

# Global corporate crime and the Sino-Forest fraud in Canada

## Abstract

Sino-Forest, formed in 1994, was a “stock market darling which promised investors a way to cash in on China’s rocketing economic growth by way of a booming domestic forestry business”.<sup>1,2</sup> The company claimed a market value of over \$6 billion dollars and was Canada’s largest, publicly-traded forest company. Sino-Forest’s billion dollar success came to an abrupt end in June, 2011 when a short-seller investment firm specializing in Asia claimed that the company was a multi-billion dollar Ponzi scheme.<sup>1</sup> Following the allegations, Sino-Forest’s stock price and bonds collapsed. As a result, Sino-Forest was forced to file for bankruptcy protection, which was granted. The company was dissolved and taken over by creditors as no buyer could be found. Several of the principles have since been charged with civil securities fraud by the Ontario Securities Commission. This paper examines the intricacies of the Sino-Forest scandal while contributing to a theoretical discussion on the role of structural holes in global capital markets. Here, we invoke Quinney’s<sup>3</sup> analysis of capital, Chamblis’s<sup>4</sup> notion of structural contradictions, and David Harvey’s<sup>5</sup> theory of accumulation by dispossession (2004).

**Keywords:** sino-forest corporation, global organized crime, corporate crime, critical criminology, richard quinney, accumulation, dispossession, William, chambliss, david harvey

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## Introduction

Sino-Forest, a forestry company located in China, was formed in 1994. The company was headed by Allan Chan, Albert Ip, Alfred Hung, George Ho, and Simon Yeung; and was based on the purchase and sale of forestry in The People’s Republic of China. A vast amount of the company’s revenue was attributed to the sale of wood fibre. Sino-Forest was listed on the Toronto Stock Exchange (TSX), valued at over \$6 billion dollars, employed almost 4,000 persons, and was believed to be a booming business that would ensure a large return to those who purchased stock in the company. It had sixty (60) offices in nine provinces in China. Sino-Forest achieved much success between the years of 2006 and 2011, their “share price[s] [growing] from \$5.75 (CDN) to \$25.30 (CDN), an increase of 340%”.<sup>6</sup>

Indeed, during the period 2006-2011, Sino-Forest told the investing public that it had generated over \$5 billion in revenue (Hearing on the Merits, vol. 1, p.62, Sept. 2, 2014). According to its annual reports, this was based on revenue from plantation wood fiber, other imported wood products, and manufacturing operations. Based on stock price, Sino-Forest was the largest forestry company listed on the Toronto Stock Exchange (Merits, *Ibid.*, p.63). Indeed, it used the Canadian financial system to raise some \$3 billion in debt and equity. (Merits, p. 84, Sept. 2, 2014, Vol.1). Unfortunately, the company’s great success came to an abrupt halt in June of 2011 when Muddy Waters,<sup>7</sup> a California based short-seller, made allegations that Sino-Forest Corporation was a “multibillion dollar Ponzi scheme.” Muddy Waters allegations went so far as to state that Sino-Forest’s fraudulent activity dated as far back as their inception in 1994.

Carson Block, Director of Research at Muddy Waters, created a team of ten researchers who spent two months researching Sino-Forest. These researchers went to China and visited many different areas across five cities, including forests that Sino-Forest claimed to own as well as offices of both the company and their various partners. The research team included people “focusing on China from the disciplines of accounting, law, finance, and manufacturing”.<sup>7</sup> By including such knowledgeable individuals in his research team, Block ensured that they would not be fooled due to language barriers

or the nature of Chinese state markets. In the following pages, the history of Sino-Forest’s multi-billion dollar fraud scheme will be described in detail, including information from the Muddy Waters report, allegations against the company by the Ontario Securities Commission,<sup>8</sup> and information which emerged from various lawsuits. We further intend to bring the reader up-to-date on the status of both the bankruptcy proceeding involving Sino-Forest Corporation as well as proceedings against the principles before the Ontario Securities Commission. Finally, we will address the status of Sino-Forest’s most recent incarnation, and then attempt to unpack this event by addressing the role of contemporary theory in explaining a case of global corporate crime and its impact on Canadian financial markets.

## Corporate crime

Corporate crime, falling under the general category of white collar crime, has a well-documented history in the study of criminology. We can begin with Edwin Sutherland’s famous 1939 address to the then American Sociological Society on this subject, which he followed with his groundbreaking book by the same title, *White Collar Crime*.<sup>8</sup> While there were individual perpetrators of white collar crime, Sutherland was interested in the use of corporate entities and their numerous administrative violations which were not penalized as criminal violations. Even before Sutherland, the playwright George Bernard Shaw<sup>9</sup> observed:....while a poor person snatches a loaf

