For New Balance, a Surprise: China Partner Became Rival

By GABRIEL KAHN
Staff Reporter of THE WALL STREET JOURNAL

At a sneaker factory in Yangjiang City in southern China, George Arnold tugged at insoles and inspected the stitching on a pair of New Balance shoes. Satisfied that they were the real thing, he told factory managers he'd wire $120,000 the next day for 6,500 pairs.

It was a sting. Mr. Arnold wasn't the North Carolina shoe buyer he claimed to be, but a private detective hired by New Balance Athletic Shoe Inc. to unravel a costly problem: deeply discounted New Balance-branded shoes showing up in stores from England to Australia.

For years, global brands have been fighting legions of counterfeiters in China that churn out cheap copies of everything from Gucci bags to car parts. But the sneaker maker Mr. Arnold visited that September night was no fly-by-night counterfeiter: It was run by Horace Chang, a Taiwanese businessman recently was one of New Balance's top suppliers.

Backfire

That's what made him so dangerous. The rush to manufacture in China is backfiring U.S. brands in an insidious new way: Sometimes their own suppliers flood the market with their goods, stealing sales and damaging the brands' cachet.

When shoes made by Mr. Chang suddenly began appearing in cut-rate shops for as little as $60, New Balance, which competes with the likes of Adidas and Reebok, was being relegated to the bargain bin. Mr. Chang declined to be interviewed, but said that he still had a legitimate license to make New Balance products, and that the company was taking steps to address the issue.
"lied" to Chinese authorities when it argued otherwise.

As more companies move to take advantage of low-cost labor and high-quality manufacture, they are finding that they pay a steep price for "Ten years ago it was just knockoffs," says Vickers, a former Hong Kong policeman who is president of International Risk Ltd., which examines background and due-diligence checks on China. Today, he says, "The No. 1 problem is collusion between your own staff and the manufacturer."

The problem is spreading. Unilever discovered one of its suppliers in Shanghai charged with selling soap and selling them directly to retailers. Procter & Gamble Co. says one of its suppliers sold empty P&G shampoo bottles to the counterfeiter, which filled them with counterfeit P&G products and sold them.

Creating Competitors

Cartier, the French luxury-goods maker, has stopped manufacturing in China for fear of falling prey to the "China trap." Says Marc Frisan, its in-house counsel, "If you don't have the control your distribution ... you end up creating your own competitor."

This unauthorized manufacturing by other companies poses a growing threat. It emerges as the factory floor to the world, with companies and governments worldwide more vocal in their objections to China's attempt to curb the problem, which encompasses an array of products. And lawsuits against foreign companies are piling up in China.

China's accession to the World Trade Organization last year has nudged it into becoming a more erratic, enforcer of intellectual-property rights. For example, Yamaha Motor Co. won a landmark decision forcing a Chinese company making counterfeit Yamaha motorcycles to pay damages.

Such victories are rare, as New Balance found. Over three years, the Boston-based company has taken Mr. Chang to contract arbitration in Massachusetts, sued him in a Chinese court and had authorities confiscate his shoes in Japan, China and Italy. But the large inventory at the factory in China...
New Balance says that Mr. Chang is still in business.

Fighting Mr. Chang, says a former New Balance president, John Larsen, "is like p
finger in a bowl of Jell-O. It keeps popping up in different parts of the world." Cot
and documents detail their tortured relationship.

Mr. Larsen says New Balance has already spent millions of dollars in legal fees, a
millions more in sales and brand image. He says its problems in China have slowe
Balance's quest to overtake Reebok and Adidas to be the No. 2 U.S. sneaker make

New Balance, along with much of the athletic-shoe industry, began to move prod
China from Taiwan and South Korea in the early 1990s. There was a ready supply
labor and an eagerness it hadn't found elsewhere.

New Balance's initial production of six million pairs, made at 14 different factory
swelled. Today, the company makes 35 million pairs a year in China, about 70% c
output.

Vast Market

But the company also wanted to tap China's vast consumer market, which was qui
developing a taste for foreign goods. It turned to Mr. Chang, whose factories first
and then in China had supplied New Balance for years. Gruff-mannered and with
experience, Mr. Chang was an unlikely partner. But he had a long history with the
and a solid command of English, and he claimed to know his way around China. It
became New Balance's official sales partner in mainland China.

To boost sales, Mr. Chang persuaded New Balance to push its lower-priced "class
for the local market. These weren't as high-tech as the later models, but their retro
turning into a must-have accessory in trend-setting markets like Japan. Over the ne
Mr. Chang continued making New Balance shoes for sale globally, while slowly i

Mr. Chang maintained close relationships with New Balance management. At the
1999 midyear sales conference, he was invited for a private meeting with its presi
Tompkins. Addressing executives in the president's private conference room, ador
track-and-field trophies, an ebullient Mr. Chang said that the China market was ab
explode, and that he could sell 250,000 pairs that year, participants say.

"That's when things got awkward," recalls Ed Haddad, New Balance's vice preside
international sales, who was in the room. New Balance had been worried for some
selling so many classic-style sneakers -- high on style but low on technology -- co
its image as a maker of quality running shoes. Mr. Haddad explained that New Ba
to scale back its classics line, and that Mr. Chang's ambitious figures were out of l
strategy. Mr. Chang was crestfallen. "He was looking for a pat on the back and ins
'You're not doing a good job,' " Mr. Haddad says.

