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This first criminal felony sentence makes clear the U.S. government's commitment to stop the trafficking of stolen timber.



# Facing the Consequences for Liquidating the Forests

## The full story behind Lumber Liquidators' guilty plea for Lacey Act violations

On February 1, 2016, for the first time in history, a major U.S. corporation was found guilty of a criminal felony for smuggling wood into the United States, related to violations of the Lacey Act. This sentence came nearly two years after an Environmental Investigation Agency (EIA) investigation revealed the indiscriminate purchasing practices of Lumber Liquidators, the largest specialty retailer of hardwood flooring in the United States. EIA's investigation showed that Lumber Liquidators purchased solid oak flooring from Chinese manufacturers made from illegally harvested timber from the Russian Far East (RFE), thereby endangering the forests and wildlife of the region and violating the Lacey Act.

The resulting prosecution by the U.S. Department of Justice (DOJ) ensured Lumber Liquidators faced very real consequences for their actions. The company pleaded guilty to one felony and four misdemeanor charges, and agreed to pay \$13.2 million in fines and penalties for importing illegally sourced timber and making false statements as to the origin of this timber. Both of these violations came as a result of the company's repeated failure to follow its own internal procedures and take action on internal warnings. Most importantly, the company has been placed on a five-year probation while it completely reforms its sourcing practices to implement an Environmental Compliance Plan in order to fully comply with the Lacey Act.

This first criminal felony sentence related to the Lacey Act will have important implications for the U.S. forest and wood products sectors and beyond, as it makes clear the U.S. government's commitment to stop the trafficking of stolen timber. This case further demonstrates that the Lacey Act can be an effective tool in stopping illegal logging and the destruction of the world's forests. It also illustrates the importance of continuing to strengthen the Lacey Act through adequate funding and staffing to ensure compliance and enforcement.



Illegally cut ash logs on the territory of Xingjia supplier Beryozoviy LLC.

## How it All Started: EIA's Undeniable Evidence from Russia and China

EIA first exposed Lumber Liquidators' sourcing practices in its 2013 report, *Liquidating the Forests*, which was the result of a multi-year investigation that included undercover meetings with loggers, traders, and manufacturers in Russia and China, interviews with Russian authorities and civil society, and extensive analysis of trade and customs data. EIA investigators documented the extent and nature of illegal logging in the RFE and tracked illegally-harvested, valuable hardwoods across the Russian border into China, through factories and warehouses, to its ultimate destination in showrooms around the world.

The investigation revealed that since the Lacey Act became law in 2008, Lumber Liquidators imported millions of square feet of solid oak flooring harvested in the RFE

from a supplier in China that freely admitted to engaging in illegal practices throughout its sourcing operations. This manufacturer, Suifenhe Xingjia Economic and Trade Company (Xingjia), sourced from many suppliers under scrutiny by Russian authorities for illegal logging in the most threatened temperate forest in the world, including at least one supplier that has received multiple convictions and significant jail time for illegal logging.

While visiting Xingjia's factories, the manager of Xingjia's Dalian factory revealed to EIA investigators that the company's largest customer was U.S. flooring giant Lumber Liquidators and explained their close relations in detail. EIA investigators then observed many pallets stacked with Lumber Liquidators' Virginia Mill Works hand-scraped solid oak flooring outside Xingjia's factory, ready for export.

## Lumber Liquidator's Suppliers: Overharvesting, Stealing Timber, Buying from Shady Middlemen

EIA's investigation revealed numerous methods of illegal logging commonly practiced in the RFE. A large portion of timber sourcing in the region is conducted by small bands of loggers, who cut high-quality timber in violation of authorized harvesting plans and protected area designations. The timber is bought and sold through multiple sawmills and middlemen – small trading companies whose chief role is to hide the illicit nature of the timber. In his first meeting with undercover EIA investigators, Xingjia's CEO Mr. Sun freely admitted that the company harvested in excess of allowable cuts from forest concessions owned by the company and operated in the Khabarovsk region of the RFE. However, according to Mr. Sun, the majority of Xingjia's timber does



Chinese border town of Suifenhe, port of entry for 96% of the RFE's valuable hardwood exports.



not come from its own forest concessions, but from third party trading companies and concession-holders.