<sup>8</sup>The Ontario Securities Commission issued a stop Order on August 26, 2011, immediately halting trading in Sino-Forest Corporation. We examined a series of hearings in this matter, beginning with the “Hearing on the Merits,” commencing September 2, 2014 (volume 1 transcript). This hearing indicated (p.17) that Counsel for the OSC had a PowerPoint presentation of fifty (50) slides which he intended to show. There are electronic versions of the hearing briefs as well from the OSC. Sino Forest was then extinct as a corporation, and did not attend this hearing on the merits. There is also mention of a SEDAR hearing brief. SEDAR is the electronic filing system used by companies to file documents with the OSC. A USB key of exhibits was given to the court reporters. There was also an August 2011 video interview with Allen Chan produced by Sino-Forest after the Muddy Waters report (and transcript, exhibit 9A&B). Of interest, the OSC began investigating Sino-Forest as early as November of 2005 [Hearings, vol. 42, Sept. 21, 2014, p. 47-48], and followed up in 2008 with further inquiries [*Ibid.*, p.53].

of bread from a baker's counter and is promptly run into jail, [the businessman] ...snatches bread from the tables of hundreds of widows and orphans and simple credulous souls who do not know the ways of company promoters; and, as likely as not, he is run into Parliament. Following Sutherland,<sup>10</sup> Marshall Clinard<sup>11</sup> published his study titled *The Black Market* in 1952. Around this time Frank Hartung<sup>12</sup> looked at white collar offenses in the wholesale meat industry in Detroit. More recently, we have exposés on the Westray mining tragedy in Nova Scotia,<sup>13</sup> the Bre-X mining fraud originating out of western Canada<sup>14</sup> to a never ending plethora of cases ranging from the Exxon Valdez spill in Alaska, the Ford Pinto case, the Enron bankruptcy, to the more recent financial frauds of 2008, including LIBOR.<sup>15-17</sup>

As the historian Edward Balleisen<sup>18</sup> has noted, all of these corporate crimes have long-standing relationships with state formation, especially in the form of regulation or lack thereof. You cannot have corporate crime without the corporate form,<sup>19</sup> and one cannot engage the capital markets in pursuit of appreciation and shareholder profits without the flexibility allowed by state actors and political gatekeepers. In fact, Sutherland was advised by his publisher's attorneys not to name the corporations in his original 1949 study, under threat of libel. The original, un-excised version was not published until 1983 by Yale University Press. Unlike the average bank robber, corporations seem to have a knack for influencing the State and securing protection for their delinquencies. This sets the stage for a more in depth look at yet another Canadian fraud with global roots.

### The alleged fraud

According to Muddy Waters,<sup>7</sup> Sino-Forest's fraudulent activity dates as far back as the company's inception in 1994. While in China, Block and his team discovered that between the years of 1994 and 1996, 65%-77% of Sino-Forest's reported revenue was generated from an equity joint venture with the Zhanjiang Leizhou Eucalyptus Resources Development Co. Ltd. (ZL). Upon further inspection, it became obvious that all of the reported numbers from the joint venture were entirely made up, with the amount of money actually earned from the deal being nowhere near the amount Sino-Forest claimed. Further, Sino-Forest was engaging in "phantom transactions"-transactions in which they greatly exaggerated the worth of their stock. As an illustration, Sino-Forest attempted to accuse the Forestry Bureau of owing them an excess of \$10 million dollars, contrary to documents pertaining to the joint venture. More specifically, the company's joint venture began on January 29, 1994. Sino-Forest "subscribed to 53% of the equity, which was to total \$10 million, and the total investment was established at \$25 million".<sup>7</sup> Sino-Forest was expected to pay 53% (valued at approximately \$5.3 million) in installments. In total, Sino-Forest paid \$1 million, leaving the company owing ZL \$4.3 million dollars. ZL expected this venture to create revenue and jobs, and planned to make more land accessible in hopes to have 8,000 hectares for harvesting and planting new trees. Unfortunately, this joint venture never became what Zhanjiang expected, with the plans for a new manufacturing facility and the extra land never happening. Halfway through the first year of the business transaction, Sino-Forest still had not covered the balance of their share of the investment. After the date with which the balance was supposed to be paid had come and gone, Sino-Forest president Allen Chan would not respond to formal letters in regards to the matter. He also failed to attend a meeting to discuss the discrepancy. Interestingly enough, while the company was missing payments and meetings in China, they were promoting false information about the joint venture in Canada in order

to secure Canadian investors. In 1998, ZL finally began to terminate their business venture with Sino-Forest, as well as put forth allegations against the company for taking money from the account and making payments [of approximately \$270,000.00] to a third party that was entirely unrelated to the joint venture.

This third party was the Huadu Baixing Wood Products Factory, a company that had no business with the joint venture. When the venture was terminated, Zhanjiang Limited (ZL) kept all of its assets and Sino-Forest kept the shell company and began to seek out new partners. They did not find a second partner but instead, turned the company into a Wholly Foreign-Owned Enterprise (WFOE) in May of 1999. Under its new operating structure, Authorized Intermediaries (AI's) would purchase and trade in Sino-Forest's timber. This allowed Authorized Intermediaries to create transactions without having to provide tax documentation. As Janet McFarland<sup>20</sup> of the *Globe and Mail* describes it: "Sino-Forest's executives allegedly boldly manufactured sham deals and created complex transactions to transfer falsified revenues among shell companies run by 'caretakers' with undisclosed connections to management." Sino-Forest's first Authorized Intermediary plan was that it would purchase logs, create wood chips with those logs, and sell the wood chips. Later, they amended the plan by creating third parties to claim new business with Sino-Forest in order to gain credibility. In 2006, the company published a document outlining their joint venture process and how it worked. This document made it obvious that Sino-Forest generated a profit but: "did not commit capital to purchase the logs; did not enter into contracts to purchase the logs from suppliers; did not take title to the logs; did not at any time store (let alone view) the logs; did not commit capital to process the logs into wood chips; did not market the wood chips; did not enter into contracts to sell the wood chips; and, did not receive cash from the parties purchasing the wood chips".<sup>7</sup>

