

*ONTARIO*  
SUPERIOR COURT OF JUSTICE  
COMMERCIAL LIST

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,  
R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF  
SINO-FOREST CORPORATION

APPLICATION UNDER THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,  
R.S.C. 1985, c. C-36, AS AMENDED

## **Factum of BDO Limited**

(Equity claims motion, returnable June 26, 2012)

June 22, 2012

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**PART I - INTRODUCTION**

1. BDO Limited ("BDO") was the auditor of Sino-Forest Corporation between 2005 and August 2007, when it was replaced by Ernst & Young LLP ("E&Y").
2. BDO issued audit reports (the "BDO Audit Reports") in respect of the 2005 and 2006 annual financial statements for Sino-Forest, the latter of which was issued in March 2007.
3. One or both of BDO's audit reports were incorporated by reference into one Sino-Forest Prospectus issued in June 2007, and three Sino-Forest Offering Memoranda, issued in July 2008, June 2009 and December 2009.
4. BDO has filed a Proof of Claim against Sino-Forest pursuant to the Claims Procedure Order of this Honourable Court, dated May 14, 2012 (the "Claims Procedure Order").
5. BDO's Claim against Sino-Forest sounds primarily in breach of contract, based upon a number of breaches of the Engagement Agreements between Sino-Forest and BDO that governed BDO's audits of Sino-Forest's 2005 and 2006 financial statements and the subsequent use of the BDO Audit Reports in Prospectuses and Offering Memoranda issued by Sino-Forest.
6. BDO opposes the hearing of this motion at this time - before the validity of any of the claims submitted under the Claims Procedure Order being initially determined in accordance with the terms of that Order. This motion runs contrary to the procedural framework put in place under the Claims Procedure Order and is premature.

7. Should this motion proceed, BDO says that its indemnity claims, similar to those advanced by E&Y and the Underwriters, are not equity claims within the meaning of s.2 of the *Companies Creditors Arrangement Act*, R.S.C. 1985, c.C-36 (the "CCAA") and should not be characterized as such.

8. As further particularized below, in addition to its own submissions herein, BDO agrees with and adopts many portions of the factum of E&Y in its opposition to the Applicant's motion.

## PART II - THE FACTS

A. BDO's role as auditor of Sino-Forest for 2005 and 2006:

9. BDO is a Hong Kong-based accounting firm formerly known as BDO McCabe Lo Limited that, among other things, conducts audits of the annual financial statements of publicly traded companies.

10. BDO audited the annual financial statements for the Applicant, Sino-Forest Corporation for the years ended December 31, 2005 and December 31, 2006. BDO was the auditor for Sino until on or about August 12, 2007, when BDO was replaced by Ernst & Young LLP ("E&Y").

11. In accordance with the Claims Procedure Order, BDO has submitted Proofs of Claim against both Sino-Forest and its officers and directors.

12. In its Proof of Claim against Sino, BDO does not advance its claim in the capacity of an equity holder or former equity holder of Sino-Forest.

13. Rather, BDO advances its claims against Sino-Forest in its capacity as Sino-Forest's former auditor for 2005 and 2006.

14. BDO claims in relation to the breach by Sino-Forest of fundamental obligations in relation to the quality and accuracy of Sino-Forest's financial reporting and disclosure; obligations that were owed directly to BDO under the terms of BDO's audit engagement agreements with Sino-Forest (collectively, the "BDO Engagement Agreements").

BDO Engagement Agreements; BDO's responding Motion Record, TAB 1A, pp. 69 - 102

15. In particular, the BDO Engagement Agreements governing the audits of the Sino-Forest annual financial statements for the 2005 and 2006 years provided that:

(a) BDO relied upon Sino-Forest and its management to bear the primary responsibility for preparing its annual financial statements in accordance with Generally Accepted Accounting Principles ("GAAP"); and

(b) Sino-Forest's management bore primary responsibility to implement appropriate internal controls to detect fraud and error in relation to its financial reporting.

