

**Court File No. CV-12-9667-00CL**

**Sino-Forest Corporation**

**SIXTH REPORT OF THE MONITOR**

**August 10, 2012**

**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

**SIXTH REPORT TO THE COURT  
SUBMITTED BY FTI CONSULTING CANADA INC.,  
IN ITS CAPACITY AS MONITOR**

**INTRODUCTION**

1. On March 30, 2012 (the “**Filing Date**”), Sino-Forest Corporation (the “**Company**”) filed for and obtained protection under the Companies’ Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended (the “**CCAA**”). Pursuant to the Order of this Honourable Court dated March 30, 2012 (the “**Initial Order**”), FTI Consulting Canada Inc. was appointed as the Monitor of the Company (the “**Monitor**”) in the CCAA proceedings. By Order of this Court dated April 20, 2012, the powers of the Monitor were expanded in order to, among other things, provide the Monitor with access to information concerning the Company’s subsidiaries. Pursuant to an Order of this Court made on May 31, 2012, this Court granted an Order extending the Stay Period (as defined in the Initial Order) to September 28, 2012. The proceedings commenced by the Company under the CCAA will be referred to herein as the “**CCAA Proceedings**”.
2. On the Filing Date, the Court also issued an Order authorizing the Company to conduct a Sale Process (the “**Sale Process Order**”).
3. The purpose of this Sixth Report is to:
  - (a) Provide an update on the Company’s CCAA proceedings including with respect to:

- (i) the Sale Process;
  - (ii) Mediation;
  - (iii) the Plaintiffs' Motion re Document Production;
  - (iv) Claims Process;
  - (v) the Company's Equity Claims Motion;
- (b) Report on the receipts and disbursements of the Company for the period May 19, 2012 to July 20, 2012; and
- (c) Provide certain information relating to the Sino-Forest Subsidiaries, including:
- (i) overview of the Sino-Forest chops, annual review and process to change legal representatives;
  - (ii) the cash position of the Sino-Forest Subsidiaries;
  - (iii) receivables;
  - (iv) the Thai Redwood Transaction;
  - (v) management's internal December 2011 financial statement impairment provisions;
  - (vi) disbursements;
  - (vii) cumulative variance analysis for the Sino-Forest Subsidiaries;
- (d) Provide an update on Sino-Forest Subsidiary operations, including:
- (i) operational changes;
  - (ii) wood fibre operations;
  - (iii) other businesses; and

- (e) Provide an update on timber assets and verification efforts.
4. In preparing this Sixth Report, the Monitor has relied upon unaudited financial information of Sino-Forest, Sino-Forest's books and records, certain financial information prepared by Sino-Forest, the Reports of the Independent Committee of the Company's Board of Directors dated August 10, 2011 (the "**First IC Report**"), November 13, 2011 (the "**Second IC Report**"), and January 31, 2012 (the "**Final IC Report**" and together, the "**IC Reports**"), and discussions with Sino-Forest's management. The Monitor has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of the information. In addition, the Monitor notes that on January 10, 2012, the Company issued a press release cautioning that the Company's historic financial statements and related audit reports should not be relied upon. Accordingly, the Monitor expresses no opinion or other form of assurance on the information contained in this Sixth Report or relied on in its preparation. Future oriented financial information reported or relied on in preparing this Sixth Report is based on management's assumptions regarding future events; actual results may vary from forecast and such variations may be material.
  5. Unless otherwise stated, all monetary amounts contained herein are expressed in US Dollars.
  6. The term "**Sino-Forest**" refers to the global enterprise as a whole but does not include references to the Greenheart Group. "**Sino-Forest Subsidiaries**" refers to all of the direct and indirect subsidiaries of the Company, but does not include references to the Greenheart Group.
  7. Capitalized terms not defined in this Sixth Report are as defined in the pre-filing report of the proposed monitor dated March 30, 2012 (the "**Pre-Filing Report**") and the affidavit of W. Judson Martin sworn March 30, 2012 (the "**Initial Order Affidavit**"). Copies of the Initial Order Affidavit (without exhibits) and the Pre-Filing Report are attached as Appendices "A" and "B" hereto.

## GENERAL BACKGROUND

### *Sino-Forest Business*

8. Sino-Forest conducts business as a forest plantation operator in the People's Republic of China ("**PRC**"). Its principal businesses include ownership and management of forest plantation trees, the sale of standing timber and wood logs, and complementary manufacturing of downstream engineered-wood products.
9. The Company is a public holding company whose common shares were listed on the Toronto Stock Exchange ("**TSX**"). Prior to August 26, 2011 (the date of the Cease Trade Order, defined below), the Company had 246,095,926 common shares issued and outstanding and trading under the trading symbol "TRE" on the TSX. Effective May 9, 2012, the common shares were delisted from the TSX.
10. On June 2, 2011, Muddy Waters, LLC ("**MW**"), which held a short position on the Company's shares, issued a report (the "**MW Report**") alleging, among other things, that Sino-Forest is a "ponzi-scheme" and a "near total fraud". The MW Report was issued publicly and immediately caught the attention of the media on a world-wide basis.
11. Subsequent to the issuance of the MW Report, the Company devoted extensive time and resources to investigate and address the allegations in the MW Report as well as responding to additional inquiries from, among others, the Ontario Securities Commission ("**OSC**"), the Royal Canadian Mounted Police and the Hong Kong Securities and Futures Commission.
12. In view of the MW Report, the subsequent litigation and regulatory investigations and other issues continue to have a significant negative impact on the Company and have threatened the long term viability of Sino-Forest's operations. For the reasons discussed in the Pre-Filing Report and the Initial Order Affidavit, the Company and the business was placed into a stalemate that could not be resolved without the Court supervised solution offered by the CCAA Proceedings.
13. The Pre-Filing Report and the Initial Order Affidavit provide a detailed outline of Sino-Forest's corporate structure, business, reported assets and financial information as well as

a detailed chronology of the Company and its actions since the issuance of the MW Report in June 2011.

## **UPDATE ON CCAA PROCEEDINGS**

### *Update on Sale Process*

14. On the Filing Date, the Company obtained the Sale Process Order. The Phase 1 Bid Deadline (as defined in the Sale Process Order) was June 28, 2012. On July 10, 2012, the Company issued a press release announcing that the Company had determined that none of the letters of intent were qualified letters of intent and therefore it was terminating the Sale Process and proceeding with the restructuring transaction contemplated under the Support Agreement.
15. Also on July 10, 2012, the Monitor issued its fourth report (the “**Fourth Report**”) to the Court providing an update with respect to the Sale Process and the letters of intent that had been received on the Phase 1 Bid Deadline. The Fourth Report also noted that none of the LOIs (as defined in the Fourth Report) were deemed “Qualified Letters of Intent” under the sale process procedures and the Company subsequently issued a press release confirming the termination of the sale process.
16. Many parties actively involved in these proceedings have requested a summary of the LOIs received. The Monitor agrees with the Company that this information is sensitive and should not be publicly available. However, the Monitor does believe that summary information regarding the LOIs should be placed in the Data Room (defined below) and made available to Mediation Parties (defined below) who have executed a Mediation Confidentiality Agreement (defined below) prior to the Mediation (defined below).

### *Update on Mediation*

17. The Monitor’s fifth report dated July 16, 2012 filed in support of the Monitor’s motion for a mediation order (the “**Mediation Motion**”) provided the background and context leading up to the Mediation Motion.
18. On July 25, 2012, this Court granted an Order (the “**Mediation Order**”):

- (a) directing mediation (“**Mediation**”) among specified “Mediation Parties”;
- (b) providing for the establishment of a data room (“**Data Room**”) for access by Mediation Parties subject to confidentiality restrictions;
- (c) scheduling September 4, 5 and, if necessary, 10 as the mediation dates; and
- (d) appointing the Honourable Justice Newbould as mediator.

A copy of the Mediation Order is attached as Appendix C hereto.

19. Since the granting of the Mediation Order, the Company has worked with the Plaintiffs and the Third Party Defendants to execute confidentiality agreements in the form agreed to with such parties at the hearing for the Mediation Order (the “**Mediation Confidentiality Agreement**”). A copy of the index to the Data Room and access to the Data Room has been provided to those Mediation Parties that have executed a Mediation Confidentiality Agreement as of the date of this Report.

*The Plaintiff’s Motion re Document Production*

20. On July 10, 2012, the Plaintiffs served a notice of motion (the “**Notice of Motion**”) (followed by a full motion record on July 11, 2012) for a motion returnable July 16, 2012 (the “**Plaintiffs’ Document Motion**”) regarding the disclosure of certain documents set out in their Notice of Motion. At a Court conference call held on July 13, 2012, the Plaintiffs’ Document Motion was adjourned to July 25, 2012. At a 9:30 appointment held on July 23, 2012, the motion was further adjourned to July 30, 2012.
21. The Plaintiffs and the Company subsequently agreed upon the list of documents to be put in the Data Room and settled a form of Order in respect of the Plaintiffs’ Document Motion. The Order was granted by this Court on July 30, 2012. A copy of the Order is attached as Appendix D hereto.

*Update on Claims Process*

22. Pursuant to an Order of this Court made on May 14, 2012, this Court granted the Claims Procedure Order providing for a call for claims against the Company and its officers and

directors. While the Claims Procedure Order did not purport to create a bar date in respect of claims against Sino-Forest Subsidiaries, claimants against the Company were ordered to indicate whether they asserted or intended to assert a similar claim against some or all of the Sino-Forest Subsidiaries. The primary claims bar date was June 20, 2012 (the “**Claims Bar Date**”).<sup>1</sup>

23. On or about the Claims Bar Date, the Monitor received a total of 228 claims with a face value in excess of \$112 billion. This includes potential duplicative claims filed against the Company and its officers, directors and subsidiaries. A summary of the claims received to date is as follows:

	<b># of Claims Submitted</b>	<b>\$ of Claims Submitted (millions)</b>
Claims	164	\$ 66,334
D&O Claims	64	\$ 45,861
<b>Total Claims</b>	<b>228</b>	<b>\$ 112,195</b>

24. As of the date of this Report, the Monitor is continuing to review the claims received, particularly in light of the Equity Claims Decision (defined below), discussed in further detail below.
25. The Monitor is also reviewing the claims under the Company’s four series of notes including the guarantees and pledges given by Sino-Forest in connection with the notes. The Monitor intends to put its summary regarding the guarantees and security in the Data Room.

---

<sup>1</sup>The applicable bar date for certain claims including Restructuring Claims and D&O Indemnity Claims is as set out in the Claims Procedure Order.

*The Company's Equity Claims Motion*

26. On June 26, 2012, this Court heard a motion brought by the Company for a direction that certain claims against the Company that result from the ownership, purchase or sale of an equity interest in the Company and resulting indemnity claims are “equity claims” as defined in the section 2 of the CCAA. The motion was not opposed by the Plaintiffs but was opposed by certain Third Party Defendants.
27. On July 27, 2012, this Court issued its decision (the “**Equity Claims Decision**”). A copy of the Equity Claims Decision is attached as Appendix E hereto. Pursuant to the Equity Claims Decision, this Court found, *inter alia*, that:<sup>2</sup>
- (a) It was not premature to determine the issue set out in the Company’s motion. Instead:
    - (i) it had been clear since the outset of the CCAA proceedings that this issue would have to be determined and this issue could be determined independently of the Claims Procedure Order;
    - (ii) the Court did not accept that any party can be said to be prejudiced if this threshold issue is determined at this time;
    - (iii) this threshold issue does not depend upon a determination of quantification of any claim; and
    - (iv) the effect of the Equity Claims Decision will be to establish whether the claims of E&Y, BDO and the Underwriters will be subordinated pursuant to the CCAA and is independent of determinations as to validity and quantification.
  - (b) The Shareholder Claims and Related Indemnity Claims are “equity claims” as defined in section 2 of the CCAA.

---

<sup>2</sup> Capitalized terms used in the summary and not otherwise defined have the meaning given to them in the Equity Claims Decision. This summary is for information purposes only. Reference should be made to the Equity Claims Decision itself.

- (c) With respect to the claims of E&Y, BDO and the Underwriter, the Court concluded that the most significant aspect of those claims constitute “equity claims”. However, the Court did not make a determination as to whether defence costs incurred in defending the class action claims were “equity claims”.
- (d) The Equity Claims Decision was without prejudice to the Company’s right to apply for a similar order with respect to (i) any claims in the statement of claim that are in respect of securities other than shares and (ii) any indemnification claims against the Company related thereto.

28. On August 3, 2012, the Court issued an Order reflecting the terms of the Equity Claims Decision, a copy of which is attached as Appendix F hereto.

## **RECEIPTS AND DISBURSEMENTS OF THE COMPANY FOR THE PERIOD TO JULY 20, 2012**

### **Actual Receipts & Disbursements for the Period May 19, 2012, to July 20, 2012**

29. The Company’s actual net cash flow for the period from May 19, 2012, to July 20, 2012 (the “**Current Period**”) together with an explanation of key variances as compared to the May 23 Forecast (as defined in the Monitor’s Third Report) is described below. Actual net cash flows for the Current Period were approximately \$8.5 million higher than forecast and summarized as follows:

<b>\$000 CAD</b>	<b>Forecast</b>	<b>Actual</b>	<b>Difference</b>
Cash inflow			
Insurance Proceeds	\$ -	\$ 6,664	\$ 6,664
Interest Income	\$ 412	\$ 417	\$ 5
<b>Total cash inflow</b>	<b>\$ 412</b>	<b>\$ 7,081</b>	<b>\$ 6,669</b>
Cash outflow			
Payroll and Benefits	\$ 121	\$ 111	\$ (9)
Board & Committee Fees	\$ 392	\$ 307	\$ (85)
Travel	\$ 185	\$ 47	\$ (137)
Rent, Communication & Utilities	\$ 40	\$ 52	\$ 13
Taxes & Other	\$ 102	\$ 47	\$ (55)
<b>Total cash outflow</b>	<b>\$ 839</b>	<b>\$ 565</b>	<b>\$ (273)</b>
<b>Net Operating Cashflow</b>	<b>\$ (426)</b>	<b>\$ 6,516</b>	<b>\$ 6,942</b>
<b>Restructuring Costs</b>			
Professional Fees	\$ 10,482	\$ 8,946	\$ (1,536)
<b>Total Restructuring Costs</b>	<b>\$ 10,482</b>	<b>\$ 8,946</b>	<b>\$ (1,536)</b>
<b>Net Cash Flow</b>	<b>\$ (10,908)</b>	<b>\$ (2,430)</b>	<b>\$ 8,478</b>
Opening Cash Balance	\$ 61,007	\$ 61,007	\$ -
Net Cash Balance	\$ (10,908)	\$ (2,430)	\$ 8,478
Ending Cash Balance	\$ 50,099	\$ 58,577	\$ 8,478

30. The key variances in actual receipts and disbursements compared to the May 23 Forecast is a favourable variance of approximately \$8.5 million primarily relating to:
- (a) A positive variance of approximately of \$6.7 million in cash inflows. This variance is permanent in nature and related to insurance proceeds received by Sino-Forest in respect of professional fees incurred. The timing and estimated value of potential insurance proceeds was unknown at the time of the preparation of the May 23 Forecast and therefore was not included as part of the Forecast; and
  - (b) A positive variance of approximately \$1.5 million in professional fees. This variance is temporary in nature and is expected to reverse in the coming weeks as invoices are submitted by the professionals and paid by Sino-Forest.

## INFORMATION RELATING TO SINO-FOREST SUBSIDIARIES

31. As set out in the Third Report of the Monitor, the Monitor (both directly and through FTI Consulting (Hong Kong) Limited (“**FTI HK**” and together with the Monitor, “**FTI**”)) established communication protocols and reporting mechanisms with Sino-Forest in Hong Kong and the People’s Republic of China (“**PRC**”).
32. The Monitor was granted further powers pursuant to the Expanded Powers Order dated April 20, 2012, the majority of which related to direct access and involvement in the Sino-Forest Subsidiaries, as opposed to the Company itself. The Company’s request for the Expanded Powers Order was primarily as a result of certain enforcement notices received from the OSC in April 2012, and personnel changes resulting from those changes.
33. FTI continues to work with Sino-Forest on its operational, financial, legal and other issues. Much of the Monitor’s activities to date have included, and continue to include, monitoring and reviewing financial information and Sino-Forest Subsidiaries’ activities in addition to attending certain meetings between the Company and third parties.
34. The purpose of this overview is to inform on the status of the Sino-Forest Subsidiaries from the start of the CCAA proceedings to date. In assessing Sino-Forest, including what actions and steps should be taken, reference was made to the IC Reports and the work and background conducted by the Independent Committee and its advisors. Copies of the IC Reports are attached as Appendices G through I hereto.

### *General Overview*

35. As was set out in the Initial Order Affidavit as well as the Pre-Filing Report, in the months after the release of the MW Report and the subsequent commencement of investigations and litigation involving Sino-Forest Corporation, the ultimate parent of the Sino-Forest Companies, the majority of the business in the PRC came to a virtual standstill. Although certain business segments continued, they did so at diminished levels and Sino-Forest’s primary business, namely the purchase and sale of standing timber, froze. Both the Initial Order Affidavit and the Pre-Filing Report observed that a

court supervised process was necessary for any chance of resolving the stalemate that the business found itself in.

36. As discussed in the following sections, Sino-Forest's financial and operational aspects of the business in the PRC continue to be negatively impacted by the uncertainty regarding the Company's affairs. Operations in Sino-Forest's standing timber business (which accounts for the vast majority of Sino-Forest's historical reported revenue and asset base) remain frozen and the remainder of Sino-Forest's businesses are operating at substantially lower levels than in past years.
37. Further, Sino-Forest's existing senior management team has been significantly reduced since the commencement of the CCAA proceedings. As has been previously reported and disclosed by the Company, in April 2012, in response to enforcement notices issued by the OSC, a number of personnel changes were made whereby members of senior management were terminated. The chief financial officer also stepped down from that role, although he remains an employee of the Company. The Monitor understands that the terminated personnel played a significant role in Sino-Forest's business. Due to the on-going concern in the Company and the Sino-Forest business, it has not been an option for Sino-Forest to replace these individuals.
38. Although Sino-Forest's cash position may appear to be ahead of its forecast (see below), the original subsidiary level forecast was mostly prepared by individuals who are no longer employed by Sino-Forest as a result of the personnel changes in April 2012 and may not be an appropriate reference point. In reality, although disbursements are lower than normal, collection of receivables is proving difficult (as discussed below) and, to date, Sino-Forest has not been able to revive its business.
39. As evidenced by recent events, Sino-Forest is experiencing the results of a deteriorating business across multiple fronts, including:
  - (a) Provisions in respect of uncollectible receivable balances and assets with impaired values have been taken in the 2011 year end internal financial statements (which are discussed in further detail below);

- (b) Management will need to review the impact of the recent de-registrations on the interim 2012 internal financial statements and to consider the need for further provisions in respect of amounts owed by de-registered AIs (which is discussed in more detail below);
  - (c) Work being performed by third party consultants to verify Sino-Forest's forestry estate is on-going and estimated to take years to complete and/or to verify a substantial portion of the estate;
  - (d) There is no indication that Sino-Forest will be able to resume its business absent a successful restructuring and resolution in these CCAA proceedings; and
  - (e) There is a limited pool of funds that continues to be depleted throughout the CCAA proceedings.
40. The deterioration of Sino-Forest is also directly influenced by what appears to be the beginning of a breakdown of its relationships with certain AIs and suppliers. As described in the Pre-filing Report, the Initial Order Affidavit and as set out in the IC Reports, it is clear that there is an emphasis put on "business relationships" among parties that is paramount to any contractual or legal relationship that may have been entered into by the parties. These relationships are relied upon for the conduct of business in this industry in the PRC. In the course of its investigation, the IC reported that it was apparent that integral to Sino-Forest's business model was its relationship with business partners. Recent events highlight the breakdown:
- (a) Certain authorized intermediaries ("AIs") who are necessary for selling standing timber under the BVI structure and who had outstanding receivable balances with Sino-Forest, have de-registered (which is discussed in more detail below);
  - (b) Certain suppliers responsible for selling standing timber to Sino-Forest have de-registered; and

(c) The trading business has stopped importing, other than the existing Thai Redwood transaction. The Thai Redwood transaction that was expected to occur in May 2012 has been delayed multiple times.

41. The Monitor also notes that as the restructuring proceedings continue with no resolution, the ability of Sino-Forest to maintain its relationship with the PRC government may become increasingly difficult.

*Chops, Annual Review and Process to Change Legal Representatives*

42. Upon filing, FTI began discussions regarding the corporate governance of the Sino-Forest Subsidiaries, particularly the PRC entities which are located in various regions in the PRC. Through initial conversations and advice provided by Hong Kong and PRC counsel, the Monitor learned that, as a corporate governance matter, companies incorporated in the PRC:

- (a) Are represented by an individual who is appointed as the “legal representative” of that company in dealing with external parties and under the PRC law; and
- (b) conduct business through “chops” which are akin to company seals. PRC companies can have different kinds of chops including the “company chops”, “financial chops” and “individual bank signatory chop”. These chops are generally located at the subsidiary where they are used and may only be used by authorized individuals.

43. Shortly after the Filing Date, Sino-Forest sent out a company-wide letter (the “**Letter**”) to all of the subsidiaries identifying new restrictions on the use of the chops and prohibiting the use of these chops without prior permission from identified senior management of Sino-Forest. As discussed in further detail below, the Letter also outlined a new protocol for proposed disbursements and for entering into new contracts and commitments above a pre-determined threshold, including prior review by FTI.

44. As previously reported, in April 2012 there were several personnel changes due in large part to the ongoing investigation and charges laid by the OSC. As a consequence of these

changes, the Company and FTI undertook a diligence exercise to determine the legal representatives for all Sino-Forest PRC companies and the location and security of the various chops. A summary of the steps taken is as follows:

- (a) The Company, through its legal counsel, conducted a corporate review of the PRC subsidiaries to determine the identity of the legal representatives of each company. This review showed that there was a consistent legal representative across many of the subsidiaries and that in most cases the legal representative was no longer an employee of Sino-Forest.
  - (b) FTI then conducted physical visits of approximately 50% of Sino-Forest's PRC subsidiaries and observed the location of the company chop, financial chop and individual bank signatory chop for those subsidiaries it inspected.
  - (c) It was determined that it was not necessary or prudent to conduct an initial review of all PRC subsidiaries. This determination was based on the fact that: chops are physically located at the subsidiary offices throughout the PRC, the costs associated with physically visiting all locations and the relative levels of business historically reported by such subsidiaries. Instead, FTI selected a sample of subsidiaries to visit based on levels of business, cash balances and physical ability to visit those locations.
45. Based on the inspections that FTI has conducted, the chops appear to be physically locked in storage or other cabinets at the subsidiary level. Initially, there was one exception, but FTI has been advised that it has been remedied. FTI cannot be sure that the chops are kept under lock and key at all times given the practical prohibitions on such monitoring. However, FTI is advised by Sino-Forest management that the protocols set out in the Letter continue to be followed.
46. The Monitor expressed concern to Sino-Forest regarding the physical location of the chops at each of the subsidiaries as well as the legal representatives (particularly those that are no longer employees of Sino-Forest). These concerns were somewhat mitigated by the implementation of the new controls under the Letter. Further, at the time these

concerns were initially raised, Sino-Forest's view was that (a) physical relocation of the chops to a more centralized location was not possible as a practical matter as they are needed by each subsidiary on a daily basis to conduct any business; and (b) any changes in legal representatives or other protocols at that time were not timely due to the fact that the PRC subsidiaries were undergoing their annual review process. The annual review process is described in more detail below.

47. Over the past number of months, Sino-Forest's PRC subsidiaries have been undergoing annual reviews. These reviews are government mandated and companies are required to pass these reviews every year in order to carry on business in the PRC. As of July 31, 2012, all of the annual reviews have now been completed. FTI is advised that all but three (3) of the PRC subsidiaries have passed their review and FTI is now in the process of receiving copies of the stamped business licenses indicating that the reviews were successful. For those three (3) that remain outstanding, two (2) are expected to be complete by August 10, 2012 and the last one by August 31, 2012.
48. Given the completion of the annual reviews, the Monitor is re-visiting discussions with Sino-Forest management to determine whether further steps should be taken to either replace the legal representatives and/or obtain a greater degree of certainty on the use and security of the chops.

#### *Cash Position of Sino-Forest Subsidiaries*

49. Prior to the CCAA proceedings, the Independent Committee, through its financial advisor, PricewaterhouseCoopers LLP ("PwC") was trying to verify the cash position of Sino-Forest. PwC was able to complete verification as of June 13, 2011 of 81% of the cash position in the PRC and 100% in Hong Kong.
50. Since the Filing Date, FTI has continued to work with Sino-Forest to verify cash positions on an on-going basis particularly given the fact that the PwC verification was as of ten (10) months prior to the filing.
51. Sino-Forest has approximately 546 bank accounts, 327 of which are located in various parts of the PRC. FTI initially commenced work to understand the logistics, location and

reported balances in these accounts and based on that, determined that the best approach was to conduct an initial review of all accounts with a balance over \$5 million. The further following actions continue to be taken by FTI in order to verify cash positions:

- (a) FTI performs a monthly review of bank statements for over 60% of the bank accounts as compared to the bank statements. Included in the accounts that are under review are all of the accounts with significant balances as well as a monthly random review of selected accounts with smaller balances;
- (b) FTI has also physically visited specific banks in efforts to confirm certain account balances as at March 31, 2012. Sino-Forest has 17 bank accounts in the PRC with balances in excess of \$5 million as at March 30, 2012. The 17 accounts represent approximately 65% of the expected total of all PRC bank accounts, or 44% of the expected total of all account balances;
- (c) FTI selected 9 of the 17 accounts to be verified and visited the banks with local Sino-Forest personnel located in: Hunan Province, Jiangzi Province, Guizhou Province, Shanghai and Guangzhou. No material misstatements were identified for any of the reviewed account balances as of March 30, 2012; and
- (d) There were 216 non-PRC bank accounts with a total balance of approximately \$167 million as at March 30, 2012. FTI has verified all of these accounts with a balance of over \$100,000 by checking bank statements, which represents approximately 99% of the total non-PRC balance. FTI performs a selected review of a portion of the non-PRC bank accounts on an ongoing basis.

52. As an example, the breakdown of accounts reviewed per segment for June 2012 is detailed below. Based on the review procedures set out in 51(a) and (d) above, there were no material misstatements in those accounts checked.

USD	Sino-Wood	Sino-Panel	Non-PRC	Total
# of accounts with balances	147	180	219	546
Balances as at June 30, 2012 (\$ 000s)	\$ 92,709	\$ 126,275	\$ 145,235	\$ 364,218
% of bank account balances reviewed	58%	64%	69%	64%

*Receivables*

53. The Initial Order Affidavit set out Sino-Forest’s receivable balances, including ongoing difficulties in collecting those receivables given the MW Report and the uncertainty surrounding the business. Sino-Forest had, in fact, instructed one of its then PRC counsel to send demand letters in respect of significant receivable balances.
54. As of July 12, 2012, the Company had recorded receivables totalling approximately \$1 billion. Details regarding the outstanding receivables balance can be found below:

	\$	%
BVI Standing Timber	\$ 887	82%
Wood WFOE Standing Timber	\$ 1	0%
Panel WFOE Standing Timber	\$ 42	4%
BVI Trading	\$ 126	12%
WFOE Trading	\$ 11	1%
Miscellaneous	\$ 14	1%
<b>Total</b>	<b>\$ 1,081</b>	<b>100%</b>

55. Subsequent to the commencement of the CCAA proceedings, management engaged another PRC law firm, Jingtian & Gongcheng (“**J&G**”) to follow up on the collection of outstanding receivables. Collection methods include detailed analysis of existing outstanding receivables, demand letters, follow up on demand letters that Sino-Forest’s prior PRC counsel had advised it sent and face-to-face discussions with third parties in respect of certain specific outstanding receivables.
56. FTI has also begun participating (and continues to participate) in weekly meetings with Sino-Forest for a status update on legal proceedings/actions launched against specific debtors throughout the CCAA proceedings. FTI has also been participating (and continues to participate) in weekly meetings with subsidiaries as well as weekly calls with Jingtian & Gongcheng.
57. More recently, FTI has taken additional measures in following up on the status of the outstanding receivables, understanding the nature of collection methods being used and the impact these methods may have had on reducing the total outstanding balance.

58. In the course of FTI's increased role in assisting with the collection of receivables, FTI requested J&G to conduct searches of several entities, the results of which can be summarized as follows:
- (a) Searches were conducted against six (6) AIs with whom the BVI entities conduct business for standing timber and who make up approximately \$887 million of the Company's reported receivables. Based on the search results, three (3) of those entities, representing \$504 million in receivables, have been de-registered.
  - (b) Searches were conducted against twelve (12) entities with whom the BVI entities conduct business for BVI trading and who make up approximately \$126 million of the Company's reported receivables. Based on the search results, six (6) of those entities, representing \$63 million, have been de-registered, one (1) of which is also included in paragraph (a) above.
59. Although discussions are ongoing regarding the impact of de-registration and possible recourse available to Sino-Forest, the receivables position of Sino-Forest appears to be significantly different from past reported receivables. On July 31, 2012, the Company issued a press release outlining the discoveries made regarding the de-registration of these parties. A copy of the press release is attached as Appendix J hereto.
60. By far, the most significant impact of the above has been the de-registration of the AIs. As was set out in the IC Reports as well as the Initial Order Affidavit, there has always been very little insight into the business of the AIs including their books and records, cash collections and disbursements. Further, based on the IC investigation, it is apparent that there are on-going issues with respect to many aspects of the business transactions between Sino-Forest and the AIs, including the nature of many of these relationships. Historically, receivables from AIs were not collected as they were used to offset new standing timber purchases, as described in the description of the BVI model in the Initial Order Affidavit and the IC Reports.
61. The Monitor has been informed by King & Wood Mallesons that "de-registration" in the PRC is effectively the wind-up or termination of such company. In other words, after de-

registration, the company ceases to exist. However, as of the date of this Report, the Company and the Monitor are still at the stage of obtaining further legal advice regarding the de-registration process and possible civil and/or criminal remedies that might be available to Sino-Forest including pursuit of the shareholders of the AIs that have been de-registered and other related parties.

62. In the event that, in fact, these debts are not honoured, they may be written off by the Sino-Forest Subsidiaries that they are owed to, which would be a typical accounting practice.

#### *The Thai Redwood Transaction*

63. In March 2011, at the initiation of a former senior employee of Sino-Forest, Sino-Forest entered into two contracts (which were subsequently amended) for the purchase of approximately 6,500 tons of Thai Redwood through a PRC distributor (the “**Thai Redwood Transaction**”). In connection with the entering into of those contracts, Sino-Forest paid a deposit of \$15 million in April 2011 and a further deposit of \$32 million in December 2011.
64. Since the commencement of the proceedings, Sino-Forest has made ongoing efforts to either receive the Thai Redwood or get a return of the deposits. In that regard, numerous meetings have taken place with various individuals involved in the Thai Redwood Transaction. FTI has attended some of these meetings.
65. To date, Sino-Forest has not received shipment of the Thai Redwood. Sino-Forest and FTI have been advised by the supplier that the delay is due to many complicating factors including the political changes in Thailand and weather conditions. However, the significant delay has been of great concern to both the Monitor and the Company and, as a result, Sino-Forest is in ongoing negotiations with its supplier for return of the deposit or delivery of the wood. As of the date of this report, no resolution has been reached. It is the Monitor’s view that, at this point, recovery of either the deposits or delivery of the Thai Redwood is uncertain.

*Management's Internal December 2011 Financial Statement Impairment Provisions*

66. Management of the Company advised the Monitor that it has recorded approximately \$560 million in impairment provisions in respect of its internal 2011 financial statements. Management is currently working on finalizing the internal financial statements for Q1 2012 and expects to do so over the coming weeks.
67. A majority of the write-offs that pertain to the internal 2011 year-end financial statements relate to goodwill impairment, trade receivable impairments, fair value impairments of standing timber and deposits and plantation prepayments made in respect of contractual commitments. The 2011 provision does not take into account any potential additional write-offs related to accounts receivable, that may have to be accounted for due to the recent discovery of the de-registration of AIs or other third parties as described above. Any additional provisions will be recorded in the Q1 2012 internal financial statements.
68. The Monitor has had a number of discussions with the Company's management to understand the rationale and underlying justification for this provision. The Monitor has also requested back up information and documentation to try to understand the Company's decision more thoroughly. To date, the Monitor has reviewed a number of documents and makes the following observations:
  - (a) Approximately 13% of the provision taken relates to trade receivable impairments and bad debts written off. The impairment provision relates to the fact that the receivables balances are more than one year old and the Company follows a policy of providing for receivables that are more than one year past due. There are a number of customers that may also be suppliers and/or be related to suppliers and therefore there may be opportunities for set-off that management is currently looking into;
  - (b) Approximately 20% of the provision taken relates to wood log deposits, of which approximately 30% relate to certain 2011 deposits with the same supplier discussed above, who is party to the Thai Redwood Transaction, but relating to separate transactions. The assumptions underlying the impairments are based on

a lack of activity with counterparties to Sino-Forest's log supply agreements since MW;

- (c) Approximately 38% of the provision taken appears to be related to Mandra goodwill and intangibles and write offs of the fair value of timber assets based on management's estimate of recovery;
  - (d) The remaining provision amounts include certain balances that management has deemed impaired and/or written off due to existing external circumstances; and
  - (e) There are a number of explanations that are still outstanding as they relate to specific questions in the PRC and/or analysis performed by individuals who are no longer employed by Sino-Forest.
69. The Monitor continues to hold discussions with management to better understand the assumptions underlying the write-offs and potential impact on the existing business. The Monitor continues to review explanations and supporting documentation in both Canada and Hong Kong.

#### *Disbursements*

70. As set out above, the Letter provided for a new protocol on authorized disbursements. The Letter specifically provided that no disbursements or new commitments were to be made over an agreed upon threshold without approval from senior management and review by FTI.
71. FTI continues to work with Sino-Forest to monitor disbursements and confirm that the protocol on disbursements is followed. On a weekly basis, FTI reviews a list of proposed payments by Sino-Forest in excess of a pre-determined threshold. On a monthly basis, FTI reviews a sample of bank statements to verify that payments in excess of a pre-determined threshold were made and to verify the ending cash balances. Based on these controls, with one exception that took place shortly after the Filing Date, the appropriate protocols on disbursements appear to be followed.

72. As of July 20, 2012, Sino-Forest is approximately \$91 million ahead of its cash flow, a significant portion of this relating to a difference in actual versus forecast disbursements. Further details explaining the variance analysis can be found in the section entitled “Cumulative Variance Analysis”.
73. A significant portion of the approximately \$91 million is attributable to lower actual disbursements than forecast in Sino-Panel. The differences are primarily a result of:
- (a) approximately \$18 million in operating expenses that were lower than forecast due to lower work levels at manufacturing plants, poor weather conditions; and
  - (b) approximately \$50 million in outstanding accounts payable payments for plantation purchases and lease payments that have been delayed (at this point in time, it is still unknown what portion of the difference is timing versus permanent).

*Cumulative Variance Analysis*

74. The Sino-Forest Subsidiaries’ net cash flows broken down by Sino-Forest’s key operating lines, together with an explanation of key variances as compared to forecast is described below. Actual net cash flows are for the period from March 30, 2012 to July 20, 2012.

USD millions	Actual	Forecast	Difference
HK/BVI/Barbados	\$ (16)	\$ (18)	\$ (2)
Sino-Wood	\$ 12	\$ (10)	\$ (22)
Sino-Panel	\$ (10)	\$ (63)	\$ (53)

The key variances in actual receipts and disbursements as compared to forecast are:

- (a) Sino-Wood:
  - (i) Sino-Wood received a \$5 million bank loan which was not originally forecast by the Company;

- (ii) Sino-Wood was supposed to receive an approximate \$5 million capital injection which has been delayed;
  - (iii) Expenses related to planted plantations of approximately \$5 million were lower than forecast due to unforeseen weather and timing issues; and
  - (iv) General overhead expenses were lower than forecast by approximately \$3 million resulting primarily from timing differences.
- (b) Sino-Panel:
- (i) Sino-Forest forecast that the Thai Redwood Transaction would be completed and that approximately \$14 million in sales would have occurred. The Thai Redwood Transaction has been delayed and therefore the sales have not yet materialized;
  - (ii) Delayed payment to a specific supplier harvesting timber has further delayed expected revenue of approximately \$9 million related to the timber;
  - (iii) A majority of the forecast accounts payable have been delayed. A portion of the positive variance of approximately \$50 million may be a permanent difference, but this has not yet been determined; and
  - (iv) Operating expenses were lower than forecast due to lower work levels at the manufacturing plants than forecast, poor weather and the delayed Thai Redwood Transaction. A portion of the positive variance of \$18 million may be permanent, but this has not yet been determined.

#### **UPDATE ON SINO-FOREST SUBSIDIARY OPERATIONS**

75. Reference should be made to the IC Reports and the Initial Order Affidavit for an overview of the different segments of Sino-Forest's business as well as historic operating levels.

### *Operational Changes*

76. Since the filing, the Monitor is not aware of any new Sino-Forest entities being incorporated or any major transfers of assets among subsidiaries. Sino-Forest has continued to employ the vast majority of its employees (other than those personnel changes that have previously been discussed), the majority of whom work in Sino-Forest's manufacturing operations.
77. Subsequent to the filing, management of the Sino-Panel subsidiaries was replaced after the April 2012 personnel changes were made. New management of Sino-Panel are in the process of dealing with on-going operational issues, meeting with agents and negotiating resolutions to the outstanding legal matters.

### *Wood Fibre Operations*

78. As set out in the Initial Order Affidavit for the year ended December 2010, revenue from wood fibre operations accounted for approximately 96.4% of Sino-Forest's reported revenue. In June 2011, upon the release of the MW Report, wood fibre operations, effectively halted, with very little purchases or sales in the third or fourth quarter of 2011 and no purchases or sales in 2012.

### *Other Businesses*

79. The balance of Sino-Forest's businesses (which are all described in the Initial Order Affidavit) accounted for approximately 3.6% of Sino-Forest's reported revenue in 2010. These businesses were also significantly impacted by the MW Report, and have continued at diminished levels for the balance of 2011 and the first quarter of 2012.
80. A brief summary of some of those on-going businesses is as follows:
- (a) *Manufacturing and Other Operations.* The industrial segment of the subsidiaries includes manufacturing and industrial operations and employs approximately 2290 employees. Historically, only two of the operations provided positive financial performance, the remaining industrial operations have historically incurred financial losses. There has been no significant changes in the operations of this business segment.

- (b) *Log Trading.* The subsidiaries dealing with trading activities are in the process of being shut down. The only potential forecast incoming supply of logs is related to the Thai Redwood Transaction, which has been discussed above. The trading business segment has an inventory of existing logs, which they are in the process of selling.

*Overall Impact*

81. The Monitor continues to be of the view that it is important for these proceedings to be completed as soon as possible given the events that have taken place and may continue to take place which have a significantly negative impact on the business.

**UPDATE ON TIMBER ASSETS AND VERIFICATION EFFORTS**

82. The Monitor is aware that verification and valuation of the Sino-Forest assets is of ongoing interest to many participants in the Sino-Forest CCAA proceedings for various reasons. Indeed, verification and valuation were issues that was addressed by the IC in its reports. The Final Report provided some information regarding verification work that was considered. However, the IC observed that even if verification work was able to be completed, there were still significant hurdles to establishing valuation given the title issues in the BVI model and the relationship issues regarding many of the AIs.
83. Indufor was engaged by Sino-Forest during the course of the independent committee investigation to perform an area verification of the forestry estate of Sino-Forest. However, for the reasons set out above as well as the time consuming nature of verification, very little or no verification was completed prior to the issuance of the Final Report.
84. Indufor, under the supervision of Stewart Murray and the Company, has continued to work on verification post-filing. The area verification process is a two stage process that is being undertaken in the PRC. The process involves incrementally confirming the geographic location of each compartment, followed by a verification of each compartment's area of stocked forest cover using an independent source of satellite imagery.

85. The Monitor has been advised that the area verification exercise currently being undertaken by Indufor is a lengthy process and requires the dedication of long term resources. The work Indufor is undertaking includes the following:
- (a) Registering and digitizing maps;
  - (b) The use of Satellite imagery and image pre-processing routines;
  - (c) Atmospheric Correction;
  - (d) Vegetation classification;
  - (e) Map uplift, digitization and satellite imagery process (a time-consuming process that is necessary to ensure compliance with restrictions that apply to the distribution of PRC maps); and
  - (f) Area verification.
86. To date, Indufor has completed six (6) verification reports confirming the compartment locations of 63,956 hectares of the Sino-Forest estate to date. The confirmation involves geo-referencing and digital mapping of the compartments and represents approximately 8% of total Sino-Forest reported net stocked area of 808,685 hectares as at the end of December 31, 2011. Analysis and findings of these reports are limited solely to the area that has been verified. No extrapolations of findings to the wider Sino-Forest estate are possible or implied.
87. The Monitor is not yet clear as to whether the Indufor work will ultimately be timely or helpful in resolving the questions concerning the value of Sino-Forest's business. The Monitor understands that this type of work is extremely time consuming and that, in order to complete any meaningful amount of verification could take years, at a minimum.
88. As set out in previous documents including the IC Reports and the Initial Order Affidavit, asset verification to any degree of certainty may be difficult in this situation given many factors including, the nature of the assets, geographical impediments, political impediments and financial resources available. The verification exercise is a lengthy

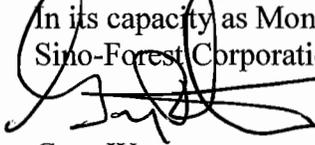
process and likely to take years to verify any significant percentage of the Sino-Forest estate.

89. The Monitor also notes that even if Indufor is able to verify even a portion of the assets, further work will need to be done to verify the underlying documents and assumptions used by Indufor. Lastly, as discussed above, verification does not establish title or deal with the relationships with the AIs (or address the issues arising from the de-registration of AIs).

Dated this 10<sup>th</sup> day of August, 2012.

FTI Consulting Canada Inc.

In its capacity as Monitor of  
Sino-Forest Corporation, and not in its personal capacity

A handwritten signature in black ink, appearing to read 'Greg Watson', is written over the text 'Sino-Forest Corporation, and not in its personal capacity'.

Greg Watson  
Senior Managing Director



**APPENDIX A - PRE-FILING REPORT**

*(See Attached)*

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

## **Sino-Forest Corporation**

### **PRE-FILING REPORT OF THE PROPOSED MONITOR**

**March 30, 2012**

Court File No. \_\_\_\_\_

**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

**PRE-FILING REPORT TO THE COURT  
SUBMITTED BY FTI CONSULTING CANADA INC.,  
IN ITS CAPACITY AS PROPOSED MONITOR**

**INTRODUCTION**

1. FTI Consulting Canada Inc. ("**FTI Canada**" or the "**Proposed Monitor**") has been informed that Sino-Forest Corporation (the "**Company**") intends to make an application under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the "**CCAA**") and to seek an initial order (the "**Initial Order**") from the Ontario Superior Court of Justice (Commercial List) (the "**Court**"), granting, *inter alia*, a stay of proceedings against the Company until April 29, 2012, (the "**Stay Period**") and appointing FTI Canada as monitor of the Company's CCAA Proceedings (defined below). The proceedings commenced by the Company under the CCAA, if granted, will be referred to herein as the "**CCAA Proceedings**".
2. FTI Canada is a trustee within the meaning of section 2 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended, and is not subject to any of the restrictions on who may be appointed as monitor set out in section 11.7(2) of the CCAA. FTI Canada has provided its consent to act as Monitor.

### **Engagement of FTI Consulting and Preparation of this Report**

3. FTI was originally retained through its Hong Kong office, FTI Consulting (Hong Kong) Limited (“**FTI HK**” and together with FTI Canada, “**FTI Consulting**”) in October 2011. The purpose of FTI HK’s retainer was primarily in connection with the work being done to determine whether the Q3 Results (defined below) could be issued. The scope of FTI HK’s retention was expanded in January 2012. The expanded role of FTI HK included assisting management in the review and preparation of detailed cash flow forecasts and analysis of outstanding receivables, including collection options. FTI Canada has been formally retained since March 12, 2012. FTI HK and FTI Canada have worked together in advising the Company and in the preparation of this report.
  
4. Since its engagement, FTI Consulting has worked with the Company and its advisors extensively. Among other things, FTI Consulting has:
  - (a) Attended in-person meetings involving Houlihan (defined below), senior management including the chief executive officer, chief financial officer and Allen Chan (Sino-Forest’s founder and chief executive officer up to August 2011) and others in order to gain information regarding Sino-Forest and its situation;
  - (b) Attended in-person and telephone meetings with other stakeholders including the Ad Hoc Noteholders (defined below), the Board (defined below) and others;
  - (c) Engaged legal counsel in Canada who has also participated in certain of these meetings;
  - (d) Had a local team review certain Sino-Forest documents and engage in discussions with Sino-Forest in both Hong Kong and the PRC (defined below);
  - (e) Met with Sino-Forest finance personnel located in Canada, Hong Kong

and the PRC;

- (f) Obtained financial and other information produced by Sino-Forest relating to its operations, its cash flow forecasts and current financial situation;
  - (g) Reviewed redacted versions of the IC Reports (defined below);
  - (h) Reviewed certain of the books and records of the Company;
  - (i) Reviewed the Note Indentures (defined below) and related guarantee and security documents; and
  - (j) Reviewed various other documents and materials relevant to the Company and its business.
5. As a result of these efforts, FTI Consulting has become familiar with the Company's current state of affairs including the basis on which it is now seeking CCAA protection, and approval of the Sale Process (defined below).
6. Although this Report has been prepared in anticipation of FTI Canada's appointment as monitor of the Company, it has been prepared with the same duty and care and with the same level of diligence as though FTI Canada had already been appointed to such role.
7. In preparing this report, the Proposed Monitor has relied upon unaudited financial information of the Company, the Company's books and records, certain financial information prepared by the Company, the IC Reports (defined below) and discussions with the Company's management. Other than as described in paragraph 4 above, the Proposed Monitor has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of the information. Accordingly, the Proposed Monitor expresses no opinion or other form of assurance on the information contained in this Report or relied on in its preparation. Future oriented financial information reported or relied on in preparing this Report is based on management's assumptions regarding future events; actual results may vary from forecast and such variations may be material.

### **Purpose of this Report**

8. The purpose of this report is to:
- (a) Inform the Court on the following:
    - (i) an overview of the Company and its current situation;
    - (ii) an outline of the Proposed Monitor's understanding of circumstances that have led to the Company's current request for relief;
    - (iii) the proposed restructuring activities of the Company including the Support Agreement (defined below);
    - (iv) the Sale Process to be undertaken for the business and assets of the Sino-Forest Companies (defined below);
    - (v) the Company's March 29 Forecast (defined below); and
  - (b) Support the Company's application and recommend that the Court grant the proposed Initial Order and Sale Process Order including the following relief:
    - (i) a stay of proceedings to April 29, 2012;
    - (ii) approval of certain payments during the CCAA Proceedings;
    - (iii) approval of a charge securing the fees and expenses of the Monitor, its counsel and counsel to the Company, counsel to the Board (defined below), Houlihan, FTI HK, counsel to the Ad Hoc Noteholders (defined below) and the financial advisor to the Ad Hoc Noteholders in the aggregate amount of CAD\$15 million (the "**Administration Charge**");
    - (iv) approval of a charge securing an indemnity in favour of the

directors and officers of the Company in the aggregate amount of CAD\$3.2 million (the “**Directors’ Charge**”);

- (v) approval of the engagement of Houlihan Lokey Capital, Inc. (“**Houlihan**”), pursuant to an engagement letter dated as of December 22, 2011, (the “**Financial Advisor Agreement**”);
  - (vi) approval of the Sale Process (defined below); and
  - (vii) authorizing and directing the Company and the Proposed Monitor to engage in certain procedures to notify the Company’s noteholders regarding certain issues related to the Support Agreement (defined below).
9. Unless otherwise stated, all monetary amounts contained herein are expressed in US Dollars.
10. The terms “**Sino-Forest Companies**” and “**Sino-Forest**” refer to the global enterprise as a whole but do not include references to the Greenheart Group (defined below).
11. This report focuses on the Company’s current situation and immediate need for court protection. This report should be read in conjunction with the affidavit of W. Judson Martin, vice-chairman and chief executive officer of the Company, sworn March 30, 2012 (the “**Martin Affidavit**”) which provides an overview as to Sino-Forest’s history, business and operations and is therefore not repeated herein.

## **BACKGROUND**

### **Overview of Sino-Forest**

12. Sino-Forest conducts business as a forest plantation operator in the People’s Republic of China (“**PRC**”). Its principal businesses include ownership and management of forest plantation trees, the sale of standing timber and wood logs

and complementary manufacturing of downstream engineered-wood products.

13. The Company is a public holding company whose common shares are listed on the Toronto Stock Exchange (“**TSX**”). Prior to August 26, 2011 (the date of the Cease Trade Order, defined below), the Company had 246,095,926 common shares issued and outstanding and trading under the trading symbol “**TRE**” on the **TSX**.
14. On June 2, 2011, Muddy Waters, LLC (“**MW**”), which held a short position on the Company’s shares, issued a report (the “**MW Report**”) alleging, among other things, that Sino-Forest is a “ponzi-scheme” and a “near total fraud”. The **MW Report** was issued publicly and immediately caught the attention of the media on a world-wide basis.
15. Since the issuance of the **MW Report**, the Company has devoted extensive time and resources to investigate and address the allegations in the **MW Report** as well as responding to additional inquiries from, among others, the Ontario Securities Commission (the “**OSC**”), the Royal Canadian Mounted Police (“**RCMP**”) and the Hong Kong Securities and Futures Commission (“**HKSFC**”).
16. To carry out this work, on June 2, 2011, the Company’s board of directors (the “**Board**”) appointed a three (3) person independent committee (the “**IC**”) to investigate the allegations contained in the **MW Report**. The **IC** retained three (3) law firms in Canada, Hong Kong and the PRC as well as financial advisors to assist in the **IC** investigation.
17. The **IC** ultimately issued three (3) reports on August 10, 2011, November 13, 2011 and January 31, 2012 (the “**First Interim Report**” the “**Second Report**” and the “**Final Report**” and collectively, the “**IC Reports**”). The **IC** was able to reach many conclusions addressing many of the allegations contained in the **MW Report**. However, the **IC** was unable to make certain conclusions, particularly as it related to certain of Sino-Forest’s relationships with third party intermediaries and suppliers. The inability of the **IC** (and others) to have conclusively resolved those

issues has had an ongoing impact on the Company, namely the ability of the Company to issue its Q3 Results and the 2011 Financial Statements (both defined below).

18. With the issuance of its Final Report, the IC concluded its active investigation. However, the Board established a Special Restructuring Committee of the Board comprised exclusively of directors independent of management of the Company for the purpose of supervising, analyzing and managing strategic options available to the Company.
19. Despite the work that was done by the IC, the IC's advisors, the Company (including senior management) and others in the last nine months, it is apparent to the Proposed Monitor that the MW Report, the subsequent litigation and regulatory investigations and other issues continue to have a significant negative impact on the Company and have threatened the long term viability of Sino-Forest's operations. For the reasons discussed below, the Proposed Monitor is of the view that the events and occurrences over the last nine months have led the Company and the business into a stalemate that cannot be resolved without a Court supervised solution.

#### **Current State of Sino-Forest**

20. The Proposed Monitor understands that the current state of the Sino-Forest Companies is effectively as follows:
  - (a) Business impact:
    - (i) The ability of Sino-Forest to access new offshore capital injections for expansion has dried up and PRC funding has been substantially curtailed given the uncertainty around the Company;
    - (ii) The Proposed Monitor understands that operations in the trading and standing timber business outside the PRC and the standing timber business in the WFOEs are effectively frozen, the trading

business has stopped importing (other than the existing Thai Redwood transaction which is ongoing) and manufacturing is operating at lower levels than normal;

- (iii) Many customers have ceased paying their receivables despite concentrated efforts by Sino-Forest to collect on outstanding balances, which, the Proposed Monitor understands includes SFC's counsel in the PRC sending legal demand letters to 12 BVI trading companies for accounts receivable totalling approximately \$126 million and 5 WFOE companies totalling approximately RMB 224.5 million;
- (iv) Sino-Forest has had to reserve millions of dollars to pay suppliers for outstanding debts, in order to avoid litigation or further hostile situations from its suppliers and landlords/farmers (which the Proposed Monitor understands has historically involved threats of violence and occupation of Sino-Forest offices in Hunan);
- (v) The Company has been unable to release its financial results for the nine-month period ended September 30, 2011 (the "**Q3 Results**") and for reasons discussed below, is unlikely to be in a position to release such statements in the near term, if ever;
- (vi) The Company has been unable to release its 2011 audited financial statements for the year ended December 31, 2011 ("**2011 Financial Statements**") and for reasons discussed below, is unlikely to be in a position to release such statements in the near term, if ever;

(b) Financial situation:

- (i) As of March 23, 2012, the Company has approximately \$70.5 million in cash;

- (ii) The ability to repatriate funds from the PRC into off shore (i.e. non-PRC) companies is limited by many factors including the historic “BVI” corporate structure, state administration of foreign exchange (“SAFE”) regulations and other currency control issues (which are discussed extensively in the Martin Affidavit);
  - (iii) The Company has limited prospects of being able to raise further capital or debt in the near future;
  - (iv) Sino-Forest has not been able to secure or renew certain existing onshore banking facilities, has been unable to obtain offshore letters of credit to facilitate Sino-Forest’s trading business, and all offshore banking facilities have been repaid and frozen, or cancelled;
  - (v) Sino-Forest’s operating subsidiaries have lost access to capital injections, local bank financing and intercompany funding for expansion opportunities due to the Company’s financial situation;
  - (vi) Due to the business constraints above, Sino-Forest’s operations are now operating on a significant burn as they are being pressured to continue to honour payables while collecting minimal receivables and failing to generate significant new sales;
- (c) Legal and Regulatory Proceedings:
- (i) Sino-Forest continues to divert significant resources to address the ongoing regulatory and criminal investigations by the OSC and the RCMP as well as inquiries from the HKSFC;
  - (ii) Numerous class actions have been commenced in Canada and the US and more are threatened;
  - (iii) The OSC has issued a Cease Trade Order in respect of the Company’s shares, which is ongoing;

- (d) Default under the Note Indentures:
- (i) As a result of the Company's failure to issue its Q3 Results, the Company is in default (the "**Financial Reporting Covenant Default**") under its four (4) series of issued notes (the "**Notes**") and is unlikely to be in a position to cure such default in the near term, if ever;
  - (ii) On January 12, 2012, the Company announced that holders of a majority of its 2014 Senior Notes and 2017 Senior Notes (who had issued default notices under their respective note indentures) had agreed to waive (the "**Waiver Agreements**") the Financial Reporting Covenant Default on certain terms and conditions (discussed below) including a covenant to make certain interest payments;
  - (iii) The Waiver Agreements terminate on the earlier of April 30, 2012 and any earlier termination of the Waiver Agreements in accordance with their terms;
  - (iv) The failure to deliver the 2011 Financial Statements by March 31, 2011 will constitute a further default under the Note Indentures (subject to a 30 day cure period);
- (e) Failure to Produce Q3 Results and 2011 Audited Statements
- (i) As set out in the IC's Second Report, subsequent to August 26, 2011, a number of documents came to the IC's attention that required further investigation and review;
  - (ii) On or before November 15, 2011, the deadline for the release of the Q3 Results, the Board's audit committee recommended and the Board agreed that the Company should defer the release of the Q3 Results until certain issues could be resolved to the satisfaction of

the Board and the Company's external auditor;

- (iii) The issues included (A) determining the nature and scope of the relationships between Sino-Forest and certain of its AIs (defined below) and suppliers, as discussed in the Second Report, and (B) the satisfactory explanation and resolution of issues raised by certain documents identified by the IC's advisors, the Company's counsel, the Company's auditors, and/or by OSC staff;
  - (iv) Although the Company (and the IC) continued to work to resolve these issues, the allegations set out in the MW Report and raised by the OSC, the Company subsequently announced that there was no assurance that it would be able to release the Q3 Results, or, if able, as to when such release would occur;
  - (v) Those same issues outlined above remain gating items to the Company's ability to release 2011 Audited Financial Statements;
- (f) Political Factors:
- (i) Sino-Forest requires ongoing support from all levels of the PRC government to operate its business in a manner that will be profitable;
  - (ii) To date, the PRC government has been supportive, but has recently expressed concern regarding the ongoing distress of the business and has indicated that it expects the Company to propose a viable solution in the near future; and
  - (iii) Loss of support from the PRC government would likely be fatal to any chance of success in restructuring the Company in a way that maximizes value for the Company's stakeholders.

21. In summary, Sino-Forest's state of affairs is such that it cannot maintain a status quo for much longer.

## **CIRCUMSTANCES OF THE CCAA APPLICATION**

22. The Martin Affidavit provides a detailed outline of Sino-Forest's corporate structure, business, reported assets and financial information. The Martin Affidavit also provides a detailed chronology of the Company and its actions since the issuance of the MW Report in June 2011 including the formation of the IC, the issuance and conclusions set out in the IC Reports, the Class Actions, the OSC, RCMP and HKSFC investigations and the defaults under the Notes.
23. This Report does not propose to repeat those details. Instead, the Proposed Monitor has focused on the following areas, which it believes are relevant for understanding the basis on which it is recommending the granting of the Initial Order and the approval of the Sale Process at this time:
- (a) Sino-Forest's historical method of doing business and certain of the legal issues that are embedded within that structure;
  - (b) the role of the PRC government and the forestry industry in the PRC; and
  - (c) Sino-Forest's current options.

### **The Company's history**

24. Sino-Forest operates through two different corporate models – the “BVI” model and the “WFOE” model. It is significant to understand the corporate models used by Sino-Forest in its operations because of the corresponding issues associated with repatriating value offshore from each of those various entities.

#### *BVI Forestry Holding Companies (“BVIs”)*

25. Until 2004, Sino-Forest used the BVI model exclusively to invest in timber rights in the PRC. The Proposed Monitor understands that the BVI model essentially involves the use of a British Virgin Island company to invest in timber rights in the PRC. Due to the restrictions on foreign companies under PRC law which do not permit foreign companies to conduct business in the PRC without business



licenses granted by competent government authorities, BVIs must carry on their sale activities through authorized intermediaries (“AIs”) onshore. Further, BVIs are not permitted to have bank accounts in the PRC. It is the AIs who enter into the direct contracts for the sale of standing timber with end customers. AIs are also responsible for remitting taxes arising from sales to the relevant PRC tax authorities. Once money is in the BVI system, it has never been repatriated offshore and any profit has always been re-invested in further plantation timber rights. The only exception to that are in the small instances where Sino-Forest has tested its on-shoring strategy (discussed in further detail below).

26. The BVI model was the model used by Sino-Forest when it started operations in 1994 due to the restrictions on foreign business operations in the PRC. Over the years, the BVI model was therefore used to purchase significant amounts of Sino-Forest’s reported timber holdings (approximately 60% of its reported timber holdings). From an investor/creditor perspective, the model is problematic for a number of reasons including:
  - (a) BVIs are restricted from carrying on business directly in the PRC – as such, many of the title verification issues that were contained in the MW Report and arose during the IC investigation were due to the fact that when BVIs purchase timber, they are only purchasing the timber rights and not any underlying land use rights (which interests are capable of being registered in most parts of the PRC);
  - (b) BVIs must sell through the AIs. This has resulted in a certain lack of transparency in a number of issues that were the focus of the MW Report and the IC investigation – including the relationships between the AIs and certain of the suppliers, an inability to see into the books and records of the AIs to verify booked sales, and the extent to which the AIs had, in fact, remitted applicable taxes to relevant tax authorities; and
  - (c) The Proposed Monitor understands that for various reasons, but primarily related to the SAFE regulations, there is no way for a BVI to efficiently

repatriate cash off shore without giving rise to significant negative tax consequences - as such, since the businesses' inception, all profit has simply been further re-invested in the BVI model in new trees.

*WFOEs*

27. In 2004, the Ministry of Commerce for the PRC began allowing wholly foreign owned enterprises (“WFOEs”) to conduct business in the trading of timber on shore in the PRC. Post 2004, almost all of Sino-Forest’s new capital invested in timber assets has been employed through the WFOE model. The Proposed Monitor understands that the WFOE model is preferable for several reasons including:

- (a) WFOEs can conduct business on shore in the PRC and as such, they do not need to use the AI model. They can (and do) transact directly with customers;
- (b) Financial information as to the WFOE holdings on Sino-Forest’s books and records is more readily verifiable and therefore more transparent in nature;
- (c) WFOEs can acquire land use rights through pre-paid long term leases. The ability of WFOEs to invest in land use rights is advantageous because (i) for the most part, it appears that these rights can be registered and are therefore more easily verifiable; (ii) the WFOE can finance its business against its land rights; and (iii) it is viewed favourably by the PRC because it is evidence of Sino-Forest’s long term intentions within the forestry industry in the PRC; and
- (d) WFOEs are preferable from a foreign investor perspective because there is an identifiable process for the repatriation of funds off-shore to the foreign investor parent.

28. As of December 31, 2010, approximately 40% of Sino-Forest’s reported timber

holdings were held through the WFOE structure.

*On-shoring*

29. As part of its long term strategy, the Company has been considering options to transition its BVI assets into WFOE assets. This process is referred to as “on-shoring”. The Proposed Monitor understands there is no single standard protocol for on-shoring Sino-Forest’s assets and that Sino-Forest is looking into various alternative methods of migrating the ownership of the BVI assets. At its root, on-shoring requires the creation of a new WFOE that is capitalized to receive timber rights from the BVIs and at the same time, acquire the accompanying underlying land use rights. The Proposed Monitor understands that the precise methods for successfully on-shoring varies on a county to county basis and requires extensive negotiations with various stakeholders including potentially the land owners and tax authorities. It could also involve the cooperation of suppliers and AIs.
30. The Proposed Monitor understands there are no assurances that on-shoring will be successful on a large scale basis and that, even if the Company is successful in on-shoring certain of its assets, that does not necessarily mean it will be successful in other regions. However, the Company has indicated that it believes there are incentives for parties to cooperate with an on-shoring process as it generally involves the promotion of business in more rural areas, the ongoing employment of individuals in those regions and cash injections to the land owners on the pre-paid leases.