In 2014, senior executives from one of Xingjia's key Russian suppliers, Beryozoviy, were convicted in a Russian court of organized crime and illegal logging during the period from 2010 to 2012. Russian-language internet searches conducted by EIA in 2012 and 2013 showed numerous news reports of this investigation as well as a previous conviction of Beryozoviy company managers for illegal logging.

Details from the Lumber Liquidators' guilty plea agreement state that the DOJ's investigation found that in one case of imports from Xingjia to Lumber Liquidators, a supplier in the Khabarovsk Province of the RFE cut as much as 800 percent above the legally allowed limit.

## Knowingly Misdeclaring Country of Harvest

Flooring manufacturers across northeastern China, including Xingjia, told undercover EIA investigators that they regularly mix together oak from Russia, China, the United States, and the European Union. Nearly every manufacturer interviewed reported that they declare "country of harvest" to be whichever country their U.S. buyer finds most desirable — a clear violation of the requirement for buyers to accurately report country of harvest on the Lacey Act declaration form accompanying every shipment. In the plea agreement, Lumber Liquidators admitted to the felony charge of knowingly declaring false country of harvest for their imports of Mongolian oak — a species only found in northeast Asia — which the company declared as harvested in Germany. According to the court file "USA versus LL", the company was aware of this false declaration, given that prior to the shipment an employee identified and communicated to the company's Quality Assurance department, their Shanghai office, and their legal department that Mongolian oak does not grow in



The world's last remaining 400 Siberian tigers live in the forests of the Russian Far East, which are being destroyed by organized criminal networks.

Germany and that the shipment's harvest declarations must be false. Despite this knowledge, Lumber Liquidators chose to bring the shipment into the United States.

During EIA's investigation, investigators met with company representatives from Zhejiang Dadongwu Greenhome, a flooring company based near Shanghai and a regular supplier to Lumber Liquidators. Greenhome officials told EIA that Lumber Liquidators knew that Greenhome used Russian oak, but that on the declaration forms required under the U.S. Lacey Act, Lumber Liquidators declared all shipments from Greenhome as German, because the "U.S. market and government don't like [wood from] Russia."

