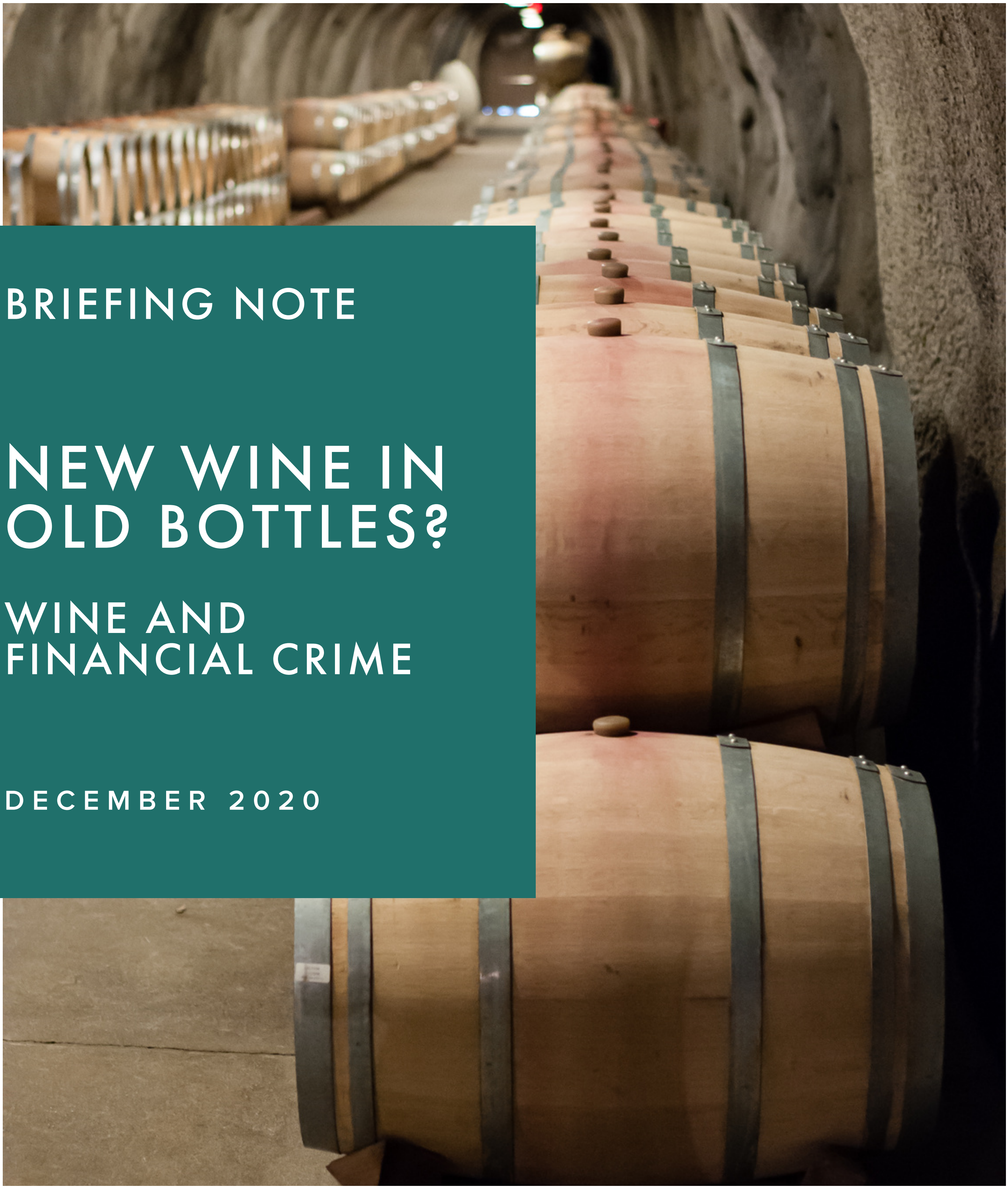

BRIEFING NOTE

NEW WINE IN OLD BOTTLES?