BDO Engagement Agreements; BDO's responding Motion Record, TAB 1A, pp. 72 -73 and 80-81

16. It was also a term of the BDO Engagement Agreements in respect of the annual audits of Sino-Forest for 2005 and 2006 that the audit reports for those years would not be used in connection with any securities offerings absent sufficient advance notice being provided to BDO, an opportunity for BDO to conduct further review of Sino-Forest, and BDO's consent to such use.

17. The BDO Audit Report for 2006 was subsequently incorporated by reference in a June 2007 Prospectus issued by Sino (the "June 2007 Prospectus") regarding the offering of Sino-Forest's common shares to the public.

18. The use by Sino-Forest of the 2006 BDO Audit Report in the June 2007 Prospectus was governed by an Engagement Agreement dated May 23, 2007, under which Sino-Forest agreed to indemnify BDO in respect of any claims by the Underwriters or any third party as a result of the further steps taken by BDO in relation to the issuance of the June 2007 Prospectus.

BDO Engagement Agreement, dated May 23, 2007; BDO's responding Motion Record, TAB 1A, pp. 85 – 87

19. BDO claims for breach of the Engagement Agreement in respect of the June 2007 Prospectus, as well that relating to the December 2009 Prospectus – which prospectus did not actually incorporate by reference any audit reports by BDO.

20. BDO also claims indemnity based upon a breach of the Engagement Agreements governing to the use of its audit reports in the three Sino-Forest Offering Memoranda, dated July 2008, June 2009 and December 2009, that are not at issue on this motion - as they related to the issuance of debt securities and not equity securities.

**B. BDO is not an equity claimant:**

21. As Sino-Forest's auditor, BDO was required to occupy a position that is the polar opposite of an equity holder. BDO was required to be completely independent from Sino-Forest – both in appearance and in fact. BDO could hold no financial stake in the fortunes of Sino-Forest, as this would fundamentally compromise its independence.

22. In particular, it is well-settled that an auditor's role is opine on the procedures used by a corporation in its financial reporting, so as to allow current security holders to oversee management of the company. An auditor's role is not to assist investors or lenders in making personal investment decisions.

David Johnston and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 4<sup>th</sup> Edition, at pp. 181 – 183

*Hercules Managements Ltd v. Ernst & Young*, [1997] 2 S.C.R. 165 at paras. 49 - 51

23. Sino-Forest's former auditors (BDO and E&Y) never assumed any of the risk and reward that would have been associated with equity ownership in Sino-Forest.

**C. The Ontario Class Action:**

24. BDO has been named as a defendant in an Ontario class action, *The Trustees of the Labourers' Pension Fund of Central and Eastern Canada et al. v. Sino-Forest Corporation et al.* (CV-11-431153-00CP) (the "Ontario Class Action"), which seeks to certify a class action on behalf of all persons who purchased Sino-Forest securities - both Sino-Forest shares and Sino-Forest Notes - in Canada during the Class Period (which is defined as March 19, 2007 to June 2, 2011), as well as all Canadian residents who purchased Sino's securities outside of Canada.

25. The largest portion of the claim in the Ontario Class Action seeks to certify a claim for \$6.5 Billion on behalf of all purchasers of Sino-Forest securities on the secondary market during the Class Period (the "Secondary Market Claim"). The Secondary Market Claim is brought on behalf of secondary market purchasers of both Sino-Forest shares and Sino-Forest

Notes. In other words, a significant portion of the Secondary Market Claim is not relevant to this motion, as it is brought on behalf of purchasers of **debt** securities and not equity holders.

26. Subject to certification, BDO has also been sued on behalf of primary market purchasers of Sino-Forest securities - again including purchasers of both shares and debt securities.