Rather than putting their own money down, Sino-Forest's Authorized Intermediaries were expected to purchase the logs from suppliers, store the logs, pay for the process of turning the logs into wood chips, and put money towards marketing the product and selling the wood chips. After this, Sino-Forest would reimburse the Authorized Intermediaries once they sold the product. Muddy Waters was unable to find any evidence to confirm whether or not Sino-Forest actually received any money this way. Indeed, many of the purchase and sales agreements among Authorized Intermediaries had survey reports allegedly verifying the forestry assets of Sino-Forest Corporation. In point of fact, the company used one company for this purpose, and had a financial stake (10%) in the so-called third party, Survey Company. Sino-Forest seemed to frequently engage in overstating its assets and sales. In a 2010 management discussion and analysis, the company claimed to have sold \$507.9 million worth of standing timber from Yunnan Province at the average price of 102 RMB/m<sup>3</sup> (this converts to approximately \$0.18/m<sup>3</sup> in Canadian dollars.) With these claims, Sino-Forest would have sold 2,265,000 m<sup>3</sup> of timber from Yunnan Province as large logs. This was technically impossible because the amount exceeds Sino-Forest's holdings "as well as the Lincang regions [where Yunnan Province is located] local quota....".<sup>7</sup> Further, Sino-Forest holds only 20,000 ha of land in Lincang city, not 200,000 ha claimed by the company. This leads to a strong suspicion that many of these sales were fabricated by the company. If the lack of land for the amount of timber the company purported to sell is not proof enough of fraud, the logistics of the sales transaction may be. When the Muddy Waters research team talked to a wood trader in Yunnan, they discovered that a typical load for a small truck to carry is

approximately 20 m<sup>3</sup> and a large truck is 30 m<sup>3</sup>. With these numbers, Sino-Forest would have needed 65,000-90,000 truckloads to travel 200km on a dangerous route, providing that no trucks or logs were lost among the journey.

From 2006 to the company's dissolution in 2011, Sino-Forest claimed timber purchases of \$2.891 billion. There is concrete proof that the company inflated such purchases by approximately \$800 million. Further, according to Muddy Waters,<sup>7</sup> they overstated the cost of land and forestry rights by about four times: the actual cost of land was \$1,098.00 per hectare of land, versus the \$4,865.00 per hectare of land that Sino-Forest claimed. Sino-Forest appears to have three other companies with whom it was fabricating transactions, which were as follows: Zhanjiang BoHu Wood Co. Ltd.; Zhangzhou Lu Sheng Forestry Development Company, and Zhangan Industrial Development Company, Ltd. Each of these companies "generally operated out of apartments while purportedly each doing annual revenue in the hundred millions from [SF] alone. Two of these agents are managed by a senior [Sino-Forest] executive, Lam Hon Chiu".<sup>7</sup> The fact that a senior executive is engaging in multimillion dollar transactions with two of his own companies seems to be a conflict of interest, and hardly an arm's length transaction. Indeed, it is interesting that on receipt of the Muddy Waters allegations, the Board of Directors of Sino-Forest spent approximately \$50 million trying to verify exactly what assets Sino-Forest owned and what "it was worth". They were unable to reach any conclusions. A typical finding is outlined below.

#### *Zhanjiang BoHu Wood Co. Ltd.*

Sino-Forest entered into business with this company in December, 2007 and purchased 150,000 ha of land [for plantation] for \$646.6 million. However, BoHu only had registered capital of \$135,000 at the time that the two companies made this agreement. Further, BoHu listed annual sales ranging from \$10 million- \$50 million (USD), which is a lot less than \$646.6 million. In their 2008 audit report, BoHu states revenue of around \$37,000.00. How could the numbers reported by Sino-Forest and BoHu differ so greatly? Either BoHu greatly understated their revenue or Sino-Forest greatly overstated their purchase from the company. When speaking with the vice president of sales for BoHu, Mr. Xu, Muddy Waters uncovered concrete proof that Sino-Forest was misleading in their statements about business with the company. Mr. Xu confirmed that BoHu does in fact do business with "Sino-Panel (one of [Sino-Forest's] subsidiaries), and has been buying plywood from it since summer 2010 in volumes less than \$1.5 million annually." Buying plywood from the company is a lot different than Sino-Forest purchasing forestry from BoHu. This is yet another one of Sino-Forest's fraudulent statements that was used to make the company seem as if it had more assets than it really did. Another matter that seems farfetched for a multi-million dollar company is Bohu's location from 2008 to 2009: an apartment building. When viewing photos of the building the company is supposed to be located, it is obvious that it is in a rundown neighbourhood. Why would a hundred million dollar company be located in an area like that? The company is now located in an office building, but the workers at Muddy Waters still find the situation very strange as the building seems to be under very tight security, which is rare for "an office of this size....in China."