WINE AND FINANCIAL CRIME

DECEMBER 2020

INSIGHT | INTELLIGENCE | INNOVATION

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THEMIS

INTRODUCTION

Every December sees a seasonal spike in wine consumption in many countries and, with restiveness around continued COVID-19 restrictions hanging in the air, 2020 is unlikely to buck the trend. A 2018 study suggested that the average Brit consumes 26 units of alcohol per day over the festive period, and festive tipples like mulled wine are a staple at Christmas markets across Europe. While opportunities for Christmas parties and socialising are fewer and further between this year, it is doubtful that people will be deterred from opening that special case over the holidays, especially if alcohol consumption trends that have emerged during the pandemic continue. According to a recent EU study, 2020 has seen a spike in drinking in countries including the UK, Finland and Sweden.

Yet with certain wine industry experts estimating that a fifth of all international wine sales are counterfeit, there is a strong probability that some fraudulently produced wine will make its way onto family tables this holiday season. The ninth joint Europol-Interpol operation targeting counterfeit and substandard food and drink drew to a close this summer, resulting in the seizure of 1.2 million litres of counterfeit alcoholic beverages by the European Anti-Fraud Office. Indeed, Europol has recently stated that the falsification of food and drink products is one of the most profitable enterprises in the European Union – second only to drug trafficking.

With many preparing to crack open their finest bottles over the next few weeks, and with release last month of Rudy Kurniawan, one of the wine industry's most prolific conmen, following a seven-year prison term and a $48 million fine, there is no "riper" time to shine the spotlight on financial crime in the wine industry.

This Themis briefing note explores wine fraud, wine-related tax evasion and money laundering involving luxury alcohol. We delve into case studies and red flags, as well as regulatory obligations and risk mitigation strategies for the wine industry.

NOTORIOUS CASES OF WINE FRAUD

Few cases are more synonymous with wine fraud than the so-called Jefferson Bottles: purported 1780 Chateau Lafite vintages bearing the etched initials of Thomas Jefferson that were sold for record sums in the 1980s. Billionaire Bill Koch, who acquired some of these bottles, hired investigators who discovered that the initials were signed erroneously (‘Th.J’ rather than Jefferson’s customary ‘Th:J’) and determined they could only have been etched using a modern dentist's drills; certainly not the 18th century copper wheels that Jefferson had at his disposal.

In the early 2000s, infamous conman Rudy Kurniawan produced and sold over $550 million of counterfeit wine, using fake aged corks and labels, detailed tasting notes and a discerning palate to blend cheaper wines into convincing approximations of extraordinary vintages. He fell on his own sword when purported 1945 and 1971 vintages of Clos Saint-Denis from Domaine Ponsot – which has actually only been produced since 1982 – were noticed amongst his collections. His targets can console themselves, however; a market has already emerged for Kurniawan’s fakes, which are now considered a curiosity and investment, aligning with Bill Koch’s blunt claim that "I used to brag that I got the Thomas Jefferson wines. Now I get to brag that I have the fake Thomas Jefferson wines."

The story of Rudy Kurniawan, now documented in crime documentary “Sour Grapes”, is unfortunately by no means a one-off. In 2006, the French national wine "fraud squad" discovered about 300,000 bottles of improperly blended wine in the winery of Georges Duboeuf, dubbed the “king of Beaujolais”. The wine contained a mix of cheap, average and high-quality grapes from different vineyards in order to conceal a bad harvest. Blending of this sort is forbidden under France’s strict appellation controlée grading and labelling system, and Duboeuf faced a trial and £20,000 fine.

Cases of wine fraud abound in Italy too. In 2014, the Italian police uncovered a plot to flood the global wine market with over 220,000 bottles of fake Brunello and Rosso di Montalcino bottles. Scammers were trying to pass off lower-quality local wine as the two coveted reds, with the Siena police force chief deeming this the “biggest fraud ever carried out in the agricultural and food sector”. Had the scam succeeded, the fake wine would have sold for up to €5 million.