When the meeting ended, Mr. Chang shook hands with Mr.
returned to Asia and set about manufacturing more of the cl
anyway, New Balance officials say.
Not long afterward, New Balance's sourcing department, which tracks how much it produces, reported that Mr. Chang had acquired materials to make 460,000 pairs. Planning on making styles and colors New Balance had never approved, says the "We saw this and said 'What the hell is going on?' " recalls Mr. Haddad.

The next sign of trouble came when New Balance's Japanese distributor rang up headquarters in Boston. A nationwide discount retailer in Japan, the company's second-largest market after the U.S., was selling the classic -- made only by Mr. Chang -- for as little as $20.

Harley Lewin, a New York lawyer retained by New Balance, remembers when he mailed photos from Japan: "I thought ... 'These guys have a major problem on their hands.' Within two weeks, he was on a plane to Japan.

While he was there, another shipment of about 6,000 pairs was blocked at customs. Shipping documents listed Mr. Chang's company, Mr. Lewin says.

New Balance was furious, and it immediately severed its distribution agreement with Mr. Chang's factory had already cranked out close to a half million pairs of shoes, going to have to get rid of them somehow. "This was a high-risk situation," says Mr. Haddad. "The shoes could seep out."

Worried that Mr. Chang might try to dump his inventory overseas, New Balance was discussing a plan to gradually sell it off through his 20 China stores. Told it would take months to sell all the shoes, New Balance then offered to buy all of Mr. Chang's stock of a particular model, about 35,000 pairs, for $10 each. Mr. Chang declined. Irritated by increasing demands of its former supplier, New Balance withdrew its offer. It began to look as if Mr. Chang knew he could find a better price elsewhere.

"Our ability to control this situation was beginning to slip away," recalls Mr. Haddad. New Balance's relations with Mr. Chang were rapidly deteriorating. And its efforts to take possession of the hundreds of thousands of New Balance sneakers were going nowhere.

Mr. Haddad complained that Mr. Chang wasn't cooperating with New Balance on the inventory. Mr. Chang's associate, Johnny Wu, responded in an e-mail that as they worked for New Balance, they refused to be treated "like a dog."

'Sick and Tired'

In April 2000, Mr. Chang e-mailed New Balance's chairman and chief executive, J. Davis, insisting that Mr. Chang's company had never exported New Balance shoes to China. He blamed any such shipments on counterfeiter in Shanghai and Guangzhou and tired of going through all these explanations," he wrote. He didn't understand why being punished after he had quadrupled sales in China. "I went to the Boston sales office expecting to be praised ... instead it was 'death penalty.' ... Is this fair?" he wrote.

He said that he had to double his production because shoe dealers for other companies such as Nike, Adidas and Reebok, also wanted to carry New Balance shoes. New Balance dismisses this explanation as completely contrary to industry practice. In the e-mail, Mr. Chang complains bitterly about being terminated as a New Balance supplier questions the fairness of its strategy in China.
Not long thereafter, the shoes began showing up at stores in Italy, Switzerland, Taiwan, according to Mr. Lewin, the lawyer. By representing himself as part of the Balance organization, Mr. Chang had been able to bypass customs regulations set fakes, New Balance says.

Having exhausted its options, New Balance tried another approach, turning to China Administration for Industry and Commerce, the intellectual-property and trademark enforcement agency. To its relief, the AIC agreed to raid five of Mr. Chang's warehouse netting over 100,000 pairs. They didn't find just New Balance shoes but also a different called Henkee, whose style and logo were almost identical.

The AIC's involvement gave New Balance confidence it might be able to trust its China's legal system. In December 2000, it filed suit in Shenzhen against two Chinese companies, one that made shoes and one that sold them.

With signs of increasing diligence in brand protection by Chinese authorities, New Balance was hopeful. The court agreed to hold the evidence -- including all those shoes -- to outcome, ensuring they couldn't be sold while the proceedings dragged on. The AIC in Shanghai submitted its own evidence that supported New Balance's claims.

Then, last February, the judge ruled against New Balance. Instead of recognizing revoked its sales agreement with Mr. Chang's distribution company, the judge cited document with Mr. Chang's manufacturing company in which New Balance had factory could make the company's shoes until 2003.

New Balance's lawyer, Mr. Lewin, says that the company "was naive" in the way its relationship with Mr. Chang.

New Balance braced for a flood of sneakers to hit the market. Since then, new shoes been spotted in Australia, and shoe buyers in the U.S. and England have been appr middlemen offering to sell container-loads. At a teeming mall in Shenzhen, just ac border from Hong Kong, budget shoe stores hawk the New Balance classic model of colors.

The company has appealed the ruling, but Mr. Lewin doesn't expect it to be overturned. The company continues to hire private detectives to monitor the situation.

Recently, New Balance changed its relationship with suppliers. It cut the number us in China to six and monitors them more closely. It has also begun using high-labels to better spot counterfeiters and keep control of its own production.

But executives fear another episode like this one. "It could happen to any of our suppliers anywhere in the world," says Mr. Haddad. "Once you teach them how to make it, they'll do it."

Write to Gabriel Kahn at gabriel.kahn@wsj.com

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