**The Role of the PRC Government**

31. Based on the conversations that the Proposed Monitor has had with members of senior management of the Company and various of its advisors, the Proposed Monitor understands that the PRC government has and will continue to play a key role in any successful restructuring.
32. The forestry industry in the PRC is subject to The Forestry Law which provides for a limited system pursuant to which verification as to legal ownership of timber

or land may be obtained. The Monitor has also been advised that it is not clear that the Forestry Law has been fully implemented on a nation-wide basis such that, in some instances, no verification from regional forestry bureaus may be available.

33. The Company has advised that the PRC has taken numerous steps in the last years to promote the timber plantation industry including opportunities for foreign investment. It is also apparent that navigating timber operations within the PRC has obvious political and state related implications due to the role of the Chinese government in business operations in China generally, the geographic location of many of the plantations, the reliance upon provincial and other registries for asset verification, and the uncertainty surrounding certain taxation and other laws in the PRC that could have significant implications on Sino-Forest's business structure and/or ability to expand.
34. Further, it is clear that in many instances, there is an emphasis put on "business relationships" among parties that is paramount to any contractual or legal relationship that may have been entered into by the parties. These relationships are relied upon for the conduct of business in this industry in the PRC. In the course of its investigation, the IC reported that it was apparent that integral to Sino-Forest's business model was its relationships with business partners.
35. The Company has advised the Proposed Monitor that it believes that the PRC has been and will continue to be supportive of Sino-Forest as an ongoing business. Sino-Forest is the largest private forestry operator in the PRC and it has complied with and promoted PRC policy in terms of growth and efficiency in the natural resource sector over its 18 years of business. All of these factors have resulted in Sino-Forest having a positive and encouraging relationship with the PRC government. Consequently, the PRC government has, by and large, been facilitative of Sino-Forest's business. Ongoing support will be required if this restructuring process is to be successful. Maintaining relations with the PRC government both nationally and locally will also be crucial to Sino-Forest's on-shoring strategy.

36. Through extensive discussions that the Proposed Monitor has had with the Company and various advisors to the Company, it has become apparent that much of Sino-Forest's historical success has been due to the leadership of Allen Chan. Although Mr. Chan resigned as CEO and chairman after the issuance of the MW Report, Mr. Chan has remained involved in Sino-Forest and, in particular, plays a key role in maintaining and building on existing PRC relations. The Martin Affidavit also contains further detail as to the importance of Mr. Chan in any restructuring.
37. It is equally clear to the Proposed Monitor that the PRC government has the ability to be a significant impediment to solutions that it does not view as favourable or in furtherance of PRC policy. The Company and Houlihan have both expressed the view that if attempts were made to break up the company, that could be viewed as being contrary to the general direction of, and have a significant impact on, the PRC's natural resource growth policies and would likely be viewed negatively by the PRC government. Further, the PRC government is cognizant of the location of many of the Sino-Forest plantations and their proximity to state run facilities and has expressed concern to the Company as to how these issues will be addressed going forward if ownership is to change hands.

### **The Company's Options**

38. The Proposed Monitor is aware that the Company, in consultation with its various advisors, has considered many alternatives to solve both the Company's current problems as well as to provide longer term solutions to the issues inherent in the BVI structure. For various reasons, the options of maintaining the status quo or attempting to liquidate the assets (i.e. timber) are not feasible options notwithstanding the guarantees and pledges that may have given the noteholders certain rights to do so. Some of the issues that would prohibit status quo or liquidation are as follows:
- (a) Status quo – as set out above and in the Martin Affidavit, the MW Report

and subsequent events have left the Sino-Forest business paralyzed and unable to continue. Sources of outside funding for expansion have dried up, sales have been halted while the business continues to burn money necessary to its operations. Further, the Company has advised that based on meetings between members of senior management and the PRC, the PRC is not content to allow Sino-Forest's current situation to continue indefinitely and has insisted that a path forward for Sino-Forest be proposed;

(b) Liquidation – It is not clear to the Proposed Monitor that a liquidation could even be achieved in this circumstance. However, even if it could be, liquidating the timber assets within the PRC is unlikely to achieve any desired result. As set out above, given the historical structural issues inherent within the BVI structure, it is doubtful that any proceeds of a liquidation could be moved off shore successfully.

39. The Proposed Monitor is aware that the Company and its advisors have engaged in extensive conversations and negotiations with an ad hoc committee of noteholders (the “**Ad Hoc Noteholders**”) for the past several months as to the various options available to Sino-Forest as well as the noteholders.
40. The Proposed Monitor understands that these extensive arm's length negotiations involved email, telephonic and in-person meetings between the various parties and have included, at different times, the Company's senior management (including Mr. Martin, the Company's chief financial officer, Mr. David Horsley and Mr. Chan), Houlihan, the Company's legal advisors, certain of the Ad Hoc Noteholders themselves and their legal and financial advisors. During the course of these meetings, the parties have explored the options available to both the Company and the noteholders including the liquidation option.

#### **THE SUPPORT AGREEMENT AND PROPOSED RESTRUCTURING**

41. Following extensive arm's length negotiations, the Company and the Ad Hoc

Noteholders have reached agreement on the terms of a support agreement (the “**Support Agreement**”). The Proposed Support Agreement has been executed by holders of the Notes holding approximately 40% of the Notes. The Support Agreement contemplates (and provides incentive for) additional noteholders becoming party to the Support Agreement by way of Joinder Agreement. As set out below, it is contemplated that the Proposed Monitor will post a copy of the Support Agreement on its website. The material terms of the Support Agreement are set out in the Martin Affidavit.

42. The Proposed Monitor has reviewed the terms of the Support Agreement. The Proposed Monitor believes that the terms of the Support Agreement are reasonable in the circumstances. In reaching that conclusion, the Proposed Monitor first considered the fact that Sino-Forest’s situation is not that of a typical debtor. The Company’s options in terms of realizing value on its assets are limited given not only the legal impediments, but also the nature and location of the physical assets. Further, other considerations included the following:
- (a) Neither maintaining the status quo nor liquidation are realistic options;
  - (b) The debt outstanding under the Indentures constitutes an overwhelming majority of the Company’s overall debt;
  - (c) The Support Agreement proposes a solution through the use of a CCAA plan that provides for, among other things:
    - (i) a structured solution pursuant to which the business operations will be liberated from the existing legal challenges facing the Company (namely the extensive litigation and contingent claims) and put into a new structure which will ultimately be able to work to fix the structural issues in Sino-Forest’s business;
    - (ii) participation rights for certain junior constituents whose claims rank behind the noteholders;

- (iii) a framework for the litigation and/or resolution of the claims faced by the Company;
- (d) As discussed below, there are significant challenges to finding another buyer of the business;
- (e) Notwithstanding those challenges, the Support Agreement contemplates a Sale Process (defined and discussed below) to determine whether a higher or better option is available; and
- (f) As discussed above, neither maintaining the status quo nor liquidation are desirable or possibly viable options.

## **THE PROPOSED SALE PROCESS**

### **Sale Process Terms**

- 43. As contemplated under the Support Agreement, the Company is also seeking approval of certain sale process procedures (the “**Sale Process**”) and related relief. If approved, the Company, in consultation with the Proposed Monitor and Houlihan, will immediately commence a marketing process for the Sino-Forest business.
- 44. The material terms of the Sale Process are set out in the Martin Affidavit. The Proposed Monitor has been consulted in the development of the proposed Sale Process terms and believes they are reasonable in the circumstances.
- 45. The Company, the Proposed Monitor, Houlihan, and advisors to the Ad Hoc Noteholders have had extensive discussions as to the appropriate time frame in which the business may be marketed. The Proposed Monitor believes that it is appropriate for the Company to seek approval of the Sale Process as part of its initial application based on the following factors:
  - (a) As set out above, the growth of the forestry business and the trading business has effectively come to a halt and are rapidly burning cash;

- (b) The Sino-Forest business is extremely complicated – for any buyer, there will be significant legal, tax, regulatory, political and cultural considerations that will need to be addressed;
  - (c) Given the extensive negative publicity that has surrounded the business, buyers will likely require extensive due diligence and that may include not just document review, but meetings in HK as well as the PRC, site visits and other time intensive exercises;
  - (d) Timber is a seasonal business with the majority of sales taking place in Q3 and Q4 of each year – if a transaction is not completed before the end of Q3 of this year, that will effectively result in a further year with few or no sales; and
  - (e) The Company needs to be able to demonstrate to the PRC government, in the near future, that it has a clear path forward, absent which it risks losing its support.
46. The proposed Sale Process is intended to be a market test of the terms of the proposed restructuring set out in the Support Agreement. However, given the size of the business and the issues surrounding the business, both Houlihan and the Company have indicated that there is likely to be a limited landscape of potential buyers. The Proposed Monitor agrees that this may be the case but nonetheless believes that it is important as part of the CCAA Proceedings that the Sale Process be commenced to determine what other interest may exist.
47. Given the urgency described above, the Proposed Monitor is aware that Houlihan has already commenced certain efforts in respect of the proposed Sale Process. Given the circumstances of this situation, the Proposed Monitor is of the view that such actions by Houlihan have been prudent.

#### **Retention of Houlihan**

48. In anticipation of a potential filing and Sale Process, the Company retained

Houlihan pursuant to the terms of the Financial Advisor Agreement. The terms of the Financial Advisor Agreement, including the proposed fee structure, are set out in the Martin Affidavit. The Proposed Monitor is aware that the Company considered at least three (3) other candidates, all of whom are well-known international investment banks, prior to retaining Houlihan.

49. The Proposed Monitor understands that the Board's decision to retain Houlihan was based on Houlihan's experience in debt restructurings including working with noteholders as well as its extensive presence in North American and Asian markets.
50. The Proposed Monitor has reviewed the terms of the Financial Advisor Agreement. The Proposed Monitor believes that, in the circumstances, it is reasonable for the Company to have retained Houlihan and negotiated the terms contained in the Financial Advisor Agreement. Accordingly, the Proposed Monitor recommends the approval of the Financial Advisor Agreement.

## **THE COMPANY'S CASH FLOW FORECAST**

### **Cash Flow Projections**

51. The Company, with the assistance of the Proposed Monitor, has prepared consolidated 13-week cash flow projections of its receipts and disbursements (the "**March 29 Forecast**"). The March 29 Forecast, together with the management's report on the cash-flow statement as required by section 10(2)(b) of the CCAA, is attached hereto as Appendix A. The March 29 Forecast shows a negative net cash flow of approximately \$19.3 million in the period March 31 to June 29, 2012, and is summarized below:

	<b>\$000 CAD</b>
Cash inflow	
Interest Income	\$ 412
<b>Total cash inflows</b>	<b>\$ 412</b>
Cash outflow	
Payroll and Benefits	\$ 181
Board & Committee Fees	\$ 253
Travel	\$ 315
Rent, Communication & Utilities	\$ 60
Taxes & Other	\$ 195
<b>Total cash outflows</b>	<b>\$ 1,004</b>
<b>Net Operating Cashflow</b>	<b>\$ (591)</b>
<b>Restructuring Costs</b>	
Professional Fees	\$ 18,730
<b>Total Restructuring Costs</b>	<b>\$ 18,730</b>
<b>Net Cash Flow</b>	<b>\$ (19,321)</b>
Opening Cash Balance	\$ 67,846
Net Cash Balance	\$ (19,321)
Ending Cash Balance	\$ 48,525

52. It is anticipated that the Company’s projected liquidity requirements throughout the CCAA Proceedings will be met by existing cash available to the Company.

**Proposed Monitor’s Report on the Reasonableness of the Cash Flow Projections**

53. Section 23(1)(b) of the CCAA states that the Proposed Monitor shall:

“review the company’s cash-flow statement as to its reasonableness and file a report with the court on the Proposed Monitor’s findings;”

54. Pursuant to section 23(1)(b) of the CCAA and in accordance with the Canadian Association of Insolvency and Restructuring Professionals Standard of Practice 09-1 (“CAIRP SOP 09-1”), the Proposed Monitor hereby reports as follows:

- (a) The March 29 Forecast has been prepared by the management of the



Applicant for the purpose described in Note 1, using the Probable and Hypothetical Assumptions set out in Notes 2 to 6;

- (b) The Proposed Monitor's review consisted of inquiries, analytical procedures and discussion related to information supplied by certain of the management and employees of the Company. Since Hypothetical Assumptions need not be supported, the Proposed Monitor's procedures with respect to them were limited to evaluating whether they were consistent with the purpose of the March 29 Forecast. The Proposed Monitor has also reviewed the support provided by management of the Company for the Probable Assumptions, and the preparation and presentation of the Cash-Flow Statement;
- (c) Based on its review, nothing has come to the attention of the Proposed Monitor that causes it to believe that, in all material respects:
  - (i) the Hypothetical Assumptions are not consistent with the purpose of the March 29 Forecast;
  - (ii) as at the date of this report, the Probable Assumptions developed by management are not suitably supported and consistent with the plans of the Company or do not provide a reasonable basis for the March 29 Forecast, given the Hypothetical Assumptions; or
  - (iii) the March 29 Forecast does not reflect the Probable and Hypothetical Assumptions;
- (d) Since the March 29 Forecast is based on assumptions regarding future events, actual results will vary from the information presented even if the Hypothetical Assumptions occur, and the variations may be material. Accordingly, the Proposed Monitor expresses no assurance as to whether the March 29 Forecast will be achieved. The Proposed Monitor expresses no opinion or other form of assurance with respect to the accuracy of any financial information presented in this report, or relied upon by the

Proposed Monitor in preparing this report; and

- (e) The March 29 Forecast has been prepared solely for the purpose described in Note 1 on the face of the March 29 Forecast and readers are cautioned that it may not be appropriate for other purposes.

## **RELIEF SOUGHT**

### **The Stay of Proceedings**

- 55. For the reasons set out herein, the Company requires a stay of proceedings while it carries out its proposed restructuring activities. The Monitor believes that the initial 30-day request is fair and reasonable in the circumstances.

### **Payments During the CCAA Proceedings**

- 56. The Company intends to make certain ordinary course payments during the course of the CCAA Proceedings in accordance with and as set out in the March 29 Forecast. The Monitor believes this course of action is fair and reasonable in the circumstances.

### **Administration Charge**

- 57. The Company is seeking an Administration Charge in the amount of CAD\$15 million with priority over all encumbrances against the Company's assets other than the Company's assets which are subject to *Personal Property Security Act* registrations (the "**Encumbered Property**"). Based on personal property registry searches that were conducted by the Proposed Monitor's counsel as of March 28, 2012, other than the Indenture Trustees under the Notes who have security in respect of the pledged shares of the Company's subsidiaries there was only one registration that appeared on its face to be with respect to specific equipment.
- 58. The beneficiaries of the Administration Charge if granted would be the Proposed Monitor, the Proposed Monitor's counsel, counsel to the Board, FTI HK, counsel to the Company, Houlihan, counsel to the Ad Hoc Noteholders and the financial

advisor to the Ad Hoc Noteholders.

59. The Proposed Monitor has reviewed the underlying assumptions upon which the Company has based the quantum of the proposed Administration Charge, the complexities of the CCAA Proceedings and the services to be provided by the beneficiaries of the Administration Charge and believes that the limit of CAD\$15 million is reasonable in the circumstances.
60. The Proposed Monitor also believes that it is appropriate that the other proposed beneficiaries of the Administration Charge be afforded the benefit of a charge as they will be undertaking a necessary and integral role in the CCAA Proceedings.

#### **The Directors' Charge**

61. The Company is seeking the Directors' Charge in the amount of CAD\$3.2 million with priority over all encumbrances on the Company's assets other than the Administration Charge and the Encumbered Property. The Proposed Monitor understands that the Board has insisted on the protection of the Directors' Charge in order to remain on the Board during the course of the CCAA Proceedings. The Martin Affidavit also sets out a summary of the current insurance policies that are available to the Board as well as the exclusions and possibility of non-renewal at the end of the term.

#### **The Financial Advisor Agreement**

62. Houlihan's engagement is reasonable given the Company's proposed Sale Process. As set out above, Houlihan was considered along with other international investment banks and selected on merit-based criteria.

#### **Publication of Notices Support Agreement**

63. The proposed initial order contemplates that the Monitor will, among other things,
  - (a) Without delay, post a copy of the Support Agreement on its website at <http://cfcanada.fticonsulting.com/sfc>; and

- (b) Publish a notice in the Globe and Mail and the Wall Street Journal (in form and substance satisfactory to the Company, the Monitor and counsel to the Ad Hoc Noteholders) notifying noteholders of the Support Agreement and the deadline of 5:00pm (Toronto time) on the Consent Date (as defined in the Support Agreement) by which any noteholders (other than an Initial Consenting Noteholder) who wishes to become entitled to the Early Consent Consideration pursuant to the Support Agreement must execute and return a Joinder Agreement.

### **The Sale Process**

- 64. As set out above, the proposed Sale Process is contemplated by the Support Agreement and is intended to test the market to determine whether a higher or better offer than the transaction contemplated under the Support Agreement is available. Further, given the circumstances and complexities of the situation as set out above, the Proposed Monitor recommends approval of the Sale Process Order on the date of this application.

### **CONCLUSION**

- 65. The Proposed Monitor is of the view that the relief requested by the Company is necessary, reasonable and justified. The Proposed Monitor is also of the view that granting the relief requested will provide the Company the best opportunity to undertake the CCAA Proceedings, to preserve value and maximize recoveries for the Company's stakeholders. As set out above, absent a restructuring, the Monitor is of the view that the business has little chance of viability. Further, given the circumstances, liquidation would likely destroy any stakeholder value.
- 66. Accordingly, the Proposed Monitor respectfully recommends that the Company's request for the Initial Order and the Sale Process Order.

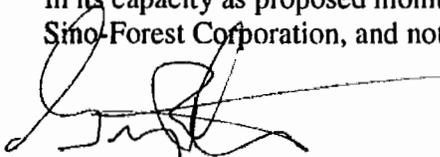
The Proposed Monitor respectfully submits to the Court this Pre-Filing Report.

Dated this 30<sup>th</sup> day of March, 2012.

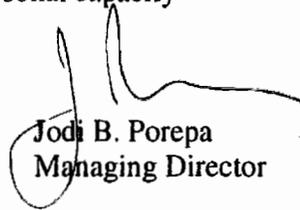
FTI Consulting Canada Inc.

In its capacity as proposed monitor of

Sino-Forest Corporation, and not in its personal capacity



Greg Watson  
Senior Managing Director



Jodi B. Porepa  
Managing Director

**APPENDIX A**

**Attached.**

Court File No. \_\_\_\_\_

**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

(the "Applicants")

**REPORT ON CASH FLOW STATEMENT  
(paragraph 10.2(b) of the CCAA)**

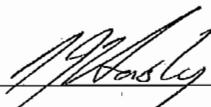
The management of Sino-Forest ("SFC" or the "Company") has developed the assumptions and prepared the attached statement of projected cash flow of SFC as of the 29th day of March 2012, consisting of a 13 week cash flow for the period March 31, 2012 to June 29, 2012 (the "March 29 Cash Flow").

The hypothetical assumptions are reasonable and consistent with the purpose of the projections as described in Note 1 to the cash flow, and the probable assumptions are suitably supported and consistent with the plans of SFC and provide a reasonable basis for the March 29 Cash Flow. All such assumptions are disclosed in Notes 2 to 6.

Since the March 29 Cash Flow is based on future events, actual results will vary from the information presented and the variations may be material.

The March 29 Cash Flow has been prepared solely for the purpose outlined in Note 1, using the probably and hypothetical assumptions set out in Notes 2 to 6. Consequently readers are cautioned that the March 29 Cash Flow may not be suitable for other purposes.

Dated at Hong Kong this 30<sup>th</sup> day of March 2012.

  
\_\_\_\_\_  
David Hotsley  
Senior Vice President & Chief Financial Officer  
Sino-Forest Corporation

Sino-Forest Corporation  
13 Week Cash Flow Forecast  
(CAD \$000)

Week Ending	Week 1	Week 2	Week 3	Week 4	Week 5	Week 6	Week 7	Week 8	Week 9	Week 10	Week 11	Week 12	Week 13	Total
6-Apr	13-Apr	20-Apr	27-Apr	4-May	11-May	18-May	25-May	1-Jun	8-Jun	15-Jun	22-Jun	29-Jun	13 Week Total	
Cash inflow	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	412
Interest Income	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	412
<b>Total cash inflow</b>	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	<b>412</b>
Cash outflow	\$ -	\$ 30	\$ -	\$ -	\$ 30	\$ -	\$ 30	\$ -	\$ 30	\$ -	\$ 30	\$ -	\$ 30	181
Payroll and Benefits	\$ 71	\$ -	\$ -	\$ -	\$ 91	\$ -	\$ -	\$ -	\$ 91	\$ -	\$ -	\$ -	\$ -	253
Board & Committee Fees	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ 26	\$ -	315
Travel	\$ 1	\$ 16	\$ 1	\$ 1	\$ 1	\$ 1	\$ 16	\$ 1	\$ 1	\$ 1	\$ 16	\$ 1	\$ -	60
Rent, Communication & Utilities	\$ 33	\$ 10	\$ 13	\$ 14	\$ 29	\$ 9	\$ 13	\$ 29	\$ 13	\$ 9	\$ 13	\$ 9	\$ -	195
Taxes & Other	\$ 131	\$ 83	\$ 40	\$ 41	\$ 178	\$ 37	\$ 86	\$ 56	\$ 162	\$ 37	\$ 86	\$ 37	\$ 30	1,004
<b>Total cash outflow</b>	\$ (131)	\$ (83)	\$ (40)	\$ (41)	\$ (178)	\$ (37)	\$ (86)	\$ (56)	\$ (162)	\$ (37)	\$ (86)	\$ (37)	\$ 382	(591)
<b>Net Operating Cashflow</b>	\$ 1,910	\$ 1,101	\$ 929	\$ 2,859	\$ 929	\$ 929	\$ 945	\$ 2,875	\$ 945	\$ 945	\$ 945	\$ 945	\$ 2,475	18,730
<b>Restructuring Costs</b>	\$ 1,910	\$ 1,101	\$ 929	\$ 2,859	\$ 929	\$ 929	\$ 945	\$ 2,875	\$ 945	\$ 945	\$ 945	\$ 945	\$ 2,475	18,730
Professional Fees	\$ (2,041)	\$ (1,183)	\$ (969)	\$ (2,900)	\$ (1,107)	\$ (965)	\$ (1,031)	\$ (2,931)	\$ (1,107)	\$ (982)	\$ (1,031)	\$ (982)	\$ (2,093)	(19,321)
<b>Net Cash Flow</b>	\$ 67,846	\$ 65,804	\$ 64,621	\$ 63,653	\$ 60,753	\$ 59,646	\$ 58,681	\$ 57,650	\$ 54,719	\$ 53,612	\$ 52,630	\$ 51,599	\$ 50,617	67,846
Opening Cash Balance	\$ (2,041)	\$ (1,183)	\$ (969)	\$ (2,900)	\$ (1,107)	\$ (965)	\$ (1,031)	\$ (2,931)	\$ (1,107)	\$ (982)	\$ (1,031)	\$ (982)	\$ (2,093)	(19,321)
Net Cash Balance	\$ 65,804	\$ 64,621	\$ 63,653	\$ 60,753	\$ 59,646	\$ 58,681	\$ 57,650	\$ 54,719	\$ 53,612	\$ 52,630	\$ 51,599	\$ 50,617	\$ 48,525	48,525
Ending Cash Balance														

Notes

- 1 The purpose of this Cash Flow Forecast is to determine the liquidity requirements for Sino-Forest Corporation during the CCAA Proceedings.
- 2 Receipts have been forecast based on historical payment patterns.
- 3 Payroll costs and other operating expenses are forecast based on historical analysis and management forecast.
- 4 Board and Committee Fees are based on board resolutions passed to date.
- 5 Travel costs have been forecast based on expected travel costs to be incurred throughout the CCAA proceedings between Canada and Hong Kong.
- 6 Estimated restructuring costs are based on projected costs associated with legal and professional fees relating to the CCAA Proceedings.

**Court File No.:**

**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**

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
(Commercial List)**

**(PROCEEDING COMMENCED AT TORONTO)**

**PRE-FILING REPORT OF THE PROPOSED  
MONITOR, FTI CONSULTING CANADA INC.**

**GOWLING LAFLEUR HENDERSON LLP**

Barristers and Solicitors  
1 First Canadian Place  
100 King Street West, Suite 1600  
Toronto ON M5X 1G5

**Derrick Tay (LSUC No. 21152A)**

Tel: (416) 369-7330 / Fax: (416) 862-7661  
Email: [derrick.tay@gowlings.com](mailto:derrick.tay@gowlings.com)

**Jennifer Stam (LSUC No 46735J)**

Tel: (416) 862-5697 / Fax: (416) 862-7661  
Email: [jennifer.stam@gowlings.com](mailto:jennifer.stam@gowlings.com)

Lawyers for the Proposed Monitor,  
FTI Consulting Canada Inc.

**APPENDIX B - INITIAL ORDER AFFIDAVIT**

*(See Attached)*

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

**AFFIDAVIT OF W. JUDSON MARTIN**  
**(Sworn March 30, 2012)**

I, W. Judson Martin, of the City of Hong Kong, Special Administrative Region, People's Republic of China, **MAKE OATH AND SAY:**

1. I am the Vice-Chairman and Chief Executive Officer of Sino-Forest Corporation ("SFC"). I therefore have personal knowledge of the matters set out below, except where otherwise stated. Where I do not possess personal knowledge, I have stated the source of my information and I believe such information to be true.

2. This affidavit is sworn in support of an application by SFC for an initial order (the "Initial Order") pursuant to the *Companies' Creditors Arrangement Act* (the "CCAA"), a sale process order (the "Sale Process Order") and other requested relief. In preparing this affidavit, I have consulted with other members of SFC's senior management team and, where necessary, members of the senior management teams of certain of SFC's subsidiaries.

3. All references to dollar amounts contained in this affidavit are to United States Dollars unless otherwise stated.

#### **I. OVERVIEW**

4. SFC is a Canadian corporation and is the direct or indirect parent of approximately 140 subsidiaries, the majority of which are incorporated in the People's Republic of China (the "PRC"). The terms "Sino-Forest Companies" and "Sino-Forest" refer to the global enterprise as a whole (but, for greater certainty, do not include the Greenheart Group, defined below).

5. Sino-Forest is a major integrated forest plantation operator and forest products company. Its principal businesses include the ownership and management of plantation forests, the sale of standing timber and wood logs, and the complementary manufacturing of downstream engineered-wood products. The majority of Sino-Forest's plantations are located in the southern and eastern regions of the PRC, primarily in inland regions suitable for large-scale replanting.

6. Sino-Forest's business operations are mainly in the PRC with corporate offices in Hong Kong and Ontario, Canada.

7. On June 2, 2011, Muddy Waters, LLC ("Muddy Waters"), which held a short position on SFC's shares, published a report (the "MW Report") alleging that Sino-Forest, among other things, was a "near total fraud" and a "Ponzi scheme." SFC's board of directors (the "Board") appointed an independent committee (the "IC") to investigate the Muddy Waters allegations.

8. While the IC has been able to address certain of the allegations made by Muddy Waters, the MW Report has had a ripple effect in causing substantial damage to SFC, its business, and future prospects for viability. As part of the fallout from the MW Report, (i) SFC now finds

itself embroiled in multiple class action proceedings across Canada and in the U.S., (ii) SFC is the subject of Ontario Securities Commission ("OSC"), Hong Kong Securities and Futures Commission ("HKSFC"), and Royal Canadian Mounted Police ("RCMP") investigations, and (iii) SFC's Audit Committee recommended, and the Board agreed, that SFC should defer the release of SFC's third quarter 2011 financial statements (the "Q3 Results") until certain issues could be resolved to the satisfaction of the Board and SFC's external auditor

9. Significantly, SFC's inability to file its Q3 Results resulted in a default under its note indentures, which could have resulted in the acceleration and enforcement of approximately \$1.8 billion in notes issued by SFC and guaranteed by many of its subsidiaries.

10. Following extensive discussions with an ad hoc committee of noteholders (the "Ad Hoc Noteholders"), holders of a majority in principal amount of SFC's senior notes agreed to waive the default arising from SFC's failure to release the Q3 Results on a timely basis, on certain terms and conditions that were set forth in waiver agreements between certain of the noteholders and SFC, which were made publicly available on January 12, 2012 and are attached as Exhibit "A".

11. While the waiver agreements prevented the indenture trustees under the relevant note indentures from accelerating and enforcing the note indebtedness as a result of SFC's failure to file its Q3 Results, those waiver agreements will expire on the earlier of April 30, 2012 and any earlier termination of the waiver agreements in accordance with their terms. In addition, SFC's pending failure to file its audited financial statements for its fiscal year ended December 31, 2011 (the "2011 Results") by March 30, 2012 will again put the indenture trustees in a position

to accelerate and enforce the bond indebtedness, creating additional uncertainty around Sino-Forest's business.

12. SFC has made considerable efforts to address issues identified by SFC's Audit Committee and the IC and by its external auditor, Ernst & Young LLP, as requiring resolution in order for SFC to be in a position to obtain an audit opinion in relation to its 2011 financial statements.

13. However, notwithstanding SFC's best efforts, many of these issues cannot be resolved to the satisfaction of SFC's auditor or cannot be resolved within a timeframe that would protect and preserve the value of the business, and that would allow SFC to comply with its obligations under its note indentures. Therefore, absent a resolution with the noteholders, the indenture trustees would be in a position to enforce their legal rights as early as April 30, 2012.

14. Following extensive arm's length negotiations between SFC and the Ad Hoc Noteholders, the parties agreed on the framework for a consensual resolution of SFC's defaults and the restructuring of its business, and entered into a support agreement (the "Support Agreement") on March 30, 2012, which was executed by holders of SFC's notes holding approximately 40% of the notes. The Support Agreement contemplates, and in fact provides an incentive for, additional noteholders becoming party to the Support Agreement by way of joinder agreements. Accordingly, I fully expect that noteholders holding more than 50% of each series of notes will ultimately sign up to the Support Agreement.

15. The Support Agreement provides that SFC will pursue a plan of arrangement or compromise (the "Plan") on the terms set out in the Support Agreement in order to implement the agreed-upon restructuring transaction as part of this CCAA proceeding which would, among other things, (i) see SFC's business operations conveyed to, and revitalized under, a new entity to

be owned primarily by the noteholders ("SF Newco"), (ii) provide stakeholders of SFC with claims ranking behind the noteholders (the "Junior Constituents") with certain participation rights in SF Newco, and (iii) create (and provide funding for) a framework for the prosecution of certain litigation claims for the benefit of certain of SFC's stakeholders. The agreement also provides that each noteholder that is a signatory thereto (the "Consenting Noteholders") will vote its notes in favour of the Plan at any meeting of creditors.

16. The Support Agreement further provides that SFC will undertake a sale process (the "Sale Process") in accordance with the sale process procedures (the "Sale Process Procedures") which have been developed in consultation with the proposed monitor, and have been accepted by the parties to the Support Agreement.

17. The Sale Process is intended to provide a "market test" by which third parties may propose to acquire Sino-Forest's business operations through a CCAA Plan (in a manner that would under certain scenarios potentially allow Junior Constituents to share in the proceeds of a sale even though the noteholders may not be paid in full) as an alternative to the SF Newco restructuring transaction between SFC and its noteholders, described above.

18. A redacted copy of the Support Agreement (redacted to preserve confidentiality of the parties only) is attached as Exhibit "B" and will be posted on SEDAR and the proposed monitor's website at <http://cfcanada.fticonsulting.com/sfc>.

19. As described in greater detail below, SFC's business operations are primarily in the PRC and are held by SFC through intermediate holding companies incorporated (for the most part) in either the British Virgin Islands ("BVI") or Hong Kong. Most of these intermediate holding companies are guarantors of SFC's note indebtedness.

20. As further described below, as a result of the uncertainty created by the MW Report, Sino-Forest's business has been severely curtailed, and Sino-Forest's ability to grow its business has been severely reduced. Therefore, SFC now needs to be restructured in order to continue the development of the business and unlock the value of its asset base for the benefit of its stakeholders. Further, although the PRC government has been generally cooperative and encouraging of Sino-Forest to date, it has expressed increasing concern as to the future of Sino-Forest in the PRC. As discussed below, the ongoing support and relationship with the PRC government (on all levels) is crucial to Sino-Forest's operations.

21. Among other things, the Sino-Forest Companies are (i) having a difficult time maintaining existing and obtaining new credit in the PRC to help fund the PRC-based business operation and in Hong Kong for the imported log trading business, (ii) making very few purchases of new timber (and therefore not expanding their asset base), (iii) finding it difficult to collect their accounts receivables, and (iv) receiving increasing demands on their accounts payable. I believe that, if Sino-Forest's business is to be saved in a manner beneficial to SFC's stakeholders, it is imperative that SFC take steps to demonstrate that Sino-Forest's business is being separated from the uncertainty created by the MW Report.

22. Accordingly, and for the reasons set out herein, the commencement of a restructuring and the Sale Process is urgently required and should be pursued to preserve SFC's business as a going concern and thus the inherent value of the enterprise.

23. This application has been authorized by the Board.

## II. PERSONAL BACKGROUND

24. I began my career with PricewaterhouseCoopers in 1979. In 1982 I joined Trizec Corporation Ltd. ("Trizec"), a Toronto Stock Exchange ("TSX") listed commercial real estate company then controlled by the Brascan Group. During my 13 years with the group of companies controlled by the Brascan Group, I held several senior positions, including Vice President, Finance and Treasurer of Trizec, Executive Vice President and Chief Financial Officer of Brookfield Development Corporation, and President and CEO of Trilon Securities Corporation.

25. After leaving the Brascan Group, I joined MDC Corporation, where my positions included Senior Executive Vice President, Chief Financial Officer and Chief Operating Officer, and a member of the company's board of directors.

26. In 1999, I was appointed Senior Executive Vice President and Chief Financial Officer of Alliance Atlantis Communications Inc. ("Alliance Atlantis"), then Canada's leading entertainment and broadcasting company that was then listed on the TSX and on the NASDAQ. I ceased to be an executive and employee of Alliance Atlantis in 2005 due to health reasons and thereafter acted as a consultant to Alliance Atlantis until 2007.

27. I have been a director of SFC since 2006. I joined the Board in 2006 as an independent, external director. I was appointed Lead Director in 2007, a position I held until June 2010, when I became an employee of SFC responsible for its acquisition of Greenheart Group Limited (Bermuda) ("Greenheart") and its subsidiaries (collectively, the "Greenheart Group"). At that time I became Executive Vice-Chairman of SFC and, following SFC's acquisition of a majority interest in Greenheart in August 2010, I became the CEO and an Executive Director of

Greenheart and in 2011 was appointed Chairman of Greenheart. On August 26, 2011, I was appointed as CEO of SFC. I have lived and worked out of Hong Kong since becoming an employee of SFC in 2010.

### **III. SINO-FOREST CORPORATION**

#### **A. Overview**

28. SFC was formed under the *Business Corporations Act* (Ontario) upon the amalgamation of Mt. Kearsage Minerals Inc. and 1028412 Ontario Inc. pursuant to articles of amalgamation dated March 14, 1994. The articles of amalgamation were amended by articles of amendment filed on July 20, 1995 and May 20, 1999 to effect certain changes in the provisions attaching to SFC's class A subordinate-voting shares and SFC's class B multiple-voting shares.

29. On June 25, 2002, SFC filed articles of continuance to continue under the *Canada Business Corporations Act* (the "CBCA"). On June 22, 2004, SFC filed articles of amendment whereby its class A subordinate-voting shares were reclassified as common shares and its class B multiple-voting shares were eliminated. A copy of the articles of continuance referred to above is attached as Exhibit "C".

30. Subject to paragraph 31 below, copies of all SFC financial statements prepared during the year preceding the application for the Initial Order are attached as Exhibit "D". In considering these financial statements, the Court should be aware that SFC cautioned in a January 10, 2012 press release, a copy of which is attached as Exhibit "E", that its historic financial statements (upon which portions of this affidavit are based) and related audit reports should not be relied upon. The circumstances giving rise to the press release are discussed below.

31. Attached as Exhibit "F" is a copy of the management-prepared unaudited financial statements for the third quarter of 2011. These statements have not been approved by SFC's Audit Committee or the Board and are subject to the limitations described in the January 10, 2012 press release. Moreover, they have not been subject to the same level of internal and external review and analysis as SFC's prior annual audited and quarterly financial statements. These financial unaudited statements have not previously been publicly disclosed.

32. Sino-Forest is a publicly listed major integrated forest plantation operator and forest products company, with assets predominantly in the PRC. Its principal businesses include the sale of standing timber and wood logs, the ownership and management of forest plantation trees, and the complementary manufacturing of downstream engineered-wood products. As at December 31, 2010, Sino-Forest reported approximately 788,700 hectares of forest plantations under management, located primarily in the southern and eastern regions of the PRC.

33. In addition, SFC holds an indirect majority interest in Greenheart, a Hong Kong listed investment holding company, which, together with its subsidiaries, as at March 31, 2011, owned certain rights and managed approximately 312,000 hectares of hardwood forest concessions in the Republic of Suriname ("Suriname") and 11,000 hectares of a radiata pine plantation on 13,000 hectares of freehold land in New Zealand.

34. While Greenheart is an indirect subsidiary of SFC, it has its own distinct operations and financing arrangements and is not party to or a guarantor of the notes issued by SFC. Greenheart Group and SFC operate out of separate office buildings in Hong Kong.

35. Greenheart Group was not implicated in the allegations made against Sino-Forest by Muddy Waters on June 2, 2011, discussed below. As such, the Greenheart Group and matters

relating thereto are not intended to be affected by or included in this proceeding. Greenheart Group has nevertheless been impacted by the allegations made against Sino-Forest. Among other things, Greenheart Group has previously relied on funding from SFC and could be negatively impacted if SFC's business ceases to operate as a going concern. This in turn could negatively impact the value of SFC's investment in Greenheart.

36. Since 1995, SFC has been a publicly listed company on the TSX with its shares traded under the symbol "TRE". SFC's registered office is in Mississauga, Ontario and its principal executive office is in Hong Kong. Two of SFC's senior financial officers reside in Ontario, as do three of its external directors.

37. SFC has issued four series of notes which have a combined principal amount outstanding of approximately \$1.8 billion. Two of the series of notes are supported by guarantees from 64 of SFC's subsidiaries (none of which are incorporated in the PRC), and the other two series of notes are supported by guarantees from 60 of those same subsidiaries and share pledges from 10 of those same subsidiaries.

38. Certain other Sino-Forest Companies have their own distinct banking facilities which are not intended to be affected by or included in this proceeding. In particular, none of the subsidiaries incorporated in the PRC are party to or guarantors of SFC's notes and are not intended to be affected by or included in this proceeding.

#### **B. Corporate Structure**

39. SFC is the sole shareholder of Sino-Panel Holdings Limited (incorporated in the BVI), Sino-Global Holdings Inc. (incorporated in the BVI), Sino-Panel Corporation (incorporated in Canada), Sino-Wood Partners Limited (incorporated in Hong Kong), Sino-Capital Global Inc.

(incorporated in the BVI), and Sino-Forest International (Barbados) Corporation (incorporated in Barbados). SFC also holds all of the preference shares of Sino-Forest Resources Inc. (incorporated in the BVI). Some of these subsidiaries have further direct and indirect subsidiaries. A copy of the Sino-Forest corporate organization chart is attached as Exhibit "G" (which includes certain major subsidiaries of Greenheart).

40. A total of 137 entities make up the Sino-Forest Companies: 67 PRC incorporated entities (with 12 branch companies), 58 BVI incorporated entities, 7 Hong Kong incorporated entities, 2 Canadian entities and 3 entities incorporated in other jurisdictions. A list of all subsidiaries with addresses is attached as Exhibit "H" (which does not include subsidiaries of Greenheart, but does contain Sino-Forest branch companies).

## **C. Capital Structure**

### **1. Equity**

41. The authorized share capital of SFC consists of an unlimited number of common shares and an unlimited number of preference shares issuable in series. Each holder of common shares is entitled to one vote at meetings of shareholders other than meetings of the holders of another class of shares.

42. Each holder of common shares is also entitled to receive dividends if, as and when declared by the Board. Holders of common shares are also entitled to participate in any distribution of net assets upon liquidation, dissolution or winding-up on an equal basis per share. There are no pre-emptive, redemption, retraction, purchase or conversion rights attaching to the common shares.

43. As at June 30, 2011, a total of 246,095,926 common shares were issued and outstanding. No preference shares have been issued.

## **2. Debt**

44. SFC has issued four series of notes which remain outstanding. The four series of notes mature at various times between 2013 and 2017. The note indenture for each series of notes provides that it is governed by New York law. Each note indenture contains a "no suits by holders" clause. Other than the debt outstanding under the notes, SFC does not have any significant levels of normal course payables.

### **(a) 2017 Senior Notes**

45. On October 21, 2010, SFC issued guaranteed senior notes in the principal amount of \$600 million. These notes mature on October 21, 2017, and interest is payable semi-annually, on April 21 and October 21, at a rate of 6.25% per annum. These notes are listed on the Singapore Stock Exchange and are supported by guarantees from 60 subsidiaries of SFC and share pledges from 10 of those same subsidiaries. A copy of the relevant indenture is attached as Exhibit "I".

### **(b) 2016 Convertible Notes**

46. On December 17, 2009, SFC issued convertible guaranteed notes in the principal amount of \$460 million. These notes mature on December 15, 2016, and interest is payable semi-annually, on June 15 and December 15, at a rate of 4.25% per annum. These notes are supported by guarantees from 64 subsidiaries of SFC. A copy of the relevant indenture is attached as Exhibit "J".

**(c) 2014 Senior Notes**

47. On July 27, 2009, SFC issued guaranteed senior notes in the principal amount of \$399,187,000. These notes mature on July 28, 2014, and interest is payable semi-annually, on January 26 and July 26, at a rate of 10.25% per annum. These notes are listed on the Singapore Stock Exchange and are supported by guarantees from 60 subsidiaries of SFC and share pledges from 10 of those same subsidiaries. A copy of the relevant indenture is attached as Exhibit "K".

**(d) 2013 Convertible Notes**

48. On July 23, 2008, SFC issued convertible guaranteed notes in the principal amount of \$345 million. These notes mature on August 1, 2013, and interest is payable semi-annually, on February 1 and August 1, at a rate of 5% per annum. These notes are supported by guarantees from 64 subsidiaries of SFC. A copy of the relevant indenture is attached as Exhibit "L".

49. In addition to the four series of notes issued by SFC, many of SFC's subsidiaries (including the Greenheart Group and many of those incorporated in the PRC) have their own distinct banking facilities, including lending facilities, which are not intended to be affected by this proceeding.

**D. The Business Model****1. Plantation / Timber Rights in the PRC**

50. There are four types of rights associated with plantations in the PRC, namely (i) plantation land ownership, (ii) plantation land use rights, (iii) timber ownership, and (iv) timber use rights. All of these are separate rights and can be separately owned by different parties.

51. Generally, private enterprises cannot own plantation land in the PRC but may hold plantation land use rights for a specified duration (up to 70 years but typically 30 to 50 years), timber ownership and timber use rights. However, foreign enterprises cannot acquire land use rights and can instead only acquire timber ownership or timber use rights.

52. The various rights associated with plantations in the PRC and the limitations on which entities can hold which rights were the driving forces behind Sino-Forest's complex business models discussed below.

53. For its timber business in the PRC, Sino-Forest utilizes two models, one involving BVI entities ("BVIs"), and the other involving subsidiaries incorporated in the PRC as wholly foreign owned enterprises ("WFOEs").

## **2. The BVI Model**

54. Until 2004, due to restrictions on foreign companies carrying on business in the PRC, and foreign ownership restrictions on land ownership and use rights, the BVI structure was the model primarily used by Sino-Forest for its forestry business in the PRC. Sino-Forest has established 58 BVI companies, 55 of which are guarantors of at least certain of SFC's notes. Not all of these BVIs are involved in the BVI model or standing timber business. Of the 58, there are 20 involved in the BVI standing timber business while the remaining BVIs are either holding companies or used in Sino-Forest's log trading business.

55. The Sino-Forest BVI entities involved in the standing timber business acquire standing timber from suppliers. The suppliers are usually aggregators who acquire the standing timber and, typically, land use rights from other suppliers or from original timber owners, such as villagers or collectives, or from smaller aggregators. As non-PRC companies, the BVIs could

not and did not acquire land use rights in the PRC, and instead only acquired the rights to timber in the PRC pursuant to the relevant standing timber purchase contracts.

56. Due to restrictions under PRC laws, foreign companies are not permitted to conduct business in the PRC without business licenses granted by competent governmental authorities. Therefore, the Sino-Forest BVI entities do not sell standing timber directly to customers. Instead, for historical and commercial reasons, they conduct the sale of standing timber through "authorized intermediaries" ("AIs", which are also called "entrusted sales agents" in the BVI model) pursuant to "entrusted sales agreements". The AIs serve as Sino-Forest's customers under the BVI model of its standing timber business.

57. Pursuant to the entrusted sales agreements entered into with the AIs, the AIs are obliged to deduct and remit all of the applicable taxes on behalf of Sino-Forest. Sino-Forest is not, however, in a position to know whether or not the AIs have in fact remitted applicable taxes on behalf of Sino-Forest.

58. As at June 30, 2011, Sino-Forest therefore accumulated and recognized a provision, based on a probability-weighted average of the amounts that the PRC tax authorities might seek to recover under various scenarios, of \$204,722,000 in its reported financial results to account for this potential tax liability. The method used to calculate this provision is explained at note 18 of SFC's 2011 second quarter financial statements, which were previously attached. A similar provision was included in SFC's 2010 Audited Financial Statements and was audited by SFC's external auditors.

59. BVIs are not allowed to have bank accounts in the PRC and money flowing in and out of the PRC is strictly controlled through foreign exchange controls. As a result, the Sino-Forest

BVI entities do not directly pay the suppliers or receive payments from the AIs. Instead, they are instructed to make set-off payments under which, pursuant to the instructions of Sino-Forest, AIs directly or indirectly make payments directly or indirectly to Sino-Forest's suppliers for amounts owed by Sino-Forest BVI entities to those suppliers. As a result, no cash actually flows directly through the BVIs. SFC then receives confirmations from the suppliers confirming that payments have been made.

60. The BVI structure is the central driver of asset value, revenue and income for Sino-Forest. As at December 31, 2010, it accounted for \$2.476 billion of book value (466,826 hectares of timber assets, representing approximately 59.2% of Sino-Forest's timber holdings by area and 89.2% of its timber holdings by book value), \$1.326 billion in revenue (representing approximately 70% of Sino-Forest's revenue), and approximately \$622 million of gross profit (representing approximately 92.6% of Sino-Forest's gross profits) for the year then ended.

61. The cashless nature of the BVI model means that Sino-Forest cannot obtain cash from its operations or monetize its assets without engaging in the complicated on-shoring process which is discussed further below. Furthermore, the set-off payment system necessitated by the BVI model impaired the IC's efforts to verify the flow of funds during its investigation.

### **3. The WFOE Model**

62. Commencing in 2004, the PRC's Ministry of Commerce permitted foreign investors to invest in PRC-incorporated trading companies and to participate in most areas of the commodity distribution industry, including the purchase of standing timber and land use rights throughout the PRC. Prior to this time, WFOEs were prohibited from engaging in the commodity distribution industry.

63. Since 2004, almost all of Sino-Forest's new capital invested in timber assets has been employed through the WFOE model (as opposed to the BVI model).

64. Unlike BVIs, WFOEs can acquire land use rights or land leases as well as standing timber rights, and can have bank accounts in the PRC. Because of the WFOEs' direct presence in the PRC, they can also obtain financing from PRC banks to finance their operations. WFOEs can log the timber and sell both logs and standing timber to end customers, which means they do not need (and do not use) AIs. The WFOEs directly pay the suppliers for the standing timber and directly receive payment from end customers instead of utilizing the set-off arrangement used by Sino-Forest's BVI entities in the BVI model.

65. As at December 31, 2010, Sino-Forest's WFOEs held approximately 244,000 hectares of purchased plantations (representing approximately 30.9% of Sino-Forest's timber holdings by area) and 77,700 hectares of planted plantations (representing approximately 9.9% of Sino-Forest's timber holdings by area). Purchased plantations and planted plantations are discussed in further detail below. The WFOE standing timber assets accounted for approximately 10.8% of Sino-Forest's timber holdings by book value, and represented approximately \$298.6 million of book value, \$74 million in revenue, and \$10 million of income for the 2010 year before the allocation of corporate overhead.

66. None of Sino-Forest's WFOEs are guarantors of SFC's notes, nor have their shares been pledged by their BVI parents.

#### **4. On-shoring Plan**

67. Given the inherent problems with the BVI structure and the relative advantages of the WFOE structure, Sino-Forest has explored various methods of migrating or "on-shoring" its BVI

timber assets into WFOE structures. The successful transition of assets from a BVI structure to a WFOE structure has many merits including, significantly, providing a foreign parent an ability to have direct access to the cash generated from the sale of BVI timber assets.

68. The on-shoring process is expected to be a multi-year process due to (i) the volume of assets that need to be moved into the WFOE model, (ii) the large number of different locations in which Sino-Forest has timber assets in the PRC, (iii) the likely multiple rounds of negotiations required with the various stakeholders in each location, and (iv) SFC's limited resources.

## **E. Operations**

69. Sino-Forest's operations are comprised of three core business segments. Wood fibre operations and log trading are the primary revenue contributors, while manufacturing and other operations enhance the value of the fibre operations by producing downstream products.

### **1. Wood Fibre Operations**

70. Sino-Forest's wood fibre operations consists of acquiring, cultivating and selling standing timber or logs from purchased and planted plantations in nine provinces across the PRC.

71. Sino-Forest's upstream wood fibre operations generate the majority of its revenue, accounting for 96.4% of total revenue in the year ended December 31, 2010. Most of the standing timber and logs sold by Sino-Forest come from Sino-Forest's tree plantations, located primarily in the southern and eastern regions of the PRC.

72. Sino-Forest operates plantations for the wood fibre operations using two principal business models: purchased and planted, each of which is explained in greater detail below. The purchased plantation model operates through two legal structures: the BVI/AI legal structure

and, to a lesser but growing extent, the WFOE legal structure. The planted plantations model is operated exclusively through the WFOE legal structure, although the WFOEs themselves are typically held indirectly through a BVI holding structure. Many foreign investors, including well known multi-national companies, hold their investments in the PRC in special purpose vehicles established overseas in jurisdictions with a familiar and internationally accepted system of corporate governance. For example, over 75% of blue chip companies listed on the Hong Kong Stock Exchange (Hang Seng Index constituent stocks excluding the Finance Sub-Index) utilize BVI holding structures, including for their investments in the PRC.

**(a) Purchased Plantation Model**

73. The purchased plantation model under the BVI/AI legal structure involves the purchase of standing timber and sale of standing timber pursuant to standardized timber purchase agreements and "entrusted sale agreements". The standing timber purchased is generally on land owned by collectives or villages, not PRC state-owned land. When conducted through the BVI/AI legal structure, of which 20 BVIs hold all of the BVI timber assets, the timber purchases are arranged through suppliers.

74. The BVI structure does not involve the BVIs concurrently purchasing land use rights or leases with the purchase of standing timber, as the BVIs cannot legally acquire land use rights. However, the BVIs' supply contracts typically contain a right of first refusal for the BVIs to acquire, or nominate an affiliate to acquire, the plantation land use rights after the timber has been harvested. Despite such common contractual provisions, such right has rarely, if ever, been exercised.

75. The BVIs do not sell standing timber directly to customers. They sell under contract to the AI (customer) who usually resells the standing timber to its own customers. The BVIs' timber sales accounts receivables are settled by the AI making payments to suppliers (directly or indirectly to other parties on their behalf) on behalf of Sino-Forest. The AI does not pay the same supplier for the same trees it is selling to its customers. It pays a supplier for trees newly purchased by Sino-Forest from that supplier. These payments made by way of set-off enable the BVIs to acquire further standing timber from suppliers, which is matured and later sold. All BVI purchases are funded through the set-off mechanism using accounts receivable owed to Sino-Forest. This is a recognized legal structure in the PRC.

76. WFOEs are also engaged in the purchase and sale of standing timber. When conducted through a WFOE, purchases of standing timber are sometimes accompanied by concurrently obtaining plantation land use rights or leases (which are purchased plantations). WFOE standing timber transactions do not involve payments by way of set-off. They are conducted on a direct fund transfer basis.

77. In both the BVI and WFOE structure, the purchase price of the trees takes into account a variety of factors such as the trees' species, yield, age, size, quality and location. Other considerations include soil and weather conditions for replanting, log prices, and regional market location and demand. Sino-Forest does not typically need to conduct extensive plantation management work with respect to the trees growing on the purchased plantations, but does take measures to ensure that the trees are protected from pests, disease and theft.

78. SFC's approach is to purchase plantations in remote parts of the PRC that the PRC government has identified in its five year plans as being areas for future development. As a result, physical access to the plantations is often very challenging.

79. As at December 31, 2010, the purchased plantations under Sino-Forest management in the PRC consisted of approximately 711,000 hectares. These plantations consisted of a diverse mix of tree species, predominantly pine, Chinese fir and eucalyptus. Purchasing trees allows Sino-Forest to quickly expand its plantation portfolio geographically, as well as its inventory of harvestable fibre and leasable land.

**(b) Planted Plantation Model**

80. The planted plantation model is conducted by WFOEs, and involves obtaining plantation land use rights, sometimes with standing timber and sometimes as bare land suitable for planting. Sales from these planted plantations do not utilize the AI model but rather generally involve direct fund transfers to and from the WFOEs' suppliers and customers. As of December 31, 2010, SFC's planted plantations in the PRC operated through WFOEs comprised approximately 77,700 hectares.

81. Sino-Forest leases suitable land on a long-term basis, typically 30 to 50 years, and applies scientifically advanced seedling technology and silviculture techniques to improve tree growth. The mature trees are sold as standing timber or as harvested logs, and then Sino-Forest replants the land with seedlings.

82. Sino-Forest's operating model allows for the sale of fibre either as standing timber or harvested logs, depending on its customers' preferences and market demand.

83. Sino-Forest's planted plantations consist primarily of eucalyptus trees, a fast-growing high yielding species. According to the seventh five-year National Forest Inventory released by the State Forestry Administration (2004 to 2008), it is estimated that the PRC has 195 million hectares of forest resources, with approximately 120 million hectares of natural forest and 62 million hectares of plantation forest. The density of its total forest area was only 70 cubic metres per hectare in the PRC.

84. The PRC government encourages the development of the plantation industry in the PRC. In June 2003, the PRC State Council promulgated "The Notice on the Decision to Speed Up the Development of Plantation Industry". Subsequently, in August 2007, "The Key Elements of the Policies in Forestry Industry" was jointly promulgated by seven ministries including the State Forestry Administration, National Development and Reform Commission, Ministry of Finance, Ministry of Commerce, State Administration of Taxation, China Banking Regulatory Commission and China Securities Regulatory Commission to develop the non-state owned plantation industry, and to encourage the participation of foreign investors in the plantation industry, either solely or jointly with others.

85. The planted plantation model is generally viewed more favourably by the PRC government because it demonstrates a long-term commitment to the forestry business. That long-term commitment is very important from the perspective of the PRC government in light of the fact that demand for wood fibre in the PRC is approximately double that of available supply.

## **2. Log Trading Operations**

86. Sino-Forest's operations in the trading of wood logs includes the sourcing of wood logs and wood-based products from the PRC and globally, and selling them in the domestic PRC market.

87. These wood-based products consist primarily of large diameter logs, sawn timber, veneers and other wood-based products sourced from the PRC, Thailand, Suriname, Papua New Guinea, Brazil, Vietnam, Russia and New Zealand. In these transactions, Sino-Forest purchases wood-based products that correspond to the requirements of wood dealers, and sells directly to these dealers. Sino-Forest's customers in these transactions are primarily wood dealers in the PRC.

### **3. Manufacturing and Other Operations**

88. Sino-Forest currently has manufacturing operations in six provinces in the PRC that produce various wood-based products. In addition, Sino-Forest has greenery and nursery operations based in Jiangsu Province, which were established to source, supply and manage landscaping products for property developers and other organizations.

89. In order to maximize and increase the value of Sino-Forest's forestry products, Sino-Forest has been investing in research and development ("R&D"). On January 12, 2010, Sino-Forest announced its acquisition of HOMIX LIMITED ("HOMIX") in order to enhance its R&D portfolio. HOMIX has an R&D laboratory and two engineered-wood production operations based in Guangdong and Jiangsu provinces, covering eastern and southern PRC wood product markets. HOMIX develops a number of new technologies suitable for domestic plantation logs including poplar and eucalyptus species. HOMIX specializes in curing, drying and dyeing methods for engineered-wood and has the know-how to produce recomposed wood products and laminated veneer lumber. Recomposed wood technology is considered to be environmentally friendly and versatile, as it uses fibre from forest plantations, recycled wood and/or wood residue.

90. The goal of Sino-Forest's R&D efforts has been to improve tree plantation yields and the quality of the trees grown on Sino-Forest's plantations. While performing R&D activities, Sino-Forest from time to time collaborates with, and receives assistance from, research and academic institutions in the PRC. Sino-Forest's R&D efforts are viewed very positively in the PRC as they also demonstrate a long-term commitment to the forestry business in the PRC and can help address the significant shortage of wood fibre in the PRC.

**F. Sales**

91. Substantially all of Sino-Forest's sales are generated in the PRC. In the year ended December 31, 2010, sales to customers in the PRC were \$1.8723 billion and sales to customers located in other countries were \$51.3 million. In the year ended December 31, 2010, sales to customers in the PRC of standing timber, logs and other wood-based products accounted for substantially all of Sino-Forest's revenue.

**G. Suppliers**

92. Logs and wood-based products supplied through Sino-Forest's trading activities are sourced primarily from suppliers outside the PRC. These products are also sourced for Sino-Forest trading activities from overseas, primarily from Thailand, Suriname, Papua New Guinea, Brazil, Vietnam, Russia and New Zealand. The credit terms granted by suppliers of these products generally range from one to three months on open account and by letters of credit. Standing timber is sourced primarily from local suppliers in the PRC.

93. As discussed above, the PRC based suppliers are usually aggregators who acquire standing timber and/or land use rights from other suppliers or from original timber owners such as villagers or collectives who have certified title to the land.

## H. Employees

94. SFC currently has 3 employees. Collectively, the Sino-Forest Companies employ a total of approximately 3553 employees, with approximately 3460 located in the PRC and approximately 90 located in Hong Kong. The Greenheart Group employs an additional approximately 273 employees.

## I. Assets & Liabilities

95. The unconsolidated book values of SFC's assets and liabilities as at June 30, 2011 are listed below.<sup>1</sup> However, given that, as described below, SFC is in default under the notes and the indenture trustees would be in a position to accelerate and enforce on the notes but for the waiver agreements (subject to sending the appropriate notices and the cure period expiring), I have categorized the full amount of the notes (including the non-current portion and the derivative financial instrument, as opposed to just the current portion) as a current liability below.

<u>Current Assets</u>		<u>Current Liabilities</u>	
Cash and cash equivalents <sup>2</sup>	\$5,676,040	Notes (current portion)	\$87,670,000
Prepayments <sup>3</sup>	\$1,173,553	Notes <sup>4</sup> (non-current)	\$1,541,744,429
Other Receivables <sup>5</sup>	\$188,575	Notes Derivative Financial Instrument	\$31,858,210
Due from Intercompany <sup>6</sup>	<u>\$109,813,620</u>	Trade Payable	\$2,202
		Others Payable	\$231,723
		Accrued Liabilities	\$39,687,268
		Due to Intercompany	<u>\$1,818,313</u>
<b>Total Current Assets</b>	<b>\$116,851,788</b>	<b>Total Current Liabilities</b>	<b>\$1,703,012,145</b>

<sup>1</sup> The chart only reflects the assets and liabilities of SFC, and therefore does not accord with the consolidated quarterly financial results for the second quarter ended June 30, 2011.

<sup>2</sup> Mainly represents cash on hand, cash at bank and short-term deposits with a maturity of three months or less.

<sup>3</sup> Mainly represents prepaid legal and professional fees and insurance.

<sup>4</sup> The Notes (current portion), Notes (non-current) and Notes Derivative Financial Instrument do not equate on this balance sheet to approximately \$1.8 billion (the face value of the notes) due to the accounting treatment of financing costs and the carrying value of the convertible notes.

<sup>5</sup> Mainly represents HST receivables, staff advances and deposits.

<sup>6</sup> Non-interest bearing with no fixed date of repayment.

<u>Non-Current Assets</u>		<u>Non-Current Liabilities</u>	
Property, Plant & Equipment <sup>7</sup>	\$1,166		
Investment in Subsidiaries <sup>8</sup>	\$1,589,153,984	Intercompany Loans	<u>\$235,000,000</u>
Intercompany Loans <sup>9</sup>	<u>\$1,582,781,672</u>		
<b>Total Non-Current Assets</b>	<b>\$3,171,936,822</b>	<b>Total Non-Current Liabilities</b>	<b>\$235,000,000</b>
<b>Total Assets</b>	<b>\$3,288,518,610</b>	<b>Total Liabilities</b>	<b>\$1,938,012,145</b>

96. With respect to the assets, while they reflect an accurate implementation of the relevant accounting policies, I do not believe that the book values of the assets reflect the realizable value of those assets for a number of reasons, including the complexities associated with the business, the significant amount of intercompany loans owing to SFC, and the costs and potential PRC tax liabilities that may be payable if the assets were realized on. SFC is not able to simply monetize its assets in the short term in order to satisfy its obligations under the notes as a result of, among other things, the hard to quantify potential PRC tax liability previously discussed at paragraph 58 above and the stringent currency exchange controls in the PRC.

97. As discussed above, Sino-Forest is not in a position to know whether or not the AIs have in fact remitted applicable taxes on behalf of Sino-Forest. Although Sino-Forest recognized a provision as at June 30, 2011 of \$204,722,000 in its reported financial results to account for this potential tax liability, I am advised by SFC's counsel in the PRC, Ching Wo Ng at King & Wood Mallesons, that the amount of the tax liabilities under PRC law arising from the operation of the BVIs could be significantly higher if responsible tax authorities take different views than that of management in respect of a number of tax issues, including, without limitation, whether by their

<sup>7</sup> Mainly represents office equipment.