#### **Allegations against Sino-Forest**

As these allegations broke, the Ontario Securities Commission issued a cease trading order in the stock of Sino-Forest on August 26,

2011. Almost immediately, Sino-Forest sought bankruptcy protection because it could not pay its bond and note holders. Indeed, in the company's press release on January 10th, 2012, Sino-Forest admitted that any previous financial claims and statements they had made could not be trusted or used when making the decision to invest in the company. As a result of the fraud allegations, Sino-Forest sought protection from creditors and that protection came into effect on March 30th, 2012. The protection took the form of freezing the accounts and staying any civil litigation against the company. The company needed this protection in order to attempt to restructure company debts and to seek out company buyers. Part of the problem was that the company was allegedly owed \$1 billion in receivables from the sale of wood and timber, but it later emerged that many of these so-called customers had disappeared after the fraud allegations were announced. The company was also being sued civilly by creditors, who filed motions in the bankruptcy proceedings to intervene and prevent Sino-Forest from discharging its debts. As noted by Andy Hoffman & Janet McFarland,<sup>2</sup> "Sino-Forest and its top executives orchestrated one of the largest frauds in Canadian stock market history through a broad-ranging scheme to falsely inflate the company's assets and revenue.....". It later emerged during bankruptcy proceedings, that there was no open market buyer for Sino-Forest Corporation and that most of its remaining assets were questionable. Ultimately, what remained of Sino-Forest was taken over by its bond holders. The only substantive recovery of hard assets on behalf of stock and bond holders was a settlement negotiated with the auditor of Sino-Forest, Ernest and Young, to the tune of \$119 million dollars.<sup>1,2</sup> Subsequently, there was another insurance settlement by \$62 million, but this included a staggering claim of \$41 million in legal fees by the firm's former executives and board directors.<sup>21</sup> Finally, the underwriters to Sino-Forest agreed to settle civil lawsuits for the sum of \$32.5 million.<sup>22</sup> These firms include Credit Suisse Securities, TD Securities Inc., Dundee Securities Ltd., Merrill Lynch Canada, Incorporated, RBC Dominion Securities, Scotia Capital Inc., CIBC World Markets Inc, among others. These "gatekeepers" represent the crème-de-la-crème of Canada's Bay Street underwriters. Finally, former CFO David Horsley forfeited \$5.6 million to investors and paid a fine of \$700,000 (costs) to the Ontario Securities Commission. How did the company manage to falsify ownership to the degree that they could sell billions of dollars worth of non-existent wood fibre? According to the complaint filed by the Ontario Securities Commission,<sup>6</sup> the scheme had three main elements:

- a) The company withheld information in regards to the amount of control it had over suppliers, AI's, and other companies located in the British Virgin Islands (BVI);
- b) The company created and used fraudulent purchase and sales contracts, using these same documents as evidence of purchase and ownership of land; and
- c) The company withheld details about "internal control weaknesses/failures that obscured the true nature of transactions conducted within the BVI network and prevented the detection of the deceitful documentation process."

The first element worked to the company's advantage because the public's lack of knowledge of the amount of control the company had over suppliers, AI's, and other subsidiaries. The second and third elements obviously worked toward the company's advantage because they were claiming to own timber on land they could not purchase, resulting in individuals purchasing shares in the company because they believed that it would be a long-term, profitable investment.

To further illustrate the complexity of the payments, Sino-Forest often had forestry clients such as Authorized Intermediaries pay other AI's for wood allegedly owned by Sino-Forest Corporation, resulting in an off-book transaction. Nevertheless, many of these off-book transactions were actually recorded as income by Sino-Forest Corporation. Amazingly, Sino-Forest had no internal audit group and no credit files on its customers. In point of fact, they had no means of "tracking whether or not ... timber had been harvested" [Hearings, vol. 42, Nov. 21, 2014, p. 162; Hearings, vol. 43, Nov. 24, 2014, p. 63]. Finally, Sino-Forest had no information as to whether its Authorized Intermediaries (AI's) were paying their requisite tax payments to the People's Republic of China [Hearing, vol. 43, Nov. 24, 2014, pp. 84, 86]. Illustrative of these elements is the Greenheart Group investment, according to OSC documents.

### Greenheart group ltd. investment

In 2010, Sino-Forest purchased a majority share of Greenheart, a Suriname forestry company listed on the Hong Kong Stock Exchange for \$120 million. Prior to this purchase, Sino-Forest had allegedly purchased lumber from Greenheart, dating back to 2007; and exercised an option to purchase thirteen percent (13%) of this resource company [Merits, vol. 43, Nov. 24, 2014, p. 143-144]. However, no logs were ever delivered at this time. Sino-Forest kept internal control problems private, resulting in a misunderstanding of the business transaction. In fact, Mr. Allan Chan, president of Sino-Forest, kept his involvement in Greenheart Group secret, withholding the information about purchasing a majority of the company as well as approximately \$22 million he received for doing so.