The rise in counterfeit wine over the past several decades is in part attributable to a surge in demand for fine wine in emerging markets. Asian buyers represented 66% of total sales at Sotheby’s fine wine auctions in 2019 and China is now the fourth largest importer of wine in the world. This trend has inevitably driven prices up, which in turn has prompted a renaissance in wine forgery, as fraudsters seek to capitalise on a lucrative market. Indeed, a 2017 Forbes article cited a Bordeaux Wine Council estimate that 30,000 bottles of fake imported wine are sold in China every hour.

These stories of wine fraud must in no sense be glamourised or turned into an anecdote - they represent large-scale international crimes with serious consequences. Counterfeiting starves the legitimate industry of around 18,500 jobs across the EU, according to the European Union Intellectual Property Office (EUIPO), and causes a 2.3% (or €62 million) loss in legal wine sales. These losses are compounded through price increases, with artificially hiked prices at the upper end of the wine market also inflating prices at the lower end.

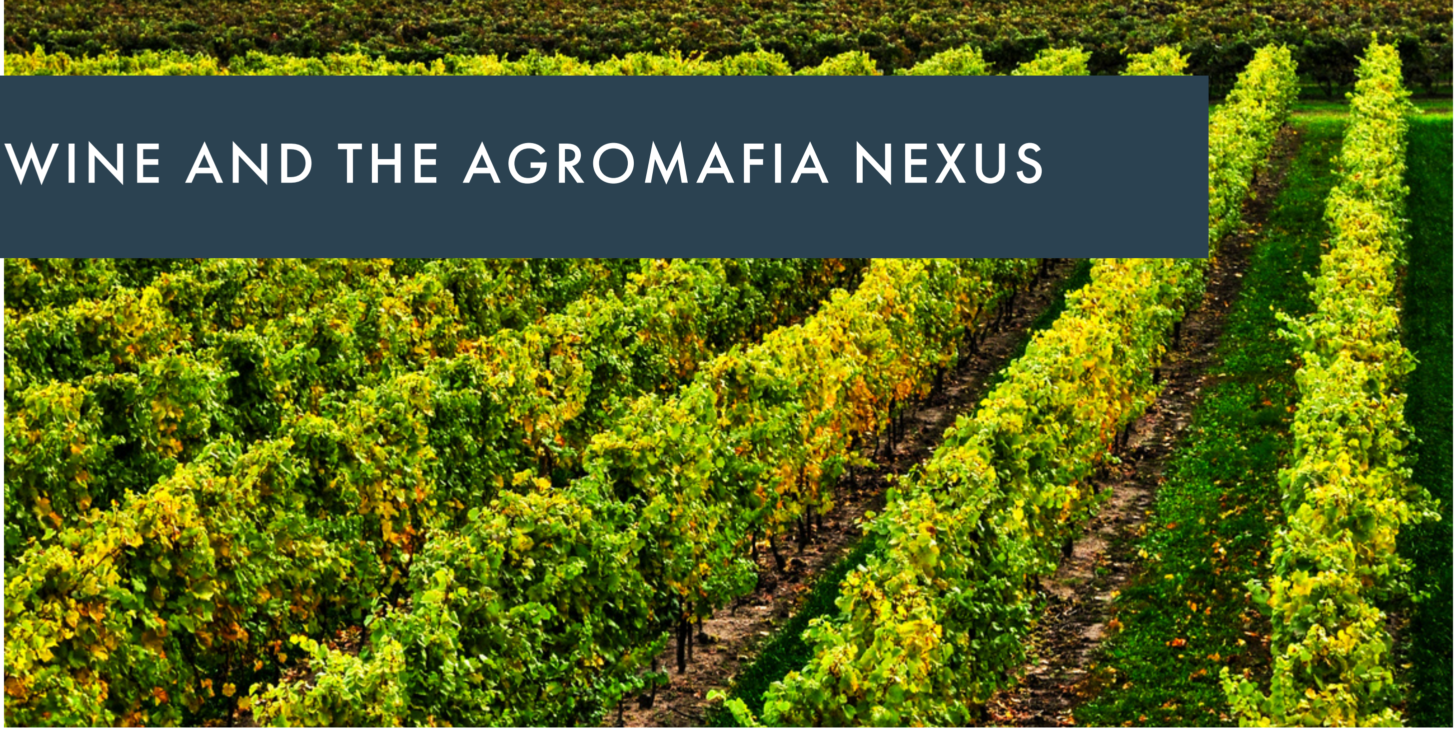
METHODOLOGIES: COUNTERFEIT LABELLING, BLENDING AND ADULTERATION