<sup>8</sup> Historical cost for interests in subsidiaries.

<sup>9</sup> Interest bearing with defined terms of repayment date.

operation the BVIs have formed an establishment in the PRC, whether value added tax is payable, the likelihood and severity of a tax penalty, the applicable default interests on late payments, the numbers of years to "look back", whether certain tax preferential treatments apply to foreign companies such as BVI entities, and other relevant matters. The views on these issues may also differ from locality to locality.

98. In addition, as a result of the currency exchange controls in the PRC, all cash to be repatriated from the PRC is subject to approval from the State Administration of Foreign Exchange (the "SAFE"). I am advised by SFC's counsel in the PRC, Ching Wo Ng at King & Wood Mallesons, that for normal and regular foreign exchange transactions in the PRC which require the approval of SAFE, the applications for such approvals can normally be processed within the time limits prescribed by law. However, the transactions undertaken by the BVIs in respect of their forestry assets in the PRC are very dissimilar to those contemplated by the relevant rules and regulations of the PRC. Therefore, there is no assurance that any application to SAFE for repatriation of funds by the BVIs can be processed within the time limits prescribed by law, or within a reasonable time thereafter.

99. As a result of Sino-Forest, among other things, operating in a critical natural resource sector with insufficient supply in the PRC, investing in research and development initiatives in the PRC, and employing a significant number of people in the PRC, it has generally enjoyed positive working relationships with all levels of government in the PRC. However, I believe that if Sino-Forest were to cease operating under a business strategy that is consistent with and supportive of PRC government policy, including its policy on sustainable forestry, for example, investing in research and development or employing a significant number of people in the PRC, Sino-Forest would enjoy much less favourable treatment from PRC government officials, and

would likely have greater difficulties resolving the issues discussed above relating to tax liabilities and repatriation of cash. This is particularly true in respect of the BVI structure where, among other things, the ability to access cash is further impaired and Sino-Forest is not in a position to know whether or not the AIs have remitted applicable taxes on behalf of Sino-Forest.

**J. Importance of Relationships to Doing Business in the PRC**

100. From my time with SFC I have come to understand the importance of relationships to doing business in the PRC. This is particularly true in relation to those doing business in the forestry sector.

101. The PRC has extensive resource needs, including in the forestry sector. Historically, forestry resources in the PRC have been collectively owned at a local level. Forestry resources have largely been managed without the resources necessary to increase yields and allow for harvesting at a commercial level from a western forestry perspective.

102. Part of Sino-Forest's success has been attributable to its ability to acquire forestry resources from local sources of supply, at a good price, and to resell them at a good profit. In relation to Sino-Forest's planted plantation model, Sino-Forest also has benefited from the application of advanced silviculture techniques to those resources. Based on my interactions with PRC government officials, I understand that the PRC government recognizes that for the industry to mature, become efficient, and improve yields to reduce the fiber deficit, forest asset management has to be consolidated.

103. A good relationship with the various levels of PRC government is important to doing business successfully in the PRC. Historically, Sino-Forest's relationships with these governments have been important to Sino-Forest's success in the PRC. Loss of their support

could, correspondingly, have significant negative consequences for Sino-Forest, for its ability to continue to do business in the PRC, and its ability to continue to control its PRC-based assets for the benefit of its stakeholders.

104. Sino-Forest's most important relationships have been and continue to be through Allen Chan ("Chan"). From my observations and experience, Chan has established significant relationships in the PRC, and my understanding is that this is a direct result of his long-standing personal contribution to the development of the forestry sector both through Sino-Forest and in a personal capacity as an informal advisor to various relevant industry bodies.

105. Following the MW Report, Chan was requested to meet with officials in the PRC State Forestry Administration ("SFA") and other senior officials on multiple occasions in Beijing. I have been introduced to some officials and attended some of these meetings.

106. My observation from my personal involvement in these discussions and meetings is that Chan continues to be consulted and respected within the PRC government as an expert in the forestry industry. I therefore believe his continued participation will be extremely helpful in allowing SFC to unlock value in the PRC for the benefit of its stakeholders.

107. Notwithstanding the allegations in the MW Report (which have received widespread coverage in the PRC and in Hong Kong), Chan has continued to be honoured within the PRC. In November 2011, at the 2<sup>nd</sup> China Forestry Expo, Chan was presented an "Outstanding Achievement" award from the China National Forestry Industry Federation (the "CNFIF"). In recognition of his contribution to the forestry industry in the PRC, Chan was the first keynote speaker following the Minister of the SFA at the China Forestry Expo.

108. Chan was also appointed Vice President of the CNFIF in 2010. The CNFIF is an affiliate of the SFA and is chaired by the Minister of the SFA or the Director of the SFA. The SFA is the PRC government ministry responsible for its forests and forest management.

109. In 2007, Chan was appointed an Honourable Director of Renmin University (also known as the People's University of China), one of the most prestigious universities in the PRC with a distinct focus on humanities and social sciences, and highly regarded by top leaders in the PRC. In addition, Chan is a member of the Jiangxi Committee of the Chinese People's Political Consultative Conference.

110. In February 2012, Chan was presented with the "2011 China Forestry Persons of the Year" award by the CNFIF.

111. Many of the PRC's commercially attractive forestry resources are in areas of sensitivity within the PRC, including areas that are sensitive from a military perspective. Private air travel is prohibited or strictly controlled in many of the areas in which Sino-Forest does business.

112. The strategic significance attaching to Sino-Forest's forestry assets in the PRC increases the importance to SFC of maintaining positive relationships with authorities in the PRC. If Sino-Forest is to monetize its PRC based assets for the benefit of stakeholders, I strongly believe that the outcome of this process must be acceptable to relevant authorities in the PRC.

113. In the course of its 18 years of operations, Sino-Forest has been viewed by the Minister of the SFA positively and as a model for privately owned enterprises carrying on business in the PRC and promoting PRC policies. For that reason, Sino-Forest has enjoyed a positive relationship with the PRC. Even since June of last year, the Minister of the SFA has remained

cooperative and encouraging of a solution for Sino-Forest. However, recently, the government has expressed increasing concern and interest as to what the solution is for Sino-Forest. As a result, not only do I believe that any solution needs to be acceptable to the authorities in the PRC, such solution needs to be presented in the very near future.

#### **IV. THE MUDDY WATERS ALLEGATIONS: CHRONOLOGY AND RESPONSES**

114. On June 2, 2011, Muddy Waters, which admitted to holding a short position on SFC's shares, published the MW Report alleging, among other things, that Sino-Forest is a "near total fraud" and a "Ponzi scheme."

115. While the allegations contained in the MW Report are diverse and far-reaching, the IC set out to address the issues raised in three core areas: (i) the verification of timber assets reported by Sino-Forest, (ii) the value of the timber assets held by Sino-Forest, and (iii) revenue recognition.

116. Among other things, the MW Report alleged that Sino-Forest does not hold the full amount of timber assets that it reports, that the timber assets actually held by Sino-Forest have been overstated, and that Sino-Forest overstated its revenue. In addition, the MW Report alleged that Sino-Forest has engaged in unreported related-party transactions. A copy of the MW Report is attached as Exhibit "M". Two subsequent reports by Muddy Waters relating to Sino-Forest are attached as Exhibit "N". These reports are attached to provide context to the Court and definitely not because I agree with their contents.

##### **A. The IC, OSC, RCMP and HKSFC Investigations**

117. On June 2, 2011, the same day that the MW Report was released, the Board appointed the IC, a Board committee consisting exclusively of independent directors, which in turn retained

independent legal and financial advisors in Canada, Hong Kong and the PRC, to investigate the allegations set out in the MW Report.

118. On June 8, 2011, the OSC publicly announced that it was investigating matters related to SFC. That investigation has been active and is ongoing.

119. Later in June 2011, the HKSFC commenced an investigation into Greenheart Group. As a company listed on the Hong Kong Stock Exchange and headquartered in Hong Kong, the HKSFC is Greenheart's primary securities regulator. I believe that the HKSFC's investigation was largely reactive to the allegations against Sino-Forest, SFC's control position in relation to Greenheart Group, and to the fact that the principal offices of Sino-Forest and Greenheart Group are located in Hong Kong. As indicated above, SFC had acquired a majority interest in Greenheart Group less than a year earlier, and had separate management and premises.

120. In addition to its investigation of Greenheart Group, the HKSFC has been assisting the OSC with its investigation. I am advised by Gary Solway of Bennett Jones LLP, counsel to SFC, that the HKSFC has a mutual-assistance treaty with the OSC. The OSC has conducted witness interviews in Hong Kong with the assistance of and out of the premises of the HKSFC.

121. Sino-Forest believes that it has attempted to cooperate with the OSC, HKSFC and RCMP investigations. Sino-Forest has made extensive production of documents, in particular to the OSC, including documents sourced from jurisdictions outside of the OSC's power to compel production.

122. Sino-Forest also has facilitated interviews by the OSC with Sino-Forest personnel. In circumstances where OSC staff sought to examine Sino-Forest personnel resident in the PRC

(where neither the OSC nor the HKSF had the ability to compel their attendance at interviews), Sino-Forest arranged to bring individuals to Hong Kong to be examined.

123. Sino-Forest has responded to extensive inquiries, the most far-reaching coming from the OSC, and has provided periodic oral briefings to OSC staff. The IC reports were provided to OSC staff on an unredacted basis, as discussed below.

124. The scope of the IC's review was significant, reflecting the wide range of allegations contained in the MW Report. The IC and its advisors worked to compile and analyze the vast amount of data required for their comprehensive review of Sino-Forest's operations and business, the relationships between Sino-Forest and other entities, and Sino-Forest's ownership of assets.

125. At the beginning of the IC's investigation, the IC informed the Board that the review would likely take at least two to three months to complete. On August 10, 2011, the IC delivered its first interim report to the Board (the "First Interim Report"). A redacted copy of the First Interim Report is attached as Exhibit "O".

126. SFC has publicly disclosed on SEDAR and on its website redacted versions of the First Interim Report and the two subsequent reports of the IC. The three reports have been redacted to protect information that the Board believes is commercially sensitive, the disclosure of which could be harmful to Sino-Forest's business and operations, especially in the PRC. These redactions have not been made to conceal information from regulatory scrutiny. Each of the three reports has been produced without redactions to OSC staff pursuant to a compelled process designed to allow OSC staff to receive information relevant to its investigation, while at the same time protecting SFC's sensitive information.

127. The First Interim Report was the result of the IC and its advisors assembling and organizing significant data from Sino-Forest's records, and reviewing Sino-Forest's cash holdings, revenue and relationships. In the First Interim Report, while the IC did not determine that there was any validity to the allegations in the MW Report, its findings were limited as the investigation was still ongoing.

128. Also in its First Interim Report, the IC's accounting advisors confirmed Sino-Forest's cash balances in specific accounts as at June 13, 2011, for accounts located inside and outside of the PRC. A total of 293 accounts controlled by Sino-Forest in Hong Kong were confirmed, representing 100% of the expected cash position in Hong Kong. However, Sino-Forest had 267 accounts in the PRC, so the logistics and requirements of in-person/in-branch verification in the PRC led the IC advisors to confirm 28 accounts, representing approximately 81% of the expected cash position in the PRC. The IC was satisfied based on this verification that Sino-Forest's expected cash position in the PRC existed as at the date of confirmation.

129. The First Interim Report was delivered to the Board shortly before the Board was asked to authorize the release of SFC's 2011 quarterly financial results for the second quarter ended June 30, 2011 (the "Q2 Results"). The Q2 Results were released on August 15, 2011.

130. Almost immediately after the Q2 Results were released, the IC's advisors identified and brought to the attention of the IC just under 60 documents, some of which raised potential conduct issues and others of which raised questions as to whether Sino-Forest's relationships with some of its AIs and suppliers were conducted at arm's length.

131. The IC concluded that interviews concerning the documents should be conducted with relevant Sino-Forest personnel. The interviews were conducted from August 24 to 26, 2011 in Hong Kong.

132. As part of its efforts to cooperate with OSC staff, on August 24, 2011, before the documents were shown to relevant Sino-Forest personnel and those personnel were provided with an opportunity to comment, the IC's advisors provided copies of the documents to OSC staff. The IC's advisors and SFC's external counsel also provided oral briefings about the interviews to OSC staff from August 24 to 26, 2011, as the interviews were being conducted.

133. Seen in their proper context, and with the benefit of fuller explanations, I believe that the documents identified by the IC's advisors and provided to OSC staff at that time fall well short of the misconduct alleged in the MW Report.

134. However, as a result of the documents and interviews, Sino-Forest placed three employees on administrative leave, and a fourth senior employee was requested to act solely on my instructions. It was my decision in each case to take this action.

135. SFC's Board met on the morning of Friday August 26, 2011, Toronto time (which was Friday evening Hong Kong time) to hear reports about the interviews and about communications between SFC and OSC staff. The Board was told that Chan had agreed to resign as Chairman, CEO and as a director of SFC pending the completion of the review by the IC of the allegations in the MW Report. He was appointed Founding Chairman Emeritus and I was appointed as CEO.

136. On August 26, 2011, the OSC issued a cease trade order with respect to the securities of SFC and with respect to certain senior management personnel. A copy of the cease trade order dated August 26, 2011 (as corrected by the OSC later that day) is attached as Exhibit "P". The Board first learned of the cease trade order during the Board meeting that day, after Chan tendered his resignation.

137. With the consent of SFC, the cease trade order was extended by subsequent orders of the OSC, copies of which are attached as Exhibit "Q". The cease trade order continues in force to this date.

138. Based on my review of the IC's second interim report to the Board (the "Second Interim Report", which is discussed below) and discussions I have had with William Ardell, Board Chair and Chair of the IC, I understand that in late August 2011, counsel for the IC received an inquiry from the RCMP requesting cooperation from the IC in connection with an investigation into the allegations in the MW Report. Representatives of the IC met with and provided information to the RCMP from time to time. The RCMP also has made information requests from time to time. It has been SFC's intention to cooperate with the RCMP in connection with its investigation.

139. On November 13, 2011, the IC delivered its Second Interim Report to the Board, a redacted copy of which is attached as Exhibit "R".

140. Subject to the limitations described therein, the Second Interim Report confirmed registered title or contractual or other rights to Sino-Forest's stated timber assets, reconciled the book value of the BVI timber assets and Sino-Forest WFOE standing timber assets as set out in the 2010 financial statements to the purchase prices for such assets as set out in the BVI and

WFOE standing timber purchase contracts reviewed by the IC advisors, reconciled reported total revenue to sales contracts, and addressed certain allegations regarding related-party transactions.

141. Subject to the scope limitations described in the Second Interim Report, the IC confirmed 99.3% of Sino-Forest's timber area to its satisfaction and that Sino-Forest had registered title to 100% of its disclosed planted timber holdings by area, and contractual or other rights to approximately 81.3% of its disclosed purchased timber holdings by area. The IC reported that it or its advisors had reviewed originals or copies of purchase contracts for the acquisition by Sino-Forest of virtually all of its disclosed timber holdings as at December 31, 2010.

142. The IC indicated in its Second Interim Report that it viewed its work to be substantially complete and that it expected to deliver its final report prior to the end of 2011.

#### **B. Failure to Release Q3 Results and Default Under the Notes**

143. Subsequent to August 26, 2011, the IC's advisors identified additional documents that raised issues meriting comment and explanation from SFC's management. Also, SFC's external counsel, in responding to requests from the OSC, also identified documents of a similar nature. Further documents meriting comment and explanation were identified by SFC's external auditors and in interviews conducted by OSC staff.

144. As SFC reached the November 15, 2011 deadline to release its 2011 third quarter financial statements (the "Q3 Results"), the Audit Committee recommended and the Board agreed that SFC should defer the release of the Q3 Results until certain issues could be resolved to the satisfaction of the Board and SFC's auditor. The issues included (i) determining the nature and scope of the relationships between Sino-Forest and certain of its AIs and suppliers, as discussed in the Second Interim Report, and (ii) the satisfactory explanation and resolution of issues raised

by certain documents identified by the IC's advisors, SFC's counsel, SFC's external auditors, and/or by OSC staff.

145. On November 15, 2011, the date upon which SFC's Q3 Results were due, SFC issued a press release announcing that the IC had delivered its Second Interim Report to the Board. A copy of the November 15, 2011 press release is attached as Exhibit "S". The executive summary to the Second Interim Report is attached as a schedule to the press release.

146. The November 15, 2011 press release also stated that the Board had concluded that, as a result of ongoing work arising from the allegations raised in the MW Report, it was not in a position to authorize the release of the Q3 Results at that time. The release stated that SFC would try to release the Q3 Results within 30 days.

147. SFC's failure to file the Q3 Results and provide a copy of the Q3 Results to the trustee and to its noteholders under its senior and convertible note indentures on or before November 15, 2011 constituted a default under those note indentures. Pursuant to the indentures, an event of default would have occurred if SFC failed to cure that breach within 30 days in the case of the senior notes, and 60 days in the case of the convertible notes, after having received written notice of such default from the relevant indenture trustee or the holders of 25% or more in aggregate principal amount of a given series of notes.

148. While SFC worked diligently to try to resolve the outstanding issues, it became clear that SFC was not going to be able to release the Q3 Results within that timeframe. On December 12, 2011, SFC issued a press release announcing that it would not be able to release the Q3 Results within the 30-day period originally indicated.

149. Moreover, in the press release, SFC announced that, in the circumstances, there was no assurance that it would be able to release the Q3 Results, or, if able, as to when such release would occur. In the December 12, 2011 press release, SFC also announced that the Board had determined not to make the \$9.775 million interest payment on SFC's 2016 convertible notes that was due on December 15, 2011. A copy of the December 12, 2011 press release is attached as Exhibit "T".

150. As disclosed in the December 12, 2011 press release, the circumstances that caused SFC to be unable to release the Q3 Results also could impact SFC's historic financial statements and SFC's ability to obtain an audit for its 2011 fiscal year.

151. SFC's failure to make the \$9.775 million interest payment on the 2016 convertible notes when due on December 15, 2011 constituted a default under that indenture. Under the terms of that indenture, SFC had 30 days to cure its default and make the required interest payment in order to prevent an event of default from occurring, which could have resulted in the acceleration and enforcement of the approximately \$1.8 billion in notes which have been issued by SFC and guaranteed by many of its subsidiaries outside of the PRC.

152. On December 18, 2011, SFC announced that it had received written notices of default dated December 16, 2011, in respect of its senior notes due 2014 and its senior notes due 2017. The notices, which were sent by the trustees under the senior note indentures, referenced SFC's previously-disclosed failure to release the Q3 Results on a timely basis. SFC reiterated in the December 18, 2011 press release that it did not expect to be able to file the Q3 Results and cure the default within the 30 day cure period. A copy of the December 18, 2011 press release is attached as Exhibit "U".

153. In response to the receipt of the notices of default, among other considerations, on December 16, 2011, the Board established a Special Restructuring Committee of the Board (the "Restructuring Committee") comprised exclusively of directors independent of management of SFC, for the purpose of supervising, analyzing and managing strategic options available to SFC. The members of the Restructuring Committee are William Ardell, Chair of the Board, who is also Chair of the Restructuring Committee and Garry West. James Hyde, Chair of the Audit Committee and an independent director, while not a member of the Restructuring Committee, has attended meetings of the Restructuring Committee and participated fully in its deliberations.

154. Following discussions with its external auditors, on January 10, 2012, SFC issued a press release cautioning that its historic financial statements and related audit reports should not be relied upon. The January 10, 2012 press release is previously attached.

### **C. The Waiver Agreements**

155. On January 12, 2012, SFC announced that following extensive discussions with the Ad Hoc Noteholders, holders of a majority in principal amount of SFC's senior notes due 2014 and its senior notes due 2017 agreed to waive the default arising from SFC's failure to release the Q3 Results on a timely basis. A copy of the January 12, 2012 press release, together with the waiver agreements, is attached as Exhibit "V".

156. Pursuant to the waiver agreements, SFC agreed to, among other things, make the \$9.775 million interest payment on its 2016 convertible notes that was due on December 15, 2011, curing that default. That payment was made in accordance with the waiver agreements.

157. While the waiver agreements prevented the indenture trustees under the relevant note indentures from accelerating and enforcing the note indebtedness as a result of SFC's failure to

file its Q3 Results, those waiver agreements expire on the earlier of April 30, 2012 and any earlier termination of the waiver agreements in accordance with their terms. In addition, should SFC fail to file its 2011 Results by March 30, 2012 (and upon the necessary notices being sent and cure periods expiring), the indenture trustees would again be in a position to accelerate and enforce.

**D. The IC's Final Report and Verification of SFC's Assets**

158. On January 31, 2012, SFC publicly released a redacted version of the final report of the IC (the "Final Report"). A copy of the redacted Final Report is attached as Exhibit "W".

159. Following the delivery of the Final Report, and in accordance with the waiver agreements, the Board adopted a resolution instructing the IC to cease its investigative, review and oversight activities. Any issues within the authority of the IC that remained outstanding were referred to SFC's Audit Committee or Restructuring Committee.

160. In its January 31, 2012 press release, attached as Exhibit "X", announcing the release of the Final Report, SFC also disclosed the results of a "proof of concept" exercise undertaken to determine if the standing timber referenced in particular purchase contracts could be located and quantified by an independent forestry expert engaged to undertake the exercise. The exercise was undertaken to address the issue raised in the Second Interim Report regarding the absence of maps in the possession of SFC's BVI subsidiaries to show the precise location of the timber subject to plantation purchase contracts.

161. As disclosed in the January 31, 2012 press release, the proof of concept exercise was confined to two compartments. The selection criteria limited the sample to purchased timber assets located in Yunnan province. The candidate assets were acquired prior to the allegations in

the MW Report. They were listed as being held by BVIs and not by WFOEs. At the IC's request, the consultants selected a shortlist of ten possible compartments covering multiple forestry bureaus and meeting the criteria above, avoiding any prospect that the sampling involved personnel from Sino-Forest. Multiple county forestry bureaus were represented in the shortlist, and the IC made the final selection of compartments to ensure more than one county forestry bureau was represented.

162. As described in the Final Report and the accompanying press release, maps for the two compartments were obtained from the relevant forestry bureaus in the PRC by the contracted survey companies and made available to the consultants. Using the techniques described in the Final Report, compartment boundaries were superimposed on recent high resolution satellite imagery which allowed for the measurement of each compartment's forest cover. The consultants compared the net stocked area of forest cover that they assessed for each compartment with that stated in the Sino-Forest purchase contracts and forest survey reports. The consultants found that the net stocked area of forest cover in each compartment was up to six percent greater than that stated in the relevant purchase contracts and forest survey reports, with the current assessed area for each compartment exceeding the purchase contract area.

163. While the consultant report and press release cautioned against extrapolation of these findings over Sino-Forest's broader forestry assets, I took considerable comfort from these findings. In relation to two randomly-selected contracts held through the BVI structure, the property descriptions and expected forest cover in the contracts matched the boundaries and forest cover on the ground.

164. Subsequent to January 31, 2012, Sino-Forest has taken steps to see the proof of concept process applied over a statistically relevant sampling of Sino-Forest's forest assets. That work is ongoing.

**E. Gating Issues to an Audit**

165. SFC has worked diligently to address issues identified by SFC's Audit Committee, the IC and by its external auditor, Ernst & Young LLP, as requiring resolution in order for SFC to be in a position to obtain an audit opinion in relation to the 2011 Results. Many of the same issues also impact SFC's ability to release the Q3 Results.

166. As SFC has publicly disclosed in its press releases, the gating issues to the release of the Q3 Results and to obtaining an audit of the 2011 Results include (i) determining the nature and scope of the relationships between Sino-Forest and certain of its AIs and suppliers, and (ii) the satisfactory explanation and resolution of issues raised by certain documents identified by the IC's advisors, SFC's counsel, SFC's auditors, and/or by OSC staff.

167. The "relationship issues" described above are discussed extensively in the Second Interim Report and in the Final Report of the IC. Relationship issues were prominent in the approximately 60 documents provided to OSC staff on August 24, 2011, and relationships continue to be an issue that SFC has been unable to resolve.

168. As part of the IC's investigative process a significant amount of electronic data was extracted and reviewed by the IC and its advisors. The same data also has been reviewed by counsel for SFC and SFC's advisors. Over one million electronic records have been reviewed.

169. The search of electronic records and other inquiries have not produced evidence to support the allegations made in the MW Report that Sino-Forest is a near total fraud or Ponzi scheme. The searches and inquiries have produced some evidence of possible lesser improper conduct that SFC has been making efforts to investigate, address and quantify.

170. There is no single theme among the documents and issues that SFC has been taking steps to address. In some cases, the documents speak to efforts to deal with foreign currency exchange restrictions applicable to the PRC. The documents suggest that in some cases SFC personnel may have received personal benefits at Sino-Forest's expense and may have appropriated some of Sino-Forest's assets. They also show that, in a few cases, whistleblower complaints in some subsidiaries alleging misconduct by certain personnel in those subsidiaries appear not to have been adequately investigated and addressed.

171. The record-keeping of SFC's subsidiaries in the PRC appeared to be adequate prior to the recent heightened scrutiny being focused on companies with significant operations in the PRC. The nature of SFC's books and records, combined with the inability to compel disclosure and participation by third party PRC companies, primarily SFC's customers (AIs) and suppliers, and the unwillingness of these companies to become involved in an investigation, makes it difficult to definitively assess some of the explanations offered by Sino-Forest personnel.

172. In light of this heightened scrutiny, SFC's subsidiaries in the PRC do not have the scope of books and records that might be used to definitively address some issues raised by potentially problematic email communications. The nature of SFC's BVI structure, and the absence of contractual rights to examine the books and records of customers and suppliers, deprives SFC of

access to information that may be necessary to allow SFC to determine whether some of the documents and issues identified are material from a financial reporting perspective.

173. Notwithstanding SFC's best efforts, many of these issues may not be capable of resolution, and certainly not within a timeframe that would allow SFC to comply with its obligations under its note indentures and securities laws. Consequently, absent a resolution with the noteholders, the indenture trustees would be in a position to enforce their legal rights as early as April 30, 2012.

174. However extensive and challenging the work done to respond to the MW Report has been, the simple fact is that the uncertainty it has created has caused Sino-Forest's business to deteriorate. Repairing the damage to the business simply cannot wait any longer. Without decisive action in the immediate term, I fear that the ability to save the business for the benefit of SFC and its stakeholders will be irreparably lost.

175. As described in greater detail herein, even though the allegations set out in the MW Report and the OSC cease trade orders are unproven, the allegations have had a catastrophic negative impact on Sino-Forest's business activities and have created substantial uncertainty regarding the future of Sino-Forest's business in the minds of the Sino-Forest Companies' stakeholders in the PRC, including its lenders, customers, suppliers, employees, and governmental officials. The allegations made against SFC have resulted in a substantial erosion of Sino-Forest's business. The business in the PRC continues to deteriorate with every passing day and it has become clear to SFC that the Sino-Forest business needs to be separated from the cloud that continues to hang over SFC if there is any future for that business (and thus value for SFC's stakeholders) to be preserved.

## **V. IMPACT OF MUDDY WATERS ALLEGATIONS ON SINO-FOREST**

### **A. Class Action Lawsuits**

176. SFC and certain of its officers, directors and employees, along with SFC's current and former auditors, technical consultants and various underwriters involved in prior equity and debt offerings, have been named as defendants in eight class action lawsuits.

177. Five of these class action lawsuits, commenced by three separate groups of counsel, were filed in the Ontario Superior Court of Justice on June 8, 2011, June 20, 2011, July 20, 2011, September 26, 2011 and November 14, 2011. A carriage motion in relation to these actions was heard on December 20 and 21, 2011, and by Order dated January 6, 2012, Justice Perell appointed Koskie Minsky LLP and Siskinds LLP as class counsel. As a result, Koskie Minsky LLP and Siskinds LLP discontinued their earliest action, and their other two actions have been consolidated and will move forward as one proceeding. The other two Ontario actions, commenced by other counsel, have been stayed. Pursuant to Justice Perell's January 6, 2012 Order, Koskie Minsky LLP and Siskinds LLP have filed a fresh as amended Statement of Claim in the consolidated proceeding. A copy of this Statement of Claim is attached as Exhibit "Y".

178. The action purports to be brought on behalf of noteholders. The plaintiffs and plaintiff law firms have not complied with the prerequisites to bringing suit in the relevant note indentures, which each contain a "no suits by holders" clause.

179. Parallel class actions have been filed in Quebec and Saskatchewan. Copies of the originating documents in those actions are attached as Exhibit "Z".

180. Additionally, on January 27, 2012, a class action was commenced against SFC and other defendants in the Supreme Court of the State of New York, U.S.A. The complaint alleges that

the action is brought on behalf of persons who purchased SFC shares on the over-the-counter market and on behalf of non-Canadian purchasers of SFC debt securities. The quantum of damages sought is not specified in the complaint. A copy of the complaint in this action is attached as Exhibit "AA".

181. Additional law firms in both the United States and Canada have announced that they are investigating SFC and certain directors and officers thereof with respect to potential additional class action lawsuits.

**B. Effects of MW Report and Related Events**

182. The allegations set forth in the MW Report, despite being denied by SFC, have had catastrophic negative effects on the reputation and business of Sino-Forest. As a result, Sino-Forest's ability to conduct its operations in the normal course of business has been materially affected. For example; creditors are increasing legal demands with respect to accounts payable; at the same time, collections of accounts receivables is increasingly difficult due to a widespread belief that Sino-Forest will not survive; sales in the WFOE model have also slowed substantially in response to views on accounts receivable payments; cash flow issues have resulted in a cessation of any expansion or modernization; the inability to fund purchases of raw materials has caused a slowdown in production or, in many cases, a shutdown; certain timber assets have been frozen as Sino-Forest has been unable to keep current with payments; deposits put down on standing timber purchases by WFOEs, of approximately \$27 million, may be unrealizable due to an inability to generate cash to pay off outstanding payables under those contracts; offshore banking facilities have been repaid and frozen or cancelled, leading to substantial damage in Sino-Forest's trading business; relationships with local governments and plantation land owners have become strained; Sino-Forest is unable to complete various projects, contracts and

acquisitions; and the PRC government is expressing increased concern over SFC and is becoming less inclined to be supportive of Sino-Forest, making the ability to obtain legal documents for Sino-Forest's operations increasingly difficult.

**1. Diversion of Operational Resources & Effects on Operations**

183. The investigations being conducted by the OSC, the HKSFCA and the RCMP, the examination by the IC (and now the Audit Committee and Restructuring Committee), and the class action lawsuits have required, and will continue to require, significant resources to be expended by the directors, officers and employees of Sino-Forest. As a result, the diversion of such resources has affected Sino-Forest's ability to conduct its operations in the normal course of business. Sino-Forest's timber and trading businesses have effectively been frozen and have ground to a halt.

184. Since the MW Report was released, in order to conserve cash, Sino-Forest has only completed cash purchases which were previously committed to and has not made any new commitments (i.e. in the WFOE structure), despite having been presented with some attractive buying opportunities. Sino-Forest has therefore not grown its asset base as it would have but for the MW Report.

185. Also, the Sino-Forest Companies have had an extremely difficult time collecting outstanding receivables as a result of the perceived uncertainty surrounding them in the PRC. The total amount of outstanding receivables in the WFOE structure was approximately \$130.5 million as at February 29, 2012, with more than 83.5% of those receivables being over 90 days. Sino-Forest's counsel in the PRC, KaiTong Law Firm, has sent legal demand letters to 12 BVI trading companies for accounts receivable totaling approximately \$126 million and five WFOE

companies totaling approximately RMB 224.5 million. Additional legal demand letters for smaller accounts are also in process, and other accounts receivable are being negotiated.

186. At the same time that the Sino-Forest Companies are having a difficult time collecting outstanding receivables, they are receiving increased demands on their payables. Certain of Sino-Forest's creditors in the PRC have taken aggressive collection tactics in the PRC, including filing court claims in an effort to be paid amounts owed to them by Sino-Forest. If the uncertainty related to SFC is allowed to continue to affect Sino-Forest's business operations, Sino-Forest expects increasing legal actions from other creditors.

187. Sino-Forest has not been able to secure or renew certain existing onshore banking facilities and has been unable to obtain offshore letters of credit to facilitate Sino-Forest's trading business. All offshore banking facilities have been repaid and frozen, or cancelled. Since June 2, 2011, all Hong Kong banks have asked for voluntary repayment of outstanding loans. Banking facilities with a total credit amount of \$67.9 million were terminated by four banks between June 10, 2011 and August 29, 2011. Facilities of \$152.3 million were frozen upon full repayment. In the PRC, facilities totaling RMB 159.6 million were asking for voluntary repayments. For the PRC banks providing facilities, Sino-Forest was requested to increase its cash deposits so as to demonstrate financial strength. This has led to substantial damage in Sino-Forest's operations, and affects Sino-Forest's ability to complete obligations under existing contracts, resulting in losses potentially in excess of \$100 million.

188. Various projects and contracts, such as nursery projects in certain provinces with a contract value of approximately RMB 1 billion, have been stopped or are unable to be fulfilled.

189. Due to the allegations in the MW Report, the PRC government is expressing increased concern over SFC and is becoming less inclined to be supportive of Sino-Forest, making the ability to obtain legal documents more difficult. For example, the PRC government has withheld cutting licenses resulting in lower harvesting volumes. Relationships with local government and local plantation suppliers have also become strained, resulting in many difficulties and obstacles in Sino-Forest's operations including an inability to complete certain acquisitions of plantations. For example, in the Anqing, Anhui area in the PRC, the local government no longer showed support to Sino-Forest and the plantation land owner refused to honour the plantation purchase contracts.

## **2. Fees and Expenses**

190. SFC has and will continue to incur a substantial amount of fees and expenses in connection with the examination by the IC (and now the Audit Committee and Restructuring Committee), the investigations by the OSC and the RCMP, and the class action lawsuits. Further, pursuant to indemnification agreements between SFC and its directors and certain officers as well as with auditors, underwriters and other parties, SFC may be obligated to indemnify such individuals for additional legal and other expenses pursuant to such proceedings. The aggregate of such fees and expenses is substantial and has had an extremely negative effect on Sino-Forest's operating results.

## **3. Value of Common Shares and Credit Rating**

191. Prior to the release of the MW Report on June 2, 2011, SFC's common shares had a 20-day volume weighted average price of CDN \$19.58 for a total market capitalization of approximately CDN \$4.8 billion. In the weeks that followed the release of the MW Report, the value of SFC's common shares plunged to a low of CDN \$1.29 for a total market capitalization of

approximately CDN \$300 million. As at August 25, 2011, the day prior to the OSC cease trading SFC's common shares, its shares were trading at CDN \$4.81 for a total market capitalization of approximately CDN \$1.2 billion.

192. The allegations set forth in the MW Report have resulted in a material decline in the market value of SFC's common shares and notes. On June 30, 2011, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on SFC to 'B+' from 'BB', lowered the issue ratings on SFC's outstanding senior notes and convertible notes to 'B+', and lowered the Greater China scale credit ratings on SFC and its notes to 'cnBB' from 'cnBBB-'. On August 29, 2011, Standard & Poor downgraded to 'CCC-', then withdrew its ratings. Fitch Ratings withdrew its Foreign Currency Issuer Default Rating and senior debt rating of 'BB-' on July 14, 2011, after placing SFC on Negative Watch on June 20, 2011. On July 19, 2011, Moody's Investors Service downgraded the corporate family and senior unsecured debt ratings of SFC to 'B1' from 'Ba2'. On August 29, 2011, Moody's downgraded to 'Caa1' from 'B1', and on December 14, 2011, Moody's downgraded to 'Ca1' and withdrew its rating.

193. Sino-Forest's primary sources of funding have been short-term and long-term borrowings, equity offerings and cash generated by operating activities. However, as a result of the reputational damage that the MW Report inflicted on SFC, I believe that SFC has no ability to access the capital markets at the present time, including to refinance its notes.

## **VI. CLAIM AGAINST MUDDY WATERS**

194. On March 29, 2012, SFC commenced a claim in the Ontario Superior Court of Justice against Muddy Waters, its principal, and persons who traded with prior knowledge of the MW Report. A copy of SFC's claim against Muddy Waters *et al* is attached as Exhibit "BB".

195. In this action, SFC seeks total damages in the sum of CDN \$4 billion in relation to harm caused to SFC as a result of the allegations made by Muddy Waters. If SFC is successfully restructured as contemplated, it is anticipated that the action will be funded by the litigation trust provided for in the Support Agreement described below, and the benefits of the action will be shared as contemplated by the Support Agreement.

## **VII. PROPOSED RESTRUCTURING TRANSACTIONS**

196. Following extensive arm's length negotiations between SFC and the Ad Hoc Noteholders, the parties entered into the Support Agreement. The Support Agreement contains, among other things, the summary terms and conditions of a going concern restructuring of SFC (the "Restructuring Transaction"). A copy of the Support Agreement is previously attached.

197. The Support Agreement provides that SFC will file the Plan in order to implement the Restructuring Transaction as part of this CCAA proceeding, and that the Consenting Noteholders will vote their notes in favour of the Plan at any meeting of creditors, each subject to certain conditions.

198. From a commercial perspective, the Restructuring Transaction contemplated by the Support Agreement is intended to accomplish the following objectives:

- (a) the separation of Sino-Forest's business operations from the problems facing SFC outside of the PRC by transferring the intermediate holding companies which own "the business" and SFC's intercompany claims against its subsidiaries (which include the entire substantive operations of the Sino-Forest Companies) to the noteholders in compromise of their claims against SFC (if the Sale Process does not generate a superior transaction, as described below);

- (b) the Sale Process being undertaken to determine if any person or group of persons will purchase Sino-Forest's business operations pursuant to the Plan for an amount of consideration acceptable to SFC and the noteholders, with the potential for excess above such amount being directed to Junior Constituents. The Sale Process is intended to ensure that SFC is pursuing all avenues to maximize value for its stakeholders;
- (c) a structure (including funding) that will enable litigation claims to be pursued for the benefit of SFC's stakeholders in accordance with the Support Agreement against a number of potential defendants (including Muddy Waters, its principal, and any persons who benefited from the allegations made by Muddy Waters in a coordinated way); and
- (d) if the Sale Process does not result in a sale, the Junior Constituents recovering some "upside" in the form of a profit participation if Sino-Forest's business operations acquired by the noteholders are monetized within seven years from the date of the implementation of the Plan at a profit, as further described in the Support Agreement.

199. The decision to enter into the Support Agreement was given careful consideration by SFC and the Board and was not taken lightly. However, the inability to obtain an audit creates a default under the note indentures which simply cannot be cured within a reasonable timeframe, if at all.

200. More significantly, it has become clear that the problems facing SFC outside of the PRC are causing Sino-Forest's business operations in the PRC to deteriorate and that, unless decisive

steps are taken to restructure Sino-Forest, the PRC business operations will continue to deteriorate to the point that they will cease to be capable of being turned around, which will further diminish the value that can be realized for SFC and its stakeholders. While there remains substantial work ahead in the PRC to turn the business around and convince stakeholders in the PRC (including customers, suppliers, employees and PRC governmental officials of all levels) that the Sino-Forest business built up over the past 18 years is here to stay, I firmly believe that the transactions which SFC proposes to initiate pursuant to the CCAA will show a path out of the uncertainty which it has faced since last June.

201. The Support Agreement provides that SFC will make an application under the CCAA in order to implement the Plan. The Consenting Noteholders executed the Support Agreement on the basis that a restructuring of SFC as proposed would be undertaken pursuant to the CCAA.

202. But for the negotiation and execution of the Support Agreement, SFC would be unable to prevent the acceleration and enforcement of the rights of the noteholders as soon as April 30, 2012, in which case SFC would be unable to continue as a going concern, and is thus insolvent. Accordingly, and for the reasons set out herein, a restructuring is urgently required and should be pursued to preserve its enterprise value.

203. SFC has reached an agreement on a consensual restructuring transaction with the Ad Hoc Noteholders. SFC is seeking a stay of proceedings under the CCAA in order to allow it time to proceed to develop the Plan which, if approved by the creditors and this Honourable Court, would, among other things, allow for a going concern emergence of Sino-Forest's business.

## VIII. THE SALE PROCESS

204. Under the Sale Process, SFC, through its financial advisor, Houlihan Lokey ("Houlihan"), and with the oversight of the monitor, will seek qualified purchasers (including existing shareholders and noteholders) of SFC's assets on a global basis and attempt to engage them in the Sale Process. The Sale Process Procedures, which were agreed to by the parties to the Support Agreement in consultation with the proposed monitor, provide that SFC will have up to 90 days to solicit letters of intent, and if qualified letters of intent are received, a further 90 days to solicit qualified bids. A copy of the Sale Process Procedures is attached as Schedule D to the Support Agreement.

205. I believe it is critically important that the Sale Process Order be granted at this time for a variety of reasons. First and most importantly, it is very important that SFC conclude a restructuring by the end of the third fiscal quarter. The business of the Sino-Forest Companies is seasonal, and the vast majority of transactions (both purchases and sales) typically occur in the third and fourth quarters. All stakeholders will therefore be prejudiced if SFC cannot complete a restructuring by the end of the third quarter, or soon thereafter, as the business will continue to be frozen through the critical fourth quarter.

206. With that target end date in mind, the process must begin immediately. I understand that in other insolvency filings in Canada, sale processes have been done on much shorter timetables than what SFC is proposing; however, I believe the proposed timetable is necessary and appropriate in light of the specific circumstances. In fact, given the critical timing of this process, I am aware that Houlihan has already been in contact with parties who may be interested parties in this Sale Process.

207. The assets being sold, especially given the allegations in the MW Report, are extremely complex and are being offered for sale without current audited financial statements. Potential buyers therefore need to be afforded sufficient time to do due diligence.

208. In addition, there are limited potential buyers for these assets. I believe that potential buyers will need to have, in addition to the significant capital to complete a transaction of this size, an in-depth and intimate knowledge of the PRC market. I do not expect that the ultimate buyer for these assets, if any, will be a typical buyer of distressed assets in an insolvency proceeding.

209. Accordingly, given that a transaction must be implemented as soon as possible, and given the complexity of the assets and the fact that there is a limited universe of potential buyers, I believe it is necessary that the Sale Process Order be granted at this time, and that the Sale Process provides the best potential for recovery for SFC's stakeholders.

210. I have no reason to believe that any creditors have a *bona fide* reason to object to the Sale Process.

#### **IX. SFC MEETS CCAA STATUTORY REQUIREMENTS**

211. I am advised by Gary Solway of Bennett Jones LLP, counsel to SFC, that the CCAA applies in respect of a "debtor company" if the claims against the debtor company or affiliated debtor companies total more than CDN \$5 million. I am further advised by Gary Solway that a "debtor company" is a company incorporated under an Act of Parliament or the legislature of a province which has, among other things, become bankrupt or insolvent.

**A. SFC is a "Company" Under the CCAA**

212. SFC is a "company" to which the CCAA applies as it is a company continued under the CBCA. A copy of SFC's articles of continuance was previously attached.

**B. SFC has Claims Against it in Excess of \$5 Million**

213. As discussed above, SFC has debts against it far in excess of the CDN \$5 million statutory requirement.

**C. SFC is Insolvent**

214. I am advised by Gary Solway of Bennett Jones LLP, counsel to SFC, that under section 2 of the *Bankruptcy and Insolvency Act* (and a similar definition exists under sections 192(2) and 208 of the CBCA), an insolvent person is one whose liabilities to creditors exceeds CDN \$1,000 and (i) is for any reason unable to meet his obligations as they generally become due, (ii) has ceased paying his current obligations in the ordinary course of business as they generally become due, or (iii) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

215. As discussed herein, the holders of SFC's senior notes entered into waiver agreements wherein they agreed not to have the indenture trustees demand immediate payment of the principal amount of the senior notes. Such waiver agreements expire on the earlier of April 30, 2012 and any earlier termination of the waiver agreements in accordance with their terms. Moreover, in addition to the default dealt with pursuant to the waiver agreements in respect of the Q3 Results, SFC will be in further default on April 30, 2012 as a result of the fact that it will

fail to file its audited 2011 Results. As discussed in greater detail herein, SFC will be unable to cure such default in the immediate to near term (if ever).

216. But for the execution of the Support Agreement and the standstill provided for therein, the indenture trustees under the notes could be entitled to accelerate and enforce the rights of the noteholders as soon as April 30, 2012. Without the liquidity provided by the waiver agreements, SFC would be unable to meet its obligations as they come due or continue as a going concern and is thus insolvent.

## **X. RELIEF SOUGHT**

### **A. Stay of Proceedings**

217. SFC needs a stay of proceedings to pursue and implement the Restructuring Transaction in an attempt to complete a going concern restructuring of its businesses. In the interim, the class actions lawsuits, as well as any other potential actions, need to be stayed so that the Restructuring Committee can focus on formulating the Plan.

### **B. Appointment of Monitor**

218. FTI Consulting Canada Inc. ("FTI") has consented to act as the monitor of SFC (the "Monitor") in the CCAA proceedings, and I believe that FTI is qualified and competent to so act.

219. FTI will be filing a pre-filing report with the Court as prospective monitor in conjunction with SFC's request for relief under the CCAA.

### **C. Payments During CCAA Proceeding**

220. During the course of this CCAA proceeding, SFC intends to make payments for goods and services supplied post-filing as set out in the cash flow projections described below and as permitted by the draft Initial Order.

**D. Administration Charge**

221. It is contemplated that the Monitor, counsel to the Monitor, counsel to SFC, counsel to the Board, Houlihan, FTI Consulting (Hong Kong) Limited, counsel to the Ad Hoc Noteholders and the financial advisor to the Ad Hoc Noteholders would be granted a first priority Court-ordered charge on the assets, property and undertakings of SFC, other than SFC's assets which are subject to *Personal Property Security Act* registrations (the "SFC Property") in priority to all other charges (the "Administration Charge") up to the maximum amount of CDN \$15 million in respect of their respective fees and disbursements, incurred at standard rates and charges. SFC believes the Administration Charge is fair and reasonable in the circumstances.

222. The nature of the Sino-Forest Companies' business requires the expertise, knowledge and continuing participation of the proposed beneficiaries of the Administration Charge in order to complete a successful restructuring. I believe this Administration Charge is necessary to ensure their continued participation.

223. I do not believe that there is any unwarranted duplication of roles between the proposed beneficiaries of the Administration Charge.

**E. Directors' Charge**

224. A successful restructuring of SFC will only be possible with the continued participation of the Board. These personnel are essential to the viability of the continuing business of Sino-Forest. SFC's Board members have specialized expertise and relationships with Sino-Forest's suppliers, employees and other stakeholders, as well as knowledge gained throughout the IC process that cannot be replicated or replaced.

225. The directors of SFC have indicated that due to the potential for significant personal liability, they cannot continue their service in this restructuring unless the Initial Order grants a charge on the SFC Property in priority to all other charges except the Administration Charge, as security for SFC's indemnification obligations for the potential obligations and liabilities they may incur after the commencement of these proceedings. It is proposed that the directors of SFC be granted a directors' charge in the amount of CDN \$3.2 million (the "Directors' Charge") over the SFC Property. SFC believes the Directors' Charge is fair and reasonable in the circumstances.

226. SFC, for itself and its subsidiaries, currently has primary insurance coverage of \$10 million and five separate excess insurance policies collectively providing CDN \$45 million (the "2012 Insurance Policies"), for a total of CDN \$55 million of coverage in place to attempt to protect SFC and its directors and officers. The 2012 Insurance Policies were put in place and became effective after prior policies of insurance were not renewed following their expiry on December 31, 2011, by the insurers who had issued the policies (the "2011 Insurance Policies"). Although coverage is being provided to SFC and certain of its directors and officers under the 2011 Insurance Policies for claims that were advanced or threatened prior to the expiry of the 2011 Insurance Policies on December 31, 2011, those policies provide no coverage or protection to SFC or its officers and directors for new claims that are made after December 31, 2011 which are based on new events or allegations unrelated to the subject matter of the claims that have already been advanced or threatened.

227. As was the case with the 2011 Insurance Policies, the 2012 Insurance Policies provide for three types of coverage: (i) director and officer liability, (ii) corporate liability for indemnifiable loss, and (iii) corporate liability arising from securities claims. The 2012 Insurance Policies expire on December 31, 2012 and exclude coverage for directors' liabilities for wages. There are

also other exclusions and limitations of coverage which may leave SFC's directors and officers without coverage under the 2012 Insurance Policies. Depending on the circumstances of any particular claim, the insurers which have issued the 2012 Insurance Policies may deny coverage on the basis that the 2012 Insurance Policies exclude such other claims, that coverage limits have been exhausted by claims made against the 2012 Insurance Policies, or that the matters reported fall within the coverage provided by the 2011 Insurance Policies (which are already responding to a number of significant claims that have the potential to exhaust or exceed the applicable limits). Finally, there is no guarantee that SFC will be able to renew the 2012 Insurance Policies when they expire at the end of the year.

228. Contractual indemnities have been provided by SFC to its directors. SFC does not have sufficient funds to satisfy those indemnities should the directors of SFC incur obligations and liabilities in that regard after the commencement of these proceedings.

229. The Directors' Charge is necessary so that SFC may benefit from its directors' experience, knowledge and ability to guide SFC's restructuring efforts. It is critical to the restructuring efforts that SFC's directors remain with SFC in order to assist SFC in achieving the Restructuring Transaction to benefit SFC's stakeholders.

230. As such, it is proposed that the priorities of the Administration Charge and the Directors' Charge be as follows:

- (a) First -- Administration Charge; and
- (b) Second -- Directors' Charge.

231. Based on the books and records of SFC, and to the best of my knowledge, there are no secured creditors who are likely to be affected by the Administration Charge or the Directors' Charge.

**F. Postponement of Annual Shareholders' Meeting**

232. As previously mentioned, SFC is a public company under the CBCA. I am advised by Gary Solway of Bennett Jones LLP, counsel to SFC, that, as such, SFC is required, pursuant to paragraph 133(1)(b) of the CBCA, to call an annual meeting of its shareholders by no later than June 30, 2012, being six months after the end of its preceding financial year which ended on December 31, 2011. Accordingly, SFC is required to call its annual general meeting no later than June 30, 2012. SFC's annual general meeting has typically been held in the month of May.

233. However, the management of SFC and other Sino-Forest Companies are presently devoting their efforts to stabilizing the business with a view to implementing the Restructuring Transaction in accordance with the terms of the Support Agreement.

234. Preparing the proxy materials required for an annual meeting of shareholders (which must be prepared well in advance of any meeting so that they can be mailed to shareholders in advance of the meeting) and holding the annual meeting of shareholders would divert the attention of senior management of the Sino-Forest Companies away from implementing the Restructuring Transaction, would require significant financial resources, and could impede SFC's ability to achieve a restructuring under the CCAA.

235. In addition, pursuant to section 155 of the CBCA, SFC is required to place before the annual meeting financial statements of SFC for a period ended not more than six months prior to

the date of the annual meeting. SFC has been unable to complete its financial statements for the reasons already discussed.

236. I am advised by Gary Solway of Bennett Jones LLP, counsel to SFC, that, under subsection 106(6) of the CBCA, if directors are not elected at an annual meeting, the incumbent directors will continue to hold office until their successors are elected.

237. Certain financial and other information is and will continue to be available to the public through SFC's court filing which will be easily accessible on the proposed Monitor's website (<http://cfcanda.fticonsulting.com/sfc>). Consequently, the failure to hold an annual general meeting within the time prescribed by the CBCA will not deprive shareholders of access to the financial information of SFC that is publicly available from SFC.

238. Under the circumstances, I believe it is impractical for SFC to call and hold an annual meeting of shareholders during this CCAA proceeding.

#### **G. Foreign Proceedings**

239. SFC is seeking in the Initial Order to have the Monitor authorized, as the foreign representative of SFC, to apply for recognition of these proceedings, as necessary, in any jurisdiction outside of Canada, including as "Foreign Main Proceedings" in the United States pursuant to Chapter 15 of the *U.S. Bankruptcy Code* (the "Chapter 15 Proceedings"). The initial effect of the Chapter 15 Proceedings would be to give effect to the Initial Order in the United States.

## **H. Financial Advisor Agreement**

240. It became clear to SFC at the beginning of September 2011, that it would greatly benefit from the expertise of a financial advisor. Accordingly, SFC invited four reputable global financial advisory firms to make presentations for the role on or about September 14, 2011. Houlihan was selected as SFC's first choice as a result of, among others, its significant experience in debt restructurings, its strong presence and reputation in both the North American and Asian markets, and its strong standing with the global noteholders community, especially those event driven funds which customarily play a leadership role in these situations.

241. On or about September 26, 2011, Bennett Jones LLP, as counsel to SFC, entered into an agreement with Houlihan relating to Houlihan's provision of financial advisory and investment banking services to SFC. That agreement was amended and replaced by an agreement dated as of December 22, 2011 (the "Financial Advisor Agreement"). A copy of the Financial Advisor Agreement is attached as Exhibit "CC".

242. The Financial Advisor Agreement provides, among other things, that if SFC commences any proceedings under the CCAA or similar legislation or statute, SFC will promptly seek to have the Court approve (i) the Financial Advisor Agreement, and (ii) Houlihan's retention by SFC under the terms of the Financial Advisor Agreement, including the payment to be made to Houlihan thereunder. As such, the draft Initial Order provides for such approvals.

243. It is my belief that Houlihan's significant restructuring experience and expertise in the area of debt restructuring has greatly benefited SFC. The proposed Restructuring Transaction would not have been achievable without the advice and assistance of Houlihan. Houlihan was also instrumental in assisting SFC in obtaining the waiver agreements described herein.

244. Houlihan has spent approximately seven months working closely with senior management of SFC and its other advisors. Houlihan has greatly assisted SFC in its restructuring efforts to date and has gained a thorough and intimate understanding of the Sino-Forest business. If SFC was deprived of the benefit of Houlihan's continued advice and assistance and was required to retain a new financial advisor, it would likely take a significant period of time for such a financial advisor to acquire a similar working knowledge of the business and would make it extremely difficult, if not impossible, to implement the Restructuring Transaction in the currently contemplated time frame. Thus, I believe that the continued involvement of Houlihan is essential to the completion of the Restructuring Transaction.

245. It is also my belief that the quantum and nature of the remuneration provided for in the Financial Advisor Agreement is fair and reasonable. Specifically, the restructuring fees payable to Houlihan are only payable if a restructuring transaction is completed and the quantum of those fees is dependent on various factors intended to measure the success of the restructuring.

#### **XI. 13 WEEK CASH FLOW FORECAST**

246. As set out in the cash flow forecast attached as Exhibit "DD", SFC's principal uses of cash during the next 13 weeks will consist of the payment of ongoing day-to-day operational expenses, the costs associated with the ongoing investigation into the MW Report, the costs associated with responding to demands from the OSC, HKSFC and RCMP for information, and professional fees and disbursements in connection with these CCAA proceedings.

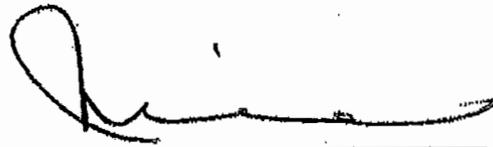
247. As at March 29, 2012, SFC had approximately \$67.8 million available cash on hand. SFC's cash flow forecast projects that, subject to obtaining the relief outlined herein, it will have sufficient cash to fund its projected operating costs for the next 13 weeks.

**XII. CONCLUSION**

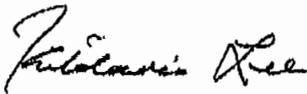
248. I am confident that granting the Initial Order and Sale Process Order sought by SFC is in the best interests of SFC and its stakeholders. SFC requires the stay of proceedings to pursue and implement the Restructuring Transaction in an attempt to complete a going concern restructuring of its businesses. The Ad Hoc Noteholders support this application and SFC's pursuit of the Plan in this CCAA proceeding.

249. Without the stay of proceedings and the opportunity to effect the Restructuring Transaction (including the Sale Process), Sino-Forest faces a possible cessation of going concern operations, the liquidation of its assets, and the loss of employment for a significant number of employees worldwide. The granting of the requested stay of proceedings will assist an orderly restructuring of SFC.

SWORN BEFORE ME at the City of Hong Kong, Special Administrative Region, People's Republic of China, this 30th day of March, 2012



W. Judson Martin



LEE HONG KU KILDARIA

Solicitor, Hong Kong SAR

**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 OR COMPROMISE OR ARRANGEMENT OF SINO-FOREST CORPORATION**  
Court File No.

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
(COMMERCIAL LIST)**

Proceedings commenced in Toronto

**AFFIDAVIT OF W. JUDSON MARTIN**  
(Sworn March 30, 2012)

**BENNETT JONES LLP**  
One First Canadian Place  
Suite 3400, P.O. Box 130  
Toronto, Ontario  
M5X 1A4

Robert W. Staley (LSUC #27115J)  
Kevin Zych (LSUC #33129T)  
Derek J. Bell (LSUC #43420J)  
Jonathan Bell (LSUC #55457P)  
Tel: 416-863-1200  
Fax: 416-863-1716

Lawyers for the Applicant

**APPENDIX C - MEDIATION ORDER**

*(See Attached)*

**ONTARIO**  
**SUPERIOR COURT OF JUSTICE**  
**COMMERCIAL LIST**

THE HONOURABLE MR. ) WEDNESDAY, THE 25<sup>th</sup>  
 )  
JUSTICE MORAWETZ ) DAY OF JULY, 2012



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 AND  
ARRANGEMENT OF SINO-FOREST CORPORATION

**ORDER**  
**(Mediation)**

THIS MOTION, made by FTI Consulting Canada Inc. in its capacity as monitor (the "**Monitor**") of Sino-Forest Corporation (the "**Applicant**") for a consent order concerning mediation and related relief was heard this day at 330 University Avenue, Toronto, Ontario.

ON READING the Monitor's Notice of Motion dated July 13, 2012 and the Fifth Report of the Monitor dated July 13, 2012 (the "**Fifth Report**"), the Responding Motion Record of the Applicants and the Responding Motion Record of Pöyry Beijing (as defined below), and on hearing the submissions of counsel for the Applicant, the Monitor, the ad hoc committee of Noteholders (the "**Ad Hoc Noteholders**"), the ad hoc group of purchasers of the Applicant's securities (the "**Plaintiffs**") and the other defendants in the Ontario Class Action and the Quebec Class Action (the "**Third Party Defendants**") and those other parties present, no one appearing for any of the other parties served with the Monitor's Motion Record, although duly served as appears from the affidavit of service of Alma Cano sworn July 13, 2012, filed.

## **SERVICE AND INTERPRETATION**

1. THIS COURT ORDERS that the time for service of the Notice of Motion and the Motion Record, including the Fifth Report, is hereby abridged and validated such that this Motion is properly returnable today and hereby dispenses with further service thereof.
2. THIS COURT ORDERS that capitalized terms used herein and not otherwise defined shall have the meaning given to them in the Fifth Report.

## **MEDIATION**

3. THIS COURT ORDERS that the parties eligible to participate in the Mediation pursuant to paragraph 5 of this Order are the Applicant, the Plaintiffs, the Third Party Defendants (which shall be read to exclude Pöyry (Beijing) Consulting Company Limited (“**Pöyry Beijing**”)), the Monitor, the Ad Hoc Noteholders and any insurers providing coverage in respect of the Applicant and the Third Party Defendants (collectively, the “**Mediation Parties**”).
4. THIS COURT ORDERS that the subject matter of the Mediation shall be the resolution of the claims of the Plaintiffs against the Applicant and the Third Party Defendants as set out in the statements of claim in the Ontario Class Action and the Quebec Class Action and any and all related claims (the “**Subject Claims**”), provided that for the purpose of the Mediation, the Plaintiffs shall not seek contribution from any of the Mediation Parties with respect to amounts that could have been sought by the Plaintiffs from Pöyry Beijing had the Plaintiffs not reached a settlement with Pöyry Beijing (the “**Pöyry Settlement**”) and provided that the Plaintiffs shall provide to the Mediation Parties, within 10 days of the date of this Order or such further time as this Court may direct, a written summary of evidence proffered by Pöyry Beijing pursuant to the Pöyry Settlement, which summary shall be treated in the same manner as material in the Data Room (as defined below) pursuant to this Order.
5. THIS COURT ORDERS that, where practicable, the Mediation Parties shall participate in the Mediation in person and with representatives present with full authority to settle the Subject Claims (including any insurer providing coverage), provided that, where not practicable, the Mediation Parties may participate in the Mediation through counsel or other representatives, subject to those counsel or other representatives having access to representatives with full

authority and undertaking to promptly pursue instructions with respect to any proposed agreements that arise from the Mediation.

6. THIS COURT ORDERS that parties in addition to the Mediation Parties shall only have standing to participate in the Mediation on consent of the Applicant and the Monitor, acting reasonably, or by further Order of this Court.

#### **DATA ROOM**

7. THIS COURT ORDERS that in connection with the Mediation, as soon as practicable, but in any event no later than August 3, 2012, the Applicant shall provide access to the Mediation Parties to the existing data room maintained by Merrill (the "**Data Room**"), provided however that prior to access to the Data Room, all participants (other than the Applicant, the incumbent directors of the Applicant and the Monitor) shall have entered into a confidentiality agreement with the Applicant on terms reasonably acceptable to the Applicant and the Monitor.

8. THIS COURT ORDERS that any Mediation Parties who enter into a confidentiality agreement as contemplated by paragraph 7 of this order shall comply with the terms of such confidentiality agreement.

9. THIS COURT ORDERS that the Applicant, its subsidiaries and affiliates, and their directors, officers, employees, agents and advisors, shall incur no liability in connection with causing, effecting or acquiescing in the establishment of the Data Room or disclosure in respect of such materials and the information contained therein in accordance with this Order. The materials in the Data Room shall be made available without any representation as to the truth of their contents or their completeness, and persons relying on those materials shall do so at their own risk. The disclosure of such materials and the information contained therein in accordance with this Order is not and shall not be public disclosure in any respect. Nothing in this paragraph affects any rights or causes of action that any person may have in relation to the prior disclosure of any of the contents of the Data Room, insofar as such rights or causes of action are independent from and not related to the provision of materials and information in accordance with this Order.