### Dacheng fraud

In 2008, Sino-Forest purchased timber plantations from a company called Guangxi Dacheng Timber Company. When putting the transaction on paper, the company recorded the same assets twice, once in the Wholly Foreign-Owned Enterprise model and again in the British Virgin Islands model. Recording the assets twice resulted in an overstatement of company value by \$30 million for that year. These assets were stated as valued around \$6.3 million dollars in the WFOE model, and were also stated as valuing approximately \$30 million dollars in the BVI model. Dacheng was paid the \$6.3 million dollars that the company stated in the WFOE model, the "funds...then funnelled through Dacheng back to other subsidiaries of Sino-Forest, as the purported collection of receivables." This activity resulted in the company overstating their assets in 2008 by an estimated \$30 million dollars. When reporting their revenue for quarter three of the next year, 2009, Sino-Forest stated revenue of \$367 million dollars. The company claimed that one of their subsidiaries sold the plantation assets for \$47.7 million, overstating revenue of \$48 million because the sale was falsely created; falsely stating \$47.7 million dollars revenue out of the total \$367 million dollars for that quarter means that Sino-Forest overstated their profit by thirteen percent (13%).

### The 450,000 fraud

In October of 2009, Sino-Forest purchased and sold 450,000 cubic meters of standing timber, using subsidiary companies connected to management. The subsidiaries claimed to have purchased the timber for an estimated \$26 million dollars from a company called Guangxi Hezhou City Yuangao Forestry Development Co. Ltd (further known as "Yuangao".) When speaking of the purchases and sales, Simon Yeung described it as "a pure accounting arrangement." This accounting arrangement consisted of three subsidiaries of Sino-Forest

purportedly buying the timber for \$26 million dollars in October, 2009, and the claiming to have sold it soon thereafter. In the fourth quarter of 2009, the subsidiaries sold the timber to three customers: Gaoyao City Xinqi Forestry Development Co., Ltd; Guangxi Rongshui Meishan Wood Products Factory; and Guangxi Pingle Haosen Forestry Development Co., Ltd. According to the Ontario Securities Commission, the buyers were caretakers for Sino-Forest, each company purchasing the timber being controlled by a member of Sino-Forest. These allegations were most likely made because of the similarity to other circular money transfers that Sino-Forest has done in the past, using a fake supplier and nonexistent customer bank accounts. The alleged sale price was \$33 million dollars, resulting in a booked profit of approximately \$7.1 million dollars. Both the supplier and customers, that Sino-Forest claimed to have been doing business with, are all peripheral companies of Sino-Forest -- meaning that they are controlled by one of the company's authorized intermediaries (AI's). Nine months later, none of the money that was supposed to have been generated through the apparent transaction had been paid.

### Its defense

In their defense, lawyers for the principals argued that it was customary business practice in China to enter into oral agreements first without putting them in writing. It was further asserted that the Chinese government forced Sino-Forest to use out-of-country entities (authorized intermediaries); and alleged that the so-called "plantation rights certificates," relating to forestry rights in China, often did not exist or were contested by villagers, due to the very nature of infrastructure in China, and the historical aversion to private property rights. Finally, lawyers asserted it was customary to put friends, relatives, and employees in subsidiary positions (suppliers and buyers) based on the Chinese practice of "guanxi," or relationships based on personal favors and familial relations. As quoted by one expert retained by the accused: Chinese managers believe that interpersonal trust minimizes fraud to ensure certainty and order. They maintain the formal legal sanctions are unnecessary for inducing performance and all contingencies need not be stipulated contractually. With guanxi, these issues can be settled informally. Importantly, counsel argued that Sino-Forest had grown so substantially from 2006 to 2010, that mistakes were made in administration, but did not necessarily constitute fraud. Ultimately, these Chinese business practices were at variance with Western accounting procedures. The problem, however, is that Sino-Forest was listed on a Canadian exchange as a public company, subject to Canadian securities statutes, not Chinese custom. It was a company of \$6 billion dollars in market value that suddenly went bankrupt, couldn't account for its alleged assets, nor pay its bond holders.

### How?

How does such a sham of a company make it big on the Toronto Stock Exchange, one might ask? They simply hire auditors that do not actually speak Chinese, and do not understand market practices in China. Sino-Forest hired Ernst and Young, located in Canada, as their auditors. They were expected to view any financial documents pertaining to the company and their assets. Unfortunately, much of the company fraud either slipped past the auditors or was blatantly ignored. In fact, as part of a settlement with the Ontario Securities Commission, Ernst and Young agreed to pay the OSC \$8 million in costs, and did not admit nor deny the following allegations.<sup>23</sup> Here, the company did not obtain "sufficient appropriate audit evidence with respect to the ownership and existence of the BVI Standing Timber

Assets....". Importantly, the "physical location of the BVI Standing Timber Assets was not clearly delineated in either the Purchase Contract or any of its available appendices".<sup>23,b</sup> The auditors should have realized that Sino-Forest's purchase contracts had significant deficiencies, especially the question of their so-called timber assets. Further, the company took part in very few visits to China to inspect Sino-Forest's claimed assets. Ernst and Young failed to have key documents translated into English; this should have been done as the senior partners involved in the audits could neither speak nor read Chinese. As a result, this global accounting firm vouched for the integrity of Sino-Forest Corporation, which raised some \$3 billion dollars in the global capital markets.