Wine forgers can tamper with bottles, their contents or both. Dates on labels or corks can be amended or blurred, or empty bottles of genuine vintages purchased and refilled with cheaper blends. Many collectors never actually drink their wines keeping them as jewels in their collection or acquiring them purely for investment purposes before selling them on. As a result, the world's most expensive bottles often lie in specialist investment wine vaults or make their way from cellar to cellar, serving not as consumption goods but as collectors' trophy items.

Even if opened, the world's rarest wines are so seldom drunk that few collectors will have tasted that particular "true" vintage before and, if they have, there are still some plausible reasons for slight variation, such as exposure to light, moisture or temperature fluctuations through sub-optimal storage or transportation conditions.

Expensive or pure vintages can be cut with inferior and cheaper grapes or harvests to inflate profit margins, breaching appellation systems designating minimum percentages from certain regions, as in the Beaujolais case described above. The addition of water – so-called "Jesus units" – can "stretch" wine further too, whilst hue and flavour-enhancing agents like elderberry juice and cinnamon can camouflage dilution. Adding sugar to sweeten wine or increase its alcohol content is prohibited above certain limits and those caught, as two prosecco producers were last year, face prosecution for breaching regulations.

Sugar adulteration is the preferable end of the wedge, but since dessert wine is expensive to make and sugar easily detectable, some fraudulent producers create more hazardous concoctions, spliced with toxic "sugar of lead" or methanol, to increase sweetness and alcohol concentration. In 1986, nineteen people were killed and fifteen blinded after drinking Italian wine laced with paint thinner – a sharp reminder that wine fraud is rarely a victimless crime or one that only targets ultra-wealthy investors.



WINE AND THE AGROMAFIA NEXUS

In Italy, data suggests all of the country's major crime syndicates invest in agriculture, which purportedly accounts for 15% of total mafia revenue. Agri-industry has a vastly reduced risk profile compared to activities like the drugs trade, and it provides a legitimate cloak and means of laundering profits from more patently illicit activities.

Indeed, fifty entities linked to Italian wine production are currently under investigation for an array of fraudulent activities, including prestigious wineries in Puglia, Padova, Reggio Emilia, Modena, Ravenna, Puglia and Naples, as well as their certifying inspectors, who stand accused of complicity. Just last month, Italian police raided a warehouse near Milan containing 80,000 items used to create 6,600 bottles of counterfeit Sassicaia 2015, a prized vintage. It is estimated the cumulative market value of this volume of genuine wine would have amounted to around €2 million.

DETECTING AND PREVENTING WINE FRAUD

At the complex scientific end of the wine authentication spectrum, existing and emergent technologies encompass the use of ultraviolet light to identify security marks on legitimate bottles; stable isotope and isoscape analysis to pinpoint conditions experienced in the vine; classification of protective "smoke taint" growers applied to grapes as a shield from wildfire smoke in certain parts of the world; analysis of phenolic compounds, which contribute to the colour and "mouthfeel" of a wine; and fluorescence spectroscopy, where naturally occurring fluorescent compounds create a unique "fingerprint" which can be identified - with promising results in the latter published last month by the University of Adelaide, showing 100% accuracy at determining a wine's geographical origins.