## **MEDIATION SCHEDULE**

10. THIS COURT ORDER THAT, the schedule for the Mediation shall be as follows:
- (a) the Mediation shall be conducted on September 4<sup>th</sup> and 5<sup>th</sup>, and if a third day is required, on September 10<sup>th</sup>, 2012 (the “**Mediation Dates**”);
  - (b) additional Mediation dates shall only be added, and any adjournments of any mediation dates shall only be accepted, with the prior written consent of all Mediation Parties;
  - (c) the Mediation shall be conducted at a location to be determined by the Mediator (as defined below); and
  - (d) the Applicant, the Plaintiffs and the Third Party Defendants shall deliver their respective written position statements to each other and to the other Mediation Parties on or before August 27, 2012.

## **APPOINTMENT OF THE MEDIATOR**

11. THIS COURT ORDERS that the Honourable Justice Newbould shall be appointed mediator (the “**Mediator**”).

12. THIS COURT ORDERS that, prior to the commencement of the Mediation, the Mediator shall have the right to communicate with this Court and the Monitor from time to time as deemed necessary or advisable by the Mediator in their sole discretion.

## **TERMINATION OF THE MEDIATION**

13. THIS COURT ORDERS that the Mediation process shall be terminated under any of the following circumstances:

- (a) by declaration by the Mediator that a settlement has been reached;
- (b) by declaration by the Mediator that further efforts at mediation are no longer considered worthwhile;

- (c) for any other reason determined by the Mediator;
- (d) mutual agreement by the Mediation Parties; or
- (e) further Order of this Court,

provided that, the Mediation shall in any event terminate on September 10, 2012, unless extended with the prior written consent of all Mediation Parties.

#### **NO IMPACT ON OTHER PROCEEDINGS**

14. THIS COURT ORDERS that all offers, promises, conduct statements, whether written or oral, made in the course of the Mediation are inadmissible in any arbitration or court proceeding. No person shall subpoena or require the Mediator to testify, produce records, notes or work product in any other existing or future proceedings, and no video or audio recording will be made of the Mediation. Evidence that is otherwise admissible or discoverable shall not be rendered inadmissible or non-discoverable as a result of its use in the Mediation. In the event that the Mediation Parties (or any group of them) do reach a settlement, the terms of that settlement will be admissible in any court or other proceeding required to enforce it, unless the Mediation Parties agree otherwise. Information disclosed to the Mediator by any Mediation Party at a private caucus during the Mediation shall remain confidential unless such Mediation Party authorizes disclosure.

15. THIS COURT ORDERS that nothing in this Order nor the participation of any party in the Mediation shall provide such party with rights within these proceedings than such party may otherwise have.

16. THIS COURT ORDERS that, subject to any applicable stay of proceedings, nothing in this Order shall prevent the Applicant, the Monitor or any other party of standing from otherwise pursuing the resolution of claims under the Claims Procedure Order granted by this Court on May 14, 2012, or any other matter in these CCAA proceedings, including without limitation, the filing and advancement of the Meetings Order and a Plan.

**CONFIDENTIALITY**

17. THIS COURT ORDERS that any mediation briefs or other documents filed by the Mediation Parties shall be used only in the context of the Mediation and for no other purpose and shall be kept confidential by all such parties irrespective of whether such Mediation Parties sign a confidentiality agreement.

18. THIS COURT ORDERS that any mediation briefs or other documents filed by the Mediation Parties that contain information obtained from the Data Room may not be shared with or otherwise disclosed to any person or entity that has not signed a confidentiality agreement, other than the Applicant, the incumbent directors of the Applicant, the Monitor and Mediator.

**MISCELLANEOUS**

19. THIS COURT ORDERS that the terms of this Order may only be varied by further Order of this Court, which may be sought on an ex parte basis on consent of the Mediation Parties.

ENTERED AT / ENREGISTRÉ À TORONTO  
DE / BOOK NO:  
LE / DANS LE REGISTRE NO.:  
TOR\_LAW\7922234\10  
JUL 30 2012

  
\_\_\_\_\_

RECEIVED: 

**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**

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
(COMMERCIAL LIST)**

**(PROCEEDING COMMENCED AT TORONTO)**

**ORDER  
(Mediation)**

**GOWLING LAFLEUR HENDERSON LLP**  
Barristers and Solicitors  
1 First Canadian Place  
100 King Street West, Suite 1600  
TORONTO, Ontario  
M5X 1G5

**Derrick Tay / Clifton Prophet / Jennifer Stam  
LSUC Nos.: 21152A / 34345K / 46735J**

Telephone: (416) 862-7525  
Facsimile: (416) 862-7661

Lawyers for FTI Consulting Canada Inc.,  
in its capacity as Monitor of the Applicant

**APPENDIX D - ORDER (JULY 30, 2012)**

*(See Attached)*



2. **THIS COURT ORDERS** the Applicant to make the documents listed in Schedule "A" hereto (the "Documents") available to the Moving Party and the other Mediation Parties (as defined in the order of this court dated July 25, 2012 (the "Mediation Order")), subject to: (i) the provisions of the Mediation Order applicable to information made available through the electronic data room referenced in the Mediation Order (the "Data Room"), including without limitation the requirement for confidentiality agreements; and (ii) any claims of privilege; and provided, for greater certainty, that the Applicant need not produce any audit-related documents created after June 2, 2011.
  
3. **THIS COURT ORDERS** that the Documents shall be added to the Data Room by the Applicant as and when they become available, but the Applicant shall make best efforts to add the Documents to the Data Room by August 16, 2012, and that, in any event, the Applicant shall add the Documents to the Data Room by no later than August 23, 2012.
  
4. **THIS COURT ORDERS** that, promptly following the addition of any Documents to the Data Room, the Applicant shall notify or shall cause to be notified, by email, those persons who have executed the Confidentiality Agreement pursuant to this Court's Mediation Order that such Documents have been added to the Data Room, but in no event shall the Applicant be required to provide such notification more than one time per day.
  
5. **THIS COURT ORDERS** that, to the extent that the Applicant withholds production of any Documents on the basis of a claim of privilege, the Applicant shall produce an itemized list describing each of the documents in the form of or substantially similar to a Schedule "B" of an affidavit of documents, with sufficient specificity to establish the Applicant's claim for privilege, including, without limitation, identifying information for each document, the nature of the privilege being asserted in respect of the document, and, if litigation privilege is being asserted, reasonable identifying

information regarding the litigation that gives rise to the privilege (the "Privilege Log"). The Applicant shall add the Privilege Log to the Data Room by August 27, 2012, unless the Court orders otherwise.

6. **THIS COURT ORDERS** that the Documents specified in clauses 1, 2(s), 3 and 4 of Schedule "A" hereto shall be in the English language.



ENTERED AT / ENREGISTRÉ À TORONTO  
DE / BOOK NO.  
LE / DANS LE REGISTRE NO.:

JUL 30 2012

PER/PAR:



## Schedule "A"

1. the unconsolidated financial statements of Sino-Forest Corporation and its subsidiaries prepared prior to June 2, 2011;
2. the following documents relating to Sino-Forest audits, for each of the fiscal years 2006 through 2010, inclusive, for each audited entity:
  - a) Information request list for each year's audit, detailing the documents to be provided by the company to the auditor;
  - b) The Year End Communication or Report of the Auditor to the Audit Committee from BDO or E&Y, including:
    - i) Audit scope and findings report;
    - ii) Significant matters discussed with management;
    - iii) Management's analysis and response;
    - iv) Significant judgments and estimates;
    - v) Audit risks encountered/identified and audit response; and
    - vi) Summary of corrected and uncorrected financial statement misstatements;
  - c) Communications between the auditors and the company regarding any disagreements with management;
  - d) The unadjusted (pre-audit) trial balance;
  - e) Proposed Adjustments presented by the auditor following each year's audit (listing adjusting journal entries, analysis and explanations);
  - f) List of related parties provided to the auditor each year;
  - g) Correspondence with the auditor concerning related parties and related party transactions;
  - h) Accounting policy manuals or documented accounting policies of the company for each year;

- i) Process and procedure manuals of the company for each year, particularly pertaining to the sales cycle and purchase/acquisition cycle;
- j) Ledgers and subledgers for the following accounts:
  - i) Cash;
  - ii) Sales;
  - iii) Timber Inventory; and
  - iv) Cost of Goods Sold;
- k) Sale transaction documents provided to (requested by) the auditors in respect of timber transactions:
  - i) Sales order (or purchase order from customer) or Sales contract/agreement;
  - ii) Invoice; and
  - iii) Proof of collection;
- l) Purchase transaction documents provided to (requested by) the auditors in respect of timber transactions:
  - i) Purchase order (or contract/agreement);
  - ii) Invoice; and
  - iii) Proof of payment;
- m) Transaction documents provided to auditor in respect of Sino's "set-off" agreements on timber transactions;
- n) Correspondence with auditors regarding confirmation of transactions with authorized intermediaries and suppliers (or authorization provided to Auditors to confirm directly with the AIs and Suppliers);
- o) Documentation concerning the auditors' procedures to independently examine timber assets, including on-site physical inspection, inventory counts, examination of transaction documentation, etc.;

- p) Internal worksheets, analyses and calculations supporting the "related party transactions" disclosure in each year's financial statements (e.g., see Note 23 of the 2009 financial statements);
  - q) Any additional information provided to/requested by the auditor regarding related party transactions;
  - r) Drafts and correspondence regarding the preparation of the Cash Flow Statement;
  - s) A statement of the total fees paid to the Applicant's auditors in respect of each of the 2006-2010 fiscal years; in addition, the Applicant shall make best efforts to break down such fees by audit-related and non-audit-related work (if any), and if non-audit related work was performed by the Applicant's auditors in any such year, a reasonably detailed description of the non-audit-related work performed by the auditors in such year;
  - t) Minutes of all meetings in which the auditors and members of management participated; and
  - u) BDO and E&Y presentations to the board of directors and management.
3. a summary of the coverage positions of the insurers of the Applicant and its directors and officers, and an approximation of the remaining insurance coverage; and
  4. the claims register as provided by the Monitor .

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

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

**ONTARIO**  
**SUPERIOR COURT OF JUSTICE**  
**COMMERCIAL LIST**  
Proceedings commenced at  
**TORONTO**

**ORDER**

**PALIARE ROLAND ROSENBERG ROTHSTEIN LLP**  
250 University Avenue, Suite 501  
Toronto, ON M5H 3E5  
Ken Rosenberg / Massimo Starnino  
Tel: 416-646-4300 Fax: 416-646-4301

**KOSKIE MINSKY LLP**  
20 Queen Street West, Suite 900  
Toronto, ON M5H 3R3  
Kirk Baert / Jonathan Bida  
Tel: 416-977-8353 Fax: 416-977-3316

**SISKINDS LLP**  
680 Waterloo Street  
London, ON N6A 3V8  
A. Dimitri Lascaris / Charles M. Wright  
Tel: 519-672-2121 Fax: 519-672-6065

Lawyers for the Ad Hoc Committee of Purchasers of  
the Applicant's Securities, including the  
Representative Plaintiffs in the Ontario Class Action

**APPENDIX E - EQUITY CLAIMS DECISION**

*(See Attached)*

CITATION: Sino-Forest Corporation (Re), 2012 ONSC 4377  
COURT FILE NO.: CV-12-9667-00CL  
DATE: 20120727

**SUPERIOR COURT OF JUSTICE – ONTARIO**

**(COMMERCIAL LIST)**

**RE: 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, Applicant**

**BEFORE: MORAWETZ J.**

**COUNSEL: Robert W. Stalcy and Jonathan Bell, for the Applicant**

**Jennifer Stam, for the Monitor**

**Kenneth Dekker, for BDO Limited**

**Peter Griffin and Peter Osborne, for Ernst & Young LLP**

**Benjamin Zarnett, Robert Chadwick and Brendan O'Neill, for the Ad Hoc Committee of Noteholders**

**James Grout, for the Ontario Securities Commission**

**Emily Cole and Joseph Marin, for Allen Chan**

**Simon Bieber, for David Horsley**

**David Bish, John Fabello and Adam Slavens, for the Underwriters Named in the Class Action**

**Max Starnino and Kirk Baert, for the Ontario Plaintiffs**

**Larry Lowenstein, for the Board of Directors**

**HEARD: June 26, 2012**

**ENDORSEMENT**

- Page 2 -

## Overview

[1] Sino-Forest Corporation ("SFC" or the "Applicant") seeks an order directing that claims against SFC, which result from the ownership, purchase or sale of an equity interest in SFC, are "equity claims" as defined in section 2 of the *Companies' Creditors Arrangement Act* ("CCAA") including, without limitation: (i) the claims by or on behalf of current or former shareholders asserted in the proceedings listed in Schedule "A" (collectively, the "Shareholder Claims"); and (ii) any indemnification claims against SFC related to or arising from the Shareholder Claims, including, without limitation, those by or on behalf of any of the other defendants to the proceedings listed in Schedule "A" (the "Related Indemnity Claims").

[2] SFC takes the position that the Shareholder Claims are "equity claims" as defined in the CCAA as they are claims in respect of a monetary loss resulting from the ownership, purchase or sale of an equity interest in SFC and, therefore, come within the definition. SFC also takes the position that the Related Indemnity Claims are "equity claims" as defined in the CCAA as they are claims for contribution or indemnity in respect of a claim that is an equity claim and, therefore, also come within the definition.

[3] On March 30, 2012, the court granted the Initial Order providing for the CCAA stay against SFC and certain of its subsidiaries. FTI Consulting Canada Inc. was appointed as Monitor.

[4] On the same day, the Sales Process Order was granted, approving Sales Process procedures and authorizing and directing SFC, the Monitor and Houlihan Lokey to carry out the Sales Process.

[5] On May 14, 2012, the court issued a Claims Procedure Order, which established June 20, 2012 as the Claims Bar Date.

[6] The stay of proceedings has since been extended to September 28, 2012.

[7] Since the outset of the proceedings, SFC has taken the position that it is important for these proceedings to be completed as soon as possible in order to, among other things, (i) enable the business operated in the Peoples Republic of China ("PRC") to be separated from SFC and put under new ownership; (ii) enable the restructured business to participate in the Q4 sales season in the PRC market; and (iii) maintain the confidence of stakeholders in the PRC (including local and national governmental bodies, PRC lenders and other stakeholders) that the business in the PRC can be successfully separated from SFC and operate in the ordinary course in the near future.

[8] SFC has negotiated a Support Agreement with the Ad Hoc Committee of Noteholders and intends to file a plan of compromise or arrangement (the "Plan") under the CCAA by no later than August 27, 2012, based on the deadline set out in the Support Agreement and what they submit is the commercial reality that SFC must complete its restructuring as soon as possible.

- Page 3 -

[9] Noteholders holding in excess of \$1.296 billion, or approximately 72% of the approximately \$1.8 billion of SFC's noteholders' debt, have executed written support agreements to support the SFC CCAA Plan as of March 30, 2012.

### **Shareholder Claims Asserted Against SFC**

#### **(i) Ontario**

[10] By Fresh as Amended Statement of Claim dated April 26, 2012 (the "Ontario Statement of Claim"), the Trustees of the Labourers' Pension Fund of Central and Eastern Canada and other plaintiffs asserted various claims in a class proceeding (the "Ontario Class Proceedings") against SFC, certain of its current and former officers and directors, Ernst & Young LLP ("E&Y"), BDO Limited ("BDO"), Poyry (Beijing) Consulting Company Limited ("Poyry") and SFC's underwriters (collectively, the "Underwriters").

[11] Section 1(m) of the Ontario Statement of Claim defines "class" and "class members" as:

All persons and entities, wherever they may reside who acquired Sino's Securities during the Class Period by distribution in Canada or on the Toronto Stock Exchange or other secondary market in Canada, which securities include those acquired over the counter, and all persons and entities who acquired Sino's Securities during the Class Period who are resident of Canada or were resident of Canada at the time of acquisition and who acquired Sino's Securities outside of Canada, except the Excluded Persons.

[12] The term "Securities" is defined as "Sino's common shares, notes and other securities, as defined in the OSA". The term "Class Period" is defined as the period from and including March 19, 2007 up to and including June 2, 2011.

[13] The Ontario Class Proceedings seek damages in the amount of approximately \$9.2 billion against SFC and the other defendants.

[14] The thrust of the complaint in the Ontario Class Proceedings is that the class members are alleged to have purchased securities at "inflated prices during the Class Period" and that absent the alleged misconduct, sales of such securities "would have occurred at prices that reflected the true value" of the securities. It is further alleged that "the price of Sino's Securities was directly affected during the Class Period by the issuance of the Impugned Documents".

#### **(ii) Quebec**

[15] By action filed in Quebec on June 9, 2011, Guining Liu commenced an action (the "Quebec Class Proceedings") against SFC, certain of its current and former officers and directors, E&Y and Poyry. The Quebec Class Proceedings do not name BDO or the Underwriters as defendants. The Quebec Class Proceedings also do not specify the quantum of damages sought, but rather reference "damages in an amount equal to the losses that it and the other members of the group suffered as a result of purchasing or acquiring securities of Sino at inflated prices during the Class Period".

[16] The complaints in the Quebec Class Proceedings centre on the effect of alleged misrepresentations on the share price. The duty allegedly owed to the class members is said to be based in “law and other provisions of the *Securities Act*”, to ensure the prompt dissemination of truthful, complete and accurate statements regarding SFC’s business and affairs and to correct any previously-issued materially inaccurate statements.

**(iii) Saskatchewan**

[17] By Statement of Claim dated December 1, 2011 (the “Saskatchewan Statement of Claim”), Mr. Allan Haigh commenced an action (the “Saskatchewan Class Proceedings”) against SFC, Allen Chan and David Horsley.

[18] The Saskatchewan Statement of Claim does not specify the quantum of damages sought, but instead states in more general terms that the plaintiff seeks “aggravated and compensatory damages against the defendants in an amount to be determined at trial”.

[19] The Saskatchewan Class Proceedings focus on the effect of the alleged wrongful acts upon the trading price of SFC’s securities:

The price of Sino’s securities was directly affected during the Class Period by the issuance of the Impugned Documents. The defendants were aware at all material times that the effect of Sino’s disclosure documents upon the price of its Sino’s [sic] securities.

**(iv) New York**

[20] By Verified Class Action Complaint dated January 27, 2012, (the “New York Complaint”), Mr. David Leopard and IMF Finance SA commenced a class proceeding against SFC, Mr. Allen Chan, Mr. David Horsley, Mr. Kai Kit Poon, a subset of the Underwriters, E&Y, and Ernst & Young Global Limited (the “New York Class Proceedings”).

[21] SFC contends that the New York Class Proceedings focus on the effect of the alleged wrongful acts upon the trading price of SFC’s securities.

[22] The plaintiffs in the various class actions have named parties other than SFC as defendants, notably, the Underwriters and the auditors, E&Y, and BDO, as summarized in the table below. The positions of those parties are detailed later in these reasons.

	Ontario	Quebec	Saskatchewan	New York
E&Y LLP	X	X	-	X
E&Y Global	-	-	-	X
BDO	X	-	-	-

- Page 5 -

Poyry	X	X	-	-
Underwriters	11	-	-	2

### Legal Framework

[23] Even before the 2009 amendments to the CCAA dealing with equity claims, courts recognized that there is a fundamental difference between shareholder equity claims as they relate to an insolvent entity versus creditor claims. Essentially, shareholders cannot reasonably expect to maintain a financial interest in an insolvent company where creditor claims are not being paid in full. Simply put, shareholders have no economic interest in an insolvent enterprise: *Blue Range Resource Corp. (Re)*, (2004) 4 W.W.R. 738 (Alta. Q.B.) [*Blue Range Resources*]; *Stelco Inc. (Re)*, (2006) CanLII 1773 (Ont. S.C.J.) [*Stelco*]; *Royal Bank of Canada v. Central Capital Corp.* (1996), 27 O.R. (3d) 494 (C.A.).

[24] The basis for the differentiation flows from the fundamentally different nature of debt and equity investments. Shareholders have unlimited upside potential when purchasing shares. Creditors have no corresponding upside potential: *Nelson Financial Group Limited (Re)*, 2010 ONSC 6229 [*Nelson Financial*].

[25] As a result, courts subordinated equity claims and denied such claims a vote in plans of arrangement: *Blue Range Resource, supra*; *Stelco, supra*; *EarthFirst Canada Inc. (Re)* (2009), 56 C.B.R. (5<sup>th</sup>) 102 (Alta. Q.B.) [*EarthFirst Canada*]; and *Nelson Financial, supra*.

[26] In 2009, significant amendments were made to the CCAA. Specific amendments were made with the intention of clarifying that equity claims are subordinated to other claims.

[27] The 2009 amendments define an "equity claim" and an "equity interest". Section 2 of the CCAA includes the following definitions:

"Equity Claim" means a claim that is in respect of an equity interest, including a claim for, among others, (...)

(d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or

(e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d);

"Equity Interest" means

(a) in the case of a company other than an income trust, a share in the company – or a warrant or option or another right to acquire a share in the company – other than one that is derived from a convertible debt,

- Page 6 -

[28] Section 6(8) of the CCAA prohibits a distribution to equity claimants prior to payment in full of all non-equity claims.

[29] Section 22(1) of the CCAA provides that equity claimants are prohibited from voting on a plan unless the court orders otherwise.

#### **Position of Ernst & Young**

[30] E&Y opposes the relief sought, at least as against E&Y, since the E&Y proof of claim evidence demonstrates in its view that E&Y's claim:

- (a) is not an equity claim;
- (b) does not derive from or depend upon an equity claim (in whole or in part);
- (c) represents discreet and independent causes of action as against SFC and its directors and officers arising from E&Y's direct contractual relationship with such parties (or certain of such parties) and/or the tortious conduct of SFC and/or its directors and officers for which they are in law responsible to E&Y; and
- (d) can succeed independently of whether or not the claims of the plaintiffs in the class actions succeed.

[31] In its factum, counsel to E&Y acknowledges that during the periods relevant to the Class Action Proceedings, E&Y was retained as SFC's auditor and acted as such from 2007 until it resigned on April 5, 2012.

[32] On June 2, 2011, Muddy Waters LLC ("Muddy Waters") issued a report which purported to reveal fraud at SFC. In the wake of that report, SFC's share price plummeted and Muddy Waters profited from its short position.

[33] E&Y was served with a multitude of class action claims in numerous jurisdictions.

[34] The plaintiffs in the Ontario Class Proceedings claim damages in the aggregate, as against all defendants, of \$9.2 billion on behalf of resident and non-resident shareholders and noteholders. The causes of action alleged are both statutory, under the *Securities Act (Ontario)* and at common law, in negligence and negligent misrepresentation.

[35] In its factum, counsel to E&Y acknowledges that the central claim in the class actions is that SFC made a series of misrepresentations in respect of its timber assets. The claims against E&Y and the other third party defendants are that they failed to detect these misrepresentations and note in particular that E&Y's audit did not comply with Canadian generally accepted accounting standards. Similar claims are advanced in Quebec and the U.S.

[36] Counsel to E&Y notes that on May 14, 2012 the court granted a Claims Procedure Order which, among other things, requires proofs of claim to be filed no later than June 20, 2012. E&Y takes issue with the fact that this motion was then brought notwithstanding that proofs of claim and D&O proofs of claim had not yet been filed.

- Page 7 -

[37] E&Y has filed with the Monitor, in accordance with the Claims Procedure Order, a proof of claim against SFC and a proof of claim against the directors and officers of SFC.

[38] E&Y takes the position that it has contractual claims of indemnification against SFC and its subsidiaries and has statutory and common law claims of contribution and/or indemnity against SFC and its subsidiaries for all relevant years. E&Y contends that it has stand-alone claims for breach of contract and negligent and/or fraudulent misrepresentation against the company and its directors and officers.

[39] Counsel submits that E&Y's claims against Sino-Forest and the SFC subsidiaries are:

- (a) creditor claims;
- (b) derived from E&Y retainers by and/or on behalf of Sino-Forest and the SFC subsidiaries and E&Y's relationship with such parties, all of which are wholly independent and conceptually different from the claims advanced by the class action plaintiffs;
- (c) claims that include the cost of defending and responding to various proceedings, both pre- and post-filing; and
- (d) not equity claims in the sense contemplated by the CCAA. E&Y's submission is that equity holders of Sino-Forest have not advanced, and could not advance, any claims against SFC's subsidiaries.

[40] Counsel further contends that E&Y's claim is distinct from any and all potential and actual claims by the plaintiffs in the class actions against Sino-Forest and that E&Y's claim for contribution and/or indemnity is not based on the claims against Sino-Forest advanced in the class actions but rather only in part on those claims, as any success of the plaintiffs in the class actions against E&Y would not necessarily lead to success against Sino-Forest, and vice versa. Counsel contends that E&Y has a distinct claim against Sino-Forest independent of that of the plaintiffs in the class actions. The success of E&Y's claims against Sino-Forest and the SFC subsidiaries, and the success of the claims advanced by the class action plaintiffs, are not co-dependent. Consequently, counsel contends that E&Y's claim is that of an unsecured creditor.

[41] From a policy standpoint, counsel to E&Y contends that the nature of the relationship between a shareholder, who may be in a position to assert an equity claim (in addition to other claims) is fundamentally different from the relationship existing between a corporation and its auditors.

#### **Position of BDO Limited**

[42] BDO was auditor of Sino-Forest Corporation between 2005 and 2007, when it was replaced by E&Y.

[43] BDO has filed a proof of claim against Sino-Forest pursuant to the Claims Procedure Order.

- Page 8 -

[44] BDO's claim against Sino-Forest is primarily for breach of contract.

[45] BDO takes the position 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 CCAA.

[46] BDO adopts the submissions of E&Y which, for the purposes of this endorsement, are not repeated.

#### **Position of the Underwriters**

[47] The Underwriters take the position that the court should not decide the equity claims motion at this time because it is premature or, alternatively, if the court decides the equity claims motion, the equity claims order should not be granted because the Related Indemnity Claims are not "equity claims" as defined in s. 2 of the CCAA.

[48] The Underwriters are among the defendants named in some of the class actions. In connection with the offerings, certain Underwriters entered into agreements with Sino-Forest and certain of its subsidiaries providing that Sino-Forest and, with respect to certain offerings, the Sino-Forest subsidiary companies, agree to indemnify and hold harmless the Underwriters in connection with an array of matters that could arise from the offerings.

[49] The Underwriters raise the following issues:

- (i) Should this court decide the equity claims motion at this time?
- (ii) If this court decides the equity claims motion at this time, should the equity claims order be granted?

[50] On the first issue, counsel to the Underwriters takes the position that the issue is not yet ripe for determination.

[51] Counsel submits that, by seeking the equity claims order at this time, Sino-Forest is attempting to pre-empt the Claims Procedure Order, which already provides a process for the determination of claims. Until such time as the claims procedure in respect of the Related Indemnity Claims is completed, and those claims are determined pursuant to that process, counsel contends the subject of the equity claims motion raises a merely hypothetical question as the court is being asked to determine the proper interpretation of s. 2 of the CCAA before it has the benefit of an actual claim in dispute before it.

[52] Counsel further contends that by asking the court to render judgment on the proper interpretation of s. 2 of the CCAA in the hypothetical, Sino-Forest has put the court in a position where its judgment will not be made in the context of particular facts or with a full and complete evidentiary record.

[53] Even if the court determines that it can decide this motion at this time, the Underwriters submit that the relief requested should not be granted.

- Page 9 -

### Position of the Applicant

[54] The Applicant submits that the amendments to the CCAA relating to equity claims closely parallel existing U.S. law on the subject and that Canadian courts have looked to U.S. courts for guidance on the issue of equity claims as the subordination of equity claims has long been codified there: see e.g. *Blue Range Resources, supra*, and *Nelson Financial, supra*.

[55] The Applicant takes the position that based on the plain language of the CCAA, the Shareholder Claims are "equity claims" as defined in s. 2 as they are claims in respect of a "monetary loss resulting from the ownership, purchase or sale of an equity interest".

[56] The Applicant also submits the following:

- (a) the Ontario, Quebec, Saskatchewan and New York Class Actions (collectively, the "Class Actions") all advance claims on behalf of shareholders.
- (b) the Class Actions also allege wrongful conduct that affected the trading price of the shares, in that the alleged misrepresentation "artificially inflated" the share price; and
- (c) the Class Actions seek damages relating to the trading price of SFC shares and, as such, allege a "monetary loss" that resulted from the ownership, purchase or sale of shares, as defined in s. 2 of the CCAA.

[57] Counsel further submits that, as the Shareholder Claims are "equity claims", they are expressly subordinated to creditor claims and are prohibited from voting on the plan of arrangement.

[58] Counsel to the Applicant also submits that the definition of "equity claims" in s. 2 of the CCAA expressly includes indemnity claims that relate to other equity claims. As such, the Related Indemnity Claims are equity claims within the meaning of s. 2.

[59] Counsel further submits that there is no distinction in the CCAA between the source of any claim for contribution or indemnity; whether by statute, common law, contractual or otherwise. Further, and to the contrary, counsel submits that the legal characterization of a contribution or indemnity claim depends solely on the characterization of the primary claim upon which contribution or indemnity is sought.

[60] Counsel points out that in *Return on Innovation Capital v. Gandi Innovations Limited*, 2011 ONSC 5018, leave to appeal denied, 2012 ONCA 10 [*Return on Innovation*] this court characterized the contractual indemnification claims of directors and officers in respect of an equity claim as "equity claims".

[61] Counsel also submits that guidance on the treatment of underwriter and auditor indemnification claims can be obtained from the U.S. experience. In the U.S., courts have held that the indemnification claims of underwriters for liability or defence costs constitute equity claims that are subordinated to the claims of general creditors. Counsel submits that insofar as

- Page 10 -

the primary source of liability is characterized as an equity claim, so too is any claim for contribution and indemnity based on that equity claim.

[62] In this case, counsel contends, the Related Indemnity Claims are clearly claims for “contribution and indemnity” based on the Shareholder Claims.

#### **Position of the Ad Hoc Noteholders**

[63] Counsel to the Ad Hoc Noteholders submits that the Shareholder Claims are “equity claims” as they are claims in respect of an equity interest and are claims for “a monetary loss resulting from the ownership, purchase or sale of an equity interest” per subsection (d) of the definition of “equity claims” in the CCAA.

[64] Counsel further submits that the Related Indemnity Claims are also “equity claims” as they fall within the “clear and unambiguous” language used in the definition of “equity claim” in the CCAA. Subsection (e) of the definition refers expressly and without qualification to claims for “contribution or indemnity” in respect of claims such as the Shareholder Claims.

[65] Counsel further submits that had the legislature intended to qualify the reference to “contribution or indemnity” in order to exempt the claims of certain parties, it could have done so, but it did not.

[66] Counsel also submits that, if the plain language of subsection (e) is not upheld, shareholders of SFC could potentially create claims to receive indirectly what they could not receive directly (*i.e.*, payment in respect of equity claims through the Related Indemnity Claims) – a result that could not have been intended by the legislature as it would be inconsistent with the purposes of the CCAA.

[67] Counsel to the Ad Hoc Noteholders also submits that, before the CCAA amendments in 2009 (the “CCAA Amendments”), courts subordinated claims on the basis of:

- (a) the general expectations of creditors and shareholders with respect to priority and assumption of risks; and
- (b) the equitable principles and considerations set out in certain U.S. cases: see *e.g.* *Blue Range Resources, supra*.

[68] Counsel further submits that, before the CCAA Amendments took effect, courts had expanded the types of claims characterized as equity claims; first to claims for damages of defrauded shareholders and then to contractual indemnity claims of shareholders; see *Blue Range Resources, supra* and *EarthFirst Canada, supra*.

[69] Counsel for the Ad Hoc Noteholders also submits that indemnity claims of underwriters have been treated as equity claims in the United States, pursuant to section 510(b) of the U.S. Bankruptcy Code. This submission is detailed at paragraphs 20-25 of their factum which reads as follows:

- Page 11 -

20. The desire to more closely align the Canadian approach to equity claims with the U.S. approach was among the considerations that gave rise to the codification of the treatment of equity claims. Canadian courts have also looked to the U.S. law for guidance on the issue of equity claims where codification of the subordination of equity claims has been long-standing.

Janis Sarra at p. 209, Ad Hoc Committee's Book of Authorities, Tab 10.

Report of the Standing Senate Committee on Banking, Trade and Commerce, "Debtors and Creditors Sharing the Burden: A Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*" (2003) at 158, [...]

*Blue Range [Resources]* at paras. 41-57 [...]

21. Pursuant to § 510(b) of the *U.S. Bankruptcy Code*, all creditors must be paid in full before shareholders are entitled to receive any distribution. § 510(b) of the *U.S. Bankruptcy Code* and the relevant portion of § 502, which is referenced in § 510(b), provide as follows:

§ 510. Subordination

(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

§ 502. Allowance of claims or interests

(e) (1) Notwithstanding subsections (a), (b) and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that

...

(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution; or

...

(2) A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined,

- Page 12 -

and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

22. U.S. appellate courts have interpreted the statutory language in § 510(b) broadly to subordinate the claims of shareholders that have a nexus or causal relationship to the purchase or sale of securities, including damages arising from alleged illegality in the sale or purchase of securities or from corporate misconduct whether predicated on pre or post-issuance conduct.

*Re Telegroup Inc.* (2002), 281 F. 3d 133 (3<sup>rd</sup> Cir. U.S. Court of Appeals) [...]

*American Broadcasting Systems Inc. v. Nugent*, U.S. Court of Appeals for the Ninth Circuit, Case Number 98-17133 (24 January 2001) [...]

23. Further, U.S. courts have held that indemnification claims of underwriters against the corporation for liability or defence costs when shareholders or former shareholders have sued underwriters constitute equity claims in the insolvency of the corporation that are subordinated to the claims of general creditors based on: (a) the plain language of § 510(b), which references claims for "reimbursement or contribution" and (b) risk allocation as between general creditors and those parties that play a role in the purchase and sale of securities that give rise to the shareholder claims (i.e., directors, officers and underwriters).

*In re Mid-American Waste Sys.*, 228 B.R. 816, 1999 Bankr. LEXIS 27 (Bankr. D. Del. 1999) [*Mid-American*] [...]

*In re Jacom Computer Servs.*, 280 B.R. 570, 2002 Bankr. LEXIS 758 (Bankr. S.D.N.Y. 2002) [...]

24. In *Mid-American*, the Court stated the following with respect to the "plain language" of § 510(b), its origins and the inclusion of "reimbursement or contribution" claims in that section:

*... I find that the plain language of § 510(b), its legislative history, and applicable case law clearly show that § 510(b) intends to subordinate the indemnification claims of officers, directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities. The meaning of amended § 510(b), specifically the language "for reimbursement or contribution . . . on account of [a claim arising from rescission or damages arising from the purchase or sale of a security]," can be discerned by a plain reading of its language.*

*... it is readily apparent that the rationale for section 510(b) is not limited to preventing shareholder claimants from improving their position vis-a-*

- Page 13 -

vis general creditors; Congress also made the decision to subordinate based on risk allocation. Consequently, when Congress amended § 510(b) to add reimbursement and contribution claims, it was not radically departing from an equityholder claimant treatment provision, as NatWest suggests; it simply added to the subordination treatment new classes of persons and entities involved with the securities transactions giving rise to the rescission and damage claims. The 1984 amendment to § 510(b) is a logical extension of one of the rationales for the original section — because Congress intended the holders of securities law claims to be subordinated, why not also subordinate claims of other parties (e.g., officers and directors and underwriters) who play a role in the purchase and sale transactions which give rise to the securities law claims? As I view it, in 1984 Congress made a legislative judgment that claims emanating from tainted securities law transactions should not have the same priority as the claims of general creditors of the estate. [emphasis added]

[...]

25. Further, the U.S. courts have held that the degree of culpability of the respective parties is a non-issue in the disallowance of claims for indemnification of underwriters; the equities are meant to benefit the debtor's direct creditors, not secondarily liable creditors with contingent claims.

*In re Drexel Burnham Lambert Group*, 148 B.R. 982, 1992 Bankr. LEXIS 2023 (Bankr. S.D.N.Y. 1992) [...]

[70] Counsel submits that there is no principled basis for treating indemnification claims of auditors differently than those of underwriters.

#### Analysis

##### **Is it Premature to Determine the Issue?**

[71] The class action litigation was commenced prior to the CCAA Proceedings. It is clear that the claims of shareholders as set out in the class action claims against SFC are "equity claims" within the meaning of the CCAA.

[72] In my view, this issue is not premature for determination, as is submitted by the Underwriters.

[73] The Class Action Proceedings preceded the CCAA Proceedings. It has been clear since the outset of the CCAA Proceedings that this issue — namely, whether the claims of E&Y, BDO and the Underwriters as against SFC, would be considered "equity claims" — would have to be determined.

- Page 14 -

[74] It has also been clear from the outset of the CCAA Proceedings, that a Sales Process would be undertaken and the expected proceeds arising from the Sales Process would generate proceeds insufficient to satisfy the claims of creditors.

[75] The Claims Procedure is in place but, it seems to me that the issue that has been placed before the court on this motion can be determined independently of the Claims Procedure. I do not accept that any party can be said to be prejudiced if this threshold issue is determined at this time. The threshold issue does not depend upon a determination of quantification of any claim. Rather, its effect will be to establish whether the claims of E&Y, BDO and the Underwriters will be subordinated pursuant to the provisions of the CCAA. This is independent from a determination as to the validity of any claim and the quantification thereof.

#### **Should the Equity Claims Order be Granted?**

[76] I am in agreement with the submission of counsel for the Ad Hoc Noteholders to the effect that the characterization of claims for indemnity turns on the characterization of the underlying primary claims.

[77] In my view, the claims advanced in the Shareholder Claims are clearly equity claims. The Shareholder Claims underlie the Related Indemnity Claims.

[78] In my view, the CCAA Amendments have codified the treatment of claims addressed in pre-amendment cases and have further broadened the scope of equity claims.

[79] The plain language in the definition of "equity claim" does not focus on the identity of the claimant. Rather, it focuses on the nature of the claim. In this case, it seems clear that the Shareholder Claims led to the Related Indemnity Claims. Put another way, the inescapable conclusion is that the Related Indemnity Claims are being used to recover an equity investment.

[80] The plain language of the CCAA dictates the outcome, namely, that the Shareholder Claims and the Related Indemnity Claims constitute "equity claims" within the meaning of the CCAA. This conclusion is consistent with the trend towards an expansive interpretation of the definition of "equity claims" to achieve the purpose of the CCAA.

[81] In *Return on Innovation*, Newbould J. characterized the contractual indemnification claims of directors and officers as "equity claims". The Court of Appeal denied leave to appeal. The analysis in *Return on Innovation* leads to the conclusion that the Related Indemnity Claims are also equity claims under the CCAA.

[82] It would be totally inconsistent to arrive at a conclusion that would enable either the auditors or the Underwriters, through a claim for indemnification, to be treated as creditors when the underlying actions of the shareholders cannot achieve the same status. To hold otherwise would indeed provide an indirect remedy where a direct remedy is not available.

[83] Further, on the issue of whether the claims of E&Y, BDO and the Underwriters fall within the definition of equity claims, there are, in my view, two aspects of these claims and it is necessary to keep them conceptually separate.

- Page 15 -

[84] The first and most significant aspect of the claims of E&Y, BDO and the Underwriters constitutes an "equity claim" within the meaning of the CCAA. Simply put, but for the Class Action Proceedings, it is inconceivable that claims of this magnitude would have been launched by E&Y, BDO and the Underwriters as against SFC. The class action plaintiffs have launched their actions against SFC, the auditors and the Underwriters. In turn, E&Y, BDO and the Underwriters have launched actions against SFC and its subsidiaries. The claims of the shareholders are clearly "equity claims" and a plain reading of s. 2(1)(e) of the CCAA leads to the same conclusion with respect to the claims of E&Y, BDO and the Underwriters. To hold otherwise, would, as stated above, lead to a result that is inconsistent with the principles of the CCAA. It would potentially put the shareholders in a position to achieve creditor status through their claim against E&Y, BDO and the Underwriters even though a direct claim against SFC would rank as an "equity claim".

[85] I also recognize that the legal construction of the claims of the auditors and the Underwriters as against SFC is different than the claims of the shareholders against SFC. However, that distinction is not, in my view, reflected in the language of the CCAA which makes no distinction based on the status of the party but rather focuses on the substance of the claim.

[86] Critical to my analysis of this issue is the statutory language and the fact that the CCAA Amendments came into force after the cases relied upon by the Underwriters and the auditors.

[87] It has been argued that the amendments did nothing more than codify pre-existing common law. In many respects, I accept this submission. However, I am unable to accept this submission when considering s. 2(1) of the CCAA, which provides clear and specific language directing that "equity claim" means a claim that is in respect of an equity interest, including a claim for, among other things, "(e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d)".

[88] Given that a shareholder claim falls within s. 2(1)(d), the plain words of subsections (d) and (e) lead to the conclusions that I have set out above.

[89] I fail to see how the very clear words of subsection (e) can be seen to be a codification of existing law. To arrive at the conclusion put forth by E&Y, BDO and the Underwriters would require me to ignore the specific words that Parliament has recently enacted.

[90] I cannot agree with the position put forth by the Underwriters or by the auditors on this point. The plain wording of the statute has persuaded me that it does not matter whether an indemnity claim is seeking no more than allocation of fault and contribution at common law, or whether there is a free-standing contribution and indemnity claim based on contracts.

[91] However, that is not to say that the full amount of the claim by the auditors and Underwriters can be characterized, at this time, as an "equity claim".

[92] The second aspect to the claims of the auditors and underwriters can be illustrated by the following hypothetical: if the claim of the shareholders does not succeed against the class action defendants, E&Y, BDO and the Underwriters will not be liable to the class action plaintiffs. However, these parties may be in a position to demonstrate that they do have a claim against

- Page 16 -

SFC for the costs of defending those actions, which claim does not arise as a result of "contribution or indemnity in respect of an equity claim".

[93] It could very well be that each of E&Y, BDO and the Underwriters have expended significant amounts in defending the claims brought by the class action plaintiffs which, in turn, could give rise to contractual claims as against SFC. If there is no successful equity claim brought by the class action plaintiffs, it is arguable that any claim of E&Y, BDO and the Underwriters may legitimately be characterized as a claim for contribution or indemnity but not necessarily in respect of an equity claim. If so, there is no principled basis for subordinating this portion of the claim. At this point in time, the quantification of such a claim cannot be determined. This must be determined in accordance with the Claims Procedure.

[94] However, it must be recognized that, by far the most significant part of the claim, is an "equity claim".

[95] In arriving at this determination, I have taken into account the arguments set forth by E&Y, BDO and the Underwriters. My conclusions recognize the separate aspects of the Related Indemnity Claims as submitted by counsel to the Underwriters at paragraph 40 of their factum which reads:

...it must be recognized that there are, in fact, at least two different kinds of Related Indemnity Claims:

- (a) indemnity claims against SFC in respect of Shareholder Claims against the auditors and the Underwriters; and
- (b) indemnity claims against SFC in respect of the defence costs of the auditors and the Underwriters in connection with defending themselves against Shareholder Claims.

### **Disposition**

[96] In the result, an order shall issue that the claims against SFC resulting from the ownership, purchase or sale of equity interests in SFC, including, without limitation, the claims by or on behalf of current or former shareholders asserted in the proceedings listed in Schedule "A" are "equity claims" as defined in s. 2 of the CCAA, being claims in respect of monetary losses resulting from the ownership, purchase or sale of an equity interest. It is noted that counsel for the class action plaintiffs did not contest this issue.

[97] In addition, an order shall also issue that any indemnification claim against SFC related to or arising from the Shareholders Claims, including, without limitation, by or on behalf of any of the other defendants to the proceedings listed in Schedule "A" are "equity claims" under the CCAA, being claims for contribution or indemnity in respect of a claim that is an equity claim. However, I feel it is premature to determine whether this order extends to the aspect of the Related Indemnity Claims that corresponds to the defence costs of the Underwriters and the auditors in connection with defending themselves against the Shareholder Claims.

- Page 17 -

[98] A direction shall also issue that these orders are made without prejudice to SFC's rights to apply for a similar order with respect to (i) any claims in the statement of claim that are in respect of securities other than shares and (ii) any indemnification claims against SFC related thereto.



MORAWETZ J.

**Date:** July 27, 2012

**SCHEDULE "A" – SHAREHOLDER CLAIMS**

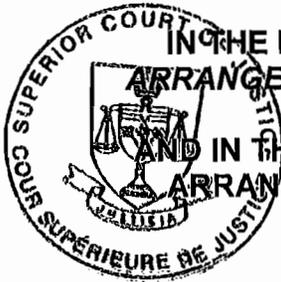
1. *Trustees of the Labourers' Pension Fund of Central and Eastern Canada et al. v. Sino-Forest Corporation et al.* (Ontario Superior Court of Justice, Court File No. CV-11-431153-00CP)
2. *Guining Liu v. Sino-Forest Corporation et al.* (Quebec Superior Court, Court File No.: 200-06-000132-111)
3. *Allan Haigh v. Sino-Forest Corporation et al.* (Saskatchewan Court of Queen's Bench, Court File No. 2288 of 2011)
4. *David Leopard et al. v. Allen T.Y. Chan et al.* (District court of the Southern District of New York, Court File No. 650258/2012)

**APPENDIX F – ORDER (AUGUST 3, 2012)**

*(See Attached)*

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
COMMERCIAL LIST**

THE HONOURABLE MR. ) FRIDAY, THE 27<sup>th</sup>  
JUSTICE MORAWETZ ) DAY OF JULY, 2012



**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**

**ORDER**

**THIS MOTION** made by the Applicant, Sino-Forest Corporation ("**SFC**") regarding the status of shareholder claims and related indemnity claims was heard this day, at the courthouse at 330 University Avenue, Toronto, Ontario,

**ON READING** the Motion Record of the Applicant, the Responding Motion Record of Ernst & Young LLP, the Book of Previously Filed Materials and Court Orders, and the Responding Motion Record of BDO Limited and the facts of the parties, and on hearing the submissions of counsel for the Moving Party, Sino-Forest Corporation, the Monitor, the Ad Hoc Committee of Noteholders, Ernst & Young, BDO, and certain underwriters named as defendants in the Ontario Class Action:

1. **THIS COURT ORDERS** that further service of the Notice of Motion and Motion Record on any party not already served is hereby dispensed with, such that this motion is properly returnable today.
2. **THIS COURT ORDERS** that the claims against SFC resulting from the ownership, purchase or sale of an equity interest in SFC, including, without

limitation, the claims by or on behalf of current or former shareholders asserted in the proceedings listed in Schedule "A", (collectively, the "Shareholder Claims") are "equity claims" as defined in section 2 of the *Companies' Creditors Arrangement Act* (the "CCAA"), being claims in respect of monetary losses resulting from the ownership, purchase or sale of an equity interest.

3. **THIS COURT ORDERS** that any indemnification claims against SFC related to or arising from the Shareholder Claims, including, without limitation, by or on behalf of any of the other defendants to the proceedings listed in Schedule "A", (the "Related Indemnity Claims") are "equity claims" under the CCAA, being claims for contribution or indemnity in respect of claims that are equity claims.
4. **THIS COURT ORDERS** that nothing in paragraph 3 determines whether this Order extends to the aspect of any Related Indemnity Claims that corresponds to defence costs in connection with the defence of any Shareholder Claims.
5. **THIS COURT ORDERS** that the order is without prejudice to SFC's right to apply for a similar order with respect to (i) any claims that are in respect of Securities other than shares and (ii) any indemnification claims against SFC related thereto.

ENTERED AT / INSCRIT À TORONTO  
ON / BOOK NO:  
LE / DANS LE REGISTRE NO.:

AUG 03 2012

PER/PAR:





### **Schedule "A"**

1. *Trustees of the Labourers' Pension Fund of Central and Eastern Canada et al. v. Sino-Forest Corporation et al.* (Ontario Superior Court of Justice, Court File No. CV-11-431153-00CP)
2. *Guining Liu v. Sino-Forest Corporation et al.* (Quebec Superior Court, Court File No: 200-06-000132-111)
3. *Allan Haigh v. Sino-Forest Corporation et al.* (Saskatchewan Court of Queen's Bench, Court File No. 2288 of 2011)
4. *David Leopard et al. v. Allen T.Y. Chan et al.* (District Court of the Southern District of New York, Court File No. 650258/2012)

**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 OR COMPROMISE OR ARRANGEMENT OF SINO-FOREST CORPORATION**

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

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
(COMMERCIAL LIST)**

Proceedings commenced in Toronto

**ORDER**

**(Regarding the Status of Shareholder  
Claims and Related Indemnity Claims  
under the CCAA)**

**BENNETT JONES LLP**

One First Canadian Place  
Suite 3400, P.O. Box 130  
Toronto, Ontario  
M5X 1A4

Robert W. Staley (LSUC #27115J)

Kevin Zych (LSUC #33129T)

Derek J. Bell (LSUC #43420J)

Raj Sahni (LSUC #42942U)

Jonathan Bell (LSUC #55457P)

Tel: 416-863-1200

Fax: 416-863-1716

Lawyers for the Applicant

**APPENDIX G - IC REPORT – FIRST INTERIM REPORT**

*(See Attached)*

**REDACTED VERSION FOR PUBLIC RELEASE**

**FIRST INTERIM REPORT OF  
THE INDEPENDENT COMMITTEE TO THE BOARD OF DIRECTORS OF  
SINO-FOREST CORPORATION**

**August 10, 2011**

**PRIVILEGED AND CONFIDENTIAL**

August 10, 2011

**FIRST INTERIM REPORT OF THE  
INDEPENDENT COMMITTEE TO THE  
BOARD OF DIRECTORS OF  
SINO-FOREST CORPORATION**

**Introduction**

The Independent Committee (the "IC") of the Board of Directors (the "Board") of Sino-Forest Corporation ("SF" or the "Company") was established by the Board on June 2, 2011, immediately following the release by Muddy Waters, LLC of its "research report" (the "MW Report") regarding SF. The mandate of the IC, in general terms, is to independently examine and review the serious and wide-ranging allegations made in the MW Report and report back to and, if appropriate, make recommendations to the Board.

On June 8, 2011, the Ontario Securities Commission (the "OSC") announced it was investigating matters related to SF. On July 5, 2011, it announced it was conducting a targeted review of Ontario reporting issuers listed on Canadian stock exchanges and having significant business operations in emerging markets. The investigation of SF is a high priority file at the OSC. It has the attention of its new Chairman and a large investigative team has been assigned to the file, likely with external advisors.

The IC's activities to date have been focused on both the original task of examining and reviewing the allegations in the MW Report, interacting with Ernst & Young ("E&Y") and responding to the extensive requests for information from the OSC investigators. The MW Report allegations are both general and sweeping and at times specific; with many of the specific allegations being quite historic in nature. The purpose of this First Interim Report is to inform the Board of the nature and scope of the IC's activities to date and the planned next steps.<sup>1</sup>

**Independent Advisors**

In early June 2011, the IC appointed the following independent advisors to assist it:

- Osler, Hoskin & Harcourt LLP ("Osler") – Canadian Counsel
- Mallesons Stephen Jaques – Hong Kong Counsel
- Jun He Law Offices – PRC Counsel
- PricewaterhouseCoopers LLP ("PwC") – Forensic Accounting Advisors

**Scope of IC's Review**

The IC, having regard to the principal allegations in the MW Report relating to the legitimacy of SF's business, initially focused its independent review on:

---

<sup>1</sup> All dollar numbers herein are in U.S. dollars and subject to rounding.

- the ownership structure of forestry assets on the SF balance sheet
- the ownership of trees by SF in Yunnan Province, which is the geographic focus of the MW Report
- the existence and value of those trees
- the revenue recognition processes of SF
- the relationship of SF with its suppliers and customers in its BVI standing timber trading activities, particularly as they affect the items above

In addition, the IC set out to independently determine the facts relevant to the numerous specific allegations in the MW Report and to respond to questions and demands for information from the OSC. The IC process has also involved extensive interaction with E&Y, SF's auditors.

The initial focus of the IC's review of the MW Report has been on the allegations that affect the current state of the Company and its recent financial and other disclosure.

A comprehensive work plan was developed by the IC advisors and approved by the IC. This is an evolving document currently approximately 75 pages in length.

#### **Business Model and Legal Regime**

To be able to respond to the MW Report and the questions of the OSC, it is essential to have a clear and detailed understanding of SF's business model and the Chinese legal regime in which it operates. The following is an overview summary of the business that the IC is utilizing to guide and focus its review and examination.

SF's business encompasses several business segments: (i) plantation fibre operations (sometimes also referred to as the tree plantation business), (ii) wood log and wood products trading operations (both import and domestic) and (iii) manufacturing and other operations.<sup>2</sup> SF also owns a majority interest in Greenheart Group Limited.

The plantation fibre operations use two principal business models, a "purchased plantation" model and a "planted plantation" model. The "purchased plantation" model operates through two legal structures: a BVI/AI legal structure and, to a lesser but growing extent, a PRC-incorporated Wholly Foreign Owned Enterprise ("WFOE") legal structure. The planted plantations model is operated exclusively through the WFOE legal structure (although the WFOEs themselves are typically held indirectly through a BVI holding structure). Management has advised all fresh cash capital invested into the PRC since 2005 has been invested in WFOE structures.

SF discloses 711,000 hectares of purchased plantations under management in the PRC at December 31, 2010, with 466,826 hectares recorded as held by BVIs and 214,182 hectares recorded as held by WFOEs at December 31, 2010. SF discloses 77,700 hectares of planted plantation under management in the PRC at December 31, 2010.

<sup>2</sup> We note that segments (i) and (ii) have been grouped under the general description of "Wood Fibre Operations" in public disclosure.

The Company recorded \$1.401 billion in revenue from its plantation fibre operations in the year ended December 31, 2010 (out of a total revenue of \$1.923 billion), of which \$1.326 billion was generated through its purchased plantation model conducted through the BVI/AI legal structure. The Company recorded \$3.122 billion in timber holdings on its balance sheet, as at December 31, 2010, of which Management has advised \$2.464 billion was recorded as timber holdings by BVIs. The plantation fibre operations represented \$620 million of Income (as disclosed in the segment footnote of the 2010 financial statements) in the year ended December 31, 2010. Over 90% of such Income was generated through the BVI/AI legal structure. The total consolidated Income of SF for 2010 was \$576 million. (Income is income (loss) from continuing operations before interest, other income, exchange losses and changes in fair market value of financial instruments.)

While significant revenues are derived from the wood log and wood products trading business segment (\$454 million in revenue in 2010, with approximately 98% of that being derived from the imported wood log and products trading portion of that business), this segment generated \$15.8 million of Income. It is a relatively low profit margin business in comparison to the profit margins in the plantation fibre operations.

Manufacturing revenue represented \$67.3 million in the year ended December 31, 2010 with a loss of \$8.7 million (excluding the Greenheart consolidation).

Thus the core activity of trading in standing timber using the "purchased plantation" model, conducted through the BVI/AI legal structure, is a central driver of asset value, revenue and income for SF.

The purchased plantation model involves the purchase of standing timber and sale of standing timber (priced either as standing timber or as logs) pursuant to standardized agreements of purchase and sale. When conducted through the BVI/AI legal structure the timber purchases are arranged through suppliers/aggregators, usually but not always under the framework of a master agreement. The BVI sales are conducted through entities referred to by SF as "authorized intermediaries" ("AIs"). The BVI structure does not involve the BVIs concurrently purchasing land use rights or leases with the purchase of standing timber. However, the BVI supply contracts usually contain certain rights for a WFOE subsidiary to negotiate such land use/lease rights (referred to as "plantation land use rights").

The planted plantation model involves the planting of seedlings on land for which SF has plantation land use rights through leases or other similar legal instruments. Management advises that sales from these planted plantation transactions do not utilize "AIs", but rather involve direct cash sales to customers.

The BVIs do not directly sell standing timber to customers; they sell under contract to an AI who may resell to others. The BVI timber sales accounts receivables are settled by the AI making payments to SF suppliers on behalf of SF. These payments enable SF BVIs to acquire further standing timber from such suppliers. As SF publicly discloses no cash flows directly through the BVIs, the BVI/AI legal structure is accordingly more complex from an accounting verification and legal structure point of view than the WFOE structure. The BVI held assets have continued to grow as proceeds have been re-invested to acquire further BVI held assets in the PRC.

Most of the IC's time and attention has been spent on gathering and analyzing information relating to the plantation fibre operations and in particular the purchased plantation model operated through the BVI/AI structure and this work is ongoing.

### Cash

Earlier in the process, as a precautionary measure, the IC requested that PwC confirm SF's cash balances. PwC did this as of June 13, 2011 for both PRC accounts and "offshore" accounts. A total of 293 accounts controlled by SF in Hong Kong were confirmed, representing 100% of the expected cash position. There are a very significant number of accounts held by SF in the PRC and the logistics and requirements of in person/in branch verification in that country led the IC to confirm only a portion of the PRC accounts (28 accounts, representing approximately 81% of the expected PRC cash position). The IC was satisfied that SF's expected cash position existed as at the date of the confirmation. PwC's brief reporting note in this regard is attached as Schedule A. The Board should be aware that SF only updates the details of its own cash position quarterly, so the confirmation results must be considered in this context. The IC has instituted certain additional controls over cash movements in excess of \$1 million held in SF Hong Kong bank accounts in order to provide the IC with some precautionary comfort during the examination process. The IC expects that the Audit Committee will report to the Board on sources and uses of cash during Q2 in the context of its report of its review of the Q2 financial statements and management's discussion and analysis.

### Fact Gathering

To date, much of the IC's work has been, and continues to be, capturing, assembling and organizing in useable, searchable form, massive amounts of data from the Company's records including:

- corporate particulars for all the SF subsidiaries (approximately 146 entities) and corporate searches of AIs and other third party entities (conducting corporate searches which in the PRC is a time consuming exercise as among other things minor differences in symbols can confuse name searches and the results of corporate searches);
- capturing electronic data (accounting data, emails and user files in Word, Excel and PDF) from the Company servers, backup tapes and user computers and personal devices of over 120 SF personnel (over 17 terabytes of data);
- approximately 452 BVI timber purchase or supply contracts for the last five years;
- approximately 1,695 timber purchase and lease contracts for the Company's Sino-Wood group of WFOE subsidiaries (the overwhelming majority of these contracts are where there is just one contract for the purchase of standing timber and lease of the land underneath that timber);
- 254 timber purchase contracts and 301 lease contracts for the Company's Sino-Panel group of WFOE subsidiaries;

- approximately 1,196 plantation rights certificates for the Sino-Wood group of WFOEs (including Mandra) have been collected and inventoried (these can cover multiple properties);
- approximately 383 plantation rights certificates for Sino-Panel WFOEs have been collected and inventoried (of these, 92 are held in the names of WFOEs and 291 are held in the names of suppliers);
- approximately 196 original forestry bureau ("FB") confirmations for BVI timber purchase transactions, 44 confirmations for WFOE timber purchase transactions and 60 confirmations for WFOE land lease transactions have been gathered. (Confirmations can cover multiple properties.);
- approximately 580 sales contracts for BVI timber sale transactions;
- 1,530 sample sale agreements for a range of activities in the Sino-Wood group of WFOEs (primarily from wood log sales and manufacturing operations);
- 56 sample sales contracts for a range of activities in the Sino-Panel group of WFOEs;
- BVI set-off documentation;
- nine master supply agreements for the purchase of standing timber;
- identities, corporate particulars and coordinates of AIs and suppliers/aggregators;
- valuation reports;
- legal advice obtained by SF; and
- certain information about the other businesses segments.

The Company has a very complex corporate subsidiary structure which operationally is organized into three main legal structure streams – the group of "operating" BVI companies in the purchased plantations business; the Sino-Panel group of WFOE companies which the IC understands holds planted plantations, purchased plantations, engages in wood log trading (involves one BVI trading company) and has some manufacturing operations; and the Sino-Wood WFOE group of companies which the IC understands holds the plantations acquired in the Mandra transaction, planted plantations, engages in wood log trading and has manufacturing operations.

The decentralized structure of the Company, including the absence of a central server in the PRC, has made the data collection exercise extraordinarily time consuming and difficult. The decentralized record keeping, the large number of offices and the apparent absence of any formal SF documentation retention protocol has required significant effort to ensure the completeness of the data received. In addition, the practice of SF personnel storing data on both their SF and personal computers has required an additional amount of work in processing electronic data.

Much of the SF and other information is, of course, in Chinese and the IC is entirely reliant on Mandarin and Cantonese speakers from among the IC advisors for appropriate translations. In this regard, it should be noted that minor translation differences can give rise to significant confusion among entities, especially third party companies, and there is evidence of such confusion in the MW Report and other public reporting.

### **Management Response**

Senior Management was initially briefly interviewed and denied the allegations in the MW Report.

Management has subsequently provided a preliminary draft response to the MW Report which confirmed in writing their denial of the allegations, and included responses to certain specific allegations. This has been followed up with limited documentation to support their explanations. The IC is seeking to independently verify their explanations with Company documentation and other sources as part of the overall review.

In addition to the fact gathering exercise described above, certain members of Management have been interviewed in respect of specific areas or issues and they and others will be further interviewed to answer questions and otherwise assist the review team as it conducts its examination process through the electronic data, FB visits and AI/supplier interviews.

### **Revenue Mapping**

The OSC requested that the relevant BVI purchase and sale contracts be "mapped" or tied back to SF's reported 2010 revenue. PwC and Management completed this project and were able to tie back all the BVI contracts as requested, together with macro customer level data from the other businesses, to the Company's total 2010 revenue. The resulting model is very detailed and can be used to analyze numerous performance metrics. The revenue mapping documents were delivered to the OSC on August 10, 2011 pursuant to the summons referred to under "Current Activities/Next Steps – OSC Investigation" below.

### **Relationship Mapping**

During the course of the IC advisors' work, as the identities of third parties and individuals related to them become known, the IC advisors are seeking to identify any documented evidence of linkages between Management and staff of SF and those third parties. This is an ongoing process. Information gained from this exercise may impact other aspects of the examination and vice versa. It would be premature to report or to draw any conclusions on this area until the examination is further advanced.

Directorship searches have been conducted in Hong Kong for key members of SF Management and certain other persons and to date no conflicts have been found. Additional searches are being done on other individuals. Corporate searches have also been initiated on a large number of AIs and entities relating to AIs, suppliers/aggregators and associated entities, which list is growing as results are analyzed, contracts reviewed, name changes identified and electronic information reviewed. The search process in the PRC is arduous, decentralized and thus considerably more time consuming than in a North American jurisdiction. As a result, the search and review is

ongoing. Corporate searches on all SF's Hong Kong, PRC and BVI subsidiaries have been conducted and received, and are being cross checked.