Another way in which Sino-Forest conducted business that made it possible for the company to engage in such extensive fraud is the company's use of off-shore, subsidiary companies. The Ontario Securities Commission<sup>24</sup> states that Sino-Forest had over 150 subsidiary companies, most of which were incorporated in the British Virgin Islands (BVI). A second set of companies were incorporated in the People's Republic of China as Wholly Foreign Owned Entities (WFOE). Complicating the picture was the finding that many sales and purchases by the BVI companies were transacted off the books of Sino-Forest Corporation, and out-of-country. In other words, "these receivables and payables do not go through the bank account of Sino-Forest in the first instance".<sup>c</sup> According to the OSC hearings, about 70% of Sino-Forest's official revenue was funneled through its BVI (British Virgin Islands) entities. The former CFO of Sino-Forest, David Horsley, testified that his firm "did not possess bank records to confirm that the cash flow in the offsetting BVI arrangement ...actually took place" [Hearings, vol. 42, Nov. 21, 2014, p. 15]. In 2010, the BVI subsidiaries represented 95% of Sino-Forest Corporation's revenue [Hearings, Vol. 5, Sept. 8, 2014, p.146, 149]. Even with respect to several WFOE companies owned by Sino-Forest, there was a \$27 million receivable balance for 2010, outstanding for more than one year [Hearing on Merits, vol. 44, Nov. 25, 2014, p. 42]. Many of the purchase contracts stipulated that the buyer was responsible for harvesting the lumber owned by Sino-Forest Corporation and had eighteen (18) months to complete that harvest and pay the Corporation (Hearings, Sept. 8, 2014, vol. 5, p. 30, 80). This left open the suggestion that while numerous contracts were signed, the actual timber in several cases was never harvested, may not have even existed, nor were receivables paid. Indeed, staff for the OSC testified that about a third of the BVI contracts for 2010 did not have a confirmation page that harvesting and payment had occurred. In other instances, a confirmation date was wholly manufactured by Sino-Forest staff. Hence, the written purchase price in the sales agreements may have been "booked" on Sino-Forest's balance sheets as income.<sup>d</sup> But it was income which was fictitious. Indeed, the former

CFO of Sino-Forest admitted that "little or no harvesting actually took place by Sino-Forest or its customers".

A more serious issue was how Sino-Forest validated its inventory of trees on land it leased from the Peoples Republic of China. The company did not have a centralized inventory database; and their previous accounting firm, Pöyry Consulting Company Limited, resigned in 2007, partly over its inability to confirm the actual amount of wood fibre owned by Sino-Forest Corporation. Further, Sino-Forest was acquiring lease rights for timber on Chinese government owned land. Various master agreements indicated that the company sought to purchase anywhere from 1.25 million to 1.4 million hectares for this purpose (Hearings, Vol. 7, Sept. 11, 2014, p.87).<sup>e</sup> As of December 2010, 799,800 hectares had been acquired at a cost of over \$1 billion dollars (Ibid. at 116), and was allegedly valued at \$3.1 billion U.S. [Hearings, vol.7, Sept. 11, 2014, p. 199]. These rights took the form of forestry right certificates granted by the Chinese government, and about 70% of these holdings were held in the off-shore, BVI model [Hearings, vol.7, Sept. 11, 2014, p. 195]. Here, the former CFO of Sino-Forest admitted that neither sales contracts nor survey reports "adequately identified the precise location of the standing timber being purchased" [Hearings, vol. 42, November 21, 2014, p. 21]. In fact, there were no maps identifying the property to be purchased or sold [Hearing on Merits, vol. 46, November 27, 2014, p. 78-79]. Clearly then, the People's Republic of China was a party to these transactions [Hearings, vol. 42, November 18, 2014, p.40], as were various Western banks, underwriters, law firms, insurance and accounting firms who vouched for the authenticity of Sino-Forest Corporation. More pointedly, Sino-Forest had applied for a 15-year, long-term loan of \$1.5 billion (US) from the China Development Bank, circa March 2011 [Merits, vol. 47, Nov. 28, 2014, pp. 19- 29]. That loan never came to fruition. Emerald Plantation<sup>25</sup> was a new company formed to receive substantially all of the assets, including its subsidiaries, of Sino-Forest Corporation following the implementation of the bankruptcy Plan of Compromise and Reorganization on 30 January 2013, as approved by the Ontario Superior Court of Justice on 10 December 2012. While in bankruptcy, Sino-Forest alleged that forestry assets held through BVI subsidiaries were worth \$3 billion. "Emerald subsequently, once inheriting these assets, attributed a zero value to these assets" (Merits hearings, Vol 1., pp 61, 81, Sept. 2, 2014; vol. 45, Nov. 26, 2014, p.13). Counsel for the defense challenged this determination on the basis that the new company had no mainland Chinese employees to operate and value these assets [Hearings on the Merits, vol. 45, Nov. 26, 2014, pp.14-15]. Nevertheless, Sino-Forest held some \$1.1 billion dollars in cash around February of 2011 as a result of an offering; and it is not clear what happened to that money [Merits, vol. 45, Nov. 26, 2014, p. 36].