Companies are further capitalising on investors' and consumers' concerns with a range of gimmicks including tamper-proof capsules that change colour once a bottle has been opened; invisible and encrypted DNA tags embedded into labels that are undetectable and impossible to replicate; inimitable bubble patterned bottle neck seals; and scannable QR codes to trace bottles back to wineries.

A LAYMAN'S RED FLAGS

Spectroscopy is all well and good in the lab, but wine investors can utilise more basic techniques to sniff out a fake at home. Bottles from before 1860 are all hand blown and should therefore wobble on flat surfaces; counterfeit bottles tend to be lighter; French bottles from 1930 onwards should have centilitre capacity embossed on the glass, and recycling symbols clearly denote modern bottles. If tampered with, corks may display depression marks from prongs and imprinted vintages should match the label – if from a top quality Bordeaux chateau, this will be branded rather than inked, and the cork will be 52mm-55mm in length (longer than others) and finely ground. Capsules with multiple creases or fingerprint indentations have likely been interfered with and, in old wines, there should be a crust around them when opened. Sediment is hard to simulate and overly sparkling, glittering or large chunks are suspicious.

Cheap counterfeit ink rubs off labels with a wet cloth and spelling mistakes on French words or font irregularities are glaring warning signs. Fake aged labels may bear grooved marks from sandpaper, the smell of tobacco or, if oven baked in batches, the ghost imprint of a different label. A blue light torch can be a helpful ally in spotting fluorescence from ultra-white paper, which has only been available since 1957, or glue, available since the 1960s.

WINE-RELATED TAX EVASION, SMUGGLING AND INVESTMENT FRAUD

Counterfeit wine is a ready vehicle for tax evasion, and the EUIPO estimates that EU governments collectively lose €1.2 billion per year from the practice in household income taxes, social security contributions, corporate income taxes, VAT and excise duties. The UK government alone is said to lose €197 million each year in excise duties due to counterfeit wines and spirits.

In 2017, Livio Mazzarello fled the UK midway through standing trial for a five-year scam worth £46.5 million, having evaded taxes for years by selling fine wine "off the books" for cash and laundering the funds through his company. The scheme was foiled when the company's importation records were found on a computer server, revealing blatant inconsistencies in stock levels, and evidence that drivers had provided fraudulent paperwork to customs officials.

Also worth guarding against is investment fraud, where companies sell expensive wines to investors before going into planned liquidation, without then shipping the wines. Similarly worrying is recovery fraud, where bogus companies or websites are established, sometimes hijacking reputable names, from which cold callers contact individuals offering to buy wine at a premium to its current market value. In the latter half of 2018 alone, the City of London Police's Action Fraud service received 22 reports of this crime, with losses of circa £100,000.

REGULATIONS COVERING THE WINE INDUSTRY

Financial crime involving wine has sparked the concern of a number of national regulators and international organisations. For instance, in 2013, Tracfin, the French anti-money laundering (AML) agency, raised alarm about the use of multiple holding companies based in tax havens linked to Chinese and Russian investors for the purchase of French vineyards. When it comes to wine fraud, Geographic Indications (GIs) not only allow for the international tracing and verification of wine but also represent legally protected intellectual property, including as defined by the World Intellectual Property Organisation.

In the UK, HM Revenue & Customs (HMRC) introduced the Alcohol Wholesaler Registration Scheme (AWRS) to tackle alcohol fraud. This scheme came into force in early 2017 and applies to all businesses that supply alcohol to other businesses for resale, covering wine producers, wine importers, specialist wine wholesalers, auctioneers and others. The firms concerned must apply for approval with the HMRC in order to carry out their activities. As a condition of approval, they must:

- Objectively assess the risks of alcohol duty fraud within their supply chains;
- Undertake reasonable and proportionate checks in their day-to-day trading to identify transactions that may lead to fraud or involve goods on which duty may have been evaded;
- Have procedures in place to take timely and effective mitigating action where a risk of fraud is identified;
- Document any checks carried out and ensure that appropriate management governance exists.