Current Activities/Next Steps

(a) FB Visits

For the last several weeks the IC advisors, accompanied by Management, have been conducting visits to various FB offices in Yunnan Province seeking confirmations from the FB officials in such offices as to SF's holdings in their respective jurisdictions. These confirmations, while not essential to establishing ownership of the timber, would constitute independent confirmatory evidence of SF's contractual rights. Yunnan was selected because of the large hectarage disclosed by SF in that province and because it was the focus of the MW Report on the issue of timber ownership. There is no system of registration for the holding or trading of standing timber maintained by the FBs visited to date. The IC's advisors understand, based on information obtained from the FBs, that each has a system for registration of plantation land use rights which is available when SF enters leases or land use agreements as in the case of transactions involving planted plantations held through WFOEs and certain of the timber supply arrangements using WFOEs where plantation land use rights are purchased concurrently with the timber supply.

Because each BVI typically purchases its rights to standing timber through contracts without concurrently purchasing plantation land use rights, the verification of SF's rights to such timber under the applicable forestry legal regime is more challenging than in the case of WFOE holdings involving plantation land use rights.

The FB process has been far more time consuming than originally anticipated for a number of reasons including:

- the confirmations being sought are not a standard official document customarily issued by an FB; that is, responding to the SF request is not a routine established process for the FB;
- the FB offices in Yunnan are in remote locations and visiting them involves very challenging and time consuming travel;
- the high public profile of the matter appears to have resulted in an initial reluctance of FB officials to become involved and a high degree of caution as to providing the cooperation requested;
- from the Company's perspective there are a very limited number of people with the relationships necessary to assist with the process of gaining access to FB officials and obtaining confirmations from them;
- time has been lost due to FB office closures in connection with local holidays, officials travelling, etc.; and

- when FBs are visited, they do not provide confirmations on the day of the visit, and follow-up visits may be required, if the FB will provide a confirmation.

The IC has also embarked on a secondary process to determine if it is possible to follow a contractual chain of title for standing timber purchased by the BVIs through the suppliers/aggregators. This is expected to be a time consuming process and success will depend on completeness of Company records and/or supplier cooperation. Further visits to review plantation rights certificates of the underlying assets at various FBs are also likely required. Initial searches, at least in the case of the BVI transactions, indicated that SF does not retain copies of underlying evidence of title or chain of title from suppliers/aggregators, although review of such documents is a required part of internal Company purchase protocol.

(b) AIs (Customers)/Aggregators (Suppliers) Interviews

It is proposed that a significant proportion of the Company's suppliers/aggregators and AIs will be interviewed by the IC's advisors with a view to understanding the relationships and verifying the financial transactions between SF with these entities, including the cost of the timber held on SF's balance sheet. The OSC has agreed to issue a summons pursuant to section 13 of the *Securities Act* (Ontario) (the "Act") for the purposes of compelling production of materials from the IC, including documents and information related to the third-party AIs and suppliers/aggregators. Such compelled production will give rise to certain confidentiality protections under the Act. In addition, OSC Staff has confirmed that, in the event of an eventual hearing, the IC and/or the Company could seek to invoke certain procedural confidentiality measures with a view to protecting the identities of the AIs and suppliers/aggregators. The process has been initiated and the Company is seeking to make the necessary arrangements.

(c) Valuations

Independent valuations are contemplated by the work plan if necessary. The extent and scope of any valuations to be conducted will be determined after the FB process and AI/supplier/aggregator interviews have been conducted.

(d) Electronic Data Searches

As noted above, a significant volume of electronic data has been secured and processed from key custodians. To date, approximately six terabytes of data (of the total 17 terabytes noted above) from 23 high priority custodians resulting in a total of in excess of approximately 845,000 unique e-mails and user files have been processed into an electronic review environment to facilitate systematic and orderly review. Numerous focused searches were initially done as a priority at the request of E&Y which resulted in approximately 11,000 responsive documents for review. PwC has since turned its attention to broader additional searches designed to address the specific allegations and issues in relation to areas of interest to it. The data is voluminous and the review teams have to date identified in excess of 138,000 documents for review and are currently working through them. As the work progresses it can be expected that the scope of the electronic review will expand to support the work and to follow up on items of interest identified in the initial review.

(e) OSC Investigation

The IC and the Company have very little insight into the OSC's investigation. The OSC has made and continues to make extensive requests for information and requires the IC's counsel, Osler, to meet with it once a week. It can be expected that the OSC will subpoena individuals to compelled interviews at which oral evidence will be given under oath. It is apparent that the OSC will not restrict itself to the specific allegations in the MW Report. This has been and continues to be a very time consuming process which has impacted the speed of the IC's examination. On August 10, 2011, at Osler's request, the OSC issued a summons pursuant to which the OSC compelled production of the 2010 SF revenue mapping spreadsheet prepared by PwC for the IC. As compelled evidence, such information will enjoy certain confidentiality protections provided under securities legislation. In addition, OSC Staff has confirmed its understanding that any disclosure of privileged information by the IC to the OSC (including any "work product" of the IC arising out of the review process) is not intended to constitute a complete waiver of the underlying privilege.

(f) Evidence Briefs

As a subsidiary element of the overall work plan, PwC has detailed plans to develop focused working briefs on eight topics: AI #16; Yuda Wood; (redacted) FB Joint Venture; Survey Company #1; AIs (overall approach and then a subset of individual and groups of AIs); suppliers; FBs; and BVI transactions (especially in relation to documentation needed or present in support of transactions). These briefs will serve to amalgamate the sources of information on these topics which range in their breadth.

E&Y

The IC and its advisors are working closely with E&Y, keeping them informed of the progress of the review process and addressing questions of particular interest to them in relation to the scope, completeness and findings of the review. As noted above, certain searches were conducted in areas of interest to E&Y and the results provided to it.

For its part, E&Y has been helpful in providing background information to PwC and the other advisors. Efforts on the part of the IC and its advisors directed to addressing E&Y questions have taken considerable effort. While many of the issues raised are ones which the IC was considering, the relative priorities are not always the same. As with the requests from the OSC, the IC and its advisors recognize E&Y's legitimate need for information and have worked to balance the various priorities while keeping E&Y fully advised of the progress of its work.

Findings

While the IC has not determined that there is any validity to any of the material allegations in the MW Report, and there are clear errors in certain specific allegations, it is premature for the IC to comment on its findings beyond the limited comments set out above. The review process is ongoing in respect of most of the matters. Furthermore, the material issues are closely interrelated and accordingly, until all the major aspects of the review process are complete, any public statement as to the IC's findings may be misleading or inaccurate.

Timing

The IC does not expect to complete its review within the originally announced timeframe of two to three months. It is difficult to estimate how much longer the IC process will take because many of the variables (e.g., OSC, FB visits, AI/supplier/aggregator interviews) are not within our control. However, the IC believes it would be prudent to announce that it will be another six to eight weeks before the IC expects to be in a position to produce its next interim report to the Board. The completion of the entire IC process is very likely to take longer than that time frame but the IC currently believes it can be concluded prior to the Company's year end.

**SCHEDULE A**  
**PRICEWATERHOUSECOOPERS REPORT MEMORANDUM ON CASH**  
**CONFIRMATIONS**

From: ICA/FAS/PwC  
To: @osler.com>@INTL  
Cc: ICA/FAS/PwC@Americas-CA, HK/CFR/PwC@Asia,  
SF-OslerTeam <SF-OslerTeam@osler.com>  
Date: 07/27/2011 10:25 AM  
Subject: Cash confirmation status for your meeting with OSC

---

Attached is the information requested on cash status - let me know if there are any questions.

#### HK Confirmations

- \$585M confirmed in 293 accounts through 87 confirmations as at June 13, 2011 (\$558M excl. 2 offshore PRC confirm).
- Confirmed loans of \$47 million.
- All confirmations received but 2 HK-controlled accounts in Shanghai were not confirmed in accordance with our standard PRC bank confirmation process. These were offshore accounts and the banks would not allow them to be confirmed through their onshore procedures. The value of these 2 accounts was \$27M.
- Expected balance of \$585M in 293 accounts covered by 87 confirmations.
- Coverage of 100%.

#### PRC Confirmations

- As at June 13, balances confirmed \$229M (\$227M excluding 1 remote PRC confirm - see below).
- Based on total \$282M balances in all PRC accounts reported by the client on June 13, confirmations covered 81% of the reported balances.
- 28 accounts out of 273 total accounts selected for confirmation. 28 confirmations received.
- 1 confirmation of an account in Guangzhou related to a Yunnan subsidiary. Since no company representative was present, the bank needed additional authorizations and the confirmation took more than 1 day. As such, it was not confirmed in front of PwC as per our standard PRC bank confirmation procedures. The value of this account was \$2M.

Privileged and Confidential  
PwC |

Email: @ca.pwc.com  
Assistant:  
PricewaterhouseCoopers LLP  
Royal Trust Tower, TD Centre, Suite 3000, Toronto ON M5K 1G8  
<http://www.pwc.com/ca>

**APPENDIX H - IC REPORT – SECOND INTERIM REPORT**

*(See Attached)*

**REDACTED VERSION FOR PUBLIC RELEASE**

**SECOND INTERIM REPORT OF  
THE INDEPENDENT COMMITTEE OF THE BOARD OF DIRECTORS OF  
SINO-FOREST CORPORATION**

**November 13, 2011**

**TABLE OF CONTENTS**  
(continued)

	<b>Page</b>
<b>I. EXECUTIVE SUMMARY .....</b>	<b>1</b>
A. Introduction.....	1
B. Overview of Principal Findings.....	4
C. Challenges.....	9
<b>II. BUSINESS MODEL AND CORPORATE STRUCTURE .....</b>	<b>14</b>
A. Business Model.....	14
B. BVI Structure .....	15
C. Corporate Structure .....	19
<b>III. LEGAL REGIME .....</b>	<b>21</b>
A. Evidence of Ownership of Tree Plantations .....	21
B. Available Legal Opinions .....	24
C. SAIC Filings .....	25
<b>IV. PROCESS TO DATE .....</b>	<b>27</b>
<b>V. TIMBER ASSET VERIFICATION.....</b>	<b>28</b>
A. Corporate Existence .....	28
B. Master Framework Agreements.....	29
C. BVI Standing Timber Asset Review.....	35
D. WFOEs Contracts and Assets .....	56
<b>VI. RELATIONSHIPS.....</b>	<b>67</b>
A. Yuda Wood .....	67
B. Other Relationships.....	74
C. Globe and Mail Allegations re: Homix and Chen Hua.....	84
<b>VII. OTHER MUDDY WATERS ITEMS.....</b>	<b>86</b>
A. Logging Versus Sale of Trees.....	86
B. Capital Hole .....	86
<b>VIII. VALUATION .....</b>	<b>89</b>
<b>IX. OSC .....</b>	<b>91</b>
<b>X. E&amp;Y.....</b>	<b>93</b>

**TABLE OF CONTENTS**  
(continued)

	<b>Page</b>
<b>XI. ROYAL CANADIAN MOUNTED POLICE (IMET).....</b>	<b>95</b>
<b>XII. CASH .....</b>	<b>97</b>
<b>XIII. NEXT STEPS .....</b>	<b>99</b>
<b>GLOSSARY</b>	

**I. EXECUTIVE SUMMARY**

## **I. EXECUTIVE SUMMARY**

### **A. Introduction**

The IC was established by the Board on June 2, 2011, immediately following the release by Muddy Waters of the MW Report regarding SF. The members of the IC are William Ardell (Chair), James Bowland, and James Hyde. At the invitation of the IC, Mr. Garry West, an independent director of SF, attends virtually all IC meetings and participates in its process. Following the delivery to the Board of the IC's draft of this Second Interim Report on November 3, 2011, Mr. James Bowland resigned as a director and therefore from the IC. The mandate of the IC, in general terms, is to independently examine and review the serious and wide-ranging allegations made in the MW Report and report back to and, if appropriate, make recommendations to the Board. To date, the IC has met approximately 48 times.

The IC Advisors' role is to support the IC in its mandate to review the allegations made in the MW Report and related matters. The IC Advisors have conducted various investigative and review processes, all at the direction of, and subject to such scope limitations as the IC, in its judgment, deemed appropriate. (See Part IV.) This Second Interim Report to the Board, while based on the work of such advisors, is the report of the IC and (other than Schedule IV) not the report of the IC Advisors.

The IC's First Interim Report to the Board dated August 10, 2011 outlined the nature and scope of the IC's activities (principally data collection) to that date and the planned next steps. The purpose of this Second Interim Report is to report to the Board on the activities undertaken by the IC since mid-August, the outcomes and findings from such activities and further next steps. The First Interim Report is attached as Schedule I.A.

While the MW Report took a scatter gun approach in its allegations, the IC determined to address the issues raised in three core areas: (i) timber asset verification; (ii) timber asset value; and (iii) revenue recognition. Overlaying the latter two areas are the issues raised by the MW allegations relating to related party transactions. The IC also determined to focus on the years 2006 to 2010. Using this framework for its review, the IC's focus since its last report has been principally on:

- the ownership structure of timber assets on SF's balance sheet;
- verifying the Company's holdings of standing timber ("purchased plantations" as referred to in the 2010 AIF) and plantation land use/lease rights ("planted plantations" as referred to in the 2010 AIF, though some plantation land use/lease rights, such as the Mandra holdings, are classified as "purchased plantations" in the 2010 AIF), held through BVIs and WFOEs and the nature of its interests in such assets (see Part V below);
- interviewing Suppliers and AIs with a view to verifying the existence and nature of SF's relationship with such third parties and seeking to obtain financial particulars about purchase and sale transactions between such third parties and SF (see Part VI below); and

- examining and assessing the relationship with Yuda Wood, historically one of the largest Suppliers of standing timber to SF supplying approximately 21.5% of BVI timber purchases from 2008 through 2011 (see Section VI.A below).

The IC's work has also included:

- examining a number of specific situations which are the subject of MW allegations or critical newspaper articles (see e.g. Sections IV.B.6, VI.B and VI.C and Part VII below);
- engaging with and assisting E&Y in its examination of various issues relevant to its reports on the Company's financial statements (see Schedule IV attached);
- responding to questions and requests for documents and information from the OSC, including enquiries made through the Hong Kong securities authorities, in connection with its publicly announced investigation (see Part IX below);
- meeting with and responding to requests for information from BJ and FTI;
- conducting interviews of certain members of Management;
- inspecting original versions of documents issued to the WFOEs and BVIs on letterheads with forestry bureau names and featuring Chops (the seal typically used in place of signatures) that indicate that they had been issued by the corresponding forestry bureau (the "forestry bureau confirmations"), and attending meetings with forestry bureaus in an attempt to verify the Company's holdings of standing timber;
- attending interviews of AIs and Suppliers, examining SF employee and other relationships with AIs and Suppliers (see Schedule IV attached); and
- meeting with and responding to requests for information from the RCMP (see Part XI).

In addition to the IC review, the MW Report has spawned various actions by public and private parties. These actions, which have affected the IC's activities and processes, include:

- an OSC investigation of matters related to SF;
- a review by E&Y of various matters relating to its 2010 and prior years' audits;
- three class action lawsuits in Ontario (one of which has a companion action in Quebec) by securities holders against the Company, its officers, E&Y and others;
- a threatened derivative claim against E&Y and certain officers and employees of the Company;

- extensive newspaper and analyst reporting of the Company, including several in-depth investigative reports; and
- an enquiry by the RCMP through IMET.

While the IC believes its work is substantially complete, there remain certain further steps which it intends to undertake as follows:

- review the information and analysis very recently provided by Management intended to respond to certain issues regarding relationships of the Company with AIs and Suppliers and between AIs and Suppliers identified in this Second Interim Report (see Part VI);
- engage an independent valuator (see Part VIII);
- such other steps as the IC, in its judgement, deems advisable in the discharge of its mandate; and
- submit its final report and recommendations to the Board.

The IC expects to be able to deliver its final report to the Board prior to the end of 2011.

## B. Overview of Principal Findings

The following sets out a very high level overview of the IC's principal findings and should be read in conjunction with the balance of this report.

### Timber Ownership

Based on its review and subject to its comments herein, the IC has confirmed to its satisfaction that the Company has:

- registered title to approximately 151,000 Ha. of SW and SP planted plantations and Mandra plantations. This constitutes approximately 17.9% of its timber holdings by area as at December 31, 2010;<sup>1</sup> and
- contractual or other rights to approximately 683,000 Ha. of plantations, being 81.3% of its timber holdings by area as at December 31, 2010 (of these, the Company holds original Plantation Rights Certificates, issued in the name of the Supplier, representing approximately 15,000 Ha., which the IC believes gives the Company a demonstrable chain of title). See Section III.B.

In connection with such confirmation, the IC has reviewed originals or copies of purchase contracts (and the corresponding set-off documentation confirming payment, in the case of the BVI purchased plantations) for the acquisition by the Company of:

- approximately 467,000 Ha. of BVIs purchased plantations;<sup>2</sup>
- approximately 237,000 Ha. of WFOE purchased plantations;<sup>3</sup> and
- approximately 129,000 Ha. of planted plantations<sup>4</sup>

representing approximately 106%<sup>5</sup> of SF's disclosed timber holdings of 788,700 Ha. as at December 31, 2010. With respect to these holdings, the IC has verified to its satisfaction that the Company has registered title:

---

<sup>1</sup> Timber holdings by area as at December 31, 2010 have been calculated by adding approximately 51,000 Ha. of planted plantation land for which the Company has contracts but has yet to classify as plantations under management for the purposes of its annual disclosure, to the Company's disclosed plantation holdings in China of 788,700 Ha.

<sup>2</sup> BVI purchased plantations are comprised of standing timber without underlying leases of land use rights.

<sup>3</sup> The Company classifies this as being comprised of all WFOE (SP) standing timber and all Mandra leased plantations. Mandra leased plantations are considered to be "purchased" plantations in the Company's public disclosure because they were acquired through the 2010 acquisition of Mandra.

<sup>4</sup> The Company classifies this as being comprised of all WFOE (SW and SP) leased plantations.

<sup>5</sup> The Company's explanation for this figure being approximately 106% of its disclosed timber holdings as at December 31, 2010 is that the IC reviewed leases for approximately 51,000 Ha. of plantation land which were

- via original Plantation Rights Certificates in the Company's name, to approximately 86,000 Ha. of WFOE purchased plantations,<sup>6</sup> and approximately 43,000 Ha. of WFOE planted plantations;<sup>7</sup> and
- via copies of Plantation Rights Certificates in the Company's name, to approximately 9,000 Ha. of WFOE purchased plantations, and approximately 12,000 Ha. of WFOE planted plantations.

In addition, as at December 31, 2010, the IC has determined that the Company has original or copies of forestry bureau confirmations relating to the acquisition of:

- approximately 467,000 Ha. of BVIs purchased plantations;
- approximately 89,000 Ha. of WFOE (SP) purchased plantations; and
- approximately 50,000 Ha. of WFOE (SP only) planted plantations.

The Company does not obtain registered title to BVI purchased plantations. In the case of the BVIs' plantations, the IC has visited forestry bureaus, Suppliers and AIs to seek independent evidence to establish a chain of title or payment transactions to verify such acquisitions. The purchase contracts, set-off arrangement documentation and forestry bureau confirmations constitute the documentary evidence as to the Company's contractual or other rights. The IC has been advised that the Company's rights to such plantations could be open to challenge. However, Management has advised that, to date, it is unaware of any such challenges that have not been resolved with the Suppliers in a manner satisfactory to the Company.

#### **Forestry Bureau Confirmations and Plantation Rights Certificates**

Registered title, through Plantation Rights Certificates is not available in the jurisdictions (i.e. cities and counties) examined by the IC Advisors for standing timber that is held without land use/lease rights. Therefore the Company was not able to obtain Plantation Rights Certificates for its BVIs standing timber assets in those areas. In these circumstances, the Company sought confirmations from the relevant local forestry bureau acknowledging its rights to the standing timber.

The IC Advisors reviewed forestry bureau confirmations for virtually all BVIs assets and non-Mandra WFOE purchased plantations held as at December 31, 2010. The IC Advisors, in meetings organized by Management, met with a sample of forestry bureaus with a view to obtaining verification of the Company's rights to standing timber in those jurisdictions. The

---

not included in the disclosed total of planted plantations of 77,700 Ha. as of December 31, 2010, due to a number of reasons, primarily because these lands had not yet been planted.

<sup>6</sup> These 86,000 Ha. of WFOE purchased plantations are composed of approximately 84,000 Ha. of leases under Mandra and approximately 2,000 Ha. of standing timber under SP.

<sup>7</sup> These 43,000 Ha. of WFOE planted plantations are composed approximately of 31,000 Ha. of leases under SW and approximately 12,000 Ha. of leases under SP.

result of such meetings to date have concluded with the forestry bureaus or related entities having issued new confirmations as to the Company's contractual rights to the Company in respect of 111,177 Ha. as of December 31, 2010<sup>8</sup> and 133,040 Ha. as of March 31, 2011,<sup>9</sup> and have acknowledged the issuance of existing confirmations issued to the Company as to certain rights, among other things, in respect of 113,058 Ha. as of December 31, 2010.<sup>10</sup>

Forestry bureau confirmations are not officially recognized documents and are not issued pursuant to a legislative mandate or, to the knowledge of the IC, a published policy. It appears they were issued at the request of the Company or its Suppliers. The confirmations are not title documents, in the Western sense of that term, although the IC believes they should be viewed as comfort indicating the relevant forestry bureau does not dispute SF's claims to the standing timber to which they relate and might provide comfort in case of disputes. The purchase contracts are the primary evidence of the Company's interest in timber assets.

In the meetings with forestry bureaus, the IC Advisors did not obtain significant insight into the internal authorization or diligence processes undertaken by the forestry bureaus in issuing confirmations and, as reflected elsewhere in this report, the IC did not have visibility into or complete comfort regarding the methods by which those confirmations were obtained. It should be noted that several Suppliers observed that SF was more demanding than other buyers in requiring forestry bureau confirmations.

#### **Book Value of Timber**

Based on its review to date, the IC is satisfied that the book value of the BVIs timber assets of \$2.476 billion reflected on its 2010 Financial Statements and of SP WFOE standing timber assets of \$298.6 million reflected in its 2010 Financial Statements reflects the purchase prices for such assets as set out in the BVIs and WFOE standing timber purchase contracts reviewed by the IC Advisors. Further, the purchase prices for such BVIs timber assets have been reconciled to the Company's financial statements based on set-off documentation relating to such contracts that were reviewed by the IC. However, these comments are also subject to the conclusions set out above under "Timber Ownership" on title and other rights to plantation assets.

The IC Advisors reviewed documentation acknowledging the execution of the set-off arrangements between Suppliers, the Company and AIs for the 2006-2010 period. However, the IC Advisors were unable to review any documentation of AIs or Suppliers which independently verified movements of cash in connection with such set-off arrangements between Suppliers, the Company and the AIs used to settle purchase prices paid to Suppliers by AIs on behalf of SF. We

---

<sup>8</sup> Composed of 106,446 Ha. of BVI plantations and 4,731 Ha. of WFOE planted plantations, of which 60,707 Ha. were confirmed in the Hunan Forestry Entity #1 Confirmation. This amount is, however, different from the total 60,696 Ha. shown on the confirmation, which appears to arise from an addition error.

<sup>9</sup> Composed of 128,309 Ha. of BVI plantations and 4,731 Ha. of WFOE planted plantations, of which 60,707 Ha. were confirmed in the Hunan Forestry Entity #1 Confirmation. This amount is however different from the total hectare of 60,696 shown on the confirmation, which appears to arise from an addition error.

<sup>10</sup> Composed of 90,905 Ha. of BVI plantations and 22,153 Ha. of WFOE planted plantations.

note also that the independent valuation referred to in Part VIII below has not yet been completed.

### **Revenue Reconciliation**

As reported in its First Interim Report, the IC has reconciled reported 2010 total revenue to the sales prices in BVIs timber sales contracts, together with macro customer level data from other businesses. However, the IC was unable to review any documentation of AIs or Suppliers which independently verified movements of cash in connection with set-off arrangements used to settle purchase prices paid, or sale proceeds received by, or on behalf of SF.

### **Relationships**

- **Yuda Wood:** The IC is satisfied that Mr. Huang Ran is not currently an employee of the Company and that Yuda Wood is not a subsidiary of the Company. However, there is evidence suggesting close cooperation (including administrative assistance, possible payment of capital at the time of establishment, joint control of certain of Yuda Wood's RMB bank accounts and the numerous emails indicating coordination of funding and other business activities). Management has explained these arrangements were mechanisms that allowed the Company to monitor its interest in the timber transactions. Further, Huang Ran (a Yuda Wood employee) has an ownership and/or directorship in a number of Suppliers (See Section VI.B). The IC Advisors have been introduced to persons identified as influential backers of Yuda Wood but were unable to determine the relationships, if any, of such persons with Yuda Wood, the Company or other Suppliers or AIs. Management explanations of a number of Yuda Wood-related emails and answers to E&Y's questions are being reviewed by the IC and may not be capable of independent verification.
- **Other:** The IC's review has identified other situations which require further review. These situations suggest that the Company may have close relationships with certain Suppliers, and certain Suppliers and AIs may have cross-ownership and other relationships with each other. The IC notes that in the interviews conducted by the IC with selected AIs and Suppliers, all such parties represented that they were independent of SF. Management has very recently provided information and analysis intended to explain these situations. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board. Some of such information and explanations may not be capable of independent verification.
- **Accounting Considerations:** To the extent that any of SF's purchase and sale transactions are with related parties for accounting purposes, the value of these transactions as recorded on the books and records of the Company may be impacted.

### Cash

As reported in the IC's First Interim Report, as a precautionary measure, the IC requested that PwC confirm SF's cash balances. PwC did this as of June 13, 2011 for both China accounts and "offshore" accounts. A total of 293 accounts controlled by SF in Hong Kong were confirmed, representing 100% of the expected cash position. There are a very significant number of accounts held by SF in China (in excess of 260) and the logistics and requirements of in-person/in-branch verification in that country led the IC to confirm only a portion of the China accounts (28 accounts, representing approximately 81% of the expected China cash position). The IC was satisfied that SF's expected cash position existed as at the date of the confirmation. The Board should be aware that at the time of the cash confirmation process, SF only updated the details of its cash position quarterly, so the confirmation results must be considered in that context. The IC has instituted certain additional controls over cash movements in excess of \$1 million held in SF Hong Kong bank accounts in order to provide the IC with some precautionary comfort during the examination process. Further, Management has advised that cash balances are now updated on a more frequent basis. See Part XII.

### BVI Structure

The BVI structure used by SF to purchase and sell standing timber assets could be challenged by the relevant Chinese authorities as the undertaking of "business activities" within China by foreign companies, which may only be undertaken by entities established within China with the requisite approvals. However, there is no clear definition of what constitutes "business activities" under Chinese law and there are different views among the IC's Chinese counsel and the Company's Chinese counsel as to whether the purchase and sale of timber in China as undertaken by the BVIs could be considered to constitute "business activities" within China. In the event that the relevant Chinese authorities consider the BVIs to be undertaking "business activities" within China, they may be required to cease such activities and could be subject to other regulatory action. As regularization of foreign businesses in China is an ongoing process, the government has in the past tended to allow foreign companies time to restructure their operations in accordance with regulatory requirements (the cost of which is uncertain), rather than enforcing the laws strictly and imposing penalties without notice. See Section II.B.2.

### C. Challenges

Throughout its process, the IC has encountered numerous challenges in its attempts to implement a robust independent process which would yield reliable results. Among those challenges are the following:

(a) Chinese Legal Regime for Forestry:

- national laws and policies appear not yet to be implemented at all local levels;
- in practice, none of the local jurisdictions tested in which BVIs hold standing timber appears to have instituted a government registry and documentation system for the ownership of standing timber as distinct from a government registry system for the ownership of plantation land use rights;
- the registration of plantation land use rights, the issue of Plantation Rights Certificates and the establishment of registries, is incomplete in some jurisdictions based on the information available to the IC;
- as a result, title to standing timber, when not held in conjunction with a land use right, cannot be definitively proven by reference to a government maintained register; and
- Sino-Forest has requested confirmations from forestry bureaus of its acquisition of timber holdings (excluding land leases) as additional evidence of ownership. Certain forestry bureaus and Suppliers have indicated the confirmation was beyond the typical diligence practice in China for acquisition of timber holdings.

(b) Obtaining Information from Third Parties: For a variety of reasons, all of them outside the control of the IC, it is very difficult to obtain information from third parties in China. These reasons include the following:

- many of the third parties from whom the IC wanted information (e.g., AIs, Suppliers and forestry bureaus) are not compellable by the Company or Canadian legal processes;
- third parties appeared to have concerns relating to disclosure of information regarding their operations that could become public or fall into the hands of Chinese government authorities: many third parties explained their reluctance to provide requested documentation and information as being “for tax reasons” but declined to elaborate; and
- awareness of MW allegations, investigations and information gathering by the OSC and other parties, and court proceedings; while not often

explicitly articulated, third parties had an awareness of the controversy surrounding SF and a reluctance to be associated with any of these allegations or drawn into any of these processes.

- (c) Small Management Team: The Company has a very small executive management team and it is stretched by:
- demands from the IC, the OSC and E&Y;
  - the placement on administrative leave in late August 2011 of certain members of Management by the Company, based upon the advice of BJ. These employees remained available to assist Management upon request on a supervised basis, which further stretched the remaining management;
  - the appointment of a new Chief Executive Officer part way through the IC process; and
  - the fact that Management is dispersed among Canada, Hong Kong and various parts of China.
- (d) Cultural/Language/Geographic Issues:
- vast majority of operational documents are in Chinese;
  - most Asia-based Management employees' first language is Chinese;
  - business practices in China and the SF business model:
    - rely heavily on personal relationships; and
    - documentation of contractual arrangements is not as comprehensive as would be typical in Western jurisdictions, is often not done until after the transaction is agreed and is frequently incomplete;
  - geographic and time distances for the North American-based teams;
  - SF's operations in China are widely and remotely geographically dispersed, a number of plantations are close to sensitive border areas and some are accessible only by overland vehicle travel; and
  - public records in China are more limited than in Western jurisdictions and are often not complete, accessible, up to date or accurate.
- (e) Corporate Governance/Operational Weaknesses: Management has asserted that business in China is based upon relationships. The IC and the IC Advisors have observed this through their efforts to obtain meetings with forestry bureaus, Suppliers and AIs and their other experience in China. The importance of

relationships appears to have resulted in dependence on a relatively small group of Management who are integral to maintaining customer relationships, negotiating and finalizing the purchase and sale of plantation fibre contracts and the settlement of accounts receivable and accounts payable associated with plantation fibre contracts. This concentration of authority or lack of segregation of duties has been previously disclosed by the Company as a control weakness. As a result and as disclosed in the 2010 MD&A, senior Management in their ongoing evaluation of disclosure controls and procedures and internal controls over financial reporting, recognizing the disclosed weakness, determined that the design and controls were ineffective. The Chairman and Chief Financial Officer provided annual and quarterly certifications of their regulatory filings. Related to this weakness the following challenges presented themselves in the examination by the IC and the IC Advisors:

- operational and administration systems that are generally not sophisticated having regard to the size and complexity of the Company's business and in relation to North American practices; including:
  - incomplete or inadequate record creation and retention practices;
  - contracts not maintained in a central location;
  - significant volumes of data maintained across multiple locations on decentralized servers;
  - data on some servers in China appearing to have been deleted on an irregular basis, and there is no back-up system;
  - no integrated accounting system: accounting data is not maintained on a single, consolidated application, which can require extensive manual procedures to produce reports; and
  - a treasury function that was centralized for certain major financial accounts, but was not actively involved in the control or management of numerous local operations bank accounts;
- no internal audit function although there is evidence the Company has undertaken and continues to assess its disclosure controls and procedures and internal controls over financial reporting using senior Management and independent control consultants;
- SF employees conduct Company affairs from time to time using personal devices and non-corporate email addresses which have been observed to be shared across groups of staff and changed on a periodic and organized basis; this complicated and delayed the examination of email data by the IC Advisors; and

- lack of full cooperation/openness in the ICs examination from certain members of Management.
- (f) Complexity, Lack of Visibility into, and Limitations of BVIs Model: The use of AIs and Suppliers as an essential feature of the BVIs standing timber business model contributes to the lack of visibility into title documentation, cash movements and tax liability since cash settlement in respect of the BVIs standing timber transactions takes place outside of the Company's books.
- (g) Cooperation and openness of the Company's executives throughout the process: From the outset, the IC Advisors sought the full cooperation and support of Allen Chan and the executive management team. Initially, the executive management team appeared ill-prepared to address the IC's concerns in an organized fashion and there was perhaps a degree of culture shock as Management adjusted to the IC Advisors' examination. In any event, significant amounts of material information, particularly with respect to the relationship with Yuda Wood, interrelationships between AIs and/or Suppliers, were not provided to the IC Advisors as requested. In late August 2011 on the instructions of the IC, interviews of Management were conducted by the IC Advisors in which documents evidencing these connections were put to the Management for explanation. As a result of these interviews (which were also attended by BJ) the Company placed certain members of Management on administrative leave upon the advice of Company counsel. At the same time the OSC made allegations in the CTO of Management misconduct.

Following the implementation of these administrative leaves and the subsequent appointment of Judson Martin as the new Chief Executive Officer of the company on August 26, 2011, the cooperation received by the IC Advisors from the Company improved significantly. As a result of Mr. Martin's direction, meetings have been arranged and held with Suppliers, AI's and additional forestry bureaus. In addition, as noted above, very recently, Management presented information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

- (h) Independence of the IC Process: The cooperation and collaboration of the IC with Management (operating under the direction of the new Chief Executive Officer) and with Company counsel in completing certain aspects of the IC's mandate has been noted by the OSC and by E&Y. Both have questioned the degree of independence of the IC from Management as a result of this interaction. The IC has explained the practical impediments to its work in the context of the distinct business culture (and associated issues of privacy) in the forestry sector in China in which the Company operates. Cooperation of third parties in Hong Kong and China, including employees, depends heavily on relationships and trust. As noted above, the Company's placing certain members of Management on administrative leave, as well as the OSC's allegations in the CTO, further hampered the IC's ability to conduct its process. As a result, the work of the IC was frequently done

with the assistance of, or in reliance on, the new Chief Executive Officer and his Management team and Company counsel. Given that Mr. Martin was, in effect, selected by the IC and BJ was appointed in late June 2011, the IC concluded that, while not ideal, this was a practical and appropriate way to proceed in the circumstances. As evidenced by the increased number of scheduled meetings with forestry bureaus, Suppliers and AIs, and, very recently, the delivery to the IC of information regarding AIs and Suppliers and relationships among the Company and such parties, it is acknowledged that Mr. Martin's involvement in the process has been beneficial. It is also acknowledged that in executing his role and assisting the IC he has had to rely on certain of the members of Management who had been placed on administrative leave.

## **II. BUSINESS MODEL AND CORPORATE STRUCTURE**

## II. BUSINESS MODEL AND CORPORATE STRUCTURE

### A. Business Model

The IC's understanding of the Company's business model remains as described in its First Interim Report and reference should be made to that for an overall understanding of the business segments of the Company and their relative importance. The plantation fibre operations and, in particular, the core activity of purchasing and selling standing timber through the BVIs/AI structure is the central driver of asset value, revenue and income for SF. BVI entities within the BVI/AI structure represented as at December 31, 2010 \$2.476 billion of book value (466,826 Ha.) and \$1.326 billion in revenue, and approximately \$622 million of Income for the year then ended before allocation of corporate overhead.

The plantation fibre operations use two principal business models, a "purchased plantation" model and a "planted plantation" model and disclose its timber assets in its AIF and other disclosure documents on that basis. The purchased plantation model operates through two legal structures: a BVI/AI legal structure and, to a lesser but growing extent, a China incorporated WFOE legal structure. The planted plantations model is operated exclusively through the WFOE legal structure (although the WFOEs themselves are typically held indirectly through a BVIs holding structure). Management advised that no new cash capital had been deployed by SF into the BVIs' standing timber operations since 2004. Recently identified e-mails suggest that payments may have been made from the WFOE structure into the BVIs structure, e.g., by an offshore customer of a WFOE to settle amounts due to a BVIs, and by WFOEs to establish BVIs Suppliers. Management has not yet provided a full explanation of all these emails. However, Management has advised that there have been transactions whereby SF subsidiaries sell imported logs offshore to a Chinese customer who then owes SF U.S. dollars or Hong Kong dollars. As a result of pressure to collect receivables and the fact that the customer does not have the required currency, SF accepts payment in RMB. The RMB is accepted as payment onshore and is used to buy trees in the BVI model.

The purchased plantation model involves the purchase of standing timber and sale of standing timber pursuant to standardized timber purchase agreements and Entrusted Sale Agreements. The standing timber purchased is generally on land owned by collectives or villages (i.e., not state-owned land). When conducted through the BVIs/AI legal structure, of which 20 BVIs hold all of the BVI timber assets, the timber purchases are arranged through Suppliers. The relationship between such Suppliers and SF has been the focus of much review by the IC. (see Part VI below.) The BVIs structure does not involve the BVIs concurrently purchasing land use rights or leases with the purchase of standing of timber. However, the BVIs supply contracts typically contain a right of first refusal for the BVIs to acquire, or nominate an affiliate to acquire the plantation land use rights after the timber has been harvested. Despite such common contractual provision, the IC Advisors did not identify any occasions when such rights have been exercised.

The BVIs do not sell standing timber directly to customers; they sell under contract to an entity referred to as an AI who usually resells to others. The BVIs timber sales accounts receivables are settled by the AI making payments to Suppliers (directly or indirectly to other parties on their behalf) on behalf of SF. These payments by way of set-off enable the BVIs to acquire further standing timber from Suppliers. As SF has publicly disclosed, no cash actually flows directly

through the BVIs – all BVIs purchases are funded through the set-off mechanism using accounts receivable owed to SF. The particulars of the sales process between BVIs and AIs is set out in Section II.B and Section V.C.15.(b), below.

WFOEs are also engaged in the purchase and sale of standing timber through the SP group of entities with such activity classified as purchased plantations in the 2010 AIF disclosure. When conducted through a WFOE, purchases of standing timber are sometimes accompanied by concurrently obtaining plantation land use rights. The IC understands that WFOE standing timber transactions do not usually involve payments by way of set-off but are conducted on a direct fund transfer basis.

The planted plantation model is conducted by WFOEs through both SP and SW. It involves obtaining plantation land use rights, sometimes with standing timber but often as bare land suitable for planting. Management advises that sales from these planted plantations do not utilize the AI model but rather generally involve direct fund transfers by the WFOEs to the customer, some of whom are the same as or related to AIs under the BVIs/AI model. The IC understands that WFOEs, whether selling standing timber or selling logs from either planted plantations or purchased plantations, both buy and sell on a direct fund transfer basis; with all transactions settled in RMB.

What has become apparent throughout the examination process, is that important and integral elements of the business model are the relationships with business partners. Management had not been forthcoming in clarifying the parties behind the Suppliers and AIs or the relationships with the forestry bureaus that Management stresses are important to the ongoing business. However, as noted above, very recently, Management presented information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board. The extent of relationships, as discussed later in this report, are important to both the business model and to reporting requirements.

## **B. BVI Structure**

The Company has established 58 companies in the British Virgin Islands. It uses these companies as both holding companies for subsidiaries in China and to engage in the purchase and sale of standing timber in China.

During the IC's review period of the first fiscal quarter of 2006 to the first fiscal quarter of 2011, a total of 20 BVIs entered into a total of 453 timber purchase contracts for the purchase of 823,153 Ha. of standing timber. The aggregate purchase price was RMB 28.654 billion. Of those purchases, 466,826 Ha. of standing timber from 310 timber purchase contracts remained in the Company's books as at December 31, 2010, with the balance being accounted for by sales between the first fiscal quarters of 2006 and 2011, and by purchases made in the first fiscal quarter of 2011.

Of those 20 BVIs, only Suri-Wood Inc. and Sino-Panel (Yunnan) Limited were incorporated prior to 2009. The remaining 18 BVIs are subsidiaries of Suri-Wood Inc. incorporated in 2009 or later and have company names not immediately associated with Sino-Forest, such as Brain Force

Limited, Glory Billion International and Trillion Edge Limited. A table summarising BVI corporate search results for all BVIs is found at Schedule V.A.1.

The BVI with the most purchases during the review period was Suri-Wood Inc., which had 131 purchase transactions amounting to a total of 325,697 Ha. and RMB 10.994 billion. However, its last purchase transaction was in 2008. Over the same period Sino-Panel (Yunnan) Limited had just two purchase transactions in 2007 amounting to 10,438 Ha. and RMB 670.5 million. Further, another BVI called Sino-Forest Resources Inc. had purchases prior to but not during the review period.

The remaining 18 BVIs account for all 320 BVI timber purchase contracts entered into from the first fiscal quarter of 2009 to the first fiscal quarter of 2011, amounting to 487,018 Ha. and RMB 16.989 billion.

During the IC's review period, Suri-Wood Inc., Sino-Panel (Yunnan) Limited and Sino-Forest Resources Inc. had a total of 582 sales transactions amounting to a total of 548,292 Ha. and RMB 27.465 billion. The BVI with the most sales during this period was Suri-Wood Inc. which had 509 sales transactions amounting to a total of 492,718 Ha. and RMB 24.099 billion. The 18 BVIs incorporated after 2009 are yet to have sales recorded as at the date of this report.

Despite criticism of the use of British Virgin Islands holding structures in the MW Report (which describes them on page 2 as an "unjustifiable black hole"), IC believes that there are proper commercial reasons for using British Virgin Islands holding structures for investing in China.

#### 1. BVIs as Investment Vehicles

Many foreign investors, including well known multi-national companies, hold their investments in China in special purpose vehicles established overseas in jurisdictions with a familiar and internationally accepted system of corporate governance. By way of example, over 75% of blue chip companies listed on the Hong Kong Stock Exchange (Hang Seng Index constituent stocks excluding the Finance Sub-Index) utilise British Virgin Islands holding structures, including for their investments in China. This reduces the uncertainties of operating under relatively new and untested Chinese corporate structures, and enables investors to enter into shareholding arrangements under familiar Western structures, governed by a common law system.

The British Virgin Islands has been a particularly popular jurisdiction in which to establish such companies, because of the lack of corporate income tax, capital duty and stamp duty on profits or issue or sale of shares. The use of such special purpose companies, one for each investment, also facilitates raising capital offshore and restructuring such companies without the uncertainties and delays inherent in the domestic Chinese system which requires a host of government approvals for even minor changes to a company ownership or structure.

#### 2. BVIs as Vehicles to Purchase and Sell Timber

The IC has been advised by its Chinese counsel that there is no express statutory prohibition that foreign companies such as the BVIs may not purchase, hold and sell assets including standing timber located in China. Foreign companies may, after obtaining necessary government approvals and clearances and going through the proper formalities relating to foreign exchange,

remit foreign exchange into China and pay the purchase prices and repatriate the sale proceeds outside of China on the basis of proper documentary support, including evidence of payment of income tax and other taxes such as VAT (which is usually withheld by the domestic payer as withholding agent).

However, business operations in China conducted by foreign companies without an onshore presence is generally not allowed. Since 1992, SAIC regulations have required foreign companies to set up onshore entities within China before carrying out “business activities” within China. Chinese laws do not have any express definition of what activities carried out by foreign companies would constitute “business activities.”

The Company has obtained Chinese legal opinions that state that the purchase of timber in China by certain BVIs and the sale of such timber by those BVIs are not prohibited by Chinese law,<sup>11</sup> and that “to the best of [local counsel’s] knowledge after reasonable investigation and inquiry and as confirmed by the Company, each of the [BVIs listed] has the right to conduct business in China in the manner as presently conducted and as described in the Disclosure Package and the Final Offering Memorandum”.<sup>12</sup> However, Chinese counsel to the IC has advised that, on the basis of the materials reviewed by it, interviews with Company officers and representatives of Suppliers, AIs and forestry bureaus, as well as its other investigations from June 2011 to the present, it cannot definitively conclude that the activities of the BVIs are not “business activities” carried on within China, and it is believed there is a risk that such activities, taken as a whole, might be considered carrying out “business activities”, which requires a business to be registered in China. Chinese counsel to the Company and Chinese counsel to the IC met to consider these issues on November 11, 2011, and concluded that, given the lack of an express definition of “business activities” under Chinese law, and the uncertainty of the Chinese legal system, it was not possible to reach a definitive opinion on this issue.

Under the BVI structure, the BVIs do not sell standing timber directly to customers, they sell to AIs who, the IC are told, usually resell to others. Instead of receiving after-tax payment directly from the AIs, the BVI sales accounts receivables are settled in RMB by the AIs making payments to Suppliers on behalf of SF, which are usually by way of set-off (and some AIs and Suppliers stated to the IC Advisors during interviews that they sometimes directed the set-offs to be made to and from other parties), and thus enable the BVIs to acquire further standing timber from Suppliers without remitting the sale proceeds offshore and purchase monies back onshore again. This process avoids Chinese foreign exchange controls which must be complied with in a normal cross-border sale and purchase transaction, and this could present an obstacle to future repatriation of sales proceeds, and could have tax implications as well.

The Chinese authorities have demonstrated tolerance towards business activities that may be regarded as technically non-compliant or arguably non-compliant as business practices are gradually regularised over time, and tax laws are enforced more strictly year by year. While such practices by the BVIs and AIs have been going on for many years (since the 1990s according to

---

<sup>11</sup> See Jingtian & Gongcheng legal opinions issued for the reference of the Company’s auditors in 2007 and 2008.

<sup>12</sup> Jingtian & Gongcheng legal opinion dated October 21, 2010 in respect of offering of 6.25% Guaranteed Senior Notes Due 2017.

Management), the Company has achieved large scale operations only in more recent years, which may result in more attention from the Chinese authorities. The BVIs are subject to withholding tax, stamp tax liabilities and VAT or business tax (as the case may be) and the AIs need to specifically record in their financial statements liabilities of those taxes to be paid on behalf of the BVIs. While AIs are responsible for paying tax on behalf of the BVIs according to the terms of the standard form entrusted sales contracts they enter into with BVIs, the IC has not been able to verify that any relevant income taxes and VAT have been paid by or on behalf of the BVIs in China.

The Company discloses potential Chinese tax liabilities as a risk factor in its AIF, and sets out the methodologies it uses for calculating such liabilities. The Company states that Management applies significant estimates and judgment to determine the appropriate amount of tax related liabilities, and contingencies for such liabilities, to be recognized and disclosed in the financial statements. The Company recognized a provision of approximately \$160 million as at December 31, 2010 for contingent Chinese tax liabilities.

In the event that this business model is challenged by the relevant Chinese authorities as carrying on business activities in China by the BVIs, Chinese counsel to the IC has advised that, quite apart from the tax and foreign exchange compliance issues mentioned above, SF may be required to cease operations under this business model and could be subjected to administrative fines and other penalties.

However, as regularization of the practices of foreign businesses in China is an on-going process (as has happened in various industries since the early 1990s), the government has in the past tended to allow foreign companies a period to restructure their operations in accordance with regulatory requirements rather than enforcing the laws strictly and imposing penalties without notice.

### 3. WFOEs as Trading Vehicles since 2004

Chinese counsel to the IC has advised that, under Chinese law, the business of purchase and sale of standing timber could be categorized as a form of trading or commodity distribution business, which is an industry in which foreign investment in China has been subject to various restrictions and has been subject to change over the years.

In 1992, the State Council issued a notice to permit foreign-invested enterprises to be established in the commodity distribution industry in five trial cities, subject to relevant approval. However, in that notice, the State Council explicitly prohibited wholly foreign-owned enterprises from engaging in that industry.

In 2004, MOFCOM issued a notice that lifted both the prohibition on wholly foreign-owned enterprises from engaging in the commodity distribution industry and the limitation to certain cities. Since then, foreign investors have been permitted to, subject to relevant regulatory approval, establish trading companies (either as joint ventures or wholly foreign-owned enterprises) to participate in most areas of the commodity distribution industry, including the purchase and sale of standing timber, throughout China.

The Company established its first WFOE to engage in the purchase and sale of standing timber in 2004 in compliance with such regulatory requirements.

### **C. Corporate Structure**

The Company's corporate structure is detailed in Schedule II.C. The organization has multiple subsidiary companies that have been formed over time to hold the different assets of the Company. There are, for example, about twenty BVIs holding different parcels of standing timber in China.

From a legal perspective, the vast majority of the subsidiaries are held through two holding companies: Sino-Wood and Sino-Panel.

#### Sino-Wood

SW holds, through many subsidiaries in the British Virgin Islands, Hong Kong and China, the Mandra assets, the BVIs' standing timber assets and a significant portion of non-Mandra WFOE assets. Management explained that functionally within SW, the domestic WFOE business and BVI business are operated quite separately. SW is also responsible for the flooring manufacturing operations, HOMIX, and the nursery business. SW is engaged in the buying and selling of imported logs.

In the SW WFOE domestic business (including Mandra), Albert Zhao is responsible for operations and Chen Hua is responsible for finance.

#### Sino-Panel

SP holds, through many subsidiaries in the British Virgin Islands and China, a significant portion of the non-Mandra WFOE assets. Management explained that Albert Ip was responsible for operations and George Ho was responsible for finance.

SP engages in both the purchased plantation business model and in the planted plantation business model. It also engages in the buying and selling of imported logs and, to a limited extent, in the buying and selling of domestic logs. We also understand it has some manufacturing operations.

For the BVI standing timber business, Albert Ip is responsible for purchases, Albert Zhao is responsible for sales, and Alfred Hung is responsible for finance.

### **III. LEGAL REGIME**

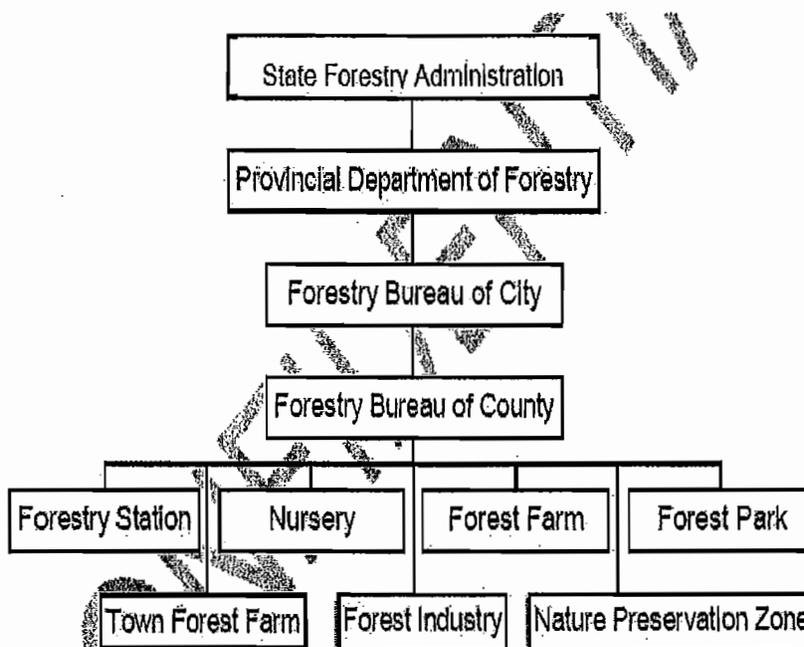
### III. LEGAL REGIME

#### A. Evidence of Ownership of Tree Plantations

The core activity of the Company's business is the purchase and sale of standing timber using the "purchased plantation" model, principally through BVIs, and to a lesser extent, through WFOEs. The BVI model is described more fully in Part II above. The BVIs (and sometimes WFOEs) acquire standing timber pursuant to timber purchase contracts from Suppliers without acquiring any land use rights. Forestry bureau "confirmation letters" are commonly obtained by the Supplier from the local forestry bureau at county level or above in respect of such contracts. One Supplier, in its interview with the IC, noted that SF is its only customer requiring confirmation letters for standing timber purchases in addition to a purchase agreement. It appears that issuing confirmations is not typical practice and that such confirmations have been provided as a "favour" at the request of the Company and its Suppliers. WFOEs acquire standing timber on a stand-alone basis or in conjunction with land use rights or land leases. When land use rights or land leases are acquired, Plantation Rights Certificates are often eventually obtained in the name of the contracting WFOE subsidiary evidencing registered title.

- (a) Forestry Administration - China utilizes a top-down hierarchical system to govern its timber resources:
  - (i) *State Forestry Administration* - the central level, responsible for national legislation, policy development, national strategic planning and key forestry programs;
  - (ii) *provincial departments of forestry* - the regional level, responsible for forest regulation, by-laws and regional policy, short-term forestry and forest resource planning and organizing key programs;
  - (iii) *city-level Forestry Bureaus* - primarily act as a bridge for county and provincial level communications; and
  - (iv) *county Forestry Bureaus* - the local level, oversees the implementation of the central or provincial projects, resource management planning and land/forest title management.

This administrative structure is illustrated in the following figure:



- (b) Regulatory Framework - The key legislation regulating the forestry industry in China is the Forestry Law (effective from January 1, 1985, as amended), and its Implementation Regulations (effective from January 29, 2000, as amended). These are supplemented by various provisions, notices and other administrative rules at the national and provincial level.

The transfer of timber and other plantation rights is permitted by the relevant legislation, in particular the “Opinions on Comprehensively Promoting the Reform of the Collectively Owned Plantation Right System” (promulgated by the State Council of China on July 14, 2008). Such Opinions provide that, among others, farmers with contractual rights over collectively-owned commercial plantations may, without change of the plantation usage, and in accordance with applicable laws and regulations, dispose of such rights relating to plantation operations and plantation tree ownership rights through sub-contracts, leases, transfers, mortgages, or as contributions in capital or under cooperative structures.

The Forestry Law and its Implementation Regulations implement a system of plantation rights registration and issuance of certificates as evidence of such registration. Pursuant to the Implementation Regulations, all entities must apply to the forestry bureau of the local government at the county level or above for plantation rights registration, and such forestry bureau is responsible for issuing Plantation Rights Certificates.

There are four types of rights associated with plantations in China, being:

- (i) plantation land ownership,
- (ii) plantation land use rights,

- (iii) timber ownership and
- (iv) timber use rights,

all of which are separate rights. Private enterprises cannot hold plantation land ownership but may hold plantation land use rights for a specified duration (up to 70 years), timber ownership and timber use rights. In certain provinces, foreign enterprises cannot acquire land use rights. The various rights are separate rights and can be separately owned by different parties.

- (c) Plantation Rights Certificates and Confirmations - A Plantation Rights Certificate should reflect plantation rights as registered in the registration system and is the ultimate proof of ownership and sets out the parties that hold each of such rights. There is a nationally mandated registration system for Plantation Rights Certificates, though there appear to be some locations where Plantation Rights Certificates are not issued. In every visit with forestry bureaus conducted by the IC Advisors, they were told that Plantation Rights Certificates are not issued for timber ownership alone and that there is no forestry bureau record of the sale and purchase of standing timber alone. In these circumstances, the Company required their Suppliers to seek and they typically obtained from local forestry bureaus, "confirmation letters" (or "approvals") relating to the standing timber purchase contracts entered into by its BVIs and some WFOEs. These confirmation letters are not title documents as there appears to be no official regulatory basis for their issue. We understand that there is no registration system for such confirmation letters or approvals.

The forestry bureau confirmations are not a form of official documents contemplated by the applicable regulatory regime. Rather, we believe, based on meetings with certain forestry bureau officials or former officials and with certain Suppliers, and discussion with Management, that they are documents issued at the request of either the Company or, more commonly, its Suppliers as a "favour" and should not be disclosed outside the Company or relied upon legally. They have what purports to be the forestry bureau's Chop on them. We believe the forestry bureau confirmations should be viewed as comfort indicating that the relevant forestry bureaus do not dispute SF's claims to the standing timber to which they relate, but which are not documents of title that could be relied upon in event of a dispute or in a court of law. However as noted below, a number of the forestry bureaus have indicated that these have been issued at SF's request and that the confirmations are for SF internal use only and may not be shown to third parties. This could limit the usefulness of these documents in any legal dispute.

In two instances the IC Advisors have identified that forestry bureau officials were either concurrently or subsequently employees of, or consultants to, SF. One forestry bureau indicated that it assigned employees to SF and other companies to assist in the development of the forestry industry in its jurisdiction.

Attached as Schedule III.A is a chart prepared by the IC's independent Chinese counsel setting out the availability of Plantation Rights Certificates in various provinces in China.

## **B. Available Legal Opinions**

Given the foregoing, the IC's independent Chinese counsel has advised that the available legal opinions regarding the Company's interests in its planted and purchased plantation standing timber, vary depending on the nature of the interest held. Schedule III.B sets out the form of opinion which JH has indicated it could provide to the IC. In summary, and subject in each case to the qualifications and assumptions set out in such form of opinion:

- (a) **if the BVI or WFOE has entered into a timber purchase contract to acquire standing timber, has from the local forestry bureau a written confirmation letter and does not have a Plantation Rights Certificate registered in its name or been provided the relevant Plantation Rights Certificate registered in the name of the Supplier for such standing timber:** each such timber purchase contract entered into by such BVIs or WFOE is valid, effective and legally binding on the parties thereto subject to the authorization by (a) the *de facto* owner with the Plantation Rights Certificate for such standing timber, if any, or (b) the ultimate farmer or collective economic organization who has legally obtained the ownership of the standing timber during the reform of the collectively-owned plantation rights system, as the case may be. If the *de facto* owner or the ultimate farmer or collective economic organization, as the case may be, refuses to grant the authorization to any contract, the contract will be void and the Company will have no contractual rights. However, if the Company has paid consideration to the Supplier pursuant to the contract, the Company will have a cause of action against the Supplier for the return of the consideration based on the legal theory of unjust enrichment;
- (b) **where the WFOE has entered into a timber purchase contract and a forest land use rights lease contract and has the relevant Plantation Rights Certificate registered in its name:** the WFOE has legally obtained the use right of the forest land and the ownership of the standing timber as recorded in the Plantation Rights Certificate;
- (c) **where the WFOE has entered into a purchase contract and forest land use rights lease contract, has a forestry bureau confirmation letter and has not acquired the relevant Plantation Rights Certificate registered in its name but has been provided the relevant Plantation Rights Certificate registered in the name of the Supplier:** the forest land use lease contract and timber purchase contract are valid, effective and legally binding upon the parties thereto and are enforceable against the parties thereto; as a result, the WFOE has contractual rights to the forest land and standing timber as provided in such contracts;
- (d) **where the WFOE has entered into a timber purchase contract and a forest land use rights lease contract and has obtained a forestry bureau confirmation letter but has not obtained relevant Plantation Rights**

**Certificate registered in its name or been provided the relevant Plantation Rights Certificate registered in the name of the Supplier:** such timber purchase contract and forest land use rights lease contract is valid, effective and legally binding subject to the authorization by (a) the *de facto* owner with the relevant Plantation Rights Certificate, if any, or (b) the ultimate farmer or collective economic organization who has legally obtained the ownership of the standing timber during the reform of the collectively-owned plantation rights systems, as the case may be. If the *de facto* owner or the ultimate farmer or collective economic organization, as the case may be, refuses to grant the authorization to any contract, the contract will be void and the Company will have no contractual rights. However, if the Company has paid consideration to the Supplier pursuant to the contract, the Company will have a cause of action against the Supplier for the return of the consideration based on the legal theory of unjust enrichment; and

- (e) **where the WFOE has entered into a timber purchase contract, has obtained the forestry bureau confirmation letter and has not acquired the relevant Plantation Rights Certificate registered in its name but has been provided the relevant Plantation Rights Certificate registered in the Supplier's name:** the timber purchase contract is valid, effective and legally binding upon the parties thereto and is enforceable against the parties thereto pursuant to the terms and conditions thereof; as a result, the WFOE has contractual rights to the standing timber as provided in such contract.

JH's form of legal opinion also provides that, while a forestry bureau confirmation letter does not constitute definitive evidence of ownership of the standing timber referred to therein, such letters may provide certain comfort in respect of the BVIs or WFOE contractual or other rights over such standing timber. This is because under applicable Chinese law, in the event of any dispute in respect of the ownership of standing timber, the disputing party shall seek determination of such ownership from the government, namely the forestry bureau, before they may start litigation in the court.

We note that in prior years SF has obtained legal opinions from its Chinese counsel regarding its plantation rights assets and business in China. These opinions were issued in connection with its annual audit or offshore securities issues. It is not clear to the IC what level of due diligence was undertaken by Chinese counsel in connection with the issue of such opinion. In the context of the IC's review, JH's due diligence process has been rigorous and has included JH's visits with forestry bureaus, review of original contracts, Plantation Rights Certificates and forestry bureau confirmations, and participation in the investigation undertaken by the IC.

### C. SAIC Filings

The SF transaction volumes with a number of AI and Suppliers do not match the revenue reported by such Suppliers in their SAIC filings. The AIs and Suppliers, which are private entities, make their own filings without input or review by SF. Attached as Schedule III.C is a chart setting out such differences. Both MW and the OSC have focused greatly on this differential.

IC Advisors made the following observations to the IC regarding the reliability of SAIC filings:

- (a) Discrepancies between the information set forth in SAIC filings and the filer's books and records, as well as the filer's tax filings, can be expected in China. There are a number of reasons for this, such as the following:
  - SAIC searches are not definitive - filings and searches are not of the same status as in many Western countries, and should not be relied upon as being up-to-date and wholly accurate; and
  - the requirements for filing accounts with SAIC branches may be different from the requirements for statutory tax audits, resulting in different numbers.
- (b) SAIC filings should not be relied upon exclusively. The unreliability of financial information in such filings is something that one should take into account in China.
- (c) The way in which companies file with the SAIC / MOFCOM / SAFE / Finance Bureau / Tax Bureau / etc. would not usually be seen as a matter that concerns the counterparties that deal with such filers in China, with the possible exception of tax filings in the case of SF, as the AIs have an obligation under the Entrusted Sales Agreements to "pay relevant taxes on behalf of the Company".
- (d) While information in such filings as to legal representations and shareholders is generally more accurate it is not uncommon practice in China that one or more registered shareholders may be a trustee or nominee holder for an underlying beneficial holder who is undisclosed.
- (e) Legal and practical consequences of inaccurate SAIC filings could range from the draconian (on a literal interpretation of the legislation in the case of repeated, egregious breaches) to an expectation not to rely on filings (as a matter of common practice). The national government policy is that filings should be accurate, but the system of corporate filings / independent audits / imposition of tax / etc. is still at an early stage in China, and as a matter of practice, legislation reflecting such policy will only be enforced as and when the regulators choose to do so.

