their 90,000 employees, even though in many cases those named in smuggling are senior managers. The companies also argue that they sell a legal product to wholesalers over whom they exercise no control. Kenneth Clarke, BAT's deputy chairman and the former Conservative chancellor of the exchequer, told the British House of Commons health select committee on February 16, 2000, that "there is no evidence I have ever seen that BAT is a participant in this smuggling. We seek to minimize it and avoid it."

However, writing in the February 3, 2000, issue of The Guardian, in response to a Center expos released a few days earlier, Clarke complained that high cigarette taxes caused smuggling and added: "where governments are not prepared to address the underlying causes of the problem . . . we act, completely within the law, on the basis that our brands will be available alongside those of our competitors in the smuggled as well as the legitimate market." Top BAT executives, at a meeting last summer, considered the company's marketing strategy in light of expanding investigations, media reports, and civil lawsuits. An industry source told the Center that BAT executives discussed halting all "transit" business but worried that shareholders would be furious at the resulting drop in profits, which one government source estimated to be as high as 500 million pounds (US $720 million) annually. BAT decided to continue the "transit" business, the industry source said, but no longer to refer to it as transit, DNP, or GT. The new company term is "WDF" for "Wholesale Duty Free." The executives also discussed taking steps to counter any civil and penal actions that could threaten the company's survival, the source said.

Massive smuggling has sparked a growing number of lawsuits. In a 12-month period ending last year, Canada, the governors of Colombia, Ecuador, and the European Union all filed separate racketeering suits in the United States against the tobacco giants. Seven nations — Germany, Spain, France, Italy, Belgium, the Netherlands, and Finland — have since joined the EU suit. Among the charges, the EU accuses the tobacco companies of aiding and abetting smuggling, involvement in organized crime, defrauding state treasuries of billions of dollars, laundering drug money, and committing wire fraud and mail fraud.

In addition, criminal investigations have multiplied. In the United States, several grand juries are examining the allegations of tobacco company involvement in cigarette smuggling, including one in Raleigh, N.C., and another in New York. A multi-agency investigation, coordinated out of Atlanta, is also looking into possible corporate involvement in cigarette smuggling and its related crimes, such as money laundering, according to federal government sources. Canada, Italy, and Britain have also launched criminal investigations. Still, with the exception of one case in Syracuse, New York, where a unit of RJR called Northern Brands International pleaded guilty in 1998 to smuggling-related charges, the tobacco industry has not faced criminal prosecution.

The growing list of civil cases, however, could prove devastating. Faced with possible treble damages under the U.S. Racketeering Influenced and Corrupt Organizations (RICO) Act, the tobacco companies are vigorously fighting the lawsuits. Already, allegations have surfaced in the Colombian lawsuit that Philip Morris is corrupting the legal process through threats and the destruction of documents. BAT is alleged to have engaged in influence-peddling by putting political and government officials in Colombia on paid consultant contracts. An affidavit sworn in September 2000 by Jos Manuel Arias Carrizosa, the executive director of the Colombia Federation of Departments [or states] says that Philip Morris Vice President J. Armando Sobalvarro tried to persuade Arias, in an October 27, 1999, meeting, that a lawsuit against Philip Morris was "not in the Departments' best interests." Sobalvarro noted that Philip Morris was lobbying Washington for a large aid package for Colombia and concluded the visit by threatening Arias that if the lawsuit against Philip Morris proceeded, "there would be blood." For investigators like Hong Kong's Godfrey, there is "absolutely no doubt" that BAT knew its cigarettes were being smuggled into China and Taiwan. "[BAT is] a very sophisticated company," he said in an interview. "There's no reason why they shouldn't know." Godfrey also said he believes that bribery became institutionalized at BAT-Hong Kong. Blood, threats, bribery, and corruption are no strangers to cigarette smuggling. And tobacco companies seem to know that as well as anyone. ■

Reported by Maud S. Beelman, Bill Birnbauer, Duncan Campbell, William Marsden, Erik Schelzig and Leo Sisti and written by William Marsden. The International Consortium of Investigative Journalists is a project of the Center for Public Integrity. This investigation was supported by www.theRake.com.

Glossary

Bootlegging: Often called "buttlegging," bootlegging refers to the act of smuggling tobacco products from low-tax to high-tax jurisdictions for resale, generally by individuals or small groups.

Cigarette dumping: The practice of selling cigarettes below the price usually charged in a domestic market in order to establish brand dominance and gain competitive edge.

Contraband: Goods smuggled into or out of a country.

Counterfeit: A form of illegal manufacturing, in which products made bear a trademark used without the trademark owner's consent.

