How To Get Away With Smuggling

Canada's Billion-Dollar Deal for Big Tobacco

By William Marsden | October 19, 2008

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.

"The police could've walked in and handcuffed everybody at

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.

Imperial Tobacco. But the government didn't have the guts of a field mouse." — *Paul Finlayson, former Imasco executive*

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.

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 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.

The Imperial settlement “is chump change. It’s just peanuts. It means nothing.”
— Paul Finlayson

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.

The government's crackdown hasn't affected the flow of smuggled cigarettes. Today, it's just a new set of players reaping the profits.

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.

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.

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Have a tip on the illicit tobacco trade? Send ideas to icijtobacco@icij.org .