Those claims are as follows:

(a) On behalf of all of the Class Members who purchased Sino common shares in the distribution to which a June 2007 Prospectus issued by Sino (the "June 2007 Prospectus") related, a claim for general damages in the sum of **\$175,835,000;**

(b) On behalf of all of the Class Members who purchased Sino common shares in the distribution to which a December 2009 Prospectus issued by Sino (the "December 2009 Prospectus") related, a claim for general damages in the sum of \$319,200,000;

(c) On behalf of all the Class Members who purchased Sino's 5% Convertible Senior Notes due 2013 pursuant to a July 2008 Offering Memorandum issued by Sino (the "July 2008 Offering Memorandum"), a claim for general damages in the sum of **US\$345 million;**

(d) On behalf of all the Class Members who purchased Sino's 10.25% Guaranteed Senior Notes due 2014 pursuant to the June 2009 Offering Memorandum issued by Sino (the "June 2009 Offering Memorandum"), a claim for general damages in the sum of **US\$400 million;** and

(e) On behalf of all the Class Members who purchased Sino's 4.25% Convertible Senior Notes due 2016 pursuant to the December 2009 Offering Memorandum issued by Sino (the "December 2009 Offering Memorandum"), a claim for general damages in the sum of **US\$460 million**.

27. It is alleged in the Ontario Class Action that the 2005 Audit Report and the 2006 Audit Report each contain the same statement by BDO; a statement that is alleged to have misrepresented that, in the opinion of BDO, Sino's 2005 and 2006 annual financial statements "...present fairly, in all material respects, the financial position of Sino as at December 31, 2005 and December 31, 2006 and the results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles."

Fresh as Amended Statement of Claim, para. 198; BDO Responding Motion Record, Tab 1A, pp. 47-48

**D. BDO's claim against Sino:**

28. As indicated above, the BDO Audit Reports were prepared pursuant to engagement agreements, dated under which Sino-Forest and its management agreed to bear primary responsibility to ensure the accuracy of Sino-Forest's financial statements and to ensure that their preparation accorded with GAAP.

29. BDO has a claim against Sino-Forest under the BDO Engagement Agreements in relation to the breach of those obligations, and that claim is not dependent upon the shareholder claims against Sino-Forest succeeding but, rather, seeks compensation relating to



the breach of the basic obligations of Sino-Forest under the BDO Engagement Agreements, as outlined above.

### **PART III - ISSUES AND THE LAW**

A. The provisions of the CCAA:

30. BDO agrees with the submissions of E&Y that, absent an equity relationship at the root of a particular claim, a particular indemnity claim should not be considered an equity claim under the definition in s.2 of the CCAA.

31. In that regard, BDO agrees with and adopts the analysis in paragraphs 29 – 32, 34 - 39, and 53 - 89 of the factum of E&Y.

32. In particular, BDO agrees with E&Y that:

(a) Absent an equity relationship at the root of a particular claim, a particular claim should not be considered an equity claim under the definition in s.2 of the CCAA;

(b) In order for s.2(1)(e) of the CCAA to subordinate an indemnity claim to those of other creditors, the indemnity claim must itself seek to compensate a loss arising from a claim that a shareholder has under an indemnity given by the subject company;

(c) The relationship between an independent third party auditor and the contractual obligations that arise from that relationship are very different from the obligations owed to a shareholder by the company in which the shares are held;

(d) A third party auditor does not, and cannot, have a direct stake in the value of the company it audits. As such, the rationale behind subordinating the claims of those that choose to participate in the increases in the value of the corporation and assume the risk of decreases in its value by buying shares, simply does not apply to an auditor that advances an indemnity claim against the corporation.

33. For BDO, the bottom line is that BDO has never been a shareholder of Sino-Forest or otherwise held equity in Sino-Forest. BDO's only relationship with Sino-Forest has been as a third party auditor and seeks indemnity from Sino-Forest pursuant to the obligations arising from that relationship - not from any equity interest.

34. BDO also agrees with the submissions of E&Y in paragraphs 98 - 104 and 108 - 116, that the clear intention behind the amendments to the CCAA dealing with equity interests and equity claims, is to enshrine in the CCAA the longstanding principle that shareholder claims should be subordinate to those of third party creditors, such as BDO. BDO agrees that the reference to "indemnity in respect of an equity claim" is aimed at preventing indemnity claims from indirectly subverting this longstanding principle by subordinating those indemnity claims against a company that serve only to indirectly benefit its shareholders.