The conclusion that the IC has drawn from this advice is that information in SAIC filings, particularly financial filings, is one data point to consider but no conclusions can be drawn from that information alone, whether it be conclusions of a financial nature, ownership nature or otherwise based.

**IV. PROCESS TO DATE**

#### **IV. PROCESS TO DATE**

The IC Advisors' report on the process conducted on behalf of the IC is attached as Schedule IV. The scope of review and the processes undertaken by the IC Advisors to date were determined by the IC and have been subject to certain limitations. The IC, in its judgment, considers such limitations to be appropriate, having regard to the challenges discussed in Section I.C of this report, time constraints and cost/benefit considerations.

**V. TIMBER ASSET VERIFICATION**

## V. TIMBER ASSET VERIFICATION

The principal objective of the asset verification process is to confirm SF's ownership of or contractual and other rights to standing timber in China, whether held by BVIs or WFOEs. In addition, steps were taken to verify the corporate existence of the subsidiary entities within the Company's corporate structure.

A central theme of the MW Report is that the Company does not own all the timber assets recorded on its books and that its reported revenue from timber is overstated. A principal task of the IC has been to examine the Company's rights to its timber assets and the revenue therefrom as reported in its 2010 Financial Statements. The chart attached as Schedule V sets out an overall summary of the Company's timber holdings as at December 31, 2010 broken down by organizational stream within the Company and showing the type of document held by the Company as evidence of title or contractual and other rights. Such documents include purchase contracts, Plantation Rights Certificates and forestry bureau confirmations.

### A. Corporate Existence

The Company provided a list of the 149 entities comprising the SF group of companies: 58 BVI entities, 7 HK entities, 75 China entities, 2 Canadian entities, 1 Barbados entity, and 6 other entities (See Schedule V.A.) and a Chart showing the organization thereof (see Schedule II.C).

The existence of the Subsidiary BVIs and the WFOEs indicated on the Chart and the Company's ownership thereof has been confirmed as at the date of the searches. As noted below, the directors and officers of all such subsidiaries, with the exception of one,<sup>13</sup> were listed in SF records as being employees of the Company at the time of the searches. This included Mr. Allen Chan, who has subsequently resigned from his position. Management and its counsel have advised that they are undertaking changes to install current Management as directors and officers of such subsidiaries. The IC has not independently verified this process. Such searches do not assure that the Company does not own other subsidiaries or interests in other entities.

#### 1. BVIs

To verify the incorporation and existence of the Subsidiary BVIs on the Chart, the IC:

- confirmed that the list provided by the Company included all of the BVIs listed as material subsidiaries in the 2010 AIF;
- obtained search results (including copies of charter documents) and original certificates of good standing through BVI counsel for all 58 BVIs listed;
- obtained original certificates of incumbency showing directors, officers and shareholders for the Subsidiary BVIs listed; and

---

<sup>13</sup> The authorized person to handle SAIC matters for Sino-Forest (Heyuan) Co., Ltd., He Qianghua, does not appear on the list of employees provided by the Company.

- summarized the search results in respect of each Subsidiary BVI listed, including verifying that the list accurately reflected the corporate name and shareholders of such Subsidiary BVI and that its directors and officers were employees of the Company at the date of the searches.

A table summarizing the BVI corporate search results is appended hereto as Schedule V.A.1.

## **2. WFOEs**

To verify the incorporation and existence of the WFOEs on the Chart, the IC Advisors have:

- confirmed that the corporate list provided by the Company included all of the WFOEs listed as material subsidiaries in the 2010 AIF;
- obtained SAIC search results in China (including up to date basic company information sheets) for all WFOEs identified in the list; and
- summarized the search results in respect of each WFOE listed, including verifying that the list accurately reflected the name and shareholders of such WFOE Subsidiary and confirming its lawful incorporation, validity of business license and current scope of business.

A table summarizing the Chinese SAIC search results is appended hereto as Schedule V.A.2.

## **B. Master Framework Agreements**

### **1. Overview of MFAs**

Between September 2006 and the second fiscal quarter of 2011, through both BVIs and WFOEs, the Company entered into nine long-term MFAs with nine different Counterparties. These contracts address the supply to the Company of standing timber covering 1,667,667 Ha. in seven provinces over varying periods of three to fourteen years.

The MW Report questioned the legitimacy of certain of the MFAs. In its response to the MW Report, Management characterized the MFAs as framework agreements that are similar to a "Heads of Agreement" commonly used in Western business circles to outline the terms of a business deal. The MFAs provide the basis for subsequent specific purchase agreements for standing timber in the specific region.

### **2. MFA Review Process**

The IC:

- reviewed the MW Report and Management's Response thereto;
- reviewed the Chinese texts and English translations of nine MFAs;

- reviewed certain public disclosure relating to the MFAs, including that set out in the 2010 AIF, 2010 MD&A and press releases issued by the Company concerning the MFAs;
- reviewed BVI and WFOE purchase contracts provided by the Company for standing timber held as at December 31, 2010, various BVI and WFOE contract spreadsheets, and BVI and WFOE asset listings as referred to elsewhere in this report;
- engaged in discussions with Management with respect to the business, including MFAs;
- performed corporate searches on each MFA Counterparty and potential related parties; and
- interviewed two of the MFA Counterparties (Supplier #3 and Supplier #19) in connection with its process interviewing certain Suppliers and AIs.

### **3. Muddy Waters MFA Allegations**

The MW Report made a number of allegations with respect to the legitimacy of various Suppliers to the Company. Pages 16 to 29 of the MW Report focus on certain MFAs and the Counterparties thereto, particularly the MFAs with:

- Gengma Dai and Wa Tribes Autonomous Region Forestry Co., Ltd. (incorporated March 25, 1995, with registered capital of RMB 3 million, contract on March 23, 2007 for a 10 year term - approximately 200,000 Ha.);
- Zhanjiang Bohu Wood Co., Ltd. (incorporated on November 2, 2007, with registered capital of RMB 10 million (versus RMB 1 million disclosed in the MW Report), contract on December 10, 2007 for a 5 year term - approximately 150,000 Ha.);
- Zhangzhou Lu Sheng Forestry Development Co., Ltd. (incorporated November 19, 2007, with registered capital of RMB 2 million (versus RMB 550,000 disclosed in the MW Report), contract on August 11, 2008 for 10 year terms - approximately 200,000 Ha.); and
- Jiangxi Zhonggan Industrial Development Co., Ltd. (incorporated January 28, 2008 (versus January 28, 2009 as disclosed in the MW Report), with registered capital of USD 5 million (as disclosed in the MW Report), contract on June 11, 2009 for a 3 year term - approximately 150,000-300,000 Ha.).

The thrust of the Muddy Waters allegations is that the Company could not have made purchases from those Suppliers in the volume stated in those agreements. A number of reasons are put forth for that allegation which broadly can be summarized as follows:

- allegations that the Counterparties are generally newly created and thus cannot be credible Suppliers of the contracted supply volumes;

- allegations that based on SAIC filings the Counterparties have insufficient capital to support the contracted supply volumes;
- allegations that the Counterparties occupy simple offices or homes indicating that they are not sophisticated enough to be credible Suppliers of the contracted supply volumes; and
- allegations that the Counterparties' SAIC filings relating to their financial activity do not reflect SF's recorded contracted volume of business with such Counterparties; (including a detailed analysis of the Gengma Dai MFA by reference to Lincang City Forestry Bureau reports of forestry activity, reports on GDP and foreign investment levels for Lincang City in addition to SAIC financial filings).

There are a number of other specific allegations pertaining to each of the above-noted MFA Counterparties some of which are addressed in Part VI.

#### **4. MFA Contract Terms**

Each English translation of an MFA is 6-8 pages long. The MFAs are substantially similar although they have evolved over time to more closely reflect apparent actual practice. Key terms, and facts are summarized below:

- The SF subsidiary entering into an MFA was a BVI in the first 6 MFAs (2006-2008) and a WFOE subsidiary in the last 3 MFAs (2009-2011). The SF subsidiary may assign all its rights and obligations under the MFA to another SF subsidiary.
- Under each MFA, the SF subsidiary has first right of refusal to purchase very large volumes of standing timber (measured by mu/Ha. and cubic meters) in a designated area or region. Plantation land use rights are explicitly excluded from this first right of refusal.
- The MFA's do not contemplate the sale of the large volumes of standing timber through one transaction. Rather, the SF subsidiary is to exercise its rights by entering into a series of specific timber purchase agreements with the MFA Counterparty. Given the SF subsidiary may assign its rights and obligations under the MFA to any other SF subsidiary, both BVIs and WFOEs may ultimately enter into those specific timber purchase agreements.
- The MFAs stipulate that after a specific timber purchase agreement has been entered into, and the subject standing timber has been harvested, the SF subsidiary then has a preferential option to lease the underlying land.
- The MFA recitals state that the Counterparty has received, either directly or indirectly through an entrusted third party, the full commission of the original owner to enter into the MFA. Regarding the actual performance of the MFA, the actual contractual warranties are weaker, stipulating that the Counterparty has acquired or will acquire the necessary consent and approvals, including those of the original owners either directly or through a third party designated by it.

- The Counterparties' representations and warranties in the MFAs have become stronger over time. All of the MFAs contain a soft "authority" representation to the effect that the Counterparty has or will have authority to transfer the assets. In the case of MFAs signed with WFOEs, this has evolved to a representation that a third party designated by the Counterparty has or will have authority to transfer. In the case of MFAs signed with BVIs, the representation is to the effect that the forests assigned are subject to a Plantation Rights Certificate or other documents that evidence legal ownership. More recent MFAs include a title representation and a compliance with law representation and, in the case of the three most recent MFAs, a representation that the forests were commercial forest lands not subject to any restrictions on transfer.

Schedule V.B.4.1 sets out a detailed summary of the MFAs terms and Schedule V.B.4.2 provides an unofficial English translation of the Gengma Dai MFA.

## **5. MFA and BVI Timber Purchase Contract Pricing**

The MFAs set maximum prices at which standing timber is to be purchased by the company SF subsidiary within areas covered by MFAs. While the MFAs contemplate the purchase of specified amounts of standing timber measured in mu/Ha. and cubic meters, with an estimated volume, the maximum contractual prices contemplated in the MFAs (generally in cubic meters) varying between 260 RMB per cubic metre and 380 RMB per cubic metre. See Schedule V.B.5.

The MFA maximum price per cubic metre of timber does not differentiate between species of trees. However, the MFAs identify the main species of trees that are to be the subject matter of the specific purchase contracts. All specific BVI timber purchase contracts for timber in that province or region signed after the relevant MFA, regardless of the identity of the Supplier, are generally priced almost exactly to the maximum price set out in the MFA for that province or region.

For example, in March 2007, SF signed an MFA with Gengma Dai setting a cap of RMB 260 per cubic metre. The IC Advisors found that most subsequent BVI timber purchase contracts for Yunnan, irrespective of the Supplier, are priced at exactly RMB 260 or to within several RMB of that. However, two contracts signed in September 2010 for pine and fir, as opposed to broadleaf, are priced at an average of RMB 510 and three contracts signed in the first fiscal quarter of 2011 are priced at an average of RMB 310. Some BVI timber purchase contracts signed before the March 2007 MFA for Yunnan were priced higher than RMB 260. A spot review revealed several contracts priced at around RMB 370.

Similarly, in December 2006, SF signed an MFA with the Hongjiang City Forestry Technology Integrated Development Services Company for Hunan timber, capping prices at RMB 260 per cubic metre. Again, most of the subsequent BVI timber purchase contracts the IC Advisors have seen for Hunan are priced at exactly that price or to within several RMB except for the five aforementioned contracts signed in September 2010 and in the first fiscal quarter of 2011.

Further, in December 2007, SF signed an MFA with Bohu Wood which priced timber in Guangxi at a cap of RMB 380 per cubic metre. All subsequent BVI timber purchase contracts for Guangxi for all Suppliers were priced either at that price or to within several RMB. In contrast,

BVI timber purchases signed for Guangxi prior to the signing of the Bohu Wood MFA tended to have higher prices, sometimes as much as RMB 465 per cubic metre.

It appears that the MFAs establish a target price at which the subsequent specific BVI timber purchase. A chart summarising the pricing information for the MFAs from September 2006 onwards is attached as Schedule V.B.5. It is noted that there are some MFAs where the MFA Counterparty itself did not subsequently enter into any specific BVI timber purchase contracts. There are also MFAs under which the Company has not disclosed any subsequent purchases.

Very recently, Management provided the IC Advisors with information, which they indicate pertains to the market pricing of timber in each of the regions that are the subject matter of the MFAs at the time of entry into each of the MFAs. The IC has not yet reviewed or analyzed this information.

## **6. Summary of Findings on MW Allegations Regarding MFA**

The MW Report seems to assume that the MFA Counterparties owned the standing timber that is the subject of the MFAs and that those Counterparties are directly supplying timber under the MFA itself. This assumption, together with the simplicity of the MFAs and the SAIC information on incorporation dates and capital, appears to have led MW to conclude that the contracts must be fraudulent.

In particular the MW Report alleges that the timber purchases under the Gengma Dai MFA were overstated by \$800 million primarily based upon information from Lincang City public records about direct sales with associated land rights from Gengma Dai as the seller. The allegations appear to be based on several misconceptions:

- that Lincang City records show all forestry transactions.
- that Gengma Dai was the sole supplier under the Gengma Dai MFA.
- that the supply disclosed by the Company was all purchased in Gengma County.

In respect thereto the IC found as follows:

- (a) Based on its interviews the IC does not believe trading in standing timber on a standalone basis is registered with the forestry bureaus. Accordingly, such trading volumes are not likely included in formal government statistics.
- (b) Management provided a letter from Gengma Dai confirming that it had sold to SF 520,000 mu (approximately 34,670 Ha.) of standing timber and 190,000 mu (approximately 12,670 Ha.) of plantation land use rights combined with standing timber. The IC reviewed contracts covering such sales. In addition, Gengma Dai indicated it had also facilitated sales of some 3,040,000 mu (approximately 202,670 Ha.) of standing timber by third parties. The IC reviewed contracts for sales of standing timber in Yunnan that at least equalled the indicated volumes although those contracts did not reference Gengma Dai or the MFA. Management explained that the MFA Counterparties did not receive compensation for such

arrangements. The IC received no other evidence of MFA Counterparties facilitating supply by other parties.

- (c) MW ignores the fact that the MFA with Gengma Dai is to be fulfilled over as long as a ten year period. The various forestry and other economic statistics cited by MW are only for Gengma County and Lincang City whereas the underlying BVI timber purchase contracts disclosed by the Company are for plantations in 18 different counties within six different cities in Yunnan (not just Lincang City). For a table showing purchases of timber assets in Yunnan Province, please refer to Schedule V.B.6.(c).

The MW Report also indicated that SAIC filings by the MFA Counterparties did not reflect the values of the contracted supply in the MFA. The general issue of the accuracy of financial information in such filings is addressed under Section III.C. However, the point in this context reflects a misunderstanding by MW of the framework nature of the MFAs. In practice, only a small portion of the volume stated by the Company to be purchased under MFAs (with the exception of Supplier #3) has actually been supplied by the MFA Counterparty. As a result, the MFA Counterparty's SAIC records, even if accurate, would not be the basis by which to measure the Company's activity levels. As set out above, in the case of Gengma Dai, the role of the MFA Counterparty is explained by Management as also being a facilitator of supply through other parties. Further detailed analysis of the actual supply provided by MFA Counterparties is set out in Schedule V.B.6.

The MW Report suggests that the MFA Counterparties are generally newly incorporated entities. Four of the entities were incorporated more than two years prior to their entry into the MFAs. Three of the MFA Counterparties were incorporated within one year of their entry into the MFAs. The IC believes it is likely that at least some of the Suppliers are specifically incorporated for the purposes of acting as project companies to supply the Company. The MW Report also suggests (based on their SAIC filings) most MFA Counterparties have very modest offices and minimal capital.

Management's response to these points was as follows:

"For foreign investors looking to invest in standing timber in the PRC, it is natural, and more likely, a necessity, to deal through local agents in a specific geographical area who are either a supplier and/or agent for the suppliers, or both, of standing timber. During the past several years, SF has worked with a small team of agents knowledgeable in their specialized geographical regions within the PRC, who work as intermediaries between SF and the local villagers and collectives, private owners and companies that own the standing timber....

Under a typical "timber acquisition contract" used by SF in the acquisition of standing timber in the PRC, the buyer, a BVI company wholly owned by SF, will acquire standing timber from the suppliers/suppliers' agent who either has expressed authority from the original holder of timber rights to sell or is the holder of the timber rights....

A good suppliers' agent does not need to have a large base nor a strong balance sheet nor a long history, but its key man needs to have extensive and in-depth local knowledge of the timber resources in the region, to have excellent

relationship with the villages, their inhabitants and their respective elders, familiarity with their local practices and preferences; and a good knowledge and understanding of local rules and regulations, and the enforcement thereof, as well as good working connection with local regulators. None of them needs a posh, western office with high tech gears located in a class A office building at the centre of a major city (as stipulated by MW). In fact, by necessity, they should be located close to the villages, with humble and low cost set up for their offices.

All SF suppliers' agents are selected on the basis mentioned above and are fully independent of and unrelated to SF in any way or form."

Schedule V.B.4.1 identifies the reported registered capital of each of the MFA Counterparties, where available in SAIC filings.

For the purposes of the IC's interviews of certain Suppliers, Management identified the key personnel at such Suppliers which included two MFA Counterparties. Interviews did not necessarily take place at the Supplier's place of business and little documentation was provided. The IC Advisors have observed that the business sophistication of these individuals and the apparent scope of the Suppliers' operations and related operations varied greatly. See Section V.C.12. The IC was unable to gain insight into the scope of capital necessary to act as a Supplier or whether the Suppliers are effectively funding their supply to the Company using deferred payments to underlying suppliers and the funds paid to it by the Company itself. The IC's analysis of BVI Suppliers activity generally is found at "BVI Suppliers General Observations" in Section V.C.13 below.

## **C. BVI Standing Timber Asset Review**

### **1. BVI Asset Review Process**

The BVI review process involved capturing, assembling and organizing into usable form massive amounts of documentation and data.

IC Advisors reviewed:

- 453 standing timber purchase contracts entered into by BVIs for the purchase of standing timber for the period January 1, 2006 to March 31, 2011, of which 337 were originals and 116 were copies. Of these, the timber acquired through 310 outstanding timber purchase contracts remained in the Company's books as at December 31, 2010 (consisting of 304 originals and 6 copies of contracts).
- 579 BVI Entrusted Sale Agreements by which BVIs sold standing timber for the period from January 1, 2006 to March 31, 2011, of which all were copies, see Section V.C.14.
- Documents among BVIs, AIs or parties related to AIs and BVI Suppliers recording set-off payments between the AI parties and BVI Suppliers on behalf of the BVIs for each timber purchase transaction. See Section V.C.14 below.

- 209 (196 originals and 13 copies) forestry bureau confirmations. The confirmations are on letterheads with forestry bureau names and feature Chops that indicate that they had been issued by the corresponding forestry bureau from 49 different forestry bureaus for BVI standing timber acquired from the third fiscal quarter of 2008 onward. 181 originals and 13 copies cover timber acquired before 2011 and the remaining cover timber acquired from January 1, 2011 until March 31, 2011.
- No originals or copies of Plantation Rights Certificates regarding BVI timber supply transactions, either in the name of the Company or other parties who previously owned the standing timber, were available to the IC Advisors. (Forestry bureaus visited generally advised that Plantation Rights Certificates are not available for standing timber only, and in one jurisdiction, are not available at all.)
- For the second fiscal quarter of 2011, 10 original BVI timber purchase contracts and set-off documents corresponding to each (set-off documents are discussed in Section V.C.15 below). No corresponding forestry bureau confirmations for these transactions were available. (Management advised that the Company has developed a new form of forestry bureau confirmation which it intends to obtain.)

The Company organized data including extensive spreadsheets listing:

- Detailed BVI timber assets spreadsheet tracking detailed information from 2006 to the first fiscal quarter of 2011 on BVI timber acquisitions and dispositions including information on contract number, buyer, seller, transaction dates and hectares moving;
- For the second fiscal quarter of 2011, BVI timber acquisitions and disposals including information on contract number, buyer, seller, transaction dates, hectares moving and set-off arrangements;
- Detailed BVI timber asset inventory information as of December 31, 2010 showing detailed flow chart of the asset inventory, a list of plantation timber holding amounts shown on the Company's balance sheet in the 2010 Financial Statements;
- Detailed BVI timber revenue information across a wide range of data points including contract tracking numbers, tree type, location, yield, margins by a number of measures, cost and maintenance costs;
- Email reviews, interviews with forestry bureaus, AIs/Suppliers and Management and other reviews as noted in Schedule IV; and
- The MW Report and the Management MW Response.

The IC observed that the Company possesses extensive and elaborate documentation with respect to its stated BVI standing timber purchases and standing timber sales.

## **2. BVI Standing Timber Purchase Contracts Reviewed**

The IC has reviewed 337 original contracts and 116 copies of contracts for the purchase of standing timber by BVIs for the period of 2006 to the first fiscal quarter of 2011, of which 304 original contracts (452,959 Ha.) and 6 copies of contracts (13,667 Ha.) were for the standing timber held as at December 31, 2010.

Through timber purchase contracts, the BVIs acquire contractual and other rights from the Supplier or if the Supplier is properly acting as authorized agent of the underlying owner, then from such underlying owner, to standing timber purchased by them under such contracts. In the case of BVI standing timber purchases, the Company does not concurrently lease or obtain plantation land use rights.

## **3. Asset Reconciliation and Tie-in to 2010 Financial Statements**

Management provided a detailed reconciliation of the contract purchase prices and amount of hectares shown in the BVI standing timber contracts to the BVI standing timber book value in the 2010 Financial Statements and the Ha. disclosure in the 2010 AIF. The IC reviewed and discussed this reconciliation (which was filed with the OSC) at length with Management. It contained a listing of BVI timber purchase contracts and purchase prices which the IC Advisors reviewed against the actual contracts. The IC is satisfied that the aggregate purchase prices shown in the BVI timber purchase contracts that SF indicated it held at December 31, 2010 reconcile to the book value of BVI standing timber assets of \$2.476 billion as recorded as part of the total timber holding shown on the 2010 Financial Statements. The BVI holdings of 466,826 Ha. of standing timber disclosed by the Company as at December 31, 2010 also tied-in to the hectare amounts contained in the BVI timber purchase contracts reviewed by the IC.

This is consistent with the Company's public disclosure reviewed by the IC. Such management reconciliation also contained consolidated information for WFOE purchased plantation standing timber assets and WFOE planted plantation assets at a corporate level.

## **4. Form of BVI Timber Purchase Contract**

The BVI timber purchase contracts are the previously discussed "specific purchase contracts". They are signed between the BVI and Counterparties (i.e. Suppliers). Not every BVI timber purchase contract is signed with a MFA Counterparty. All are written in Chinese and mostly follow a template format with standard wording, even though they may have varying titles. An English translation of an example contract, together with a summary of the terms, is attached as Schedule V.C.4.

## **5. BVI Supply Contract Payment Process**

The BVI timber purchase contracts do not specify the manner in which Suppliers are paid. The Company discloses in Note 4 to its 2010 Financial Statements that as a result of the accounts receivable from the BVI timber purchase contracts being denominated in RMB (which is not freely remittable out of China and its conversion is restricted), the majority of accounts receivables arising from sales by BVIs of standing timber are realized by the Company instructing its AIs i.e., customers/debtors, to settle on behalf of the Company the amounts

payable by it to Suppliers for further standing timber purchases and other liabilities denominated in RMB. For more discussion of set-off arrangements between BVIs and AI, see Section V.C.15.

Management advised that no new cash capital had been deployed by SF into the BVIs' standing timber operations since 2004. Rather the proceeds of disposition of BVI standing timber sales were generally redeployed to purchase further standing timber supply using the BVI/AI model. The IC email review indicated certain emails suggesting payment of certain BVI Supplier accounts payable were made by an offshore subsidiary of a customer and the IC has sought an explanation thereof from Management. Management's explanation is set out in Section VI.B.1, below.

## **6. Timber Rights Diligence Process**

### **(a) Company Surveys**

Each BVI timber purchase contract had an accompanying Forest Resource Survey Report ("**Survey Report**") which provides a general introduction of the county where the forest resources contemplated by the survey are located. The IC considered such surveys in connection with the asset verification process. The Survey Report also sets out the general geographic location of the county (including the longitude/latitude coordinates) and describes its natural conditions, total plantation land area, forest covering rate, timber reserves, tree types, tree details such as average height, diameter, density, transport conditions, and social and economic conditions. The Survey Report generally describes the verification method used and sets out the verification results of plantation area (mu), total number of compartments and sub-compartments that compose the plantation, and timber reserves (cubic meters). Although the reference numbers of compartments are included, no centralized system which connects compartments to the location of specific plantations is available to the IC and other location data that would be required to identify specific locations of the plantations is general in nature.

The Survey Reports for the BVI timber purchase contracts are almost exclusively produced by one survey company called Survey Co #1. The use of one company has raised concerns by the OSC. Management has provided an explanation as to its use of the surveys. See Section G of Schedule IX.

Management explained that the Survey Report was part of the due diligence process to determine suitability for acquisition and not a valuation or cash flow analysis. Management indicates in its diligence process summary that it also conducts an internal investment return analysis. The technical data, however, set out in the Survey Report were factors in the pricing of the timber. The most important factor is the volume of timber given that, on the basis of price per cubic metre of timber, the BVI timber purchase contracts are almost always priced in accordance with MFA pricing.

Management has explained that it reviews maps that allow them to locate the properties but does not retain them. The IC has not been able to verify this explanation and notes the Plantation Rights Certificates in the Company's possession in respect of WFOE timber transactions have detailed location descriptions. The IC Advisors were able to verify that most Mandra and SW purchase contracts have attached to them either a map or a description of boundaries or both. It is

not clear to the IC Advisors how the Company would be able to identify the relevant areas of timber purchased by the BVIs at the time of sale or harvesting.

(b) Standing Timber Chain of Title Diligence

The IC initially considered and rejected a process of tracing the Company's title back through the chain of supply to the holder of a Plantation Rights Certificate in favour of a forestry bureau confirmation process. The issue was revisited in light of the delays related to obtaining new confirmations, information that emerged about the nature of the confirmations and the OSC request for BVI timber purchase contract attachments.

None of the BVI timber purchase contracts have as attachments either (i) Plantation Rights Certificates from either the Counterparty or original owner or (ii) villager resolutions, both of which are contemplated as attachments by the standard form of BVI timber purchase contract employed by the Company. The OSC expressed grave concerns as to such absence and surmised in its discussions with the IC that such absence is per se evidence of fraud. The IC disagrees with this proposition and has indicated that to the OSC. While there is little question possession of such documentation would provide significant evidentiary comfort that the representations of the Suppliers in the BVI timber purchase contracts were accurate, the IC believes that their absence is evidence of Chinese forestry practices, weak internal diligence practices and weak document retention practices rather than anything else.

The response of Management to the MW Report indicated as part of a comprehensive diligence review process for timber purchases that the Company reviewed underlying Plantation Rights Certificates if timber was purchased directly from the plantation right land owner. If the supply of the timber was through a Supplier who owned the rights, Management indicated the underlying contract by which such Supplier purchased the timber and, if available, the Plantation Rights Certificate of the underlying owner of that property, were reviewed. A complete set of the steps that Management indicated in its response that it followed is set out in Schedule V.C.6.(b).

Ms. Xu Ni (Head of Legal) relayed from Mr. Ip that the operations department reviewed Plantation Rights Certificates and village resolutions as part of the Company's diligence review process but that copies of such documents were not maintained. The reluctance by Suppliers to provide the underlying documents was confirmed during the various visits by the IC Advisors.

IC Advisors, in its e-mail review in August found a detailed SP diligence checklist from 2008. SP is a holding company for many non-Mandra SF WFOE companies that also purchase and sell standing timber. The diligence checklist stipulates that legal chain of title documentation is to be reviewed as part of the purchase of standing timber. Although the timber purchase process is conceptually the same for a WFOE as a BVI (although payment procedures are different), the document does not specify that the outlined diligence process is applicable to purchases by the BVI group. No similarly detailed document specifically addressed BVIs. An accounting flow diligence checklist for the BVI purchases indicates that Messrs. Chan and Ip were closely involved in BVI purchase planning and in approving individual purchases at several stages including selecting the BVI to make such purchases.

In response to a detailed OSC request, Management provided an updated report on its diligence process that evolved from prior explanations. Management indicated that when buying from a Supplier who was authorized by the original owner, it did not view Plantation Rights Certificates and may only view parts but not all of the underlying contract relevant to its purchase. Further, when buying from a Supplier who purchased from another Supplier, Management indicated that it relies upon Supplier representations without viewing underlying contracts or Plantation Rights Certificates. Management indicated that they may randomly check villagers' authorizations. No evidence was produced to support the Management explanation.

Management also indicated in its response to the OSC that it had visited certain forestry bureaus to view the history of the area in which timber is purchased and advised of SF's intention to purchase. It is unclear to the IC the extent and nature of the diligence that Management could have undertaken at forestry bureaus. The IC interviews with forestry bureaus indicate none maintained any records of standing timber-only transfer transactions, although most acknowledged they had issued Plantation Rights Certificates for land ownership.

In the course of assisting the Company to inspect specific transaction documents in connection with the 2011 second fiscal quarter report, it became apparent to the IC Advisors that the BVI timber purchase contracts and BVI timber sale contracts for the 2011 second fiscal quarter were only documented at quarter end. No forestry bureau confirmations were obtained in the second fiscal quarter of 2011. (Management advised that the Company has developed a new form of forestry bureau confirmation, which it intends to obtain.) Forestry bureau confirmations in respect of the 2011 first fiscal quarter purchases and the related BVI purchase contracts were provided to the IC Advisors in June 2011 for review.

The IC requested on a number of occasions commencing in late July that Management seek copies of the attachments to the BVI purchase contracts from the Suppliers. The Company provided copies of correspondence dated September 20, 2011 in which it made requests for the information but has advised that none has been forthcoming. In advance of and at each Supplier interview, requests for documentation including the attachments to BVI timber purchase contracts were made but no pertinent documents were produced by any BVI Supplier even though some BVI Suppliers undertook at various points to provide them.

#### **7. Plantation Rights Certificates Not Generally Available for Standing Timber Alone**

As noted above, under Chinese national forestry law (see Section III.A), Plantation Rights Certificates, a document evidencing ownership issued by governments in China (through local forestry bureaus), should theoretically be available for standing timber.

As noted above, the BVI standing timber contracts contemplate either a Plantation Rights Certificate or other valid ownership certification being held by the Counterparty or the original owner of the Counterparty in assisting the BVI in registering ownership of timber.

However, Management indicates that in practice it is not able to obtain Plantation Rights Certificates for standing timber purchases when no land transfer rights are transferred. Nine forestry bureaus visited by the IC generally advised that Plantation Rights Certificate's were not

available to a holder of interests in standing timber only. Very recently, one official at one forestry bureau suggested that Plantation Rights Certificates may be available for standing timber alone. However, he advised that the forestry bureau had never issued such a certificate. This suggestion is also inconsistent with all of the other information received by the IC in respect of BVI standing timber and the availability of such Plantation Rights Certificates has not been tested.

While this is not definitive evidence that Plantation Rights Certificates are not available anywhere in China for standing timber alone, the IC has concluded that proof of ownership of standing timber through possession by SF of a Plantation Rights Certificate for standing timber interests alone is not currently available in the jurisdictions in which SF has been conducting business.

## **8. Forestry Bureau Confirmations**

### **(a) Existing Confirmations**

The IC is satisfied that it is not yet possible to obtain Plantation Rights Certificates for standing timber alone in most, if not all jurisdictions in which the Company is doing business.

Management indicated that, in the absence of Plantation Rights Certificates, it has sought further acknowledgements from relevant forestry bureaus in the form of “confirmations” that it has rights in the timber. The Company has previously obtained legal opinions from the Chinese law firm of Jingtian & Gongcheng regarding the issuance of such confirmations. According to the legal opinions, if in a particular locality the work of registering plantation rights and issuing the new format of Plantation Rights Certificates has been delayed, and it is not possible to obtain the old form of Plantation Rights Certificates, and the BVI needs to prove the legality of its plantation rights to a third party, the BVI may apply to the competent department in charge of forestry administration at county level or above where the timber is located for the issuance of a “certification letter or confirmation letter” to prove the lawful rights that the BVI holds over the timber, and in such a case, such a certification letter or confirmation letter may be seen as valid proof that the BVI has the right to own the timber. Management has advised that they relied upon such opinions and also believe that these confirmations provide additional comfort in the event of any dispute.

The Company provided and the IC reviewed 196 originals and 13 copies of existing confirmations for the period of 2006 to the first fiscal quarter of 2011 in the possession of the Company, of which 181 originals (452,958 Ha.) and 6 copies (13,868 Ha.) comprising all of the 466,826 Ha. of the Company’s disclosed BVI standing timber holdings as at December 31, 2010.

The BVI confirmations were in the form prepared by SF outside counsel and all were printed on letterheads with forestry bureau names and featured Chops that indicate that they had been issued by the corresponding forestry bureau. The confirmations reviewed are substantially of the same standard form, which include the following key terms:

- forestry bureau confirms that it has reviewed the BVI timber purchase contract before issuing such confirmations;

- forestry bureau approves the contract arrangement under which timber is transferred to the BVIs;
- forestry bureau agrees to issue Plantation Rights Certificates to the BVIs and register its timber ownership according to the schedule of municipal or city government implementation for Plantation Rights Certificates; and
- forestry bureaus confirm that subject to applicable laws the BVI is entitled to harvest, transport and sell the timber once the timber grows to full size.

Attached to each confirmation is a chart setting out the timber stipulated in the corresponding BVI timber purchase contracts. Because SP WFOEs also obtain confirmations for both standing timber and leases, the wording of SP WFOE confirmations is different.

Further, it is apparent from documentation found in email searches that the Company, at least in some instances, prepared the actual forestry bureau confirmations on notional forestry bureau letterhead on which a forestry bureau Chop was then obtained. Management explained that it created the notional letterhead copies, as the issue of the confirmation was not a statutory or mandated action, but rather a favour to assist the activities of the Company. Accordingly, they had to arrange all the logistics to obtain the confirmation. The IC Advisors did not find any evidence, through its email searches or otherwise, of the Company having falsified the Chop on forestry bureau confirmations.

There are indications in emails and in interviews with Suppliers that gifts or cash payments are made to forestry bureaus and forestry bureau officials. The reasons are not clear although two Suppliers noted benefits were provided for the issuance of confirmations.

Affirmations of existing confirmations were not initially sought by the IC for the reasons set out below. Eventually certain affirmations were sought and the results are described under Section V.C.9 - "Summary Outcome of Forestry Bureau Visits" below.

(b) New Form of Forestry Bureau Confirmations sought by the IC

After input from Management, the IC concluded that it would be disruptive to SF's forestry bureau relations to reconfirm the existing confirmations. A new form of confirmation with a more limited scope (i.e. did not address issues such as transportation, harvesting, and sale, as SF did not have these rights) was agreed upon with Management and sought from forestry bureaus. It is attached as Schedule V.C.8.(b).

The IC Advisors determined that it was appropriate to initially focus on BVI forestry assets in Yunnan Province in its asset verification process because Yunnan was the focus of the Muddy Waters allegations pertaining to the Company's plantation assets, and the vast majority of the Company's book value and net income resides in the BVI standing timber business. Yunnan Province represented 186,700 Ha. of the Company's total plantation assets as at December 31, 2010 and 201,673 Ha. as at March 31, 2011. The IC Advisors conducted an analysis to select forestry bureaus at which new confirmations would be sought. Management arranged visits at each of the forestry bureaus, with the exception of Yunnan FB#8 which was originally selected

by the IC Advisors but not yet visited. This focus was later broadened to include BVI forestry assets elsewhere and WFOE forestry assets both Mandra WFOEs and non-Mandra WFOEs.

## **9. Summary Outcome of Forestry Bureau Visits**

The IC Advisors attended meetings with ten forestry bureaus or associated bodies between July 7 and November 12, 2011. The process by which meetings were arranged and the scheduling of those meetings took substantially longer than expected by the IC. Management explained that these delays were due to local holidays, changes in officials, personal holidays of officials, official forestry bureau requirement for background survey diligence and the adverse publicity surrounding SF, and conflicting demands on Management's time involved in both assisting the IC and conducting the Company's business.

The forestry bureaus responsible for Plantation Rights Certificates and from whom the Company has confirmations are located in the areas in which the Company assets are located, and visits to such locations involved significant time and travel, including multiple modes of transportation, often to somewhat remote locations in southern China.

The IC, on the advice of Management as to the importance of its forestry bureau relationships and on the advice of the IC Advisors that some form of introduction from the Company was a necessity, had Management arrange all of the visits and follow-up. The IC had little visibility into that process. Management attended and participated in all the forestry bureau meetings. There was sometimes disagreement with Management as to the tenor and findings of the meetings. The details of the IC process around the forestry bureau meetings is set out in Part IV. The status and results of these meetings to date are set out in narrative format below and a table in Schedule V.C.9.1. Summaries of the meetings with forestry bureau officials at the individual forestry bureaus are provided in Schedule V.C.9.2 and more complete notes of the interviews are available to the Board for its confidential review.

New confirmations representing a total of 54,781 Ha. of BVI standing timber were issued by two forestry bureaus from Yunnan selected by the IC Advisors (Yunnan FB#9 (14,433 Ha.) under Yunnan FB#6 (40,348 Ha.)). The visit to the Yunnan FB#2 resulted from the advice of the Yunnan FB#1 that it would not be able to issue a confirmation but that underlying county forestry bureaus may do so.

Two new confirmations representing a total of 75,892.71 Ha. of BVI standing timber were issued by two organizations related to forestry bureaus selected by Management. These were Hunan Forestry Entity #1 in Hunan Province (60,696.88 Ha.) and Yunnan Forestry Entity #1 in Yunnan Province (15,195.83 Ha.). The IC understands that these organizations are sponsored by the Hunan FB#2 and Yunnan FB#7, respectively.

Each of the four new confirmations varied from the form of confirmation agreed upon by SF's in-house counsel and the IC Advisors. Some of the material differences between the old confirmations and the new confirmations include the following:

- The new confirmations only state that SF BVIs have contractual rights and do not discuss other ownership characteristics.

- The Hunan Forestry Entity #1 issued a new confirmation (“**Hunan Forestry Entity #1 Confirmation**”) corresponding to 60,696.88 Ha.<sup>14</sup> which states that standing timber transactions comply with national and provincial laws, regulations and policies and such contracts are lawful and effective.
- The three Yunnan confirmations confirm the contract and Ha. information set out in the table of plantation rights as well as confirm that the BVI standing timber purchase contracts are lawful and effective.

There were indeterminate outcomes from several forestry bureau visits as follows:

- One forestry bureau in Yunnan Province (Yunnan FB#4) agreed to issue a new confirmation during the IC Advisors’ visit subject to its completion of certain due diligence exercises, which it indicated would take approximately one month to complete from July 22, 2011. As of the date of this report, the new confirmation has not been received.
- Two forestry bureaus in Yunnan Province (Yunnan FB#3 and Yunnan FB#5) declined to issue new confirmations relating to a total area of 95,550 Ha., as at December 31, 2010 or 121,062 Ha. as at March 31, 2011, referring the IC to the county level forestry bureau within that area. Management later advised that the forestry bureaus were willing to issue the confirmations after conducting some due diligence. As of the date of this report, new confirmations from these two forestry bureaus have not been received. In the case of the Yunnan FB#5, Management arranged for the issuance of the confirmation in relation to Yunnan Forestry Entity #1 as noted above.

Existing confirmations representing a total of 90,905 Ha. of BVI standing timber were acknowledged by two forestry bureaus as having been issued by that forestry bureau. The reconfirmation process was subject to certain caveats noted below, including that Management selected the forestry bureaus at which reconfirmations were sought. A brief description of the two visits follows below:

- One forestry bureau in Hunan Province (Hunan FB#1) affirmed the issuance of certain samples of confirmations prior to the MW Report corresponding to BVI plantations with a total area of 13,845 Ha. as at December 31, 2010. At the forestry bureau meeting, the party to whom Management introduced the IC Advisors affirmed the authenticity of the confirmation. Subsequent to the meeting, the IC Advisors determined that the person was a recently retired former vice-chief who had been briefly on the SF payroll after the announcement of his retirement, receiving a monthly consulting fee. Management provided evidence of the arrangement and of termination of employment.
- One forestry bureau in Guangxi Province (Guangxi FB#1) affirmed the issuance of certain confirmations corresponding to BVI plantations with a total area of 77,060 Ha. as at December 31, 2010. A single official attended the meeting.

---

<sup>14</sup> The hectareage of 60,696.88 Ha. differs from the total shown on the Hunan Forestry Entity #1 Confirmation, which shows 60,707 Ha. The difference appears to arise from an arithmetic error.

The new confirmations and acknowledged existing confirmations also cover certain WFOE standing timber assets and these are detailed under Section V.3.(d). Other information obtained from forestry bureaus:

- The level of transparency as to the nature of the diligence undertaken in issuing new confirmations or examining and reconfirming existing confirmations did vary, ranging from confirmation of an extensive review of underlying documentation (including confirmation of discussion of the underlying Suppliers and the review of such Suppliers' rights, including underlying Plantation Rights Certificates in the names of Suppliers) to no indication as to the methodology by which (or if) diligence was undertaken prior to the issuance of a confirmation.
- The interviews indicate that forestry bureaus have varying levels of completion in different Provinces with respect to the issuance of Plantation Rights Certificates to village collectives and other parties residing in the relevant area. All forestry bureaus visited by the IC Advisors in Yunnan Province and one in Hunan Province claimed to have issued Plantation Rights Certificates in respect of all plantations under their jurisdiction. In the case of the only forestry bureau visited in Guangxi, the IC Advisors were told that not many Plantation Rights Certificates (less than 3% in terms of plantation area) had been issued by it. The IC inquired about the ability to review Plantation Rights Certificate registries that are ostensibly available to the public. In some instances, it was indicated that no Plantation Rights Certificate registry exists. At other times, it was indicated that the Plantation Rights Certificate registry existed, but could not be reviewed or was kept at the county level rather than the city level. A variety of other reasons were provided as to why the Plantation Rights Certificate registry could not be seen at the time of the visit.
- All of the forestry bureaus acknowledge the activity of SF in their jurisdiction. A number expressly indicated that foreign offshore companies were not entitled to obtain Plantation Rights Certificates; but most expressly acknowledge that a foreign company was able to buy timber and sell timber.
- It was also clear that the forestry bureaus were of the view that the only means to establish legal rights with respect to the sale of standing timber alone was through contract.
- A number of the forestry bureaus indicated they had active relationships with SF and were aware of its activities as a buyer. In two instances the forestry bureau confirmed that SF was the largest owner of plantation forest areas within their jurisdiction.
- During the Hunan FB#2 visit, the party with whom the IC Advisors met advised that a specific vice-chief of the forestry bureau had been assigned to work closely with SF and that whilst he still drew a basic salary from the forestry bureau he also acted as a consultant to SF to assist SF in conducting its business. The IC Advisors were told that this arrangement had been in place for several years and a similar arrangement was in place between another forestry company and the forestry bureau at the direction of the local government. IC Advisors have confirmed that according to the Company's records

the vice-chief has appeared on the payroll since January 2007 with a monthly payment of RMB 15,000 which is likely to be significant compared with his forestry bureau salary.

- The IC Advisors were informed by one of the forestry bureaus (Yunnan FB#2) that the harvest of plantations belonging to SF in that county is very difficult, if not impossible, to be approved since the forest of that county is located in the “Natural Forest Preservation Zone”. The forestry bureau also indicated that there could be a few exceptions, namely the “Middle or Lower Output Forest Replanting Scheme”. It is not apparent whether standing timber purchased by SF qualified as “Middle or Lower Output Forest”.

#### **10. Introduction to Supplier and AI Interviews**

The IC Advisors have attended meetings with Suppliers and AIs between September 22, 2011 and October 25, 2011. The IC concluded that the only means by which Supplier and AI interviews could be arranged was through Management. Much delay was encountered in arranging such meetings; in part, Management advised, due to concerns about confidentiality and in part due to the notoriety of the matter, particularly after the OSC announced the CTO. Certain limited assurances were eventually provided by the OSC. All such meetings were also attended by Management with the concurrence of the IC. Apart from an initial meeting with Supplier #1 at the request of Management and the concurrence of the IC, the interviews were led by the Company’s counsel, BJ.

The purpose of these meetings was to obtain information relevant to certain allegations made by Muddy Waters – specifically ownership of timber, the genuineness of the BVI purchase and sale transactions and allegations of related party relationships.

The IC Advisors established and provided an interview protocol, a detailed sample of transactions and a list of specific documents to SF which the IC Advisors understand were provided to Suppliers/AIs in advance of the meetings.

The IC Advisors created a detailed set of questions to be asked by BJ at these meetings. The IC Advisors were provided with additional questions from the OSC to be asked by BJ at these interviews. The IC Advisors posed some additional questions at the meeting.

The interviewees declined to show any evidence of financial transactions, notwithstanding the request provided to them. The reasons given for not producing financial documents included avoiding scrutiny regarding tax, media exposure, and that SF should have copies of certain of the same documents.

The limited sample documents provided by certain of the interviewees such as Plantation Rights Certificates and villager’s resolutions were not the documents requested in the interview protocol and could not be tied back to the sample transactions.

Many of the responses of the interviewees were similar – for example, no financial records were given, no copies of documents presented could be taken and the interviewees were not prepared to discuss any aspect of any other companies that deal with SF that they control or that appear to be in the same corporate group or any transactions with other parties, including any other

Suppliers and AIs. The SAIC filings indicate a number of accounts payable and receivable as well some minority cross shareholdings amongst Suppliers and AIs.

Members of Management and Supplier/AI employees attended all meetings with the IC Advisors but one meet and greet with Supplier #1.

The IC and its Advisors are unable to compel the AIs and Suppliers to cooperate or to produce documents.

With the exception of the Supplier Supplier #20, none of the meetings took place at the business addresses of the AIs and Suppliers provided by SF or the registered addresses noted in the relevant SAIC filings.

With respect to Supplier #3, the meeting took place at substantial business premises of what the IC Advisors understand to be a Supplier #3-related entity.

## **11. Summary of Supplier Interviews**

During September 2011 the IC Advisors interviewed four of nine selected Suppliers (Supplier #3, Supplier #1, Supplier #20 and Supplier #19). Summaries and detailed notes in respect of each visit are also available to the Board for its confidential review.

In preparation for the Supplier interviews the IC Advisors reviewed SAIC filings for the Suppliers and AIs and identified numerous potential relationships between AIs and BVI Suppliers such as payables and receivables amongst them, cross personnel appointments and cross minority shareholdings. This raised questions amongst the IC Advisors as Mr. Allen Chan had previously explicitly denied knowledge of any relationships between BVI Suppliers and AIs or between BVI Suppliers/AIs and the Company. Details of these relationships are discussed below at Section VI.B. Very recently, Management provided information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

Interviews were held with Supplier #1 and Supplier #3, which are Suppliers to BVIs and WFOEs, and Supplier #20 and Supplier #19, which are Suppliers to WFOEs only. Supplier #3 also purchases logs from the Company's log import trading business segment and is not an AI of the plantation fibre business as characterized by MW. All of the Suppliers interviewed indicated that they did business at arm's length with the Company and that there were no common employees or shareholders between them and the Company. However, three of the four Suppliers interviewed confirmed that they had personnel that were former SF employees. These relationships are discussed below at Part VI.

The Suppliers generally confirmed the levels of business activity between them and the Company but none of the Suppliers of BVI timber produced any documentation evidencing receipt of funds from the Company's AIs or any other parties or relevant chain of title documentation. A few sample documents such as contracts, villagers' resolutions, Plantation Rights Certificates and/or confirmations were provided by Supplier #1, Supplier #20 and Supplier #19. However, apart from the five Supplier/SF contracts provided by Supplier #20 and

one contract provided by Supplier #1, none of the supporting documentation provided could be reconciled with transactions selected for review by the IC Advisors based on the information available on the documents. Nor could this documentation provide assistance in understanding movements of funds between these Suppliers and the relevant parties. Some interviewees did acknowledge doing business with other Suppliers and/or AIs.

The IC Advisors have also found additional information which suggests connections between former SF employees, Suppliers and AIs. (see Schedule VI.B.1.1). This information has been provided to SF Management for comment.

Supplier interviews indicated that the Supplier due diligence process for the purchase of timber is likely less rigorous than that of the Company. A number of the Suppliers advised that they used rotating project companies and under-reported revenue, all with the purpose of minimizing taxes payable. Additionally, some Suppliers indicated that they only traded in standing timber and avoided applying for Plantation Rights Certificates also in an effort to minimise tax payable. The table in Schedule V.C.11 sets out a summary of the outcome of Supplier and AI visits to date.

Very recently, Management provided information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

## **12. Suppliers Site Visits**

In addition to the Supplier interviews, the IC instructed the IC Advisors to conduct unannounced site visits for a small sample of these companies to verify their existence at the addresses recorded in their SAIC filings, or at an address taken from the Company's records. Certain of these visits are described in more detail in Schedules V.C.11.

A selection of Suppliers was identified that would enable the IC Advisors, where applicable, to combine this manner of testing in conjunction with travel to various locations for planned Supplier visits, or to visit locations within a travel radius of two hours or less of an IC Advisor's office.

During the period from October 18, 2011 to October 20, 2011, the IC Advisors performed site visits to the following Suppliers offices based on addresses provided by SF and company information included in SAIC filings:

- Supplier #1 was a supplier to BVIs and WFOEs from 2007 to 2010. Four locations were identified in the surrounding area. Three of the locations were no longer occupied by Supplier #1 and the fourth address was incorrect. The IC Advisors were provided with a new address from individuals identifying themselves as Supplier #1 personnel. A sign at the site indicated that Supplier #1 had offices at this new location. One of the three Supplier #1 interviews took place at a business location in Chongqing, which appeared to involve newly planted forest plantations, although this location was not independently identified as being owned by Supplier #1.

- Supplier #10 was a supplier to BVIs in 2007 and 2008. Two locations were identified in the surrounding area. Offices belonging to Supplier #10 could not be found at either location.
- Supplier #11 was a supplier to BVIs in 2006 and 2009. Two locations were identified in the surrounding area. One address was not sufficiently specific to be located and the second address was not a corporate office.

Results of these site visits have been summarized in Schedule V.C.11.

### **13. BVI Suppliers General Observations**

A chart showing the Suppliers to the BVIs from 2002 through 2011 by volume of transactions is attached as Schedule III.C. In that period the BVIs purchased from as few as four Suppliers to as many as eight Suppliers in any given year. The length of time the BVIs have dealt with any one Supplier has not exceeded four years despite large volumes of transaction.

#### **(a) Suppliers as Project Companies**

Management has suggested that the use of limited life project companies is not uncommon in China. The IC was advised that Mr. Chan undertook to identify the conglomerate structure behind these Suppliers in August, 2011. Such information was provided very recently. It identifies certain persons as supporting certain of the Suppliers and in many cases the same person supporting multiple Suppliers. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

Further, interviews with certain Suppliers have supported the notion that the Suppliers are part of a conglomerate. However, such Suppliers have declined to reveal the identity of such entities or their backers with a limited exception and that person is one of the people identified by Mr. Chan. The SAIC information on the shareholders of the various BVI Suppliers does not point to a consistent pattern of direct replacement of successive Suppliers with the same shareholders. However the use of nominee shareholders has been alluded to by many of those interviewed so the true beneficial ownership of the Suppliers may not be discernable through SAIC filings.

The MW Report noted in some instances the low capitalization based on SAIC filings and unsophisticated offices of some Suppliers. Management's general response to such allegations is reproduced in Section V.B.6, "Summary of Findings on MW Allegations on MFA". If certain Suppliers are part of a group of companies, the level of capitalization of Suppliers as project companies would be less of an issue as they would be supported by their respective parent company with greater capital resources. The timing of payments by the Suppliers to underlying landholders or other Suppliers and whether such Suppliers utilize SF payments to them in order to pay underlying owners or suppliers is not known to the IC.

#### **(b) Local Knowledge**

Management also suggested that the Company relies heavily on Suppliers due to their unique local knowledge on contacts necessary to aggregate and sell plantation assets in their respective provinces. That appears generally correct for the MFA Counterparties with one exception. Upon

reviewing the timber purchase agreements, the IC Advisors observed that several of the Suppliers conduct business with the Company in multiple provinces rather than in one specific location that would require focused local knowledge. For instance, while Supplier #6 has its head office in Jiangsu Province, it has sold timber to the BVIs in five different provinces including Guangxi, Guizhou, Heilongjiang, Hunan and Yunnan.

(c) Payments to Suppliers

The IC Advisors found limited anecdotal evidence in an email in the Company records that suggested the Supplier mark-up on two contracts was in the range of 158% to 170%.

Payments to BVI Suppliers occur by way of set-off from Company customers. These are all documented by set-off documents although the Suppliers and AIs interviewed declined to provide the IC Advisors with any independent evidence of movement of funds evidencing payments. The basis for the price paid to Suppliers by the Company has not been determined although all the Suppliers interviewed and Management maintain the relationship between the Company and Suppliers is at arm's length and all pricing on market terms.

Very recently, Management provided the IC Advisors with information that it indicated supported that MFAs were priced at then market prices for the regions to which such MFAs applied. Such information has not been reviewed by the IC Advisors or independently verified.

**14. BVI Standing Timber Sales Contract Reviewed**

(a) Contract Review

The IC also reviewed 579 copies of contracts for the sale of BVI standing timber for the period of 2006 to the first quarter of 2011, of which 167 sales contracts with an aggregate sale price of approximately \$1.327 billion related to sales in 2010. As described below, these 2010 sales contracts have been reconciled to the revenue of \$1.327 billion in respect of the sale of BVI standing timber recorded on the 2010 Financial Statements.

(b) BVI Standing Timber Revenue Reconciliation

The IC Advisors established procedures to assist the IC in determining the facts related to revenue reconciliation issues. The IC Advisors have performed the following procedures to date:

- Obtained understanding of revenue streams and revenue recognition policies as applied by SF across its operating segments; and
- Obtained a listing of all transactions and, for standing timber, related purchase and sales agreements, and have tied revenue reported in the 2010 Financial Statements for BVI timber sales to the sales prices shown in the underlying BVI timber sales contracts.

**15. Terms of BVI Timber Sale Agreements**

As disclosed in the 2010 Annual Report, the BVIs sell standing timber through Entrusted Sale Agreements. These are contracts signed between the BVIs and the AIs. The IC reviewed 579

BVI Entrusted Sale Agreements by which BVIs sold standing timber for the period from January 1, 2006 to March 31, 2011, of which all were copies. All are written in Chinese and mostly follow a template format with standard wording. These agreements are also referred to as "AI Agreements". The IC Advisors observed the following regarding such contacts:

(a) Agency vs. Principal Transactions

The AIs are Chinese incorporated companies that engage in timber trading. In the preamble to the Entrusted Sale Agreements, it is stipulated that the BVI "entrusts" the AI to sell the standing timber on its behalf. AIs are sometimes described by SF as "selling agents".

Under a typical Entrusted Sale Agreement, the AI is entrusted by the BVI to sell the BVIs standing timber assets located in China on its behalf. Notwithstanding its stated role as an "agent", the Entrusted Sale Agreements stipulate that the AI is itself directly liable for paying SF. That is, the AI's obligation to make payment to SF is not conditional upon the AI on-selling the standing timber to its customers. The AI does not receive any commission or fee from SF. It appears in reality that the Entrusted Sale Agreements are principal-to-principal contracts and do not appear to involve an actual "agency" arrangement. During meetings with AIs in September and October 2011, representatives from the AIs confirmed to the IC Advisors that they do not act as "agents" for SF and are responsible for finding their own customers. The IC understands that Management has treated the BVI sales transactions as being complete upon the sale to the AIs for revenue recognition process.

(b) Payment through Set-Off

Payment terms may vary but typically involve payment of 20% of the total sale price within 60 days of signing the Entrusted Sale Agreement, an additional 40% within 150 days, and the balance within 270 days of signing. Upon signing, the AI has full powers and rights to dispose of and handle the standing timber, and simultaneously, all risks in the standing timber pass to the AI. This confirms that the Entrusted Sale Agreements do not involve an agency arrangement.

In practice, proceeds from the Entrusted Sale Agreements are not paid to SF but are held by the AIs as instructed by SF and subsequently used to pay for further purchases of standing timber by the same or other BVIs. The AIs will continue to hold these proceeds until the Company instructs the AIs to use these proceeds to pay for new BVI standing timber purchases. No proceeds are directly paid to the Company, either onshore or offshore.

When an AI makes payment for a new BVI standing timber purchase, the funds used to make payment may originate from the proceeds of multiple Entrusted Sale Agreements. However, the Company's accounting records show that any set-off payments made by an AI are deemed to contribute to either the partial or complete settlement of the account or accounts receivable from an AI in the books of a BVI that is earliest in time. That is, the accounts receivable from any one particular AI in the books of a BVI are always settled in chronological order while any one account receivable may be settled through one or more set-off payments by the AI for new BVI standing timber purchases. Examination of the accounting records of the Company indicate that most AIs with regular entrusted sales transactions with the Company will at any one time have multiple accounts payable to the Company.

Further, the BVI on whose behalf an AI holds proceeds from an Entrusted Sale Agreement may request that AI to use those held proceeds to pay for a new standing timber purchase by a different BVI. For example, the BVI Suri-Wood Inc. entered into 131 standing timber purchase transactions from 2006 to 2008 but has had none since. Proceeds from the sales of standing timber purchased through these 131 standing timber purchase transactions have been used to pay for new standing timber purchase transactions by 18 new BVIs established from 2009 onwards, including Amplemax Worldwide, Ace Supreme and Glory Billion International. The 18 new BVIs have yet to have any sales.

In this way, proceeds from the Company's BVI timber sales have been re-invested on behalf of SF to expand its asset base in China. This re-investment of the proceeds from standing timber sales by the BVI is confirmed in Note 4 to the Company's audited financial statements set out in the 2010 Annual Report. SF refers to such arrangements as "set-off arrangements".

(c) Set-off Documents

Set-off arrangements are not stipulated in the Entrusted Sale Agreements themselves but rather are stipulated in separate documents which SF refers to as "Set-off Documents". The set-off documents are organized into sets and use standard wording and formatting, with each set containing the following documents:

- written instructions from a BVI with accounts receivable from an AI for that AI to make payment to a particular Supplier as payment for a new timber purchase by that same BVI or another BVI. These written instructions feature the name of the BVI at the top and are dated, signed and stamped and set out the amount to be paid;
- written notification from SF to the Supplier that payment is being made through the AI via set-off on behalf of the purchasing BVI. This written notification features the name of the BVI at the top and is dated, signed and stamped and set out the amount to be paid;
- written confirmation from the AI that payment has been made to the Supplier as requested by the instructing BVI. This written confirmation features the name of the AI and is undated and stamped and sets out the amount and date of payment; and
- written confirmation from the Supplier to the instructing BVI and paying AI that payment has been received from the AI. This written confirmation features the name of the Supplier and is dated stamped and sets out the amount and date of payment received.

The set-off documents are only produced and stamped after the Company enters into a new BVI Timber Purchase Contract and therefore reflect the payment of the consideration for this new BVI Timber Purchase Contract using proceeds from earlier Entrusted Sale Contracts held by the AIs on behalf of the Company. The set-off documents do not explicitly relate to any particular Entrusted Sale Contract and are not a record of BVI sales transactions. Apart from the Entrusted Sale Contract itself, and until set-off documents are produced pursuant to a new BVI timber purchase, there is no other document produced dealing with payment or settlement of BVI timber sales.

The IC Advisors have received copies of the Set-off Documents related to all the BVI standing timber purchase transactions between the first fiscal quarter of 2006 and the first fiscal quarter of 2011. However, the IC Advisors have not been provided with any documents showing movement of money to confirm that such set-off arrangements have been carried out. During meetings of the IC Advisors with AIs and Suppliers, representatives from the AIs and Suppliers declined to produce such documents showing movements of money. Common reasons cited for declining to produce documents included "tax reasons" and sensitivity towards the MW allegations and the resultant publicity. Further, some AIs visited stated that they may not in fact make payment themselves as instructed by SF but would instead arrange for other parties ("**fourth parties**") to make payment on their behalf. Those fourth parties may then instruct "fifth" or "sixth" parties to make payment.

In this situation, the Suppliers receiving payment will sometimes instruct its own "fourth" parties to receive payment on its behalf. All the AIs interviewed stated that these fourth parties are unrelated to SF. A common reason cited to explain the use of such expanding set-offs was for tax reasons but all AIs declined to discuss exactly how such use of fourth parties reduce taxes payable. During the meeting with Supplier #1, its legal representative explicitly stated that it would always instruct another party to receive payment from the AIs on its behalf. Reasons given for this arrangement included tax minimization and the fact that Supplier #1 did not have transactions with the AIs and therefore would be unable to account for the receipt of payment from the AIs.

(d) Tax Arrangements

The Entrusted Sale Agreement expressly provides that all taxes and fees that are to be borne by the BVI are to be withheld and paid by the AI to the appropriate tax bureau on behalf of the BVI. However, SF has not provided any documents to the IC Advisors showing that the AIs had in fact paid tax on behalf of any BVIs. Management has advised that they have not requested confirmations from the AIs with respect to payment of taxes. The AIs also declined to produce any such documents during meetings although several confirmed that they made such payments. Others either declined to discuss the issue of paying tax on behalf of SF or indicated that they were not aware of the details of whether tax is paid. The Company has recorded in its audited balance sheet as at December 31, 2010 a provision of approximately \$160 million in respect of any contingent liability it may have with respect to these tax liabilities.

(e) Harvesting Timber

All the Entrusted Sale Agreements impose an obligation on the AI to return the plantation land within a stipulated period. Some additionally impose an explicit obligation on the AI to harvest the timber within a stipulated period. It should be noted that there are harvesting quotas imposed by forestry bureaus in many areas. Management are of the view that these quotas are subject to negotiation. Harvesting license requirements are also stipulated in Chinese laws. The IC Advisors have not received any information confirming that any standing timber sold through Entrusted Sale Agreements has been harvested. The AIs and Suppliers also could not confirm that any BVI standing timber has been so harvested. The ability of the Company to exercise its preferential option to lease such land for replanting is premised on the harvesting thereof.