## Lumber Liquidators' Direct Role in Russia-China Wood Sourcing

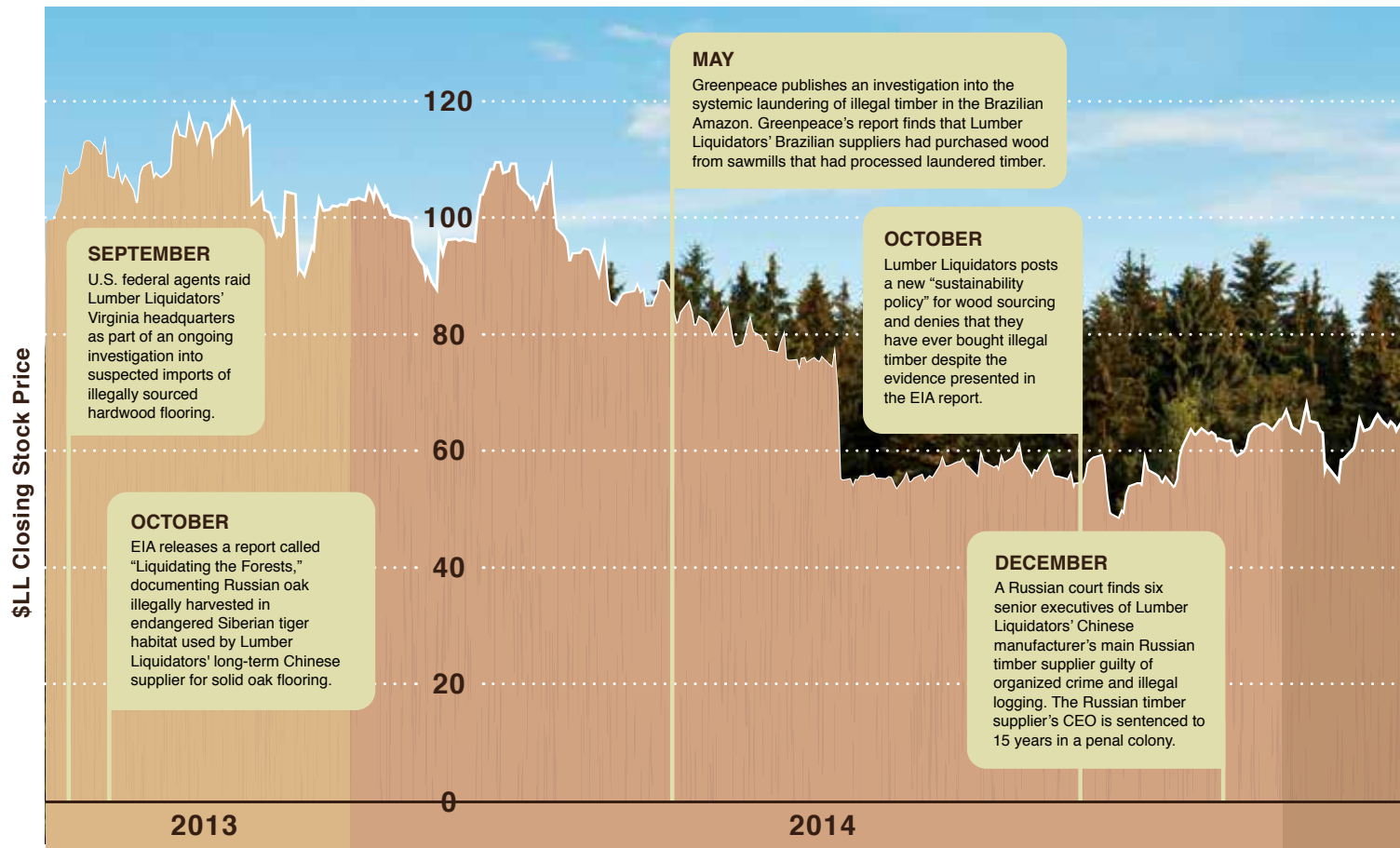
EIA investigators learned from several industry sources in Russia that as much as 80 percent of valuable hardwood exports from the RFE to China consist of illegally sourced timber. While being interviewed by undercover

## Scientific Testing Brings Greater Certainty

EIA obtained eight samples of solid oak hardwood flooring from a batch of flooring that investigators observed being prepared by workers in Xingjia's Dalian factory for a shipment to Lumber Liquidators. EIA sent these eight samples for testing of stable isotopes — a decades-old technology that has recently been applied to wood products testing. Test results indicated with a 97 percent or greater degree of certainty that seven out of the eight samples came from trees grown in the RFE.



Workers packaging Lumber Liquidator's flooring at Xingjia Dalian factory.



Since the DOJ investigation began and the formaldehyde scandal came to light, company shares have gone down by approximately 88 percent from a high of \$119.44 in November 2013.

EIA investigators, Xingjia officials made clear that they believed Lumber Liquidators was well informed of these illegal practices, in part due to multiple visits by company officials from Virginia and Shanghai to Xingjia's Chinese sawmills during their six-year sourcing relationship. Lumber Liquidators was able to establish greater oversight and assume direct control over all sourcing in China in 2011 when it acquired Shanghai-based Sequoia Flooring, a company that had previously provided them with quality control, product control, and logistics services, and established a representative office in Shanghai. As the company stated in its 2014 Form 10-K filed with the SEC: "Sourcing directly from the mill and our unique store model provides the foundation for our value proposition, which we market aggressively to the homeowner, or a contractor on behalf of a homeowner."