According to its web site, Emerald Plantation aims to sell quality wood from their timber assets in China. Along with the assets of Sino-Forest, Emerald Plantation allegedly holds a large number of assets in the Greenheart Group (previously known as Omnicorp Limited), "a Hong Kong company with access to wood fibre in Suriname, South America and New Zealand".<sup>26</sup> However, in late November 2014, Emerald Plantation sold 63% of its interest in Greenheart to a Chinese investment company [Merits, vol. 46, Nov. 27, 2014, p. 39-40].

<sup>e</sup>Apparently, all of these assets were surveyed by one company, Sino Group, Zhanjiang Southern Forestry Projects Quality Supervision Co., Ltd. [Hearings, Vol. 7, Sept. 11, 2014, p. 144-145]. An owner of this survey firm was also an employee of Sino-Forest Corporation [Hearings, vol. 42, Nov. 21, 2014, p. 20]. It later developed that draft survey reports were found on the computer of a Sino-Forest employee [Ibid.].

<sup>b</sup>One of the issues which Ernst and Young apparently overlooked were huge bonuses in 2010, often three to four times their salary for 2009 among 52 senior management employees of Sino-Forest Corporation [Hearings on the Merits, vol. 43, November 24, 2014, pp. 120-132].

<sup>c</sup>OSC staff testified that "So whereas in BVI model, that settlement takes place off-book through this offsetting arrangement, in the WFOE model, I understand that to be an on-book settlement process where Sino-Forest itself directly pays its suppliers and directly receives the proceeds on the sale of standing timber from the customer." cf. Hearings, Vol. 6, Sept. 11, 2014, p.23.

<sup>d</sup>Indeed, this booking of income was questioned late in 2005 by the OSC, to which Sino-Forest responded that they recorded income when a sales contract existed, delivery had occurred, and the price was fixed and determinable [Hearings, vol. 42, Nov. 21, 2014, pp.50-51].

On their company profile page, it is stated that Emerald Plantation Holdings are in a position where they could create and generate revenue from China's wood industry. With the large population, much money can be made from the sales of "quality wood fibre and value-added engineered products along the wood supply chain." Consultation with the stock price (at 23 cents/share) and outstanding shares produced a recent market capitalization of \$69 million (US).<sup>f</sup> Consultation with its annual report (2016) revealed a company claiming plantation assets of \$106 million (US),<sup>g</sup> with negative revenue of \$ 120 million (US) for 2014, and another loss of \$22 million for 2015.<sup>26</sup> Before the sale of Greenheart, Emerald Plantation Holdings reported forestry assets of \$119 million in the PRC for 2013 [Hearings, vol. 46, November 26, 2014, p. 48]. More recently, however, a buyer emerged for the assets of Emerald Plantation Holdings Limited. In a press release dated April 2016, New Plantation Limited has agreed to purchase the remaining assets of what was Sino-Forest Corporation for the sum of \$242 million.<sup>25</sup> This figure is far in excess of Emerald Plantation's current stock value, but still suggests a pattern of fraud in overstating Sino-Forest's original assets and income.

### Ontario securities commission

After literally 188 days of testimony, the Ontario Securities Commission issued its findings in July of 2017.<sup>27</sup> Specifically, and under the general direction of CEO Allen Chan, the corporate hierarchy of Sino-Forest Corporation conspired to overstate both their timber assets and wood sales—making their balance sheets misleading and fraudulent. Of interest, Chan was well-connected to political elites in the Communist Party as well as with the China National Forestry Industry Federation. The Commission elected to precede under their civil fraud rules rather than pursue a criminal indictment, which would have required a higher degree of proof. Hence, the standard of proof for this investigation was a balance of probabilities; not proof beyond a reasonable doubt. None of the principals in this action returned to Canada for the hearings; most were deposed in mainland China, Hong Kong, or the Dominican Republic. The principle conspirators facilitated this fraud by controlling so-called arms-length suppliers and customers without disclosing that control. The documentation process for timber assets and sales was convoluted and in many cases simply fictitious. In many cases, the ownership title to forestry land or timber rights was missing; thus, Sino-Forest did not even own these assets.<sup>28</sup> This documentation put forward by the principles allowed them to deceive and mislead their own auditors—thus giving Sino-Forest Corporation a veneer of legitimacy in Canadian exchanges and globally. As a result, the revenue and assets reported by this Canada-listed company were patently false and misleading to investors.