Further, the IC Advisors have seen no evidence of SF exercising this right in respect of BVI standing timber holdings.

(f) Attachments

The Entrusted Sale Agreements do not include a schedule of attachments and therefore, provide no insight as to what underlying documents if any SF produces to the AI when the sale transactions occur. A number of AIs indicated that they did their own diligence investigations but the nature and extent of that investigation was not detailed; others have indicated that when the AIs purchase the timber, they usually review the purchase contracts between SF and the Suppliers.

**16. Summary of AI Interviews**

The IC Advisors conducted interviews with four of five selected AIs (AI #2, AI #4, AI #3 and AI #1). Summaries and detailed notes in respect of each visit are also available to the Board for its confidential review.

All of the AIs indicated in the interviews that they did business at arm's length with the Company and that there were no common employees between them and the Company. However, several AIs confirmed that they had personnel that were former SF employees. Further, several AIs admitted to having or to have had connections with Suppliers but denied that these connections affect the arm's length nature of transactions with SF. These connections are discussed in detail below at Section VI.B.

The AIs indicated that they bought standing timber from SF and sold it to their own customers. As noted above, they do not act under the direction of SF and are not in essence "agents". Accordingly, they are not paid any commission or agency fees.

The AIs generally confirmed the levels of business activity reported by the Company but none produced any documentation of fund transfers to the Company or its Suppliers. Common reasons cited for declining to produce documents was sensitivity towards the issues raised by MW and tax.

Like with the Suppliers, AI interviews suggested that the due diligence process undertaken by AIs is likely less rigorous than those of the Company. All AIs indicated that they only traded in standing timber and therefore did not rely on Plantation Rights Certificates. AIs reported that they instructed their personnel to perform site visits and inspect timber offered by SF and review contracts between SF and earlier suppliers but without keeping copies of such documents. It was not clear if any AIs visited forestry bureaus to make inquiries.

Most AIs indicated that they did not harvest any timber and were not aware if their customers applied for harvesting permits.

**17. AI Site Visits**

In addition to the AI interviews, the IC instructed the IC Advisors to conduct unannounced site visits for a small sample of these companies to verify their existence at the addresses recorded in

their SAIC filings, or at an address taken from the Company's records. Certain of these visits are described in more detail in Schedule V.C.11.

A selection of AIs was identified that would enable the IC Advisors, where applicable, to combine this manner of testing in conjunction with travel to various locations for planned AI visits, or to visit locations within a travel radius of two hours or less of an IC Advisor's office.

During the period from October 18, 2011 to October 20, 2011, the IC Advisors performed site visits to the following AIs offices based on addresses provided by SF and company information included in SAIC filings:

- AI #2 has been an AI customer to BVIs from 2007 through to 2011. Three locations were identified in the Guangzhou area. AI #2 was found at one of the three sites, but had changed its name. Brochures at the location displayed the English name of Shareholder #10, a shareholder of the WFOE Supplier, Supplier #19.
- AI #3 has been an AI customer to BVIs from 2008 through to 2011. Two locations were identified in the Shanghai area. The company had recently vacated one site and could not be located at the other.
- AI #4 has been an AI customer to BVIs from 2008 through to 2011. One location was identified in the Shanghai area. The company could not be located at the site.

Results of these site visits have been summarized in Schedule V.C.11.

Representatives of AI #2 and AI #4 were included in the AIs interviewed. Those interviews took place at the offices of AI Conglomerate #1 ("AI Conglomerate #1"), an entity identified by Management as the conglomerate parent of these companies. The offices of AI Conglomerate #1 suggest the existence of a substantial business.

Representatives of AI #3 were included in the AIs interviewed. Those interviews took place at the offices of AI Conglomerate #2, an entity identified by Management as the conglomerate parent of this company. The offices of AI Conglomerate #2 suggest the existence of a substantial business.

## **18. AI General Observations**

### **(a) Scale of Transactions with AIs**

From the first fiscal quarter of 2006 to the first fiscal quarter of 2011, SF has dealt with approximately 14 different AIs, with no AI having dealings with SF spanning more than 4 years. Of those 14, 3 have been deregistered as of the date of this report, namely AI #8, AI #11 and AI #5. The total volume of transactions with the 14 AIs from the first fiscal quarter of 2006 to the first fiscal quarter of 2011 is approximately RMB 27 billion.

The volume of transactions with individual AIs can vary. The annual transaction sales volume with each AI from 2002-2011 is set on Schedule III.C. The five current AIs as at the first fiscal quarter of 2011 are AI #4, AI #1, AI #2, AI #6 and AI #3. From the first fiscal quarter of 2006 to

the first fiscal quarter of 2011, they have had a combined approximately RMB 16.9 billion of transactions with SF.

(b) AIs as Project Companies

On August 19, 2011, Mr. Allen Chan provided an organizational diagram setting out the relationships between the five current AIs as at the first fiscal quarter of 2011 and their relationships with their holding companies (“Holdcos”<sup>15</sup>). He explained that the AIs were project companies which would change periodically but that the Holdcos remained the same. The diagram shows that AI #2 and AI #4 both fit under the one Holdco called AI Conglomerate #1 (or “AI Holdco”) while the other 3 current AIs each have their own Holdcos. The SAIC filings received by the IC however did not indicate any relationship between these Holdcos and the 5 AIs.

This organizational diagram was presented to Mr. Albert Zhao during his interview on August 24, 2011. Mr. Zhao explained that during his tenure with SF, where he was in charge of liaising with AIs in relation to sales, he had only ever dealt with 5 AIs. He clarified that the individuals within the AIs with whom he liaises remain constant despite changes in the company with which they worked over time. Mr Zhao further indicated that the 5 AIs presented to him on the organizational chart were current as at the first fiscal quarter of 2011 and were comprised of the same main individuals as all other AIs he has dealt with.

**D. WFOEs Contracts and Assets**

**1. Review Process Undertaken on WFOE Plantation Contracts and Assets**

The primary focus of the asset verification has been the BVI standing timber assets. However, as the time frame and the difficulty of that process evolved, it was determined to also focus efforts on gathering, cataloguing and reviewing WFOE documentation. With respect to the WFOE timber assets, such documentation is not centralized and involved travelling to a number of offices and steps by the Company to centralize documentation within China. As in the case of the BVI assets, the review involved reviewing copies and originals of purchase contracts and land lease agreements, forestry bureau confirmations in the case of certain SP transactions and, in the case of SW and to a lesser extent SP, reviewing Plantation Rights Certificates.

Management has advised that WFOE standing timber assets as at December 31, 2010 represented approximately \$298.6 million of book value (97,038 Ha.), \$74 million in revenue and \$10 million of Income for such year before allocation of corporate overhead; and that, SW and SP WFOE planted plantations represented approximately \$103.8 million in book value as at December 31, 2010, but have not yet contributed materially to revenue.

---

<sup>15</sup> “Holdcos” refers to groupings which may not be legal groupings with cross shareholdings in the Western sense but rather groups of companies under common control or influence.

## 2. Review of Sino-Wood WFOE Plantation Assets

### (a) Contract Review Results

All timber assets under SW are plantation land leases classified as planted plantations in the Company's public disclosure. The IC assembled and reviewed a total of 623 SW plantation land lease contracts (19 originals and 604 copies) covering 51,700 Ha. of planted plantations as at December 31, 2010. This is compared to the Company's disclosed total of 52,663 Ha. of planted plantations under SW as at December 31, 2010. Given its small size, the IC did not investigate this discrepancy. The plantation area of a typical SW plantation land lease contract is small compared to that of the BVI timber purchase contracts.

The IC Advisors selected and reviewed in more detail a sample of 19 original plantation land lease contracts covering the largest plantations of the four WFOEs under SW, representing approximately 8.89% of SW's total timber assets. Many more original plantation land lease contracts were made available for review at various SF offices in China but were not further inspected. This was due to the IC Advisors having previously reviewed copies of these and to the availability of Plantation Rights Certificates under SW for asset verification.

In contrast to the relative uniformity of BVI timber purchase contracts, the SW plantation land lease contracts are not in one standard form. SW contracts adopt a variety of forms and terminology, including land lease, land use right transfer, land contracting and plantation right/profit sharing structures. However, they generally involve the transfer of plantation land use rights, timber ownership and timber use rights at the same time. Plantation right/profit sharing structures refers to the arrangement whereby the villagers holding the plantation land ownership receive a percentage of the profits generated by the plantation in return for accepting reduced land lease fees from SF.

### (b) Plantation Rights Certificates Reviewed

To the knowledge of the IC, the SW division does not ever purchase standing timber on a standalone basis and has not had a policy of seeking forestry bureau confirmations.

The IC Advisors reviewed a total of 418 copies of Plantation Rights Certificates provided by the Company representing approximately 42,979 Ha. of planted plantations held under the SW division.

The IC then reviewed 287 original Plantation Rights Certificates covering a total plantation area of 31,121 Ha. The details of this and a brief explanation regarding the Plantation Rights Certificates that were not available for review are set out below.

The IC inspected original Plantation Rights Certificates of (i) Gaoyao Jiayao Forestry Development Co., Ltd. in an office of Gaoyao Jiayao Forestry Development Co., Ltd. located in Zhaoqing city on October 18, 2011, (ii) Sino-Forest (Heyuan) Co., Ltd. and Zhangzhou Jiamin Forestry Development Co., Ltd. in an office of Sino-Forest (Heyuan) Co., Ltd. located in Heyuan city on October 19 and 20, 2011, and (iii) Guangxi Guijia Forestry Co., Ltd. in an office of Guangxi Guijia Forestry Co., Ltd. located in Nanning city on October 21, 2011, as arranged by SF.

The Company has advised that amongst the 418 copies of Plantation Rights Certificates which the IC Advisors initially reviewed, some had been superseded while others had been cancelled and reissued. Reasons for certain Plantation Rights Certificates being superseded or cancelled and reissued included that there were recalculations conducted for the area covered by the Plantation Rights Certificates. As a result, not all of the 287 original Plantation Rights Certificates later reviewed by the IC Advisors correspond exactly to copies amongst the 418 Plantation Rights Certificates that were initially reviewed.

Further, Management advised that a total of 136 Plantation Rights Certificates have been mortgaged as security for Plantation Rights Certificate loans and were therefore not available for review. Please refer to notes 5 and 8 of Schedule V.D.2.(f) for details. The IC Advisors reviewed a small sample of the mortgages.

Finally, certain SW WFOEs share their rights over the plantations with other parties on a 7:3 ratio and this is reflected in their Plantation Rights Certificates. A total of 54 Plantation Rights Certificates fall into this category. The Company has included 100% of the area covered by these 54 Plantation Rights Certificates in its calculations of proven ownership to the IC, covering 2,554 Ha., whereas the IC Advisors have only included 70% of the area for these assets in their calculations—a minor difference of 765 Ha. Please refer to notes 6, 9 and 10 of Schedule V.D.2(f) for details.

The IC has not visited any forestry bureaus to attempt to confirm the original Plantation Rights Certificates against registries, if any, maintained by such forestry bureaus.

### **3. Review of Sino Panel Timber Assets**

#### **(a) Contract Review Results**

Unlike SW, SP does engage in the purchase and sale of standing timber as well as leasing plantation land so contracts reviewed for SP comprised of both timber purchase contracts and plantation land lease contracts. Accordingly, SP's standing timber and plantation land lease assets are divided into and respectively classified as purchased plantations and planted plantations.

The IC assembled and reviewed a total of 358 copies of SP WFOE contracts covering 173,424 Ha. as at December 31, 2010. These are comprised of 107 standing timber purchase contracts covering 96,169 Ha. of purchased plantations and 251 plantation land lease contracts covering 77,254 Ha. of planted plantations.

#### **(b) Reconciliation of Surplus**

The figures obtained from the IC's review of contracts are higher than the Company's recorded figures as at December 31, 2010 of 122,136 Ha., comprised of 97,038 Ha. of purchased plantations and 25,098 Ha. of planted plantations as shown in the asset reconciliation provided by Management to the IC and the OSC. Management has provided a reconciliation and explanation of this surplus of approximately 51,000 Ha. as well as the minor difference in its WFOE purchased plantation Ha. figure. The core of Management's reconciliation to disclosed figures as at December 31, 2010 was that such figures are lower primarily because they excluded

bare land that had been leased but on which timber had not been replanted whereas the IC's contract review totals did include this bare land. The IC accepted this reconciliation and explanation and made no further investigations into this surplus.

(c) Plantation Rights Certificates Reviewed

(i) Purchased Plantations

The IC has reviewed a total of 383 original Plantation Rights Certificates which account for a total plantation area of 27,715 Ha. This Plantation Rights Certificate coverage amounts to a total of approximately 15.98% of SP's total timber assets of 173,424 Ha. based on contracts reviewed. These Plantation Rights Certificates are comprised of 301 Plantation Rights Certificates for 16,026 Ha. of standing timber and 82 Plantation Rights Certificates for 11,689 Ha. of plantation land leases.

The IC reviewed a total of 301 Plantation Rights Certificates for standing timber held under the SP division. Of these, 10 are in the name of SF covering 2,329 Ha. while 291 are in the name of Suppliers covering 13,697 Ha.

Regarding the 10 Plantation Rights Certificates in the name of SF, it is normally not possible to have Plantation Rights Certificates issued for standing timber only transactions. The Company explained that the standing timber purchase contracts corresponding to these 10 Plantation Rights Certificates were signed by Sino-Panel (China) but that the Plantation Rights Certificates were issued to Sino-Panel (Yunnan) Forest Management Co., Ltd. with the understanding that Sino-Panel (Yunnan) Forest Management Co., Ltd. would then purchase a lease over the same plantation land and would be assigned the rights over the standing timber from Sino-Panel (China). It was also explained that the Supplier in question agreed to delay the signing of the lease until after the issuance of the Plantation Rights Certificates and supported the application for those Plantation Rights Certificates. However, as at the date of this report, that lease is yet to be signed. Additionally, no documentation evidencing an assignment of the standing timber to Sino-Panel (Yunnan) Forest Management Co., Ltd. has been received. Nevertheless, for the purposes of this report, the IC has included these 2,392.2 Ha. of standing timber as being supported by original Plantation Rights Certificates.

Regarding the 291 Plantation Rights Certificates issued in the name of Suppliers, these are Plantation Rights Certificates issued to Suppliers that have sold the standing timber the subject of those Plantation Rights Certificates to SF WFOEs. As a form of security, these Suppliers allow the SF WFOEs to take possession of these Plantation Rights Certificates for the duration of the timber purchase contract, whose termination is usually deemed to occur when the timber is sold by SF or harvested. The SF WFOEs only have a contractual relationship with the Suppliers who remain the registered holders of the rights stipulated on the Plantation Rights Certificates. Nevertheless, in light of the contractual relationship between SF WFOEs and such Suppliers, and SF's possession of such Plantation Rights Certificates, for the purposes of this report, the IC has identified these 13,697 Ha. of standing timber as being supported by demonstrable chain of title to the original Plantation Rights Certificates.

(ii) Planted Plantations

The IC has reviewed a total of 82 Plantation Rights Certificates covering a total of 11,689 Ha. All of these 82 Plantation Rights Certificates are issued under SF's name.

The IC has not visited any forestry bureaus to attempt to confirm the original SP Plantation Rights Certificates against registries, if any, maintained by such forestry bureaus for purchased or planted plantations.

(d) Forestry Bureau Confirmations Reviewed

The IC has reviewed a total of 103 original forestry bureau confirmations covering a total of 138,914 Ha. which in turn represents approximately 80.1% of SP's total timber assets of 173,424 Ha. based on contracts reviewed. Of these, 42 confirmations covering 88,684 Ha. relate to standing timber while another 61 confirmations covering leases covering 50,230 Ha. relate to plantation land leases.

(e) Overlap between Plantation Rights Certificates and Forestry Bureau Confirmations

For the reasons outlined above, SP WFOEs sometimes have Plantation Rights Certificates and forestry bureau confirmations for the same plantation and therefore create an overlap between the totals of Plantation Rights Certificates and forestry bureau confirmations. The total amount of overlap between Plantation Rights Certificates and forestry bureau confirmations for SP is 26,333 Ha. which is comprised of overlaps of 15,264 Ha. for standing timber and 11,069 Ha. for plantation land leases. In some instances the forestry bureau confirmations were issued after the Plantation Rights Certificate had already been issued.<sup>16</sup>

(i) Purchased Plantations

Of the 96,169 Ha. of purchased plantations, approximately 88,684 Ha. are covered by forestry bureau confirmations. At the same time, approximately 16,026 Ha. are also covered by original Plantation Rights Certificates (13,697 Ha. in Suppliers' names and 2,329 Ha. in SF's name). Of the 16,026 Ha. covered by original Plantation Rights Certificates, only 762 Ha. (which originate from 2 transactions) are not concurrently covered by forestry bureau confirmations. Therefore, the overlap between forestry bureau confirmations and Plantation Rights Certificates is 15,264 Ha.

---

<sup>16</sup> Examples of forestry bureau confirmations being issued after the issuance of a PRC include those relating to SP plantation land lease contract JUW-RES-REN-002-07, whereby the PRC was issued under SF's name on November 27, 2007 while the confirmation was issued on July 28, 2008. Another example is the uncoded SP plantation land lease contract dated December 2, 2007 for 13,126.70 Mu (875.11 Ha) in the jurisdiction of Hunan FB#1 whereby two corresponding PRCs were issued on October 17 and November 6, 2007 while the confirmation was issued on August 8, 2008.

(ii) Planted Plantations

Of the 77,254 Ha. of planted plantations, approximately 50,230 Ha. are covered by forestry bureau confirmations. At the same time, approximately 11,689 Ha. are covered by original Plantation Rights Certificates in SF's name. Of these 11,689 covered by Plantation Rights Certificates, only 620 Ha. (which originate from 1 transaction) are not concurrently covered by forestry bureau confirmations. Therefore, the overlap between forestry bureau confirmation is 11,069 Ha.

(f) Forestry Bureau Visits

In conjunction with its visits to forestry bureaus to obtain BVI standing timber confirmations, the IC concurrently sought to acknowledge the issuance of old confirmations or to obtain new confirmations in respect of SP WFOE properties within the jurisdiction of the same forestry bureaus. A total of 15,980 Ha. of purchased plantation holdings and 10,904 Ha. of planted plantation holdings as at December 31, 2010 were so acknowledged or confirmed.

In respect of acknowledging the issuance of old confirmations, the Guangxi FB#1 confirmed that it had issued SP-related confirmations covering a total of 10,773 Ha. of purchased plantations and 9,518 Ha. of planted plantation holdings.

The person whom the IC Advisors met at the Hunan FB#1 acknowledged that it had issued SP-related confirmations covering a total of 476 Ha. of purchased plantations and 1,386 Ha. of planted plantations. This acknowledgment was given by the previous vice-chief, who had been appointed as a consultant to the Company.

The Hunan Forestry Entity #1 issued a new confirmation covering a total of 2,374 Ha.

The Yunnan FB#2 issued a new confirmation covering a total of 2,357 Ha. of SP purchased plantations.

See section V.C.9 for a further description of the various forestry bureau visits.

(g) SP Supplier Interviews

All of the Suppliers that were interviewed by the IC Advisors had contracts to supply timber to SP WFOEs. A summary of the IC's findings in respect of them is set out above under Part VI.

**4. Review of Mandra Holdings**

(a) Mandra - Executive Summary

The Company first became a shareholder of the Mandra group of companies in April 2005 with a 15% investment and completed the full acquisition of all of the Mandra group of companies in 2010.

The Company provided a chart of Mandra properties at the corporate subsidiary level that contained book values and hectare amounts that tied into the 2010 Financial Statements. It

indicated a total of 147,144 Ha. held by Mandra subsidiaries which included 93,689 Ha. of plantations, 1,231 Ha. of bare land and 52,224 Ha. subject to long-term lease prepayments. The book value for the latter hectare amount was not included in timber holdings line item in the balance sheet included in 2010 Financial Statements but rather under the line item "Other Assets".

Approximately 853 contracts entered into by Mandra subsidiaries of the Company (as the buyer) covering plantation lands of 141,719 Ha. were reviewed. Management provided a reconciliation of the difference between that number and the publicly disclosed number of 147,144 Ha. held at December 31, 2010. Some 1,196 copies of Plantation Rights Certificates covering 95,420 Ha. were reviewed covering approximately 64.73% of the publicly disclosed total Ha. for Mandra and 1,115 original Plantation Rights Certificates related to Mandra assets have been sighted by the IC. These cover approximately 85,664 Ha. or 58.2% of the publicly disclosed total land holdings in the Mandra group of subsidiaries. Management explained that the balance of the properties were either subject to Plantation Rights Certificates under mortgage, under review for harvesting licensing or were properties for which Plantation Rights Certificates were in the process of being sought.

Underlying documentation relating to the purchases was also reviewed. As a general matter, documentation for Mandra properties was systematically more comprehensive than in other Company groups.

(b) Brief Mandra History Overview

The Company first made an investment by way of loan subscription to Mandra in April 2005. According to the minutes of the Company reviewed, Mandra became operational in 2006 prior to the issuance of bonds in a related public offering. There was extensive discussion in the Board minutes with respect to the Mandra investment throughout the period of time the Company held its investment, including recognition of a deteriorating financial condition. The Mandra bonds were publicly rated and Moody's issued a number of press releases concerning Mandra's financial status from 2006 through 2010, including a default situation in 2009 so Mandra cash flow situation was notorious. The Company took effective control of Mandra through a series of share acquisitions and bonds as addressed elsewhere in this report. The Globe made a series of accusations suggesting that the Company had bought Mandra while in a financially weakened state implying that Mandra's state was not public information. This is demonstrably wrong. A detailed review of the Globe report is set out in Schedule V.D.4.(b).

The IC reviewed Mandra diligence reports prepared in respect of legal matters pertaining to the Mandra companies at the time of its acquisition and a diligence report with respect to Plantation Rights Certificates held by its domestic subsidiaries.

(c) Mandra Review Process

(i) Number of contracts and Plantation Rights Certificates reviewed:

- A. Approximately 853 copies of contracts have been assembled. The large majority of these transactions involve both purchasing timber

and leasing underlying plantation land at the same time. The 853 contracts cover plantation land of 141,719 Ha.

- B. The IC Advisors visited and inspected original Plantation Rights Certificates of Mandra in offices of Anqing Mandra Forestry Co., Ltd and Mandra Forestry (Jiangxi) Co., Ltd located in Anqing city and Nanchang city respectively as arranged by SF.
- C. A total of 1,196 copies of Plantation Rights Certificates of Mandra have been reviewed covering plantation land of 95,240 Ha. representing 64.73% of the publicly disclosed total for Mandra of which 1,115 original Plantation Rights Certificates have been verified covering plantation land of 85,664 Ha. or 58.20% of the publicly disclosed totals for Mandra.
- D. 17 original plantation land disposal contracts, under which all the 1,810 Ha. plantation of Huanggang Mandra Forestry Co., Ltd. and Wuhu Mandra Forestry Co., Ltd were disposed, have been reviewed.
- E. The IC has reviewed two original mortgage certificates covering 6,982 Ha. plantation being mortgaged. The balance of the mortgaged Plantation Rights Certificates were not reviewed

(ii) Types of contracts – Planted Plantations

There were four primary types of contracts:

- Timber purchase with plantation land lease contract – Anqing Mandra Forestry Limited’s contracts with total contract area of 95,535 Ha. are substantially of this type. The WFOE purchases standing timber and leases underneath plantation land at the same time. The WFOE is entitled to harvest the existing timber and replant trees thereafter. The consideration for the purchase of timber and for the annual plantation land rental are calculated separately at a fixed rate according to the reserves of timber (in cubic meters) and area of plantation land (in mu). A map indicating the boundaries of the plantation, Plantation Rights Certificates of the villagers, villagers’ resolution and the WFOEs’ internal survey report are usually attached to the contracts.
- Timber and plantation land contracting right transfer contract – the overwhelming majority of Xuancheng Mandra Forestry Limited’s contracts with total contract area of 6,700 Ha. are of this type. The contracting rights of the timber and underlying plantation rights are transferred to the WFOE from the previous contracting party and consent is obtained from the plantation land owner. The consideration for the purchase of timber and plantation land is usually calculated together at a fixed rate per mu for the whole contracting term.

- Forestry resources transfer contract – the overwhelming majority of Mandra Forestry (Jiangxi) Limited, Yihuang Mandra Forestry Limited and Zixi Mandra Forestry Limited contracts with total contract area of 37,674 Ha. are of this type. Timber and underlying plantation land use rights are transferred together to the WFOE and consideration for timber and plantation land are usually calculated together at a fixed rate per mu.
- Plantation land use right transfer contract – The contracts for Wuhu Mandra Forestry Limited are of this type. Only the plantation land use right is transferred to the WFOE and the transferor is obliged to clear the timber thereon.

The IC has not visited any forestry bureaus to attempt to confirm the original Mandra Plantation Rights Certificates against registries, if any, maintained by such forestry bureaus.

(d) MW-HSBC Letter Timing and Issues

In reviewing the incorporation applications in the SAIC files of four Mandra entities, MW retrieved a letter from The Hongkong and Shanghai Banking Corporation Limited (“**HSBC**”) dated February 1, 2005. The letter (which is a poor-quality copy) has a re. line referring to a Mandra company, but in fact comments on HSBC’s banking relationship with “Sino-Wood Barters [sic.]” (“the Company”), noting, for example, that it considers “the Company” “good” for “normal business engagement”. MW characterizes the letter as “suspicious”. The MW Report includes a photograph of the letter, the appearance of which could suggest that it has been tampered with (see Schedule V.D.4.(d).1).

The IC Advisors retrieved the HSBC letter in question from SAIC filings in connection with applications regarding the formation of three Mandra entities, Anqing Mandra Forestry Limited, Xuancheng Mandra Forestry Limited and Wuhu Mandra Forestry Limited. These three companies were formed on March 14, 2005, prior to the date SF initially became a shareholder of Mandra. The IC Advisors also found a Chinese version of the HSBC letter (see Schedule V.D.4.(d).3) in the SAIC filings of Anqing Mandra Forestry Limited. It is also dated February 1, 2005, and generally appears to be identical to the English version of the letter that appeared in the MW Report, speaking only to Mandra Forestry Anhui Limited without mention of Sino-Wood.

Management denied knowledge of the HSBC letter in its response to the MW Report, stating that, on the date of the letter, SF was not a shareholder of Mandra. BJ has retrieved an email subsequent to the MW Report attaching what the author, Ringo Yip, Senior Manager - Corporate Planning, SF, characterizes as “the true HSBC bank reference letter” (see Schedule V.D.4.(d).2). This letter, which is also dated February 1, 2005, generally appears to be identical to the letter in the MW Report, except that the subject and copy line properly refers to Sino-Wood, not Mandra Forestry Anhui Limited.

The IC’s Chinese advisors have observed that, according to the Implementation Rules of Law of Wholly Foreign Owned Enterprises, a foreign investor is required to include evidence of credit in its application for forming a WFOE. Such evidence is normally issued by a bank in which the foreign investor maintains an active account, to certify to the regulatory authority that the foreign investor is of good credit and able to conduct business through the proposed WFOE. If this was

the purpose of the HSBC letter, the letter should address Mandra Forestry Anhui Limited, a major investor in WFOEs, not Sino-Wood, which was not an investor in WFOEs at the time.

Management explained that they do not have any record of the forged version of the letter and do not know who forged such letter.

## **VI. RELATIONSHIPS**

## **VI. RELATIONSHIPS**

The MW report made a number of allegations regarding the relationships of the Company with AIs and Suppliers and between AIs and Suppliers, particularly with respect to Yuda Wood. The IC Advisors, in the course of their review, identified a number of possible relationships which warranted explanation. These are outlined below in this Part VI. Management has very recently provided to the IC information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board. Some of such information and analysis may not be capable of independent verification.

The objectives of the IC's examination of the Company's relationship with its AIs and Suppliers were to determine, in light of the MW allegations, if such relationships are arm's length and to obtain, if possible, independent verification of the cash flows underlying the set-off transactions described in Section II.A. That the Company's relationships with its AIs and Suppliers be arms length is relevant to SF's ability under GAAP to:

- book its timber assets at cost in its 2010 and prior years' audited financial statements; and
- recognize revenue from standing timber sales as currently reflected in its 2010 and prior years' audited financial statements.

### **A. Yuda Wood**

#### **1. Muddy Waters' Allegations**

- (a) In the MW Report, Muddy Waters alleged that Yuda Wood, a major Supplier based in Hunan Province, was a significant "undisclosed subsidiary" of SF, which has been receiving "massive amounts of money" from SF subsidiaries and which is "the nerve center for [SF's] illicit activities".
- (b) In addition to the allegations in the MW Report, Muddy Waters published a short follow-up report on June 20, 2011, that focused on SF's relationship with Hong Kong's Sonic Jita, the holding company of Yuda Wood, which specifically alleged that:
  - (i) when Hong Kong Sonic Jita was owned by SF executives and SF itself, SF engaged in a major undisclosed related party transaction with Hong Kong Sonic Jita (in 1997); and
  - (ii) while Hong Kong Sonic Jita is currently nominally owned by parties unrelated to SF, SF and Hong Kong Sonic Jita shared "at least one key executive" (identified by the Chinese name of Albert Ip), who in 2005 entered into a contract with Hong Jiang City, Hunan Province on behalf of Hong Kong Sonic Jita.

- (c) However, Hong Kong Companies Registry filings show a change of control and ownership of Hong Kong Sonic Jita on July 28, 1997 and July 28, 1998 respectively, prior to the occurrence of the alleged related party transactions cited in the MW Report. In particular, those filings show that:
  - (i) from November 13, 1993 to July 28, 1997, the directors of Hong Kong Sonic Jita were SF executives and associated parties, and that from November 13, 1993 to July 28, 1998, the shareholders of Hong Kong Sonic Jita were parties associated with SF.
  - (ii) parties associated with SF were replaced as directors and shareholders of Hong Kong Sonic Jita on July 28, 1997 and July 28, 1998, respectively by Jin Juemin and Li Haibao, who appear to have been associated with Beijing Sonic Jita, a forestry engineering contractor to SF's factories within China, and who renamed the company as "Sonic Jita Engineering Ltd." from August 1, 1997.
- (d) In his statutory declaration dated August 15, 2011 (see Section VI.A.2(d) below), Allen Chan stated that up to July 28, 1998, SF did not engage in any transactions with Hong Kong Sonic Jita, and that, up until this date, the Company (under all its registered names) had not engaged in any business and remained a dormant company, and that after this date, Hong Kong Sonic Jita was no longer a related party to SF.
- (e) Nevertheless, in the course of the IC Advisors' Yuda Wood review, they identified information that suggested that SF had a close relationship with Yuda Wood, may have been involved in its establishment and exercised an influence over certain of its RMB bank accounts, funding and tax payments.

## 2. Review Conducted

### (a) Evidence Brief

To address the MW allegations, and to gain a better understanding of the connections between SF and Yuda Wood, the IC Advisors prepared an interim evidence brief plan (draft dated August 23, 2011) that included an electronic data review as described above in Schedule IV, relationship mapping and meetings with Management and with E&Y. Relationship mapping findings are set out in Schedule VI.A.2(a).

### (b) BJ's Interviews with Management

The IC Advisors attended interviews conducted by BJ with Management between July 26 to August 11, 2011. Information concerning the Yuda Wood relationship was presented to members of Management. The members of Management interviewed were Allen Chan, KK Poon, Alfred Hung, Albert Zhao, George Ho and Chen Hua.

(c) Review for Associated Parties

- (i) During the IC Advisors' review of the SAIC filings for Yuda Wood and other companies identified during the process, a document was found within the Yuda Wood SAIC search results which linked Simon Yeung to the purchase of a manufacturing facility in Hunan in Yuda Wood's name prior to when Yuda Wood had yet to be officially incorporated. Mr. Yeung's Chinese signature appeared on an offer, and ultimately an executed purchase contract, for Yuda Wood to acquire the factory facility.
- (ii) This document was presented to Mr. Yeung for an explanation at his interview by the IC Advisors. On August 25, 2011, Mr. Yeung responded that he was performing a favour for Mr. Huang Ran as he was absent from the region at the time the facility became available for sale and that he did not act on behalf of Yuda Wood in any capacity.

(d) Statutory Declarations

The issues of SF's relationship with Yuda Wood were still being examined by the IC Advisors in the middle of August, 2011, at a time when the Company's quarterly report for the period ending June 30, 2011 ("Q2s") were being prepared. To address certain issues relating to Yuda Wood pending completion of the IC's review, statutory declarations were obtained by the IC and the Audit Committee from the following members of Management at the IC's request:

- Allen Chan;
- Albert Ip; and
- Chen Jun.

The declarations were prepared with assistance from the Company's counsel and were sworn on August 15, 2011.

In his statutory declaration, Allen Chan declared that:

- (i) he did not hold a direct or indirect or beneficial shareholding interest in Yuda Wood, Beijing Sonic Jita or Hong Kong Sonic Jita or their affiliates, and was not involved in their operations and that he did not have other personal arrangements with or entitlements from these entities; and
- (ii) to his knowledge, no officer, director or employee of SF held a direct or indirect or beneficial shareholding interest in Yuda Wood, Beijing Sonic Jita or Hong Kong Sonic Jita or their affiliates or was involved in their operations, and that to his knowledge, no other officer, director or employee of SF had any other personal arrangements with or entitlements from these entities.

In his statutory declaration, Albert Ip:

- (i) denied having ever been an executive of Hong Kong Sonic Jita, held himself out to be a representative of Hong Kong Sonic Jita or entered into a contract in 2005 with Hong Jiang City, Hunan Province, on behalf of Hong Kong Sonic Jita; and
- (ii) further declared that Zhan Xiaokun and Chen Jun did not become employees of SF until after resigning as directors from, and selling their shares in, Hong Kong Sonic Jita.

However, searches at Hong Kong's Companies Registry in August 2011 indicated that Chen Jun remained a director and shareholder of Hong Kong Sonic Jita since joining SF in July 2010. In response to this finding, SF counsel arranged for Chen Jun to make a statutory declaration in which he declared that he had been only a nominee shareholder in Hong Kong Sonic Jita, and had submitted a letter to the other shareholder and director of Hong Kong Sonic Jita, Huang Ran, on June 26, 2010, tendering his resignation as director and asking to transfer his shares to Huang Ran. Huang Ran appears, from the documents exhibited to Chen Jun's statutory declaration, to have only filed documents implementing such requests with Hong Kong's Companies Registry and Stamp Duty office one year later, on June 10, 2011. Those documents were dated July 30, 2010, and included minutes of a shareholders' meeting allegedly held in Hong Kong on July 30, 2010, and attended by Chen Jun, at which his resignation as director and sale of his shares was approved. Chen Jun stated in his declaration that he did not attend any such meeting.

(e) IC Advisors' Interviews with Management

As the IC Advisors' Yuda Wood review proceeded subsequent to the release of the Q2s, they identified additional information relevant to SF's relationship to Yuda Wood.

The IC Advisors presented to the IC on August 23, 2011 a draft Yuda Wood interim evidence brief memo which set out certain matters of concern that warranted further investigation. (This memo was subsequently presented to the Board on August 23, 2011, and delivered to the OSC under summons.)

The IC Advisors recommended that certain members of Management be interviewed about the subject matter raised in certain emails identified by the IC Advisors, and about the Yuda Wood relationship generally; these emails suggested a close relationship between SF, its past and current employees, and past and current shareholders of Yuda Wood and/or its holding company.

The interviews conducted by the IC Advisors took place in Hong Kong from August 24, 2011 to August 26, 2011 and were also attended by BJ who occasionally participated. The members of Management interviewed were: Allen Chan, Albert Ip, George Ho, Eric Chan, Alfred Hung, Simon Yeung, Albert Zhao,

Chen Hua and KK Poon. The IC Advisors have delivered completed notes of such interviews to the IC, which delivered them to E&Y and to the OSC under summons. The IC authorized Osler to provide such notes to BJ so it could provide copies of the relevant interview notes to each interviewee and his or her respective counsel.

Following their respective interviews, Mr. Martin put Messrs. Ho, Hung and Yeung on administrative leave and Mr. Ip on limited duties.

The IC Advisors subsequently conducted interviews on September 8, 2011 with Messrs. Chen Jun, and Zhan Xiaokun. Both are current employees of SF and both are former 50% shareholders of Hong Kong Sonic Jita, the holding company of Yuda Wood.

(f) Interviews and Meetings with Yuda Wood

Further to the steps set out in their Yuda Wood evidence brief plan, the IC Advisors requested a meeting with Yuda Wood for the purposes of interviewing Yuda Wood's sole shareholder, Huang Ran.

On September 1, 2011 a meeting was held in Shenzhen. The nature of the meeting was a "meet and greet" between Huang Ran and SF's new Chief Executive Officer, Judson Martin. Huang Ran was accompanied by Supporter #2 who appears to be a shareholder and supervisor of Jiangxi Tianyao which is also a supplier to SF and Supporter #1. BJ and JH were also present. The IC Advisors were told by Management and BJ not to take any notes or ask any questions during the meeting as a condition of participation.

The key items noted during the September 1, 2011 meeting with Huang Ran are as follows:

- Huang Ran stated that he was in charge of running Yuda Wood's daily business. He denied that Yuda Wood is obligated by SF's instructions and stated that no one from SF has any interest in Yuda Wood.
- Huang Ran declined to disclose the names of the supporters behind Yuda Wood.
- Huang Ran stated that the only company to which Yuda Wood sold standing timber was SF.
- Huang Ran advised that he owns three other companies in China, namely Supplier #26, Supplier #9 and Supplier #25, which also act as Suppliers to SF. The SAIC filings indicate that Huang Ran holds a majority shareholding interest in those companies.

Following the meeting in Shenzhen, the IC Advisors were advised by BJ that Huang Ran would meet them again the next day in Chongqing, a five hour

journey from Hong Kong and Shenzhen. The IC Advisors were also told that such meeting the next day would be another “meet and greet”, and that it was unlikely that they would be able to review any documentation.

The second meeting with Huang Ran took place in Chongqing on September 2 2011. The meeting was conducted in accordance with the Interview Protocol for Suppliers and AIs prepared by the IC Advisors and sent to Allen Chan, Judson Martin and BJ on August 4, 2011. (See Schedule VI.A.2.(f).)

The key items noted during the second meeting with Huang Ran are as follows:

- The meeting was a “meet and greet” and consisted of a meeting over lunch and a subsequent meeting at Huang Ran’s premises.
- Huang Ran confirmed he is the legal representative of Yuda Wood.
- Huang Ran declined to talk about any companies he is associated with other than Yuda Wood.
- Huang Ran advised that transactions with SF account for over 50% of Yuda Wood’s business.
- Huang Ran advised that Yuda Wood acquires plantations from aggregators, not directly from farmers.
- Huang Ran advised that Yuda Wood obtains confirmations from forestry bureaus at the request of SF; the forestry bureaus have no obligation to issue them.
- Huang Ran advised that Yuda Wood sometimes directs payments to it from AIs to other parties, so there may be no evidence of Yuda Wood having received funds.
- Huang Ran agreed to try to collect documents for the IC Advisors’ review.

A third meeting with Huang Ran was scheduled and took place at SP’s Guangzhou office on September 28, 2011.

The key items noted during the third meeting with Huang Ran are as follows:

- Huang Ran was cooperative and gave responses to all questions.
- The IC Advisors were shown copies of four contracts with two farmers’ resolutions attached, and two contracts between Yuda Wood and its suppliers. With the exception of one contract for approximately 4,000 Ha., matched on the basis of the city and county of the plantation alone, the sample contracts provided between Yuda Wood and its suppliers could not be directly reconciled with transactions selected for review by the IC

Advisors, as specific location data was not available. No copies of these documents were allowed to be made.

- Huang Ran stated that Yuda Wood's business is trading and planting plantations and that SF represents approximately 40% - 50% of Yuda Wood's business.
- Huang Ran advised that in cases where SF directs a third party AI to settle its transactions with Yuda Wood (i.e. all BVIs transactions), Yuda Wood would always nominate a fourth party (which may in turn nominate a fifth or sixth party) to receive the payment "for tax reasons".
- Huang Ran declined to discuss tax related matters and when asked if Yuda Wood has ever issued VAT receipts to SF, he stated he was uncertain if that was the case, but if so, Yuda Wood should have records of any VAT receipts issued to SF.
- During the interview, Huang Ran was shown two emails by Rebecca Huang of BJ, which she identified as being the two emails resulting from the email review that were of concern to E&Y.
- In response to the two emails, Huang Ran denied that SF controlled Yuda Wood. He acknowledged that SF, through George Ho, Vice-President, Finance, monitored and was a joint operator of one of Yuda Wood's bank accounts (each of Yuda Wood and SF had knowledge of one of two passwords which were jointly required to release funds from the account).
- When shown the lists of SF Suppliers/AIs provided to the OSC and companies identified through relationship mapping or SAIC filings, Huang Ran acknowledged only that he has an interest in Supplier #9. When asked about other companies, he declined to discuss them. He did state that Yuda Wood "may have done one or two transactions" with Supplier #3 a few years ago.
- According to SF's records, the total volume of transactions between SF and Yuda Wood from 2007-2010 was RMB 4.56 billion. The IC Advisors were not provided access to the Yuda Wood books and records in order to confirm this volume during any of the three meetings.

(g) Management Responses

The IC Advisors completed additional electronic review for Yuda Wood related emails and the IC and E&Y requested a response from Management. The final version of such response was delivered to the IC, the audit committee and E&Y on October 22, 2011. The IC Advisors provided comment to the IC on Management's response to the emails in that such response was determined to be incomplete.

### **3. Findings Relating to Yuda Wood**

- (a) The IC is satisfied that Mr. Huang Ran is not currently an employee of the Company and that Yuda Wood is not a subsidiary of the Company. However, there is evidence suggesting close cooperation (including possible payment of capital at the time of establishment, joint control of certain of Yuda Wood's bank accounts and the numerous emails indicating coordination of funding, and other business activities). Management has advised, based on its own inquiries, that they believe that no such payment of capital has occurred. Management explanations of a number of Yuda Wood-related emails and answers to E&Y's questions are being reviewed by the IC but may not be capable of independent verification.
- (b) Considerations Relevant to Yuda Wood Review:
  - (i) The meetings with Huang Ran occurred at a location related to a separate project company that Huang Ran is associated with and the second meeting occurred at the Guangzhou offices of SP.
  - (ii) The IC Advisors were not given access to certain of Yuda Wood's books and records in order to trace the flow of funds related to a selected sample of transactions (which sample was provided to Yuda Wood in advance).
  - (iii) Huang Ran declined to provide the names of other individuals or companies that control or have an interest in Yuda Wood.

Please see Schedule V.C.11 for a summary of Supplier site visits.

### **B. Other Relationships**

#### **1. Relationships Identified in Preparation for Suppliers/AIs Interviews**

In preparation for the Supplier and AI interviews the IC Advisors performed reviews of SAIC filings for the Suppliers and AIs and identified numerous potential relationships between AIs and BVI Suppliers. Relationships identified to date for the key Suppliers and AIs are summarised in Schedule VI.B.1.1. In light of the potential relationships identified, the IC Advisors further reviewed BVI timber purchase contracts, Entrusted Sale Agreements and summary charts of BVI transactions. As a result of this review, the IC Advisors identified transactions which require explanations.

Observations included that SF's top Supplier from 2007-2010, Supplier #1, had no transactions with any SF BVIs in the Company's first and second fiscal quarters of 2011. In this same period, three new Suppliers, owned partly by recently departed SF employees, appeared and conducted several billions of RMB of business in the Company's first and second fiscal quarters of 2011.

Other observations included a number of payments to Suppliers in 2011 being made by an offshore customer that appears to be related to AI Conglomerate #1 / Supplier #3, suggesting that

there may be funds held offshore on behalf of SF BVIs or offshore payment obligations owed to SF BVIs.

Further observations included set-off arrangements between AIs and Suppliers with potential relationships as well as the sale of BVI standing timber to AIs that are potentially connected to the Suppliers that supplied the same standing timber.

These observations are summarized below. Some of these observations were raised with Mr. Judson Martin via email on October 19, 2011. A copy of the correspondence to Mr. Martin is attached as Schedule VI.B.1.2. As noted above, very recently, Management provided to the IC information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

(a) Suppliers with Former SF Employees

In addition to Yuda Wood, to date, the IC Advisors have identified 13 Suppliers where former SF employees, consultants or secondees are or have been directors, officers and/or shareholders. Including Yuda Wood, these suppliers account for 43% of SF plantation purchases between 2006 and the first quarter of 2011. Very recently, in Management's explanation of relationships, a number of additional relationships were identified. These have not yet been reviewed by the IC Advisors.

(i) Supplier #2

Supplier #2 was established in 2010 and acts as a major Supplier to BVIs, taking up much of the slack in supply of timber left by the absence of Supplier #1 as a Supplier in 2011. It appears to be partly owned by an individual who was a SF employee from 2007 to 2010.

According to SAIC search results, Supplier #2 was incorporated on May 27, 2010, and has 2 shareholders. The first is Shareholder #11, who holds 80% of the shares and contributed RMB 800,000 of the registered capital. The second is Shareholder #12, who holds 20% of the shares and contributed RMB 200,000 of the registered capital. The total registered capital is just RMB 1 million.

According to the first SF employee lists obtained through electronic data searches, Shareholder #12 was an employee of the SF WFOE Hunan Jiayu Wood Products Co., Ltd. from March 1, 2007 to March 1, 2008, as a manager in the resources department. He was also employed at Sino-Panel (Luzhai) Co., Ltd. from March 1, 2007 to March 31, 2010, as a manager in the operations department. These positions appear to be intermediate positions.

In the third and fourth quarters of 2010 Supplier #2 had over RMB 1.8 billion worth of standing timber transactions with the BVI companies. In

the first quarter of 2011 Supplier #2 had over RMB 1.76 billion worth of standing timber transactions with BVI Companies.

According to a scan of his Chinese ID card found in the SAIC filings, Shareholder #11, the 80% shareholder of Supplier #2, was born on June 9, 1987. This means that he was 23 years old when Supplier #2 engaged in transactions worth RMB 3.56 billion with SF from the third quarter of 2010 to the first quarter of 2011.

(ii) Supplier #21

Supplier #21 has been acting as a Supplier to BVIs since the Company's second fiscal quarter of 2011. According to SAIC search results, Supplier #21 was incorporated on March 11, 2011. It has registered capital of RMB 5 million and its legal representative is the previously mentioned Shareholder #12, the former employee of SF until March 31, 2010, and the 20% shareholder of Supplier #2. Shareholder #12 holds 70% of the shares while Shareholder #13 holds the other 30%.

An email located in the Company's records suggested that senior management personnel knew of Shareholder #12 using proceeds paid from Sino-Panel Luzhai and Jianghua WFOEs to Supplier #2 for timber purchases to pay the registered capital of Supplier #21.

In the second fiscal quarter of 2011, Supplier #21 had over RMB 1 billion in transactions with the SF BVIs. The first such transaction was for RMB 432 million and was dated April 7, 2011.

(iii) Supplier #7

Supplier #7 has been acting as a Supplier to BVIs - since the first fiscal quarter of 2009. In 2009, Supplier #7 had over RMB 1.8 billion of standing timber transactions with the BVIs. In all of 2010 and the first fiscal quarter of 2011 it had no transactions with the BVIs. In the second fiscal quarter of 2011 it had over RMB 435 million of transactions with the BVIs.

According to SAIC search results, it was registered on January 20, 2009, with a registered capital of RMB 500,000. Its 60% shareholder is Shareholder #14, who was an employee of the SF Jiamu WFOE from May 1, 2007 to October 31, 2007, as a project assistant in the logistics department. He was also employed by the SF Hezhou WFOE from November 1, 2007 to October 31, 2008, as a manager in the projects department. During his interview, Mr. Allen Chan described Shareholder #14 having been a junior employee and the IC's findings appear to confirm this.

(iv) Other Suppliers and AIs with Former SF Personnel

Other observations regarding SF Suppliers with former SF personnel as summarised in the table below. A more detailed discussion of these Suppliers is contained in Schedule VI.B.1.1.

Name of Company	Role	Transactions with SF (RMB)	Date of Registration	Registered Capital (RMB)	Former SF Personnel, their shareholding or role and SF employment date
Supplier #2	BVI and WFOE Supplier	3.59 billion (BVI) (Aug 2010 to Mar 2011) 72 million (WFOE) (Oct 2010)	May 27, 2010	1 million	Shareholder #12 (20%) (SF Mar 1, 2007 to Mar 31, 2010)
Supplier #21	BVI Supplier	1 billion (Q2 2011)	Mar 11, 2011	5 million	Shareholder #12 (70%) (SF Mar 1, 2007 to Mar 31, 2010)
Supplier #7	BVI and WFOE Supplier	1.8 billion (BVI) (Jan to Dec 2009), 205 million (WFOE) (Aug 2010), 435 million (Q2 2011)	Jan 20, 2009	500,000	Shareholder #14 (60%) (SF May 1, 2007 to Oct 31, 2008)
Supplier #22	WFOE Supplier	39 million (Mar 2011)	Dec 10, 2010	2 million	Shareholder #14 (30%) (SF May 1, 2007 to Oct 31, 2008) Shareholder #19 (70%) (SF Sep 24, 2007 to Aug 6, 2010)
Supplier #18	BVI Supplier	49 million (Dec 20, 2007)	Sep 12, 2006	500,000	Shareholder #14 (director and GM Aug 2007 to Apr 2008) (SF May 1, 2007 to Oct 31, 2008) Officer #1 (supervisor Aug 2007 to Apr 2008) (SF 2005 to present)
Supplier #12	BVI and WFOE Supplier	837.6 million (BVI) (Q3 and 4 2009) 31 million (WFOE) (10 Jan 2010)	Aug 7, 2009	500,000	Shareholder #14 (shareholder Aug 7, 2009 to Oct 15, 2009) (SF May 1, 2007 to Oct 31, 2008)
Supplier #23	WFOE Supplier	3.3 million (Oct 3, 2007)	Jun 15, 2005 (deregistered Mar 5, 2008)	500,000	Shareholder #20 (70%) (SF April 1, 2004 to present)
Supplier #24	WFOE Supplier	182 million (Oct 2009)	Apr 28, 2008	20 million	Shareholder #1 (39%)
Supplier #25	WFOE Supplier	99 million (Oct 2007 to Apr 2010)	Oct 31, 2005	500,000	Shareholder #1 (100%)
Supplier #9	WFOE Supplier	1.1 billion (Apr 10 to Mar 11)	Aug 19, 2009	2 million	Shareholder #1 (80%)
Supplier #26	WFOE Supplier	170 million (Aug 21, 2010)	Jan 5, 2010	2 million	Shareholder #1 (80%) Shareholder #21 (20%) (SF Luzhai Jan 1, 2008 to Mar 31, 2010, Gaoyao Jiayao left May 30, 2003, join date unknown)
Supplier #20	WFOE Supplier and customer	61 million (sale to SF) (2010) 65 million (purchase from SF) (2009)	Dec 2, 2008	1 million	Shareholder #21 (70%) (SF Luzhai Jan 1, 2008 to Mar 31, 2010, Gaoyao Jiayao May 30, 2003 to present) Shareholder #17 (30%) (SF 2000 to 2008)
Supplier #19	WFOE Supplier	478 million (Mar to Nov 2009)	Jan 28, 2008	USD 5 million	Shareholder #9 (SF 2001 to 2007)

(b) AIs with Former SF Employees

(i) AI #2

AI #2 is a current AI that was registered on February 15, 2002 with a registered capital of RMB 500,000. From the third quarter of 2007 to the first quarter of 2011, it purchased approximately RMB 4.093 billion of standing timber from BVIs.

During the interview with AI #2, the IC Advisors were introduced to Officer #3 as the person in charge. Officer #3 was an employee of the Company from 2004 to 2007.<sup>17</sup>

(c) Potential Relationships between AIs and Suppliers

(i) Supplier #13 and Supplier #1

Supplier #13 is a supplier to BVIs WFOEs. It was registered on June 5, 2009, with registered capital of RMB 5 million. In September 2010 it sold approximately RMB 796 million of timber to the BVIs over two transactions. From October to December 2009 it completed approximately RMB 179 million of transactions with the WFOEs.

According to SAIC filings, the 60% shareholder is Shareholder #15 while the 40% shareholder is Supporter #2. On September 1, 2011, Supporter #2 was introduced to Mr. Judson Martin in the presence of Mr. Robert Staley and Ms Rebecca Huang of BJ as a supporter behind Yuda Wood.

(ii) Supplier #4, Supplier #5 and AI #6.

There are two Suppliers and an AI that have a common person as their "supervisor". The practical role of "supervisor" varies within different Chinese companies and it is not known what the role of this person is within each of these companies.

Supplier #4 is a supplier to BVIs that was registered on December 15, 2005, with a registered capital of RMB 500,000 and was deregistered on July 16, 2009. Its 100% shareholder was Shareholder #16. Its supervisor is Officer #2. From 2006 to 2009, it sold RMB 3.28 billion of standing timber to the BVIs.

Supplier #4 is a supplier to BVIs that was registered on April 16, 2009, with a registered capital of RMB 300,000. Its 100% shareholder was the

<sup>17</sup> According to SAIC search results, Officer #3 is not listed as a shareholder or officer of AI #2. Similarly, the SAIC search results do not indicate any shareholding by AI Conglomerate #1. However, during the interview with AI Conglomerate #1, its chief Shareholder #5 introduced Officer #3 as the person in charge of AI #2 and stated that AI #2 was his investment. For details of the interview, please refer to Schedule V.C.11.

same Shareholder #16. Its supervisor is the same Officer #2. From 2009 to the first quarter of 2011, it sold RMB 2.64 billion of standing timber to the BVIs.

AI #6 is an AI that was registered on January 13, 2010 with a registered capital of RMB 200,000. From 2010 to the first quarter of 2011 it purchased RMB 2.15 billion of standing timber from the BVIs. According to SAIC filings, its supervisor is the same Officer #2. From January to November its 100% shareholder was Shareholder #18.

(d) Payments for BVI Standing Timber Purchases Made by Companies that are Not AIs

(i) Trading Co. #1

According to emails located in the Company's records, Trading Co. #1 is incorporated in the BVI and is owned by Shareholder #4, the brother of Shareholder #3 of Supplier #3. That email was sent to SF personnel and also contains the Hong Kong HSBC bank details of the company. A search seeking the identity of shareholders of Trading Co. #1 was denied (shareholding information in the BVI is only available with the consent of the shareholder).

According to the SAIC search results, and confirmed at the AI interview with AI #4 and AI #2, Shareholder #4 is a former shareholder of AI Conglomerate #1, the Holdco of these two AIs.

In the first fiscal quarter of 2011, in four different BVI standing timber purchases with Supplier #2, payment was made partially by Trading Co #1. This is unusual as payments for BVI standing timber purchases are normally made by SF's AIs as set-offs against SF's standing timber sales to those AIs. It is not clear on what basis Trading Co. #1 owed money to SF and made those payments to Supplier #2. The SAIC search results for Supplier #2 do not indicate that Shareholder #4 is involved in Supplier #2.

These payment records suggest that there may be funds held offshore by Trading Co. #1 (or others) on behalf of SF, or accounts payable to SF BVIs by Trading Co. #1 (or others).

Management advises that Trading Co. #1 is owned by Shareholder #4 and is a customer of both SP and SW Trading that purchases imported logs from the Company. Supplier #2 is a supplier of plantations that Shareholder #4 is not involved with. The Company sold imported logs to Trading Co. #1 and by the end of 2010, Trading Co. #1 owed the Company \$39 million. The Company had purchased plantations from Supplier #2 and owed it for these purchases. The Company's finance department pressured Trading Co. #1 to pay its account after year end, but it did not have the U.S. dollars to pay the amounts owing. Trading Co. #1

was directed to pay its liability using RMB and it was directed to pay it to Supplier #2 in partial settlement of the plantation purchases. Management very recently provided the IC with information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

(ii) Other Set-off Arrangements Involving Non-AI Companies

The IC Advisors have also identified other instances where Suppliers of BVI standing timber purchases have received payment from companies other than AIs. The companies identified appear to be domestic import/export companies.

Payments by these companies in RMB to Suppliers of the BVIs in China may suggest that they have accounts payable to the BVIs. If this is the case, BVI funds outside China (or accounts receivable offshore in foreign exchange) are being transferred by way of set-off into China for purchase of standing timber that become part of the BVI assets in China.

Specific examples include payments in 2010, where Supplier #3 received payment from non-AI companies, including Trading Co. #2 and Trading Co. #3. Similarly, in 2010 the Supplier #5 received payment from Trading Co. #4.

It is again unclear on what basis these non-AI companies are making set-off payments on behalf of SF.

(e) Payments to Potentially Connected Suppliers

(i) AIs AI #4 and AI #2 Paying Potentially Connected Supplier #3

SF charts of BVI purchase and sale transactions indicate that from 2009 to 2011, the AIs AI #4 and AI #2 made over RMB 604 million in set-off payments on behalf of SF for BVI timber purchases from the Supplier.

At the Supplier #3 supplier interview in Schedule V.C.11, Shareholder #3, the chief of Supplier #3, confirmed that he founded AI Conglomerate #1, the holding company which owns AI #4.

Based on the SAIC search results, it appears that 40% of the shares of AI Conglomerate #1 are held by a Hong Kong company called Shareholder #22 that is 100% owned by a company called Shareholder #23, which is a BVI company. Emails located in the Company records indicate that Shareholder #23 is controlled by Shareholder #3 and that it is through this BVI structure that Shareholder #3 maintains his shareholding in AI Conglomerate #1 and therefore the two AIs. A search seeking the identity of shareholders of Shareholder #23 was denied (shareholding information

in the BVI is only available with the consent of the shareholder). The most current SAIC search results show that Shareholder #3 is currently the vice chairman of AI Conglomerate #1. During the interview with Shareholder #5, the IC Advisors were told that the information was out of date and that Shareholder #3 had transferred his shares to Shareholder #5 and his brother Shareholder #6 in 2009. However, SAIC search results showed that Shareholder #3 participated in a board resolution of AI Conglomerate #1 in 2010. The holding structure is illustrated in a chart attached to such emails.

- (ii) AIs AI #6 and AI #5 Paying Potentially Connected Suppliers Supplier #4 and Supplier #5.

SF charts of BVI purchase and sale transactions indicate that in 2010, the AI AI #6 made over RMB 313 million in set-off payments on behalf of SF for BVI timber purchases from the Supplier #5 both of whom have a common supervisor as noted above. In 2009, AI #5, which is an AI identified by Management as also controlled by the same entity which controls AI #6, made over RMB 170 million in set-off payments on behalf of SF for BVI timber purchases from the Supplier #5. From 2007 to 2008, AI #5 made over RMB 499 million in set-off payments on behalf of SF for BVI timber purchases from Supplier #4. The IC intends to assess the implications of these potential relationships.

- (f) Sale of Standing Timber to AI Potentially Connected to Supplier of that Timber

- (i) Timber Bought from Supplier #3 and Sold to AI #4 and AI #2.

SF charts of BVI purchase and sale transactions indicate that from October 2008 to March 2011, SF sold a total of approximately RMB 145 million of standing timber to the AIs AI #2 and AI #4 that was purchased from Supplier #3. During the interview with Shareholder #5, the IC Advisors were told that the information was out of date and that Shareholder #3 had transferred his shares to Shareholder #5 and his brother Shareholder #6 in 2009. For further details about the relationship between AI #2, AI #4 and Supplier #3, please refer to Schedule VI.B.1.1.

- (ii) Timber Bought from Supplier #8 and Sold to AI #3

SF charts of BVI purchase and sale transactions indicate that from July 2006 to December 2009, SF sold a total of approximately RMB 456 million of standing timber to AI #3 that was purchased from the connected Supplier #8. For details about the relationship between AI #3 and Supplier #8, please refer to Schedule VI.B.1.1.

(g) Lam Hon Chiu – Jiangxi Zhonggan

Certain of the related-party allegations in the MW Report concerned Lam Hon Chiu, who was characterized in the MW Report as an “executive” of the Company. The MW Report alleged, among other things, that Lam Hon Chiu was also the manager of two of the Company’s “agents” (which agents were unnamed), as well as the legal representative and President of Supplier Jiangxi Zhonggan.

Management responded that Lam Hon Chiu, also known as Marco Lam, had once held the position of Vice-President, Business Development and Logistics, with the Company, but left Sino-Forest on July 22, 2007.

Management provided the IC with a letter of Sino-Panel (Asia) Inc. dated July 17, 2007, confirming the termination of Lam Hon Chiu’s employment, effective July 23, 2007. The letter was acknowledged by Lam Hon Chiu on July 17, 2007. In addition, Management provided a copy of an Employee Termination Checklist dated July 22, 2007, acknowledged by Lam Hon Chiu on July 17, 2007, and an MPF Member Termination Statement for Employer in respect of Lam Hon Chiu issued by HSBC Life (International) Limited on November 7, 2007. These materials are attached as Schedule VI.B.1(g).

During the interview with Supplier Jiangxi Zhonggan on September 22, 2011 Lam Hon Chiu confirmed his previous employment with the Company. He further stated that Jiangxi Zhonggan, the Supplier of which he is legal representative, did not have any transactions with Sino-Forest until after his employment with it had ended.

(h) Relationship Mapping

The IC Advisors identified other possible relationships between SF, its parent and current employees and AIs and Suppliers.

To date numerous interrelationships and linkages between SF’s current/former employees, and AIs, Suppliers, forestry bureaus and their current/former employees have been identified and further potential relationships continue to be identified as enquiries continue.

On the instructions of the IC, the IC Advisors have passed the details of possible relationships identified to date to Management for further follow up and explanation. As noted above, very recently, Management provided information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

## **2. E&Y Directors**

Muddy Waters alleged that the Board appears to be a retirement plan for partners of E&Y. In particular, Muddy Waters suggested that there are currently five retired E&Y partners on the Board.

In fact, there are only two current directors of the Company who were formerly partners of E&Y, Mr. James Hyde and Mr. Garry West. Mr. Hyde left E&Y in 2002 to take a position in industry, and became a director of the Company in 2004. Mr. West retired from E&Y in June 2007 and became a director of the Company in February 2011. No other persons on the current Board have been E&Y partners.