35. As with E&Y, BDO's claim against Sino-Forest stems primarily from the breach of the BDO Engagement Agreements and from misrepresentations made by Sino-Forest to BDO in

the course of BDO's retainer as its auditor. The damages claimed are distinct from those claimed by the Sino-Forest shareholders in the Ontario Class Action; they are not simply an attempt to "flow through" damages to benefit Sino-Forest's current or former shareholders.

**B. No authority for treating auditors' claims as equity claims:**

36. Sino-Forest has failed to put forward a single authority for treating auditors' indemnity claims as equity claims - either from the U.S. or from Canada.

37. The best that Sino-Forest can do is to put forward two U.S. cases in which underwriters' indemnity claims were subordinated to those of the other creditors and one U.S. and one Canadian case where directors' indemnity claims were subordinated (Sino-Forest factum, para. 58).

*In re Jacom Computer Services Inc.*, 280 B.R. 816 (Bankr. D.Del. 1999) *In Re: Drexel Burnham Lambert Group Inc., et al.*, 148 B.R. 982; 1992 Bankr. LEXIS 2023( Bankr. S.D.N.Y. 1992); Sino-Forest Book of Authorities, Tabs 13 and 14

38. In other words, Sino-Forest would have this Court equate indemnity claims brought by underwriters, directors and officers with those advanced by auditors.

39. However, the difference between auditors and these other parties is fundamental and goes to the heart of how equity claims have traditionally been characterized and the rationale behind the 2009 amendments to the CCAA.

40. The Ad Hoc Committee of Note Holders in its factum (para. 22) discusses how U.S. Courts have interpreted statutory language in the U.S. Bankruptcy Code (s.510(b) as being

aimed at subordinating those claims that have a "nexus or causal relationship to the purchase or sale of securities."

*Re Telegroup Inc.* (2002), 281 F. 3d 133 (3rd Cir. U.S. Court of Appeals), Ad Hoc Committee's Book of Authorities, Tab 12; *American Broadcasting Systems v. Nugent*, Ad Hoc Committee's Book of Authorities, Tab 13

41. As indicated in Sino-Forest's factum (at para. 43), a significant policy rationale behind treating debt and equity holders differently is that shareholders have unlimited upside potential when purchasing shares, while creditors have no corresponding upside potential - their expectation is to be repaid what is owed to them with whatever interest has been negotiated.

*Nelson Financial Group (Re)*, 2010 ONSC 6229 at para. 25; Sino-Forest Book of Authorities, TAB 4

42. The questions to be asked therefore are:

(a) On what side of the creditor / shareholder divide do auditors fall? In negotiating the terms of their engagement (i.e. the contract) as auditors, do they expect to participate in the upside of the company that retains them? Or, do they simply seek to receive the consideration provided for under the contract -- and any rights therein, which may include the right to claim indemnity?; and

(b) Is there a direct causal relationship between the services provided by auditors in auditing financial statements and the purchase or sale of securities?

43. The answer to these questions are clear. Auditors are independent and are required to be independent. Auditors do not and *cannot* throw their lot in with company they are auditing. Auditors do not *and cannot* seek to benefit from increases in the share value of the company

they audit and they do not *and cannot* agree to participate in the company's downside. To treat auditors and their claims in the same manner as equity holders would be antithetical to their independent role in auditing public companies.

44. Further, there is no causal relationship between the audit of a company's financial statements and the purchase or sale of shares.

45. It is well-settled that an auditor's role is opine on the procedures used by a corporation in its financial reporting, so current security holders can oversee management of the company.

**An auditor's role is not to assist investors or lenders in making personal investment decisions.**

David Johnston and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 4<sup>th</sup> Edition, at pp. 181 - 183

*Hercules Managements Ltd v. Ernst & Young*, [1997] 2 S.C.R. 165 at paras. 49 - 51

46. In contrast to an auditor such as BDO, an Underwriter is retained to assist in the sale of equity or debt securities to members of the public and the Underwriter will often have a direct or indirect stake in the economic fortunes of the issuer in promoting such sales.

David Johnston and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 4<sup>th</sup> Edition, at pp. 133 - 136

47. For example, the Underwriters involved in the June 2007 Prospectus and the subsequent issuance of Sino-Forest common shares agreed with Sino-Forest to be the initial purchasers of the shares issued under the June 2007 Prospectus. Further, the Underwriters' compensation on that offering was directly tied to the proceeds received on the ultimate public sale of those shares.