Duty-free zone: Usually located next to an international airport or port. Goods can be sold, stored and reshipped in these zones without payment of custom duties or other direct taxes, provided they are not imported into the country where such sites are located.

Duty not paid: A company euphemism for goods that have been smuggled.

Excise tax: A tax levied on certain goods manufactured or sold within a country.

Free-trade zone: Typically sited in developing countries, free-trade zones are designed to attract business foreign investments by creating areas in which normal trade barriers and bureaucratic requirements are lowered or eliminated.

General Trade (GT): A euphemism used by tobacco companies to indicate smuggled goods.

Tax stamp: A stamp affixed to a cigarette pack to demonstrate payment of state or local excise taxes.

Trademark: An officially registered name, logo or symbol used to identify a product legally protected by its owner or manufacturer.

Transit trade: A company euphemism for moving goods between countries without payment of taxes, or smuggling.

Transshipment: the shipment of goods through one or multiple intermediate locations before reaching its final destination. Sometimes used by smugglers to obscure the origin of particular goods.

CIGARETTE PACKAGING TERMS

Container: A standard shipping unit. One 40-foot container usually contains about 1,000 master cases, or 10 million cigarettes.

Master case: Contains 10,000-12,000 cigarettes

Carton: Contains 10 packs of cigarettes.

Pack: Generally contains 20 cigarettes.

Sources: The Framework Convention Alliance: Glossary of terms in the illicit trade. Testimony by John W. Colledge III before the U.S. House of Representatives, Committee on the Judiciary, May 1, 2008.

On the Web

The Tobacco Underground homepage (**http://www.publicintegrity.org/investigations/tobacco/**) features an interactive map of smuggling routes, key shipping points and the locations of contraband cigarette producing facilities.

You can view undercover video from a facility in Kaliningrad, Russia that produces contraband Jin Ling cigarettes. **http://www.publicintegrity.org/investigations/tobacco/articles/entry/758/**

Sociologist Luk Joossens is one of the world's top experts on tobacco smuggling and was the co-author of a 1995 study that that first alerted the world to the fact that billions of cigarettes were missing and likely diverted to black markets in dozens of countries. You can see an interview with him at **http://www.publicintegrity.org/investigations/tobacco/articles/entry/760/**

Jorge Abraham was a tobacco smuggler from El Paso who masterminded the trafficking of as many as half a billion cigarettes across the United States. He talks to ICIJ reporters at **http://www.publicintegrity.org/investigations/tobacco/articles/entry/755/**

In his more than 30 years in law enforcement, John W. Colledge investigated cigarette smuggling, narcotics, money laundering, and arms trafficking. You can hear his interview with ICIJ at **http://www.publicintegrity.org/investigations/tobacco/articles/entry/757/**

Tom Zyckowski was one of four FBI agents who went undercover in parallel cigarette smuggling cases, Operation Royal Charm and Operation Smoking Dragon. Listen to him speak to ICIJ reporters at **http://www.publicintegrity.org/investigations/tobacco/articles/entry/756/**

Since a series of press exposés in 2000-2001 documented the tobacco industry's extensive history of smuggling, the industry has seemingly retreated from the practice. Yet for Britain's largest cigarette manufacturer, Gallaher Tobacco, the smuggling may have continued. To learn more about the lawsuit brought against Gallaher, go to **http://www.publicintegrity.org/investigations/tobacco/articles/entry/759/**

ICIJ has collected a wide range of online resources for those interested in learning more about tobacco smuggling. These can be accessed at **http://www.publicintegrity.org/investigations/tobacco/pages/resources/**

Finally, all the stories from ICIJ's 2000-2001 investigation into tobacco smuggling are hosted on our website. To read these stories, please visit **http://www.publicintegrity.org/investigations/tobacco/pages/archives/**

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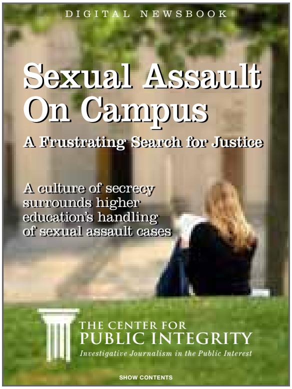

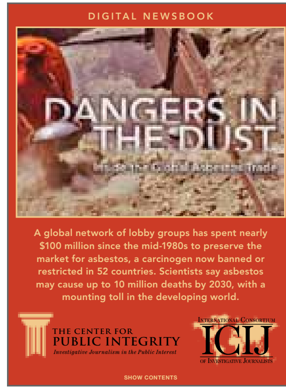

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