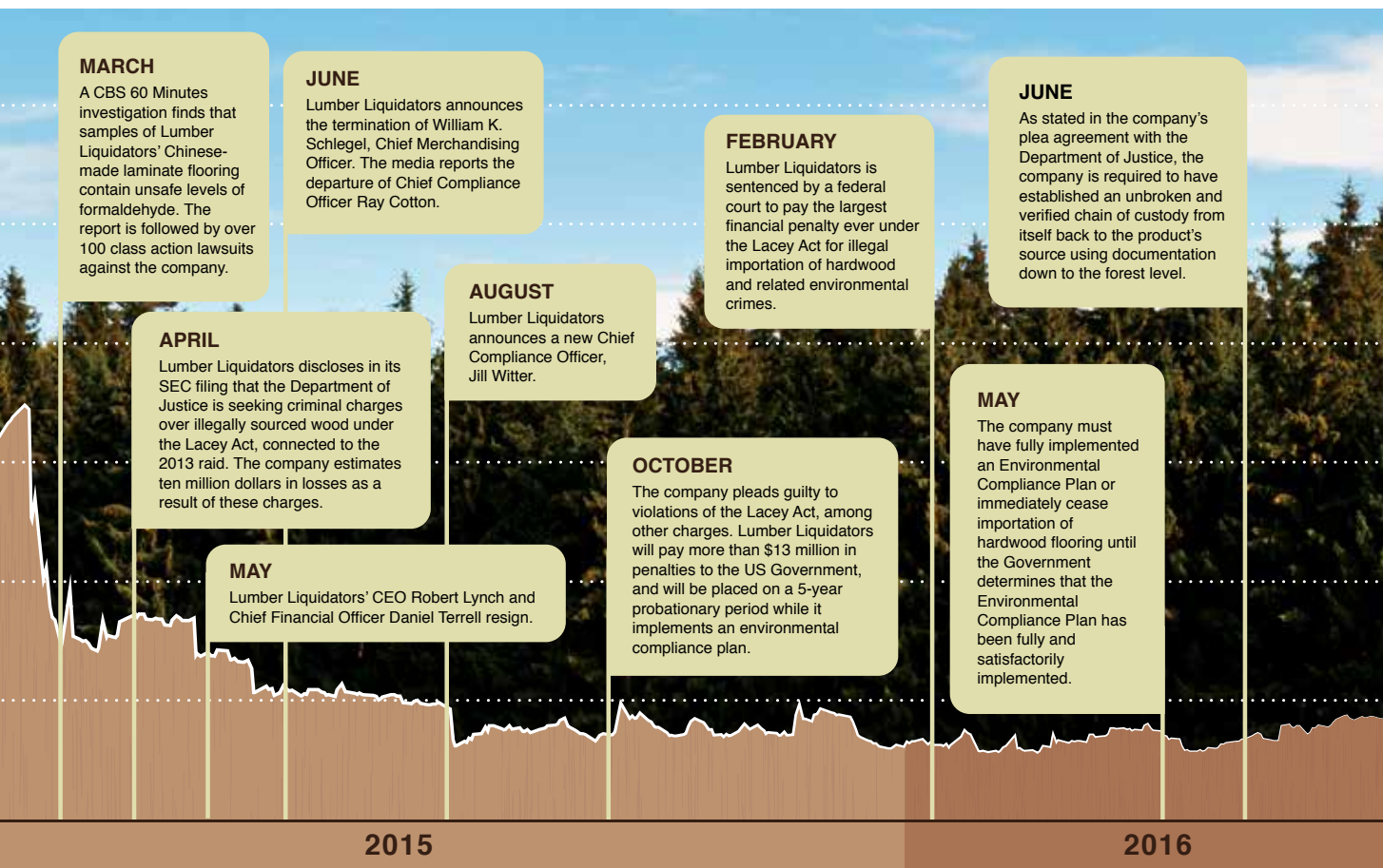
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As stated in the court documents from the recent sentencing, the U.S. government found that Lumber Liquidators should have known that the Mongolian oak "was taken in violation of a foreign law."

## 2013-2015: Timeline of the U.S. Government's Lacey Act Investigation

On September 26, 2013, the U.S. Immigrations and Customs Enforcement, together with the Fish and Wildlife Service, raided the Lumber Liquidators' corporate offices in Toano, VA and a store in Richmond, VA as a result of the company's suspected illegal wood imports. The company's stock value dropped five percent immediately following the raid, and by December 2013 the stock value had dropped by 20 percent. EIA published its investigation *Liquidating the Forest* shortly after the government took action.