### To quote the Commission (OSC, 2017: 615):

"Sino-Forest's documentation process in the BVI Model involved preparing documents in batches and using manual systems which allowed for the backdating of contracts and post-quarter-end revisions. All documentation originated with Sino-Forest—there was no independent record. The Forestry Bureau Confirmations, which could not be disclosed to anyone outside of Sino-Forest, do not confirm Sino-Forest's legal ownership of standing timber. It was not possible

<sup>f</sup>Based on 300 million outstanding shares. Bloomberg business quotes as of May 26, 2016.

<sup>g</sup>The auditors for Emerald Plantation Holdings, KPMG, concluded in the 2015 annual report as to plantation assets: "This is very suspect because the auditor hired to examine forestry assets stated 'We have been unable to obtain sufficient appropriate audit evidence to verify the Group's ownership of these assets....'" See p. 2 and p. 62 of 2015 annual report.

to locate the specific standing timber plantations from the purchase contracts, Survey Reports or Forestry Bureau Confirmations. There was no record of payments by multiple AIs to multiple suppliers on behalf of Sino-Forest, and payments were often made prior to the preparation of purchase contracts. Sino-Forest did not keep track of harvesting and no new Forestry Bureau Confirmations were requested from the Forestry Bureaus when partial areas of standing timber plantations were sold".

By examining a sample of transactions involving Sino-Forest, the OSC concluded that just in the fourth quarter of 2009 alone, the company overstated its revenue by \$30 million US. Essentially, the claimed revenue was fictitious.<sup>29</sup> In another case study, the investigating panel concluded that sales and purchases of Sino-Forest wood products among purported third parties were not "independent arms' length transactions" since Sino-Forest controlled both the buyer and seller. Hence, yet again, the transaction was fictitious and the claimed funds simply did not exist (Ibid., 1001). Indeed, a lot of the paperwork was backdated to justify the sale or purchase of wood timber or products. Subsequent to convicting the principles of Sino-Forest of civil securities fraud, a hearing was conducted with respect to sanctions and costs.<sup>25</sup> Under the securities statute for civil fraud, the principles can be fined administrative penalties, ordered to disgorge assets, and prohibited from certain conduct on Canadian exchanges. The Commission then banned the four principles from acquiring any Canadian securities, trading in those securities, or becoming a director, officer, or investment fund manager of companies with public listings in Canada. The four principles were ordered to pay an administrative fine of \$11.6 million dollars. They were further ordered to disgorge profits totaling \$64.4 million dollars. All the respondents were ordered to pay Commission costs in the sum of \$5 million dollars.<sup>29</sup>

What is clear is that all of the five remaining defendants are currently living in China, and "the chance of the OSC collecting anything is virtually nil. The most severe sanction the men face – a lifetime ban from the Canadian capital markets—would also be meaningless because the men are unlikely ever to resume business activities in Canada".<sup>27</sup> "The OSC may well win the case. But it would be a Pyrrhic victory.... Instead, the case has exposed gaps in Canada's securities regulation regime—particularly when key elements of an alleged fraud occur in other countries, where authorities may be unwilling to co-operate". [a clear reference to China]

### Conclusion

How does one interpret all of this? Clearly, the capital markets in Canada allowed a Chinese-based company to list its securities on the Toronto Stock Exchange, and to trumpet its fictitious balance sheet – such that Sino-Forest became a stock darling. This was largely due to "structural holes" in the capital markets, as manifested by regulatory and auditing failures to understand the complicated business plan of Sino-Forest, and to do the necessary field work to verify foreign timber assets allegedly held by the company.<sup>4</sup> Hence, this fraud was facilitated by the very definition of how capital markets work, and by the *laissez-faire* nature of audits and regulatory agencies which are supposed to protect the public.<sup>3</sup> As David Harvey:<sup>5</sup> "Stock promotions, Ponzi schemes, structured asset destruction through inflation, asset stripping through mergers and acquisitions, the promotion of level of debt encumbrance that reduce whole populations, even in the advanced capitalist countries, to debt peonage, to say nothing of corporate fraud, dispossession of assets (the raiding of pension funds and their decimation by stock and corporate collapses) by credit and stock

manipulations—all of these are central features of what contemporary capitalism is about”. Indeed, it can be argued that the Sino-Forest fraud is a perfect example of “accumulation by dispossession.” Here, investors in core countries sought higher rates of return in countries like China, only to confront the structural problems which arise in a transition from state socialism to state capitalism. Here, primitive accumulation takes the form of outright fraud. Did this fraud have a major impact on North American financial markets? Other than the loss of billions of dollars of capital by investors—many of whom were large financial entities like labor and business pension funds—civil fraud of this magnitude was simply absorbed within the global capital markets. Indeed, the bankruptcy proceeding and the OSC civil proceedings have largely shielded the principles from criminal prosecution on what might normally have been one of Canada’s largest corporate crimes since the notorious Bre-X gold mining scandal.<sup>30–35</sup> Finally, the role of the Chinese government has yet to be fully examined in this context. What the scandal has clearly revealed, however, are structural holes in the global capital markets. If those holes are to be plugged, it will require further regulation of those markets and will likely be opposed by proponents of laissez-faire markets, including corporate interests.

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## Conflicts of interest

The author declares that there are no conflicts of interest.

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