Affidavit of Rebecca Wise, sworn April 23, 2012, Exhibit "A"; Book of Previously Filed Materials filed by Sino-Forest, Tab 11

48. The role of the Underwriters was directly tied to the issuance of Sino equity securities and their compensation included a partial assumption of the reward and corresponding risk that is associated with the fluctuating value of those securities.

49. Again, Sino-Forest's former auditors (BDO and E&Y) never assumed any of the risk and reward that would have been associated with equity ownership in Sino-Forest. They never stood to gain from any increases in the value of Sino-Forest shares, nor did they assume the corresponding risk from a drop in their value. Their audits of Sino-Forest's financial statements were aimed at assisting in the buying or selling of shares but, rather, to assist in the oversight of Sino-Forest's management by persons who already held shares.

50. As such, even if U.S. jurisprudence interpreting a different statute with different wording was of assistance - which it probably is not, given the differences - auditors are in a much different position from underwriters, directors or officers. The reasoning in that case law simply does not apply to the claims advanced by BDO.

**C. Summary of BDO's position:**

51. BDO contracted to do the audits of Sino-Forest for 2005 and 2006 on the basis that BDO would be paid fees for its services and on the basis that BDO would be entitled to rely upon Sino-Forest and its management to bear primary responsibility:

- (a) for preparing its annual financial statements in accordance with GAAP; and

- (b) for implementing appropriate internal controls to detect fraud and error in relation to its financial reporting.

52. BDO has advanced a claim against Sino-Forest based upon a breach of those contractual provisions.

53. BDO never signed up to participate in the growth of Sino-Forest or to assume the risks associated with holding an equity interest in Sino-Forest. It never agreed to tie its fortunes to those of the company or to otherwise be treated as a shareholder of Sino-Forest in any other respect.

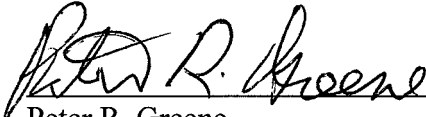
54. It cannot have been the intention of the amendments to the CCAA to treat third party professional firms, such as auditors, in the same manner as shareholders and to subordinate their legitimate contractual claims as if they were shareholder claims. What about lawyers who provide opinions within underwritings based upon facts provided by the company? Surely any claims made by such lawyers based upon incorrect corporate information would not be equity claims.

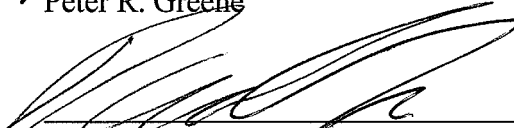
55. BDO is an independent firm that provided audit services to Sino-Forest in exchange for a fee and certain other contractual assurances, including express contractual indemnifications regarding the use of the BDO Audit Reports in certain primary market issuances of Sino-Forest shares.

**PART IV - RELIEF SOUGHT**

56. BDO respectfully requests that this Court dismiss the Applicant's motion.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 25<sup>th</sup> day of June, 2012.

  
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**SCHEDULE "A"**  
**LIST OF AUTHORITIES**

1. *In re Jacom Computer Services Inc.*, 280 B.R. 816 (Bankr. D.Del. 1999)
2. *In Re: Drexel Burnham Lambert Group Inc., et al.*, 148 B.R. 982; 1992 Bankr. LEXIS 2023( Bankr. S.D.N.Y. 1992)
3. *Re Telegroup Inc.* (2002),281 F. 3d 133 (3<sup>rd</sup> Cir. U.S. Court of Appeals)
4. David Johnston and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 4<sup>th</sup> Edition, at pp. 181 - 183 and pp. 133 - 136
5. *Hercules Managements Ltd. v. Ernst & Young*, [1997] 2 S.C.R. 165

**SCHEDULE "B"**  
**RELEVANT STATUTES**

1. *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,  
R.S.C.1985, c. C-36, AS AMENDED

Court File No: CV-12-9667-00CL

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