The company shares dropped even further when it was discovered that Lumber Liquidators' laminated flooring from China contained formaldehyde levels that were far above the legal threshold permitted by the California Air Resources Board (CARB). Meanwhile, the DOJ investigation under the Lacey Act continued, and in the spring of 2015, Lumber Liquidators disclosed that the U.S. government would pursue criminal charges for violations of the Lacey Act. At that



point, the company set aside 10 million dollars as estimated losses it would incur from the criminal case. Shortly after the disclosure, the company's CEO resigned from his position, and in the following weeks three more senior officers stepped down: the Chief Financial Officer, the Chief Merchandising Officer, and the Chief Compliance Officer.

In addition to the direct monetary damage incurred, Lumber Liquidators anticipated substantial reputational and market risks associated with the criminal charges. The company stated in its SEC Form 10Q of April 29, 2015 that "negative publicity surrounding these government investigations and legal actions also may harm our reputation and the demand for our products. Any one of these results could negatively affect our operations, financial conditions and liquidity and impair our ability to grow or sustain our business." Since the DOJ Lacey Act investigation began and the formaldehyde scandal came to light, company shares have plummeted by approximately 88 percent from a high of \$119.44 in November 2013.

## Found Guilty: Lumber Liquidators' 2015 Plea Agreement

In October 2015, Lumber Liquidators pleaded guilty to one felony count for entry of goods by means of false statements and four misdemeanor due care counts under the Lacey Act.

"The defendant will plead guilty because the defendant is in fact guilty of the charged offenses."



On October 22, 2015, Lumber Liquidators' pleads guilty to five counts related to illegal logging in federal court.

The company agreed to pay \$7.8 million in fines, \$1.2 million in community service payments, and \$969,000 in forfeited proceeds. In addition, Lumber Liquidators will forfeit \$3.2 million in cash as a substitute for the forfeiture of the flooring in question. The plea agreement is clear that the facts of the agreement "do not represent the entirety of the government's evidence against the defendant."



# Summary of Charges against Lumber Liquidators

How Lumber Liquidators failed to exercise due care, subsequently imported illegally harvested timber, and violated the Lacey Act declaration requirement.

*From the Statement of Facts in Lumber Liquidators' Plea Agreement with the DOJ*

## Count 1: Felony misdeclaration of *Quercus mongolica*, found only in Northeast Asia, as German origin

In February 2013, Lumber Liquidators sought to transfer products it purchased from "Company X", in China, between Lumber Liquidators' Canadian warehouse to its facilities in the United States, requiring the company to submit a Lacey Act declaration. As there was no supporting documentation showing legal origin for these products, a Lumber Liquidators employee examined older records provided by Company X and identified inaccurate past documentation which falsely identified Mongolian oak flooring imports as German origin. This employee sent an email to colleagues in the Quality Assurance department, the manager of the company's China office, and a member of the legal department, stating that the previous declarations had to be false, since Mongolian oak does not grow in Germany. Despite these findings, and lacking additional supporting documentation, Lumber Liquidators decided to import 12 shipments of solid oak flooring into the United States in violation of the United States Federal Criminal and Penal Code. During EIA's investigation, profiled in EIA's 2013 report *Liquidating the Forests*, undercover investigators met with company representatives from Zhejiang Dadongwu Greenhome, a flooring company based near Shanghai. Greenhome officials provided EIA with a Lacey Act declaration for Mongolian oak, declared as harvested in Germany. It is quite likely that Company X is in fact Greenhome.

## Count 2: Transport of illegally imported timber, falsely declared as of German origin

Between October 1, 2011, and January 30, 2012, Lumber Liquidators purchased and imported 23 shipments of finished oak flooring from Company X. The accompanying Lacey Act declarations for those 23 shipments contained false statements regarding the species and/or the country of harvest. These wood flooring shipments were sent from China to Norfolk, Virginia and subsequently shipped and transported to warehouses, online retail customers, and to Lumber Liquidators' retail stores for sale in Virginia and other states. Despite internal company guidance, Lumber Liquidators did not seek accurate documentation proving the species of timber, location of harvest, legality of harvest, or the chain-of-custody. The 23 shipments totaled 382,290 ft<sup>2</sup> (615 m<sup>3</sup>) of solid oak flooring, with an estimated retail value of \$1,641,523.