The HMRC may apply sanctions - including refusing an application or revoking an AWRS approval - in the case of failure to consider risks, undertake due diligence checks or respond to clear indications of fraud. To help wine traders with these checks, the Food Standards Agency published a “Due diligence guidance for wine traders” document in June 2016 outlining key recommended compliance steps.[1]

In cases where luxury wine merchants or auction houses transact in goods and receive or make cash payments of €10,000 or more (in any currency), they classify as high value dealers (HVDs) and are therefore subject to additional AML regulations and monitored by the HMRC. Indeed, the “Understanding risks and taking action for high value dealers” guidance published by the HMRC in October 2020 lists “alcohol/cash and carry” as one of the “higher risk” HVD sub-sectors.[2]

1. https://www.food.gov.uk/sites/default/files/media/document/due_diligence_guidance_june_2016.pdf
2. https://www.gov.uk/government/publications/money-laundering-understanding-risks-and-taking-action-for-high-value-dealers/understanding-risks-and-taking-action-for-high-value-dealers

REGULATIONS COVERING THE WINE INDUSTRY

HVDs are obliged to undertake AML risk assessments, conduct due diligence on all customers and implement a comprehensive structure of AML policies, procedures and training. Enhanced due diligence is required in particularly high risk situations, for instance if the customer is a politically exposed person or comes from a high risk third country.

HVDs also have to file suspicious activity reports (SARs) to the National Crime Agency if they suspect any malpractice. However, numbers are notoriously and disproportionately low – especially for auction houses and the luxury goods sector. In fiscal year 2019/20, SARs from HVDs comprised only 0.06% of the total number received. Given the government's concern that billions of pounds of illegally-derived proceeds are laundered through the UK annually, and the fact that high value goods are a customary means of cleaning funds, these figures suggest inadequate reporting in the sector.

Wine merchants and auction houses are certainly at risk. In a recent BBC interview, head wine detective at UK fine wine merchant Berry Bros & Rudd said that he and his team intercept a fake bottle of wine passing through their premises every couple of months, whereas Sotheby's employs high-powered magnifying camera loupes to review the labels of wines it is asked to auction. As organisations get to grips with the HVD requirements and find their footing with newly-embedded policies and procedures, numbers of SARs should start to increase.

CONCLUSION

Crime in the wine industry is no new phenomenon. Pliny the Elder purportedly bemoaned the high incidence of counterfeit wine in Ancient Rome and wine fraud was even punishable by death in medieval Germany. It seems safe to assume that the age-old practice will be around for years to come and as authentication technologies increase in sophistication and accuracy, so too will counterfeiters' methods of simulation.

Wine fraud has consequences far graver than simple embarrassment at having been duped or paying over the odds for a bottle, with governments and citizens absorbing the cost of associated health risks, tax evasion, money laundering and, especially where organised crime syndicates like the Sicilian agromafia or Mexican cartels are involved, extortion and violence. Just last month, criminals seeking to steal five bottles of expensive wine worth $50,000 killed a French restaurateur in Mexico City to carry out this theft.

Themis is here to support businesses in the wine industry looking for compliance-related guidance. In June 2020, we released a briefing note containing detailed advice to help HVDs implement AML requirements, entitled “Money Laundering Risk for High Value Dealers”. This document is available via our members' portal.

In addition to our thematic insight, we have an experienced team of investigators who can help with your due diligence needs, including enhanced due diligence if you are a high value dealer. We can also employ our Themis AFC Rating to “take the pulse” of your existing financial crime risk management approach and recommend improvements to rectify identified gaps. Finally, we can help educate your staff about the risks your business may face via dedicated training sessions.

With the festive season in full swing, do keep enjoying your Christmas tipple - just make sure you know where it comes from!

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