## Count 3: Transport of illegal timber from Russia declared as European oak

Between May 29, 2013, and July 14, 2013, Lumber Liquidators imported 35 shipments of solid oak flooring, totaling 677,880 ft<sup>2</sup> (1,134 m<sup>3</sup>) with an estimated retail value of \$3,518,197. The supplier, "Company Y," provided documentation clearly showing the Russian origin of the timber. However, Lumber

Liquidators declared all of these shipments as *Quercus petraea*, an oak species found only in Europe. The wood products were subsequently shipped and transported to warehouse facilities, to online retail customers, and to Lumber Liquidators' retail stores for sale in Virginia and other states. Despite internal guidelines and despite documents showing that the wood was harvested in the Russian Far East and therefore high-risk timber, Lumber Liquidators did not take the necessary measures to ensure that declarations were truthful prior to submission. Instead the company increased purchases of RFE timber products from Company Y in 2012 and 2013.

While the plea agreement does not name the Chinese supplier, it is clear that Company Y is in fact Suifenhe Xingjia Economic and Trade Company, the Chinese flooring company highlighted in EIA's 2013 report. Xingjia's CEO and its factory manager openly admitted illegal logging and bribery to undercover EIA representatives.

## Count 4: Importation of illegally harvested timber from Russia

Between May 29, 2013 and September 23, 2013, Lumber Liquidators imported 79 shipments of solid oak flooring, worth an estimated retail value of \$7,845,008, all from the same concession in Russia. These 79 shipments totaled 2,560 m<sup>3</sup>, constituting 800 percent of the allowable harvest under that concession's permit. Lumber Liquidators personnel knew the limits of this concession from this permit, and email exchanges demonstrate knowledge of the high risks of illegal overharvesting. Despite internal guidance, and despite documentation showing that the wood was harvested in the RFE and therefore high risk timber, Lumber Liquidators did not take sufficient measures to ensure that the shipments from this concession did not exceed the amounts allowable under the harvest permits.

## Count 5: False declaration of Myanmar timber as Indonesian mahogany

Between July 1, 2013 and September 10, 2013, Lumber Liquidators imported six shipments of flooring, totaling 143,086 ft<sup>2</sup> (238 m<sup>3</sup>) with an estimated retail value of \$790,402, that it declared as Indonesian big-leaf mahogany (*Swietenia macrophylla*) but which was in fact merpauh (*Swintonia floribunda*) from Myanmar. These shipments came from "Company Z" based in Shenzhen, China. During a September 2012 visit, two Lumber Liquidators employees visited Company Z and learned that this supplier could not provide documentation of country of harvest. Between September 2012 until the U.S. government's raid of Lumber Liquidators' headquarters in September 2013, Lumber Liquidators was unable to procure legal documentation from Company Z. Throughout this period, Lumber Liquidators continued to source flooring from Company Z, including the six shipments of illegally declared Myanmar timber. Despite past problems with documentation, Lumber Liquidators did not require Company Z to provide documentation showing location of harvest, legality of harvest, or chain-of-custody prior to importation.

Under its new compliance plan, as of May 1, 2016 Lumber Liquidators must prove legality of the entirety of their imports, or the company could be subject to further litigation and be forced to cease imports entirely.

The plea agreement notes that Lumber Liquidators increased purchases of Russian oak flooring in 2012 up until the moment the U.S. government carried out the raid of the company's offices in September 2013. The decision to increase purchases was made despite employees' awareness of illegality and the fact that the company's own internal guidance listed Russian oak in the highest category of risk.

## Five-Year Probation and Lacey Act Compliance Plan

As part of the plea agreement, the company must implement a comprehensive Lacey Act Compliance Plan for all imports to ensure legal wood sourcing, accurate reporting, and accurate labeling. This detailed plan requires the company to document an "unbroken and verified chain of custody from itself back to the product's source using documentation down to the forest level."

The real cost to the company will come from having to forego cheap, stolen wood in its supply chain while the DOJ looks over its shoulder.

The company's Chief Compliance Officer (CCO) will be responsible for implementing the program and directing a Lacey compliance team. The plan contains detailed instructions for risk assessment and mitigation, vendor evaluation, purchase order review, and auditing and monitoring. It requires, for example: a written authorization by the CCO before entering into business with a new supplier; in-person audits and on-site visits; and a random species verification program for suppliers deemed medium or high risk. The agreement notes that if Lumber Liquidators "fails to implement the Compliance Plan within three months of sentencing, it will have to cease the importation of hardwood flooring until the DOJ determines that the Compliance Plan has been satisfactorily implemented."

## Lumber Liquidators' Environmental Compliance Plan

Four key components the company will undertake in its practice of due care:

- » **Risk Assessment:** In evaluating risk, the company will consider a range of factors including, but not limited to, reported instances of illegal or unethical logging in the region or related to a specific product; protected status of the species; country-level corruption rating from third-party sources; unusual "deals" or sales methods; relative market and offer prices, among others. The risk evaluation requires the Lacey compliance team to conduct an internet search in order to determine what most recent legality concerns have been identified. The company will then designate each supplier and product as low, medium, or high risk and set out specific restrictions to address identified risk. If the supplier is considered medium or high-risk, the Chief Compliance Officer (CCO) must give initial approval before any product is purchased and must make a written record of the decision making process.
- » **Vendor Validation and Evaluation:** The CCO is also responsible for ensuring the company does not conduct business with suppliers or vendors that violate the Lacey Act. The CCO must provide written authorization to conduct business with a new supplier before undertaking any transactions, following an extensive review of the supplier. The review includes a risk assessment, sample purchase-order evaluation, and in-person audit. Self-reported information provided by vendors is deemed insufficient and additional procedures are required to independently verify and augment such data.
- » **Purchase Order Review:** The Lacey Compliance Team shall be responsible for implementing a risk-based approach to ensuring that Purchase Orders comply with the Lacey Act. The purpose is not a simple audit, but is intended to ensure that by May 1, 2016, Lumber Liquidators can establish an unbroken and verified chain of custody from itself back to the product's source using documentation down to the forest level. Records must be compiled before each shipment documenting compliance with the purchase order review requirements. Every shipment of a medium or high-risk product or from a medium or high-risk supplier must undergo a thorough review and sign-off by the CCO before it can be imported into the United States.
- » **Auditing and Monitoring:** The CCO shall ensure appropriate monitoring of the compliance program, including field and desk audits and any necessary corrective action. The compliance program will also be audited three times during the first four years of probation.

This compliance plan will significantly alter the way Lumber Liquidators sources its timber and will place the company on a level playing field with companies that have been conducting rigorous due care in supply chains all along. The real cost to the company will come from having to forego cheap, stolen wood in its supply chain while the DOJ looks over its shoulder.

## Lessons for the Timber Industry: Due Diligence is Indispensable

Thanks to the Lacey Act, Lumber Liquidators' model of increasing profit margins by buying cheap, illegally sourced timber has failed. This demonstrates that investing up front in proper due care is a far more cost effective business decision than risking reputational damage, as well as significant economic and legal costs for non-compliance.

The DOJ's enforcement and Lumber Liquidators' guilty plea have sent a strong signal that U.S. wood products' importers are increasingly being held accountable for conducting proper due care. This case shows that companies can no longer feign ignorance of the origins of the timber they buy from Chinese and other suppliers. U.S. importers of wood products sourced from China and possibly containing high-risk timber, in particular wood flooring, plywood, and furniture, should expect increased scrutiny from the U.S. government.



Lumber Liquidators' guilty plea profiled in The New York Times, February 2016.

This case illustrates the high risk of sourcing wood products from China, the United States' largest timber trading partner. China and Chinese companies must ensure the legal origin of any timber products destined for U.S. markets. China urgently needs to enact a prohibition on illegal timber imports and place mandatory due diligence requirements on Chinese importers of wood products, similar to other demand-side policies in the United States, the EU, and Australia. Other countries with significant timber imports from China, such as Japan, must also follow this example. The Lumber Liquidators case is a prime example that, if properly implemented, laws like the Lacey Act can be effective tools in reducing and eventually stopping illegal logging as a major driver behind the destruction of the world's forests.

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