It would appear that Muddy Waters confused Mr. Jamie Bowland, a recently departed director with a long career at BMO Capital Markets, with a "James Boland" - an American who sits on a public company board. While Mr. Jamie Bowland had advised that he worked briefly for a predecessor to E&Y in the 1970s, he was not a partner thereof.

Muddy Waters may also have confused Mr. W. Judson Martin, the Chief Executive Officer, with a "J. W. Martin" - a former E&Y partner who is not associated with the Company. Mr. W. Judson Martin has never been an E&Y partner or employee.

Finally, the Company has been advised by E&Y that Mr. Peter D.W. Wang has a similar name to an E&Y partner, although he, too, has not been an E&Y partner.

## **C. Globe and Mail Allegations re: Homix and Chen Hua**

Homix is currently an indirect wholly owned subsidiary of the Company. Dayang is currently a wholly owned subsidiary of Homix. The Globe, in a story printed September 3, 2011, claimed that SAIC corporate filings for Dayang indicate Chen Hua, a Vice-President of SF, was also a shareholder in Dayang at the time of the sale of Homix to SF in 2010 for \$7.1 million. The Globe characterized Dayang as a "unit of Homix" and stated that SF closed the purchase of Homix in June 2010. Muddy Waters says that SF paid Ms. Chen \$7 million (without relating such payment to any particular transaction). Based on SF public disclosures at the time, the transaction was closed in January 2010.

Based on the Dayang SAIC filings that have been reviewed by the IC Advisors, the IC was able confirm that the SAIC filings do not show Chen Hua as holding an interest or a position in Dayang after January 28, 2008. The Homix sale is recorded in the SAIC filing and disclosed by SF as occurring on January 4, 2010. The SAIC searches show Chen Hua was a 30% shareholder (and Chair) from August 2003 to November 2004. She was again shown as a 30% shareholder for three days in January 2008. BJ advised the IC Advisors that Ms. Chen has stated to them that she was a nominee holder who held for the owner who was a friend. She further indicated to BJ that she acted as Chair in the initial stages as she had good relationships that were relevant to the business.

**VII. OTHER MUDDY WATER ITEMS**

## VII. OTHER MUDDY WATERS ITEMS

The IC has not attempted to address every allegation made by MW but rather has focussed its review as previously described. Set out below are two additional of allegations of MW, which the IC also believes warrant comment.

### A. Logging Versus Sale of Trees

One of the allegations in the MW Report was that, given logistics and operational realities, SF's Yunnan Province timber sales are largely fabricated. For example, Muddy Waters noted that Yunnan is a remote, rugged, mountainous province, making the prospect of harvesting any sizeable quantity of logs, even by hand, daunting. Moreover, even if the Company were able to harvest the logs claimed, the roads through the mountains are dangerous, with switchbacks and steep precipices. Roads leading into the agricultural areas are of an even lower quality and often unpaved. During the rainy season (from May to October), travel by road would be further complicated by mud and occasional landslides. According to the MW Report, the value of purchases made under the Yunnan MFA was overstated by approximately \$800 million.

In response to these allegations, Management explained that, in fact, its revenue from Yunnan Province was solely the result of the sale of standing timber. No cutting or transport was involved, as the trees were sold as living trees and not harvested as logs.

The IC Advisors reviewed the Company's 2010 MD&A, the MD&A for the three months ended March 31, 2011, and the Q2s, and determined that this particular element did not require further investigation, as the Company's public disclosure supported Management's assertion that the revenue generated by the Company in Yunnan Province resulted from the sale of standing timber. For example, the 2010 MD&A stated that the revenue from broadleaf in Yunnan accounted for approximately 45.5% of standing timber revenue in the year ended December 31, 2010. The MD&A for the three months ended March 31, 2011 disclosed that during the three months ended March 31, 2011, the Company sold approximately 9,868 Ha. of plantations which were acquired under MFAs, mainly in the provinces of Guangxi, Yunnan and Hunan. Finally, the Q2s indicated that in the six months ended June 30, 2010, 92.9% of standing timber sales were of broadleaf from Yunnan Province.

### B. Capital Hole

The MW report raises an allegation it refers to as the "Capital Hole". The essence of this allegation is that there is a gap between the capital available to SF in China which it could access through equity injections, debt and asset dispositions, and the capital SF reports to have spent in China on acquisitions.

Management was asked to address this allegation in its overall response to the MW allegations. Management's primary response is as follows:

"MW's premise is that SF's business generated \$3.5 billion of cash flow (after change in working capital components and changes in short term borrowings) but that SF purchased \$5.0 billion worth of trees, thereby SF has a cash shortfall of \$1.5 billion. Since Chinese government records only show between \$0.7

billion and \$1.2 billion of investment by SF into the PRC, SF in China must be short of cash of between \$0.3 billion and \$0.8 billion. MW then argued that SF must not have been acquiring all of the trees that SF publicly discussed. In reality, the alleged cash short fall has been made up by fund raising exercises undertaken at the parent level outside of China. And not all of this cash raised has gone into China to fund trees acquisitions. In fact, the operating cash flow figures that MW used are taken from our financial statements and include expenses in the income statement and investments in working capital assets in Hong Kong that have been funded by capital raised at the parent level and kept in Hong Kong. The expenses have not been funded by operating cash flow in China. The expenses made in Hong Kong should not be included as deduction against the operating cash flow in China. For example, SF's selling, general and administrative expense and Interest for the period of time referred to the MW Report has been in excess of \$0.7 billion. This amount has been wrongly deducted by MW from the China operating cash flow to arrive at the incorrect operating cash flow used in the MW report. This \$0.7 billion has been funded by cash raised at the parent level and paid outside of China, and therefore this amount needs to be added back to the operating cash flow within China. The remaining of the alleged excess/shortfall in the MW Report is caused by MW wrongly lumping together the change in working capital components. Some of the change relates to onshore WFOE's and is funded by their operating cash flow in China, some of the change is related to the BVI plantation purchases and is funded by this model and some of the change is related to Hong Kong log trading business which is funded off shore by capital raised by the parent. For example, SF funded the Imported log trading business in Hong Kong (the investment in this business is included in the change in non-cash working capital components when determining operating cash flow) to the extent of \$220 million. This amount needs to be added back to the operating cash flow. When one adjusts for these two amounts and includes the actual investment in China, one arrives at an excess funding scenario – there is no cash hole as MW so sensationally alleged.”

The IC did not ask the IC Advisors to examine the capital hole allegation in favour of focusing on the primary issues described in Part I above.

## **VIII. VALUATION**

## VIII. VALUATION

Key allegations in the MW Report relate to the valuation of SF's standing timber holdings being overstated. The MW Report suggests that Poyry, the company retained by SF to provide certain valuation services, had been provided manipulated data and had its scope of work restricted by SF. The MW Report also suggests that timber holdings are overstated by way of alleging purchase transactions are fabricated.

Initially, the IC instructed the IC Advisors to focus on verifying existence and ownership of the assets, with a subsequent step being the valuation of those assets. The IC determined in August 2011 that the valuation exercise would need to run concurrently with the other efforts.

At the request of the IC, the IC Advisors pursued the engagement of an independent valuator with appropriate forestry expertise in China. The scoping of this project with a prospective valuator was completed. However, through the course of its own review, the IC determined it had material concerns with respect to such valuator's independence and did not proceed with it further. At the same time, SF was giving consideration to a course of action which would require a valuation of its own and, in order to avoid duplication of costs and effort, the IC determined it would combine its needs with those of the Company and proceed with a new process.

A key concern identified by the IC Advisors was the information from SF that longitude/latitude coordinates of standing timber plantations cannot be obtained from the Surveyor Reports. Such reports show GPS coordinates for the village/general area rather than detailed coordinates that would facilitate specific identification and a site-walk/examination.

The IC and Management are currently negotiating an engagement letter with an independent valuator pursuant to which it would conduct a valuation process in respect of a sample of SF's standing timber.

**IX. OSC**

**IX. OSC**

On June 8, 2011, the OSC announced it was investigating matters related to SF. A discussion of the OSC's investigation and the work of the IC in that regard is attached as Schedule IX, which is privileged and confidential.

**X. E&Y**

## **X. E&Y**

As auditor, E&Y is entitled to inspect the books and records of the Company. The IC agreed and instructed the IC Advisors to keep E&Y informed as to the status of the IC's review process and have addressed questions of particular interest to E&Y in relation to the scope and progress of the review.

At the outset the IC provided E&Y with the first draft of the proposed work plan of PwC as submitted to the IC. The IC has continued to discuss the work plan with E&Y as it has developed. The IC also has given E&Y access to the Sino-Forest data captured by PwC on behalf of the IC.

A particular area of interest for the IC and E&Y has been Sino-Forest's relationships with AIs and Suppliers, particularly, the Hong Kong Sonic Jita and Yuda Wood relationships.

The IC has briefed E&Y regularly on the nature and progress of the IC's review in relation to the following topics:

- Cash;
- Fact Gathering;
- Management Response;
- Revenue Mapping;
- Relationship Mapping;
- Alleged Non-Arm's Length Relationships;
- Forestry Bureau Visits and Confirmations;
- Customer/Supplier Visits;
- Current Activities/Next Steps; and
- Timing.

**XI. ROYAL CANADIAN MOUNTED POLICE (IMET)**

**XI. ROYAL CANADIAN MOUNTED POLICE (IMET)**

The RCMP has advised the IC that it has commenced a preliminary investigation into the allegations of fraud asserted in the MW Report. Particulars of the IC's discussion with the RCMP to date are set out in Schedule XI, which is privileged and confidential.

**XII. CASH**

## **XII. CASH**

As reported in the IC's First Interim Report, as a precautionary measure, the IC requested that PwC confirm SF's cash balances. PwC did this as of June 13, 2011 for both PRC accounts and "offshore" accounts. A total of 293 accounts controlled by SF in Hong Kong were confirmed, representing 100% of the expected cash position. There are a very significant number of accounts held by SF in China and the logistics and requirements of in person/in branch verification in that country led the IC to confirm only a portion of the China accounts (28 accounts, representing approximately 81% of the expected China cash position). The IC was satisfied that SF's expected cash position existed as at the date of the confirmation. The Board should be aware that SF only updates the details of its own cash position quarterly, so the confirmation results must be considered in this context. The IC has instituted certain additional controls over cash movements in excess of \$1 million held in SF Hong Kong bank accounts in order to provide the IC with some precautionary comfort during the examination process.

### **XIII. NEXT STEPS**

### **XIII. NEXT STEPS**

Subject to the direction of the Board, the IC expects to complete its review prior to the end of 2011 and intends to:

- (a) review the information and analysis recently received from Management relating to certain relationship issues;
- (b) in cooperation with Management, engage an independent valuator to conduct a valuation process with a scope and parameters acceptable to the IC;
- (c) such other steps as the IC, in its judgement, deems advisable in the discharge of its mandate; and
- (d) submit its final report and recommendations to the Board.

The IC expects to be able to deliver its final report to the Board prior to the end of 2011.

## **GLOSSARY**

## GLOSSARY

“\$” means, unless otherwise specified, U.S. dollars;

“**2010 Acquisition**” means the Company’s acquisition of substantially all of the outstanding common shares of Mandra (not already owned by the Company) on February 5, 2010;

“**2010 AIF**” or “**AIF**” means the Company’s annual information form for the year ending December 31, 2010;

“**2010 Annual Report**” means the Company’s annual report for the 2010 calendar year;

“**2010 Financial Statements**” means the Company’s audited consolidated financial statements and the notes thereto as at and for the year ended December 31, 2010;

“**2010 MD&A**” means the Company’s management discussion and analysis for the year ending December 31, 2010;

“**AI**” means an authorized intermediary, an entity through which a BVI conducts its sales;

“**AIC**” or “**SAIC**” means China’s State Administration for Industry and Commerce, the national authority responsible for administering industry and commerce;

“**AI HoldCo**” or “**AI Conglomerate #1**” means AI Conglomerate #1, a holding company that controls several AIs;

“**Audit Committee**” means the Audit Committee of the Board;

“**BJ**” means Bennett Jones LLP, Canadian counsel to the Company;

“**Board**” means the Board of Directors of SF;

“**BVI**” means a subsidiary of the Company incorporated in the British Virgin Islands;

“**Chart**” means the corporate structure chart provided to the IC Advisors by the Company and attached as Schedule II.C;

“**China**” means The People’s Republic of China;

“**Chop**” means the seal typically used in place of signatures in China;

“**Company**” or “**SF**” or “**Sino-Forest**” means Sino-Forest Corporation and, where the context requires, its consolidated subsidiaries;

“**Counterparty**” means a party to an agreement with SF that is not a subsidiary of the Company;

“**CTO**” means the cease trade order of the OSC dated August 26, 2010;

“**Dayang**” means Jiango Dayang Timber Co. Ltd., a wholly-owned subsidiary of Homix;

“**E&Y**” means Ernst & Young LLP, the auditor of the Company;

“**Entrusted Sale Agreements**” has the meaning set forth in Section V.C.15;

“**forestry bureau confirmations**” or “**confirmations**” means documents issued to the WFOEs and BVIs on letterheads with forestry bureau names and featuring Chops (the seal typically used in place of signatures) that indicate that they had been issued by the corresponding forestry bureau, but does not include new confirmations;

“**FTI**” means FTI Consulting, a consulting firm advising the Company;

“**GAAP**” means the Generally Accepted Accounting Principles;

“**Gengma Dai**” means Gengma Dai and Wa Tribes Autonomous Region Forestry Company Ltd., an agent through which the Company purchases timber assets in the Yunnan region of China;

“**Globe**” means *The Globe and Mail*, a Canadian national newspaper;

“**Ha.**” means hectares, which is equivalent to 15 mu (statements of Ha. herein are approximate, given the rounding associated with the conversion of mu to Ha.);

“**Homix**” means Homix Limited, a company acquired by SF in June 2010;

“**Hong Kong Sonic Jita**” means Sonic Jita Engineering Co. Ltd., the Hong Kong incorporated parent company of Yuda Wood;

“**Hunan Forestry Entity #1 Confirmation**” means the new forestry bureau confirmation issued by Hunan Forestry Entity #1 (see Section V.C.9);

“**IC**” means the Independent Committee to the Board;

“**IC Advisors**” means one or more of PwC, Osler, Mallesons and JH;

“**IMET**” means an Integrated Market Enforcement Team of the RCMP;

“**Income**” means income from continuing operations before interest, other income, exchange losses and changes in fair value of financial instruments;

“**JH**” or “**Chinese counsel to the IC**” means Jun He Law Offices, independent Chinese IC counsel;

“**Jiangxi Zhonggan**” means Jiangxi Zhonggan Industrial Development Company Ltd.;

“**Mallesons**” means Mallesons Stephen Jaques, independent Hong Kong counsel to the IC;

“**Management**” means, at any time, the management of SF at that time;

“**Mandra**” means Mandra Forestry Holdings Limited, a wholly-owned subsidiary of SF;

“**Mandra Bonds**” means aggregate principal amount of \$194,470,000 of 12% Guaranteed Senior Notes due May 2013 issued by Mandra Finance;

“**Mandra Finance**” means Mandra Forestry Finance Limited;

“**MD&A**” means management discussion and analysis;

“**MFAs**” means master framework agreements between various BVIs or WFOEs, on the one hand, and various Chinese entities, on the other, which establish a framework for the supply of standing timber to the Company in specified areas;

“**MOFCOM**” means China’s Ministry of Commerce;

“**mu**” means a Chinese unit of measure for area, which is equivalent to 0.067 Ha;

“**Muddy Waters**” or “**MW**” means Muddy Waters, L.L.C.;

“**MW Report**” means the initial “research report” issued by Muddy Waters dated June 2, 2011;

“**OSC**” means Ontario Securities Commission;

“**Osler**” means Osler, Hoskin & Harcourt LLP, independent Canadian counsel to the IC;

“**Plantation Rights Certificate**” means a governmental registered certification of ownership issued by a forestry bureau in China to evidence certain forestry-related rights;

“**PwC**” means PricewaterhouseCoopers LLP, forensic accounting advisors to the IC;

“**Q2s**” means, collectively, the financial statements of the Company for the six months ended June 30, 2011 and the related MD&A;

“**RCMP**” means Royal Canadian Mounted Police;

“**RMB**” means Renminbi, the official currency of China;

“**SAFE**” means China’s State Administration for Foreign Exchange;

“**SAIC**” means China’s State Administration for Industry and Commerce, the national authority responsible for administering industry and commerce;

“**Sino-Panel (China)**” means Sino-Panel (China) Investments Ltd., a WFOE;

“**SP**” or “**Sino-Panel**” means Sino-Panel (Asia) Inc. (BVI), a BVI;

“**Staff**” means Staff of the OSC;

“**Subsidiary BVIs**” means, as of the date hereof, all BVIs, other than Greenheart Resources Holdings Limited;

**“Supplier”** means a supplier to the Company of plantation assets, either rights to standing timber or plantation/land use rights or both;

**“Survey Company #1”** means Survey Company #1, a survey company engaged by SF to provide it with surveyor services in connection with its plantation assets;

**“Survey Report”** means a Forest Resource Survey Report that accompanies BVI timber purchase contracts;

**“SW”** or **“Sino-Wood”** means Sino-Wood Partners, Limited, a Hong Kong incorporated subsidiary of SF;

**“TSX”** means Toronto Stock Exchange;

**“VAT”** means valued-added tax;

**“WFOE”** means a subsidiary of the Company incorporated in China as a “Wholly Foreign Owned Enterprise”;

**“WFOE MFAs”** means the four MFAs entered into between WFOEs and vendor Counterparties from 2009 to 2011, described further in Section V.B; and

**“Yuda Wood”** means Huaihua City Yuda Wood Co. Ltd, a Supplier.

**APPENDIX I - IC REPORT – FINAL REPORT**

*(See Attached)*

**FINAL REPORT OF  
THE INDEPENDENT COMMITTEE OF THE BOARD OF DIRECTORS  
OF SINO-FOREST CORPORATION**

**Privileged & Confidential**

January 31, 2012

TABLE OF CONTENTS

	Page
I. PROCESS SINCE NOVEMBER 13, 2011 .....	2
II. RELATIONSHIPS .....	2
III. TIMBER ASSET PROOF OF CONCEPT .....	9
IV. ASSET VERIFICATION .....	13
V. ONTARIO SECURITIES COMMISSION .....	13
VI. OUTSTANDING MATTERS .....	13

GLOSSARY

SCHEDULES

SCHEDULE I: SECOND INTERIM REPORT – EXECUTIVE SUMMARY

Notes:

1. Capitalized terms used in this Final Report shall have the respective meanings ascribed to them in the Glossary.
2. The IC Advisors have conducted various investigative and review processes, all at the direction of, and subject to such scope limitations as the IC, in its judgment, deemed appropriate. This Final Report, while based on the work of such advisors, is the report of the IC and not the report of the IC Advisors.

## INTRODUCTION

The IC was established by the Board on June 2, 2011 immediately following the release by Muddy Waters of the MW Report. The IC has issued two interim reports to the Board since that date, the first dated August 10, 2011 and the second dated November 13, 2011. The initial members of the IC were William Ardell (Chair), James Bowland and James Hyde. At the invitation of the IC, Mr. Garry West, an independent director of SF, has attended virtually all the IC meetings and participated in its process. Mr. Bowland resigned as a director and from the IC on November 3, 2011 following the delivery to the Board of the IC's draft Second Interim Report. The IC has formally met approximately 75 times, in most cases for several hours, and met informally and communicated by email almost daily, either as IC members or in another Board capacity.

As was noted in the Second Interim Report, the IC focused on the years 2006 and following and limited its process to the examination and review of the issues raised in three core areas: (i) timber asset verification; (ii) timber asset value; and (iii) revenue recognition. Overlaying or intertwined with the latter two areas were the issues raised by the MW allegations regarding related party transactions and relationships. These issues have proved to be very difficult to definitively resolve.

The Second Interim Report described the process undertaken by the IC in its examination and review of the allegations made in the MW Report, summarized the outcomes and findings resulting from such process and identified certain further steps which the IC intended to take. Attached as Schedule I to this report is the Executive Summary from the Second Interim Report which includes an overview of the IC's principal findings as to timber ownership, forestry bureau confirmations and Plantation Rights Certificates, book values of timber, revenue reconciliation, relationships, cash and the BVI structure. The Executive Summary also discusses the challenges encountered by the IC in conducting its process.

The Second Interim Report stated that, while the IC believed its work was substantially complete, there remained certain further steps which it intended to undertake as follows:

- review the information and analysis which had very recently been provided by Management and which was intended to respond to certain issues regarding relationships of the Company with AIs and Suppliers and between AIs and Suppliers as identified in Part IV of the Second Interim Report;
- work with management to engage an independent valuator; and
- such other steps as the IC, in its judgment, deemed advisable in the discharge of its mandate.

This Final Report of the IC sets out the activities undertaken by the IC since mid-November, the findings from such activities and the IC's conclusions regarding its examination and review. The IC's activities during this period have been limited as a result of Canadian and Chinese holidays (Christmas, New Year and Chinese New Year) and the extensive involvement of IC members in the Company's Restructuring and Audit Committees, both of which are advised by different advisors than those retained by the IC. The IC believes that, notwithstanding there remain issues which have not been fully answered, the work of the IC is now at the point of diminishing

returns because much of the information which it is seeking lies with non-compellable third parties, may not exist or is apparently not retrievable from the records of the Company.

In December 2011, the Company defaulted under the indentures relating to its outstanding bonds with the result that its resources are now more focused on dealing with its bondholders. This process is being overseen by the Restructuring Committee appointed by the Board. Pursuant to the Waiver Agreement dated January 18, 2012 between the Company and the holders of a majority of the principal amount of its 2014 Notes, the Company agreed, among other things, that the final report of the IC to the Board would be made public by January 31, 2012.

Given the circumstances described above, the IC understands that, with the delivery of this Final Report, its review and examination activities are terminated. The IC does not expect to undertake further work other than assisting with responses to regulators and the RCMP as required and engaging in such further specific activities as the IC may deem advisable or the Board may instruct. The IC has asked the IC Advisors to remain available to assist and advise the IC upon its instructions.

#### **I. PROCESS SINCE NOVEMBER 13, 2011**

The IC Advisors' privileged report on outstanding items as at the date of the Second Interim Report and limited processes conducted by the IC Advisors since November 13, 2011 (being the date of the IC's Second Interim Report) has been delivered to the Board. Many of those challenges, which are fully described in section C of the Executive Summary of the Second Interim Report, continued to affect the IC's process since November 13, 2011. See Schedule I.

The scope of review and the processes undertaken by the IC Advisors since November 13, 2011 were determined by the IC and have been subject to certain limitations. The IC, in its judgment, considers such limitations to be appropriate and in the best interest of the Company, having regard to the challenges referred to above, time constraints and cost/benefit considerations. This Final Report to the Board, while partially based on the work of the IC Advisors, is the report of the IC and not the work of the IC Advisors.

#### **II. RELATIONSHIPS**

The objectives of the IC's examination of the Company's relationships with its AIs and Suppliers were to determine, in light of the MW allegations, if such relationships are arm's length and to obtain, if possible, independent verification of the cash flows underlying the set-off transactions described in Section II.A of the Second Interim Report. That the Company's relationships with its AIs and Suppliers be arm's length is relevant to SF's ability under GAAP to:

- book its timber assets at cost in its 2011 and prior years' financial statements, both audited and unaudited
- recognize revenue from standing timber sales as currently reflected in its 2011 and prior years' financial statements, both audited and unaudited.

**A. Yuda Wood**

Yuda Wood was founded in April 2006 and was until 2010 a Supplier of SF. Its business with SF from 2007 to 2010 totalled approximately 152,164 Ha and RMB 4.94 billion. Section VI.A and Schedule VI.A.2(a) of the Second Interim Report described the MW allegations relating to Yuda Wood, the review conducted by the IC and its findings to date. The IC concluded that Huang Ran is not currently an employee, and that Yuda Wood is not a subsidiary, of the Company. However, there is evidence suggesting a close cooperation between SF and Yuda Wood which the IC had asked Management to explain. At the time the Second Interim Report was issued, the IC was continuing to review Management's explanations of a number of Yuda Wood-related emails and certain questions arising there-from.

Subsequent to the issuance of its Second Interim Report in mid-November, the IC, with the assistance of the IC Advisors, has reviewed the Management responses provided to date relating to Yuda Wood and has sought further explanations and documentary support for such explanations. This was supplementary to the activities of the Audit Committee of SF and its advisors who have had during this period primary carriage of examining Management's responses on the interactions of SF and Yuda Wood. While many answers and explanations have been obtained, the IC believes that they are not yet sufficient to allow it to fully understand the nature and scope of the relationship between SF and Yuda Wood. Accordingly, based on the information it has obtained, the IC is still unable to independently verify that the relationship of Yuda Wood is at arm's length to SF. It is to be noted that Management is of the view that Yuda Wood is unrelated to SF for accounting purposes. The IC remains satisfied that Yuda is not a subsidiary of SF. Management continues to undertake work related to Yuda Wood, including seeking documentation from third parties and responding to e-mails where the responses are not yet complete or prepared. Management has provided certain banking records to the Audit Committee that the Audit Committee advises support Management's position that SF did not capitalize Yuda Wood (but that review is not yet completed). The IC anticipates that Management will continue to work with the Audit Committee, Company counsel and E&Y on these issues.

**B. Other Relationships**

Section VI.B.1 of the Second Interim Report described certain other relationships which had been identified in the course of the IC's preparation for certain interviews with AIs and Suppliers. These relationships include (i) thirteen Suppliers where former SF employees, consultants or secondees are or have been directors, officers and/or shareholders (including Yuda Wood); (ii) an AI with a former SF employee in a senior position; (iii) potential relationships between AIs and Suppliers; (iv) set-off payments for BVI standing timber purchases being made by companies that are not AIs and other set-off arrangements involving non-AI entities; (v) payments by AIs to potentially connected Suppliers; and (vi) sale of standing timber to an AI potentially connected to a Supplier of that timber. Unless expressly addressed herein, the IC has no further update of a material nature on the items raised above.

On the instructions of the IC, the IC Advisors gave the details of these possible relationships to Management for further follow up and explanation. Just prior to the

Second Interim Report, Management provided information regarding AIs and Suppliers relationships among the Company and such parties.

This information was in the form of a report dated November 10, 2011, subsequently updated on November 21, 2011 and January 20, 2012 (the latest version being the "Kaitong Report") prepared by Kaitong Law Firm ("Kaitong"), a Chinese law firm which advises the Company. The Kaitong Report has been separately delivered to the Board. Kaitong has advised that much of the information in the Kaitong Report was provided by Management and has not been independently verified by such law firm or the IC. Kaitong's work on the information received from Management includes:

- Reconciling the annual transaction amount for each Supplier and AI with the purchase/sales detailed data, which were provided by Management;
- Checking registration documents filed with SAIC to verify the basic information (legal representative, shareholding structure and establishment date) of Suppliers and AIs; and
- Performing Internet searches on the backers including their current and past position, investment and news.

The Kaitong Report generally describes certain relationships amongst AIs and Suppliers and certain relationships between their personnel and Sino-Forest, either identified by Management or through SAIC and other searches. The Kaitong Report also specifically addresses certain relationships identified in the Second Interim Report. The four main areas of information in the Kaitong Report are as follows and are discussed in more detail below:

- (i) **Backers to Suppliers and AIs:** The Kaitong Report explains the concept of "backers" to both Suppliers and AIs. The Kaitong Report suggests that backers are individuals with considerable influence in political, social or business circles, or all three. The Kaitong Report also states that such backers or their identified main business entities do not generally appear in SAIC filings by the Suppliers or AIs as shareholders thereof and, in most instances, in any other capacity.
- (ii) **Suppliers and AIs with Former SF Personnel:** The appendices to the Kaitong Report list certain Suppliers that have former SF personnel as current shareholders.
- (iii) **Common Shareholders Between Suppliers and AIs:** The Kaitong Report states that there are 5 Suppliers and 3 AIs with current common shareholders but there is no cross majority ownership positions between Suppliers and AIs.
- (iv) **Transactions Involving Suppliers and AIs that have Shareholders in common:** The Kaitong Report states that, where SF has had transactions with Suppliers and AIs that have certain current shareholders in common as noted above, the subject timber in those transactions is not the same;

that is, the timber which SF buys from such Suppliers and the timber which SF sells to such AIs are located in different counties or provinces.

The IC Advisors have reviewed the Kaitong Report on behalf of the IC. The IC Advisors liaised with Kaitong and met with Kaitong and current and former Management. A description of the Kaitong Report and the IC's findings and comments are summarized below. By way of summary, the Kaitong Report provides considerable information regarding relationships among Suppliers and AIs, and between them and SF, but much of this information related to the relationship of each backer with the associated Suppliers and AIs is not supported by any documentary or other independent evidence. As such, some of the information provided is unverified and, particularly as it relates to the nature of the relationships with the backers, is viewed by the IC to be likely unverifiable by it.

**1. Backers to Suppliers and AIs**

As noted above, the Kaitong Report explains the concept of backers of certain Suppliers and AIs. The Kaitong Report in effect supersedes certain of the information previously provided by Management and reported in the Second Interim Report (Part V.C.18(b)) concerning AIs and their supporters (then referred to as AI Holdcos or conglomerate).

The Kaitong Report states that all backers to Suppliers and AIs have strong business networks and good relations with various levels of the identified Chinese governments but does not explain the nature of the connections. The Kaitong Report stresses the importance of "Guanxi" in Chinese business, but is not specific as to particular benefits and why these particular relationships are important. The Kaitong Report contains little information to validate the political or business connections of such backers, or the nature of the relationship between the backers and the Suppliers or AIs. There is no documentary evidence of the nature of their support for their respective Suppliers or AIs nor the consideration (if any) received by the backers for their support of the Suppliers or AIs. The Kaitong Report suggests that such backers may provide resources that are important in China such as introductions, endorsements and connections.

As described in Schedule II, the IC Advisors conducted a review of the emails of twenty-three custodians using keyword searches related to the backers.

The documents identified by the IC Advisors from such review as being of potential interest showed no direct communication between backers and SF personnel. No additional substantive information was obtained from such email review or the interactions between the IC Advisors and Kaitong and management either on the relationships between SF and the backers or the roles and involvement of the backers in the business dealings between SF and the AIs and Suppliers. Management has advised that, while they were aware of certain backers of the AIs and Suppliers, the backers were not directly involved in the interactions with the Company. This appears to be borne out by the key word searches.

The SAIC information reviewed by the IC Advisors indicated one connection between an identified backer and an associated Supplier and the Kaitong Report indicates another between a backer and one of his associated Suppliers.

As described below, certain of the persons identified as backers of AIs were interviewed prior to the Second Interim Report and, in some cases, acknowledged an association with the AI for which the Kaitong Report identified them as its backer.

Given the general lack of information on the backers or the nature and scope of the relationships between the Suppliers or AIs and their respective backers and the absence of any documentary support or independent evidence of such relationships, the IC has been unable to reach any conclusion as to the existence, nature or importance of such relationships. As a result, the IC is unable to assess the implications, if any, of these backers with respect to SF's relationships with its Suppliers or AIs. Based on its experience to date, including interviews with Suppliers and AIs involving persons who have now been identified as backers in the Kaitong Report, the IC believes that it would be very difficult for the IC Advisors to arrange interviews with either the AIs or Suppliers or their respective backers and, if arranged, that such interviews would yield very little, if any, verifiable information to such advisors. The IC understands Management is continuing to seek meetings with its AIs and Suppliers with the objective of obtaining information, to the extent such is available, that will provide further background to the relationships to the Audit Committee.

(a) New Suppliers

The Kaitong Report also addresses the observation in the Second Interim Report that several new Suppliers have appeared since 2009 and completed very large transactions with SF. The Kaitong Report states that Management advised that the main reason to have new Suppliers is that as the Company expands its business into new geographic regions, it needs Suppliers established in each such region. In addition, the Company would also like to balance the transactions among Suppliers so as to reduce dependency risk on certain Suppliers. Supplier #21 is named as one such Supplier. This Supplier has the same backer (Backer #24<sup>1</sup>) and one similar shareholder (Shareholder #12 as to 70%) as the earlier supplier, Supplier #2, where Shareholder #12 is shown in SAIC filings as a 20% shareholder. This particular new Supplier is supplying in Sichuan Province, a relatively new area for SF.

(b) Backers to AIs

The Kaitong Report states that from 2006 to 2011 Sino-Forest sold timber to a total of 13 AIs and of these, 6 are supported by four backers. These backers are Backer #5, Backer #7, and Backer #3<sup>2</sup>, Backer #2 and Backer #8. The Kaitong Report states that it is not known if the remaining 7 AIs have backers.

The IC Advisors have interviewed Backer #5, Backer #3 and Backer #2 prior to production of the Kaitong Report as former Management had identified them as associated with certain corporate entities then referred to as AI Holdcos or

---

<sup>1</sup> For the purposes of this report, certain persons or entities that were labelled as "Shareholder" in the Second Interim Report are referred to as "Backer" in this Final Report. The numeric portion of the assigned name of such persons or entities remains the same where previously referred to in the Second Interim Report.

<sup>2</sup> Formerly referred to as AI-Supplier Contact #3

conglomerates. All confirmed their associations with the relevant AIs , but did not produce any documentation verifying such association.

## 2. Suppliers and AIs with Former SF Personnel

The Appendices to the Kaitong Report list the Suppliers with former SF personnel as current shareholders. According to the information previously obtained by the IC Advisors, the identification of former SF personnel indicated in the Kaitong Report to be current shareholders of past or current Suppliers is correct.

### (a) Suppliers with former SF personnel

The Kaitong Report, which is limited to examining Suppliers where ex-SF employees are current shareholders as shown in SAIC filings, does not provide material new information concerning Suppliers where former SF employees were identified by the IC in the Second Interim Report as having various past or present connections to current or former Suppliers except that the Kaitong Report provides an explanation of two transactions identified in the Second Interim Report. These involved purchases of standing timber by SF from Suppliers controlled by persons who were employees of SF at the time of these transactions. Neither of the Suppliers have been related to an identified backer in the Kaitong Report. The explanations are similar indicating that neither of the SF employees was an officer in charge of plantation purchases or one of SF's senior management at the time of the transactions. The employees in question were Shareholder #14 in relation to a RMB 49 million purchase from Supplier #18 in December 2007 (shown in SAIC filings to be 100% owned by him) and Shareholder #20 in relation to a RMB 3.3 million purchase from Supplier #23 (shown in SAIC filings to be 70% owned by him) in October 2007. The Kaitong Report indicates Shareholder #20 is a current employee of SF who then had responsibilities in SF's wood board production business.

The IC is not aware that the employees' ownership positions were brought to the attention of the Board at the time of the transactions or, subsequently, until the publication of the Second Interim Report and understands the Audit Committee will consider such information.

### (b) AIs with former SF personnel

The Kaitong Report indicates that no SF employees are listed in SAIC filing reports as current shareholders of AIs. Except as noted herein, the IC agrees with this statement. The Kaitong Report does not address the apparent role of an ex-employee Officer #3 who was introduced to the IC as the person in charge of AI #2 by Backer #5 of AI Conglomerate #1. Backer #5 is identified in the Kaitong Report as a backer of two AIs, including AI#2. (The Kaitong Report properly does not include AI #14, as an AI for this purpose, whose 100% shareholder is former SF employee Officer #3. However, the IC is satisfied that the activities of this entity primarily relate to certain onshoring transactions that facilitated the transfer of SF BVI timber assets to SF WFOE subsidiaries.)

There was one other instance where a past shareholding relationship has been identified between an AI #10 and persons who were previously or are still shown on the SF human

resources records, Shareholder #26 and Shareholder #27. Management has explained that such entity sold wood board processing and other assets to SF and that the persons associated with that company consulted with SF after such sale in relation to the purchased wood board processing assets. Such entity subsequently also undertook material timber purchases as an AI of SF in 2007-2008 over a time period in which such persons are shown as shareholders of such AI in the SAIC filing reviewed (as to 47.5% for Shareholder #26 and as to 52.5% for Shareholder #27). That time period also intersects the time that Liu Zhiwei is shown in such human resources records and partially intersects the time that Shareholder #27 is shown on such records. Management has also explained that Shareholder #26 subsequent to the time of such AI sales became an employee of a SF wood board processing subsidiary. Management has provided certain documentary evidence of its explanations. The IC understands that the Audit Committee will consider this matter.

**3. Common Shareholders between Supplier and AIs**

The Kaitong Report states that there are 5 Suppliers and 3 AIs that respectively have certain common current shareholders but also states that there is no cross control by those current shareholders of such Suppliers or AIs based on SAIC filings. The Kaitong Report correctly addresses current cross shareholdings in Suppliers and AIs based on SAIC filings but does not address certain other shareholdings. With the exception of one situation of cross control in the past, the IC has not identified a circumstance in the SAIC filings reviewed where the same person controlled a Supplier at the time it controlled a different AI. The one exception is that from April 2002 to February 2006, AI #13 is shown in SAIC filings as the 90% shareholder of Supplier/AI #14. AI #13 did business with SF BVIs from 2005 through 2007 and Supplier/AI #14 supplied SF BVIs from 2004 through 2006. However, the IC to date has only identified one contract involving timber bought from Supplier/AI #14 that was subsequently sold to AI #13. It involved a parcel of 2,379 Ha. timber sold to AI #13 in December 2005 that originated from a larger timber purchase contract with Supplier/AI #14 earlier that year. Management has provided an explanation for this transaction. The IC understands that the Audit Committee will consider this matter.

**4. Transactions involving Suppliers and AIs with Current Shareholders in Common**

The Kaitong Report states that where SF has had transactions with 5 Suppliers and 3 AIs that have current shareholders in common (but no one controlling shareholder) as shown in SAIC filings, the subject timber in the transactions they each undertook with SF is not the same; that is, the timber which SF buys from the Suppliers and the timber which SF sells to the AIs where the Supplier and AI have a current common shareholder were located in different areas and do not involve the same plots of timber. The Kaitong Report further states that where SF has had transactions with 5 Suppliers and 3 AIs with current shareholders in common as shown in SAIC filings, SF had transactions with those AIs prior to having transactions with those Suppliers, thus SF was not overstating its transactions by buying and selling to the same counterparties.

Other than the immaterial timber parcel transaction referred to in Section II.B.3 above, which is a 2005 transaction, the IC believes that the Kaitong Report is accurate in respect of the specific transactions cited by it, except that it could not independently confirm the

information reported for sales from Suppliers with cross minority interests to AI #3 of timber parcels in Jiangxi Province due to the absence of detailed location information in the sales contracts.

The Kaitong Report does not specifically address historical situations involving common shareholders and potential other interconnections between AIs and Suppliers that may appear as a result of the identification of backers. There is generally no ownership connection shown in SAIC filings between backers and the Suppliers and AIs associated with such backers in the Kaitong Report.

The Second Interim Report indicated some potential connections between shareholders of Supplier #3 and two AIs that Management then associated with an entity called AI Conglomerate #1. No direct ownership was indicated between such AIs and AI Conglomerate #1 based on the SAIC filings reviewed, although the Kaitong Report indicates that the current owner of AI Conglomerate #1 is a backer of such AIs. The IC is also now satisfied that based on various corporate filings, there is no current cross ownership between AI Conglomerate #1 and Supplier #3. Further, the IC believes, based on its review of the timber purchase contracts between Supplier #3 and SF and the timber sales contracts between SF and AIs backed by the owner of AI Conglomerate #1 that there were no purchases and sales of the same timber with those parties during any period for which the IC believe there may have been cross ownership between shareholders of Supplier #3 and shareholders of AI Conglomerate #1 (or the two AIs). Further, Management has also provided the IC information suggesting that no proceeds from any sales to those AIs were redeployed to purchase timber from Supplier #3 or entities known to be controlled by its shareholder, Shareholder #3.

The IC notes that there were significant set-off payments from such AIs to Supplier #3 (approximately RMB 1.04 billion). Given Supplier #3 is a major Supplier and such AIs are major AIs, this is consistent with the BVI business model.

### III. TIMBER ASSET PROOF OF CONCEPT

#### A. **Background**

The Second Interim Report discussed the absence of maps in documentation for BVI timber purchase transactions. In response to these concerns, Management provided information regarding various issues regarding the due diligence conducted prior to entering into a BVI timber purchase contract, including maps which in the case of timber purchases were provided through forestry bureaus.

Management also provided copies of news articles regarding foreigners being subject to criminal sanctions in China for possessing maps and other geographical information that were deemed to be classified as state secrets. The IC has reviewed these responses from Management and was unable to verify all of Management's assertions regarding forestry maps or that forestry mapping information would be regarded as subject to such sanctions but recognizes that this is an area of the law in China where a conservative approach may be prudent.

In mid December 2011, Management provided a document entitled “Detailed Description of Locating Forestry Resources in China” which explains how the locations of BVI standing timber assets are determined. This document has been provided to the Board.

It indicates that although certain types of stand maps and these land descriptions are available as part of PRCs, maps are not readily available for continuing possession by persons trading in standing timber without a lease as is the case of the transactions by SF’s BVI model. Management indicates that such maps usually can be borrowed from forestry bureaus (but not retained) and are used by the survey companies as part of the Company’s due diligence. Management believes the ability of a foreign company to retain such maps is unclear and has adopted a cautious approach to this issue. The advice received by the IC from independent forestry experts is that this practice is not inconsistent with the practice of other parties in China who buy and sell standing timber without leasing the underlying land.

**B. Independent Review by Forestry Experts**

**(i) Background**

The IC requested that a sample proof of concept exercise be undertaken by an independent forestry expert to determine if the specified areas of forest in a particular BVI purchase contract could be located and quantified by such party.

The IC determined that it was appropriate to use two forestry companies that were also being retained by the Company in connection with its restructuring and the valuation process associated therewith. These two independent forestry experts were Indufor Asia Pacific Limited (“Indufor”) and Stewart Murray (Singapore) Pte. Ltd. (“Stewart Murray”). Members of the IC were involved in that retainer process. These entities had been retained through BJ for such valuation process and the report they provided was a report to BJ from Indufor on the work done by Indufor and Stewart Murray (collectively, the “Forestry Experts” and their report dated January 27, 2012, the “Forest Report”). The Forest Report has been delivered to the Board. The Forest Report describes the proof of concept asset verification process undertaken to determine if the net stocked area of two forest compartments purchased under two specific SF BVI timber purchase contracts could be verified.

The importance of such a “proof of concept” engagement is that it confirms the technology, methodology and reporting framework that can be used for the wider area verification of the SF estate, subject to access to maps meeting the standards described below.

**(ii) Summary**

As part of the proof of concept process and based upon information from SF, including maps that SF indicated were borrowed by SF’s contract survey company from the relevant forestry bureaus, the Forestry Experts were then able to locate the two compartments in question and to relate them to the specific contracts. They measured the net stocked area of forest cover in the two compartments compared to the net stocked area for those compartments described in the survey attached to the contracts. Indufor reported that the actual net stocked area of the two selected compartments fell within six percent of the net stocked area recorded for those within the contract documents.

The analysis and findings of the report are limited solely to the two compartments described therein. Indufor states that no extrapolation of findings to the wider SF estate is possible or is implied.

(iii) The Process and Detailed Findings

The IC selected two compartments from ten possible compartment options suggested by the Forestry Experts.

The Forest Report indicates that the ten forest compartment options put forward to the IC met criteria requiring that the compartments:

1. were impartially selected by Indufor and Stewart Murray for the IC and not selected by SF;
2. were part of the SF purchased timber plantations located in Yunnan province of China;
3. were listed as being held by BVI entities and not by WFOE entities, and;
4. should cover multiple county forestry bureaus. It was the IC's intention to select compartments that were in different county forestry bureau jurisdictions.

The IC selected the following two compartments for the area verification process:

1. Purchase Contract STP-SUW-0409 dated January 7, 2011 and Survey Report STP-SUW-0409 dated 27 December 2010. Compartment 11. Located in Jianchuan county, near the township of Ma-teng. Jurisdiction of the Jianchuan County Forestry Bureau, with a stated area of 1145 mu (being 76.3 hectares).
2. Purchase Contract STP-SUW-0411 dated January 14, 2011 and Survey Report STP-SUW-0411 dated 5 January 2011. Compartment 44. Located in Heqing county, near the township of Beiya. Jurisdiction of the Heqing County Forestry Bureau, with a stated area of 957 mu (being 63.8 hectares).

The Forest Report summarizes the results of the proof of concept process as follows:

1. maps of the two compartments were provided by SF to Indufor, which SF indicated were borrowed by the contracted survey company from forestry bureaus;
2. the two maps clearly showed the extent of each compartment's boundary that corresponded to those in Surveys related to the contracts;
3. each compartment's boundary was able to be spatially located (geo-referenced) for use within a Geographic Information System;
4. the Forestry Experts located and physically visited the two forest compartments;
5. the use of recent high resolution satellite images allowed the removal of gaps and areas of unstocked forest from the calculation of each compartment's net stocked area;
6. the net stocked area calculated by the verification process for the two compartments slightly exceeded that stated in the forest survey reports attached to the SF purchase contracts for the compartments; and

7. it is important to reemphasise that no extrapolation of the area verification findings to the wider SF estate is possible.

The Forestry Experts utilized the maps as described above but were not permitted to retain them. Indufor has advised the IC that did not present any material issues to its process or conclusions. They confirm that the compartments were forested, but did not undertake an assessment of standing timber volume.

The Forestry Experts used the combined results of the field observations and satellite imagery to assess the net stocked area for each of the two forest compartments. Net stocked area is forested area and excludes any unstocked forest gaps. The following table compares the SF purchase contract areas and the net stocked area mapped by the Forestry Experts using remote sensing processes.

**Table 1: Net Stocked Area Comparison of Purchase Contract vs. Assessed Area**

Identification Reference	Purchase Contract Area (Ha.)	Assessed Area (Ha.)	Difference (Ha.)	Difference (%)
Compartment 11	76.3	80.5	4.2	+5.5%
Compartment 44	63.8	66.5	2.7	+4.2%

The exercise did prove the concept that was presented for testing – subject to the provision of adequate maps, it was possible to use a combination of remote sensing and ground inspection to assess the net stocked area. The Forestry Experts reported that it should indeed be possible for the Company to use the same technology, process and methodology as demonstrated in the Forest Report to verify the area and land cover status of its entire forest estate. The Forestry Experts observed and emphasised that the viability of such a large scale area verification exercise is critically dependent on having access to maps that meet certain standards, these being:

1. that the maps are provided in a format that is readily usable and reliable, be that in a high quality digital or paper format;
2. the maps are already geo-referenced, or can be readily and reliably geo-referenced; and
3. the maps clearly show the boundaries of each forest compartment or collection of forest compartments.

The Forestry Experts observed that the availability of maps meeting such specifications described above should enable an efficient area verification process of the wider SF estate to be undertaken. Forest compartment maps that did not meet such specifications would prevent their area from being verified.

The Forestry Experts therefore concluded that a large scale area verification exercise has to follow the sequence outlined below:

1. digital geo-referenced maps are combined with satellite images.
2. the locations of the necessary field sample sites are identified.
3. field sample sites are visited and the forest ground cover data are recorded.

4. the forest cover data are combined with the satellite images and the resulting net stocked area of each forest compartment can be measured.

The concept of testing a sample of BVI purchase contracts and survey information by forestry experts was discussed among the IC and counsel to the IC, although the design and testing of the proof of concept that was undertaken was a matter determined by the Forestry Experts within the parameters for selection of the two test areas determined by the IC.

The IC Advisors were not involved in the preparation of the Forest Report although such report was made available to them in order to assist counsel in advising the IC in the preparation of the Final Report.

#### IV. ASSET VERIFICATION

The Company's counsel has engaged Stewart Murray to assist the Company in compiling a full forest description and implementing a forest asset valuation framework as at December 31, 2011. This will enable Management to give its opinion and guidance as to the fair market value of the Company's forest assets to the Board. Stewart Murray will identify and report to the Board on the sources of data (and any assumptions therein) that are incorporated within the Company's forest description, including assigning and reporting the levels of confidence that surround key assumptions. This engagement is expected to expand to include a verification and validation process of the key components that underpin forest value involving both Stewart Murray and Indufor. The exercise will involve a highly structured process that will, over time, systematically assess the area of forest cover and merchantable volume across the SF estate. Members of the IC were involved in determining the scope and parameters of the engagement of Stewart Murray. The IC Advisors were not directly involved in the retainer process of such experts.

#### V. ONTARIO SECURITIES COMMISSION

The OSC sought extensive information from the IC in letters dated December 7, 2011 (7 pages) and December 22, 2011 (29 pages), much of which was information properly sought from the Company.

The IC advised the OSC on January 4, 2012 that it would respond to their extensive inquiries.

The IC has responded to the December 7<sup>th</sup> letter and a response to the December 22<sup>nd</sup> letter, which also requires input from the Company, is expected to be completed within a reasonable period of time after the completion of this report.

#### VI. OUTSTANDING MATTERS

As noted in Section I above, the IC understands that with the delivery of this report, its examination and review activities are terminated. The IC would expect its next steps may include only:

- (a) assisting in responses to regulators and RCMP as required; and
- (b) such other specific activities as it may deem advisable or the Board may instruct.

## GLOSSARY

“\$” means, unless otherwise specified, U.S. dollars;

“**2010 AIF**” or “**b**” means the Company’s annual information form for the year ending December 31, 2010;

“**2010 Financial Statements**” means the Company’s audited consolidated financial statements and the notes thereto as at and for the year ended December 31, 2010;

“**2010 MD&A**” means the Company’s management discussion and analysis for the year ending December 31, 2010;

“**AI**” means an authorized intermediary, an entity through which a BVI conducts its sales;

“**AI HoldCo**” means AI Conglomerate #1;

“**Audit Committee**” means the Audit Committee of the Board;

“**BJ**” means Bennett Jones LLP, Canadian counsel to the Company;

“**Board**” means the Board of Directors of SF;

“**BVI**” means a subsidiary of the Company incorporated in the British Virgin Islands;

“**China**” means The People’s Republic of China;

“**Chop**” means the seal typically used in place of signatures in China;

“**Company**” or “**SF**” or “**Sino-Forest**” means Sino-Forest Corporation and, where the context requires, its consolidated subsidiaries;

“**CTO**” means the cease trade order of the OSC dated August 26, 2010;

“**E&Y**” means Ernst & Young LLP, the auditor of the Company;

“**Executive Summary**” means the executive summary of the Second Interim Report, attached hereto as Schedule II;

“**Final Report**” means the final report of the IC to the Board dated January 31, 2012;

“**Forest Report**” the report of the Forestry Experts dated January 27, 2012 referred to in Section IIIB(i);

“**forestry bureau confirmations**” or “**confirmations**” means documents issued to the WFOEs and BVIs on letterheads with forestry bureau names and featuring Chops (the seal typically used in place of signatures) that indicate that they had been issued by the corresponding forestry bureau, but does not include new confirmations;

“**Forestry Experts**” means, collectively, Indufor and Stewart Murray;

“**FTI**” means FTI Consulting, a consulting firm advising the Company;

“**GAAP**” means the generally accepted accounting principles as set out in the Canadian Institute of Chartered Accountants Handbook – Accounting as applicable to public companies in Canada;

“**Ha.**” means hectares, which is equivalent to 15 mu (statements of Ha. herein are approximate, given the rounding associated with the conversion of mu to Ha.);

“**IC**” means the Independent Committee to the Board;

“**IC Advisors**” means one or more of PwC, Osler, Mallesons and JH;

“**IMET**” means an Integrated Market Enforcement Team of the RCMP;

“**Indufor**” means Indufor Asia Pacific Limited;

“**JH**” or “**Chinese counsel**” means Jun He Law Offices, independent Chinese IC counsel;

“**Kaitong**” means a Chinese law firm retained by the Company;

“**Kaitong Report**” means the report of Kaitong dated January 20, 2012 regarding certain relationship issues;

“**Mallesons**” means Mallesons Stephen Jaques, independent Hong Kong counsel to the IC;

“**Management**” means, at any time, the management of SF at that time;

“**Mandra**” means Mandra Forestry Holdings Limited, a wholly-owned subsidiary of SF;

“**MD&A**” means management discussion and analysis;

“**mu**” means a Chinese unit of measure for area, which is equivalent to 0.067 Ha.;

“**Muddy Waters**” or “**MW**” means Muddy Waters, L.L.C.;

“**MW Report**” means the initial “research report” issued by Muddy Waters dated June 2, 2011;

“**OSC**” means Ontario Securities Commission;

“**Osler**” means Osler, Hoskin & Harcourt LLP, independent Canadian counsel to the IC;

“**Plantation Rights Certificate**” or “**PRC**” means a governmental registered certification of ownership issued by a forestry bureau in China to evidence certain forestry-related rights;

“**PwC**” means PricewaterhouseCoopers LLP, forensic accounting advisors to the IC;

“**RCMP**” means Royal Canadian Mounted Police;

“**RMB**” means Renminbi, the official currency of China;

“SAIC” means China’s State Administration for Industry and Commerce, the national authority responsible for administering industry and commerce;

“Second Interim Report” means the second interim report of the IC to the Board dated November 13, 2011;

“Stewart Murray” means Stewart Murray (Singapore) Pte Ltd.;

“Supplier” means a supplier to the Company of plantation assets, either rights to standing timber or plantation/land use rights or both;

“Survey Report” means a Forest Resource Survey Report that accompanies BVI timber purchase contracts;

“SW” means Sino-Wood Partners, Limited, a Hong Kong incorporated subsidiary of SF;

“WFOE” means a subsidiary of the Company incorporated in China as a “Wholly Foreign Owned Enterprise”; and

“Yuda Wood” or “Yuda” means Huaihua City Yuda Wood Co. Ltd, a Supplier.

**SCHEDULE I**  
**SECOND INTERIM REPORT - EXECUTIVE SUMMARY**

**A. Introduction**

The IC was established by the Board on June 2, 2011, immediately following the release by Muddy Waters of the MW Report regarding SF. The members of the IC are William Ardell (Chair), James Bowland, and James Hyde. At the invitation of the IC, Mr. Garry West, an independent director of SF, attends virtually all IC meetings and participates in its process. Following the delivery to the Board of the IC's draft of this Second Interim Report on November 3, 2011, Mr. James Bowland resigned as a director and therefore from the IC. The mandate of the IC, in general terms, is to independently examine and review the serious and wide-ranging allegations made in the MW Report and report back to and, if appropriate, make recommendations to the Board. To date, the IC has met approximately 48 times.

The IC Advisors' role is to support the IC in its mandate to review the allegations made in the MW Report and related matters. The IC Advisors have conducted various investigative and review processes, all at the direction of, and subject to such scope limitations as the IC, in its judgment, deemed appropriate. (See Part IV.) This Second Interim Report to the Board, while based on the work of such advisors, is the report of the IC and (other than Schedule IV) not the report of the IC Advisors.

The IC's First Interim Report to the Board dated August 10, 2011 outlined the nature and scope of the IC's activities (principally data collection) to that date and the planned next steps. The purpose of this Second Interim Report is to report to the Board on the activities undertaken by the IC since mid-August, the outcomes and findings from such activities and further next steps. The First Interim Report is attached as Schedule I.A.

While the MW Report took a scatter gun approach in its allegations, the IC determined to address the issues raised in three core areas: (i) timber asset verification; (ii) timber asset value; and (iii) revenue recognition. Overlaying the latter two areas are the issues raised by the MW allegations relating to related party transactions. The IC also determined to focus on the years 2006 to 2010. Using this framework for its review, the IC's focus since its last report has been principally on:

- the ownership structure of timber assets on SF's balance sheet;
- verifying the Company's holdings of standing timber ("purchased plantations" as referred to in the 2010 AIF) and plantation land use/lease rights ("planted plantations" as referred to in the 2010 AIF, though some plantation land use/lease rights, such as the Mandra holdings, are classified as "purchased plantations" in the 2010 AIF), held through BVIs and WFOEs and the nature of its interests in such assets (see Part V below);
- interviewing Suppliers and AIs with a view to verifying the existence and nature of SF's relationship with such third parties and seeking to obtain financial particulars about purchase and sale transactions between such third parties and SF (see Part VI below); and

- examining and assessing the relationship with Yuda Wood, historically one of the largest Suppliers of standing timber to SF supplying approximately 21.5% of BVI timber purchases from 2008 through 2011 (see Section VI.A below).

The IC's work has also included:

- examining a number of specific situations which are the subject of MW allegations or critical newspaper articles (see e.g. Sections IV.B.6, VI.B and VI.C and Part VII below);
- engaging with and assisting E&Y in its examination of various issues relevant to its reports on the Company's financial statements (see Schedule IV attached);
- responding to questions and requests for documents and information from the OSC, including enquiries made through the Hong Kong securities authorities, in connection with its publicly announced investigation (see Part IX);
- meeting with and responding to requests for information from BJ and FTI;
- conducting interviews of certain members of Management;
- inspecting original versions of documents issued to the WFOEs and BVIs on letterheads with forestry bureau names and featuring Chops (the seal typically used in place of signatures) that indicate that they had been issued by the corresponding forestry bureau (the "forestry bureau confirmations"), and attending meetings with forestry bureaus in an attempt to verify the Company's holdings of standing timber;
- attending interviews of AIs and Suppliers, examining SF employee and other relationships with AIs and Suppliers (see Schedule IV attached); and
- meeting with and responding to requests for information from the RCMP (see Part XI).

In addition to the IC review, the MW Report has spawned various actions by public and private parties. These actions, which have affected the IC's activities and processes, include:

- an OSC investigation of matters related to SF;
- a review by E&Y of various matters relating to its 2010 and prior years' audits;
- three class action lawsuits in Ontario (one of which has a companion action in Quebec) by securities holders against the Company, its officers, E&Y and others;
- a threatened derivative claim against E&Y and certain officers and employees of the Company;

- extensive newspaper and analyst reporting of the Company, including several in-depth investigative reports; and
- an enquiry by the RCMP through IMET.

While the IC believes its work is substantially complete, there remain certain further steps which it intends to undertake as follows:

- review the information and analysis very recently provided by Management intended to respond to certain issues regarding relationships of the Company with AIs and Suppliers and between AIs and Suppliers identified in this Second Interim Report (see Part VI);
- engage an independent valuator (see Part VIII);
- such other steps as the IC, in its judgement, deems advisable in the discharge of its mandate; and
- submit its final report and recommendations to the Board.

The IC expects to be able to deliver its final report to the Board prior to the end of 2011.

## B. Overview of Principal Findings

The following sets out a very high level overview of the IC's principal findings and should be read in conjunction with the balance of this report.

### Timber Ownership

Based on its review and subject to its comments herein, the IC has confirmed to its satisfaction that the Company has:

- registered title to approximately 151,000 Ha. of SW and SP planted plantations and Mandra plantations. This constitutes approximately 17.9% of its timber holdings by area as at December 31, 2010;<sup>1</sup> and
- contractual or other rights to approximately 683,000 Ha. of plantations, being 81.3% of its timber holdings by area as at December 31, 2010 (of these, the Company holds original Plantation Rights Certificates, issued in the name of the Supplier, representing approximately 15,000 Ha., which the IC believes gives the Company a demonstrable chain of title). See Section III.B.

In connection with such confirmation, the IC has reviewed originals or copies of purchase contracts (and the corresponding set-off documentation confirming payment, in the case of the BVI purchased plantations) for the acquisition by the Company of:

- approximately 467,000 Ha. of BVIs purchased plantations;<sup>2</sup>
- approximately 237,000 Ha. of WFOE purchased plantations;<sup>3</sup> and
- approximately 129,000 Ha. of planted plantations<sup>4</sup>

representing approximately 106%<sup>5</sup> of SF's disclosed timber holdings of 788,700 Ha. as at December 31, 2010. With respect to these holdings, the IC has verified to its satisfaction that the Company has registered title:

---

<sup>1</sup> Timber holdings by area as at December 31, 2010 have been calculated by adding approximately 51,000 Ha. of planted plantation land for which the Company has contracts but has yet to classify as plantations under management for the purposes of its annual disclosure, to the Company's disclosed plantation of holdings of 788,700 Ha.

<sup>2</sup> BVI purchased plantations are comprised of standing timber without underlying leases of land use rights.

<sup>3</sup> The Company classifies this as being comprised of all WFOE (SP) standing timber and all Mandra leased plantations. Mandra leased plantations are considered to be "purchased" plantations in the Company's public disclosure because they were acquired through the 2010 acquisition of Mandra.

<sup>4</sup> The Company classifies this as being comprised of all WFOE (SW and SP) leased plantations.

<sup>5</sup> The Company's explanation for this figure being approximately 106% of its disclosed timber holdings as at December 31, 2010 is that the IC reviewed leases for approximately 51,000 Ha. of plantation land which were not included in the disclosed total of planted plantations of 77,700 Ha. as of December 31, 2010, due to a number of reasons, primarily because these lands had not yet been planted.

- via original Plantation Rights Certificates in the Company's name, to approximately 86,000 Ha. of WFOE purchased plantations,<sup>6</sup> and approximately 43,000 Ha. of WFOE planted plantations;<sup>7</sup> and
- via copies of Plantation Rights Certificates in the Company's name, to approximately 9,000 Ha. of WFOE purchased plantations, and approximately 12,000 Ha. of WFOE planted plantations.

In addition, as at December 31, 2010, the IC has determined that the Company has original or copies of forestry bureau confirmations relating to the acquisition of:

- approximately 467,000 Ha. of BVIs purchased plantations;
- approximately 89,000 Ha. of WFOE (SP) purchased plantations; and
- approximately 50,000 Ha. of WFOE (SP only) planted plantations.

The Company does not obtain registered title to BVI purchased plantations. In the case of the BVIs' plantations, the IC has visited forestry bureaus, Suppliers and AIs to seek independent evidence to establish a chain of title or payment transactions to verify such acquisitions. The purchase contracts, set-off arrangement documentation and forestry bureau confirmations constitute the documentary evidence as to the Company's contractual or other rights. The IC has been advised that the Company's rights to such plantations could be open to challenge. However, Management has advised that, to date, it is unaware of any such challenges that have not been resolved with the Suppliers in a manner satisfactory to the Company.

#### **Forestry Bureau Confirmations and Plantation Rights Certificates**

Registered title, through Plantation Rights Certificates is not available in the jurisdictions (i.e. cities and counties) examined by the IC Advisors for standing timber that is held without land use/lease rights. Therefore the Company was not able to obtain Plantation Rights Certificates for its BVIs standing timber assets in those areas. In these circumstances, the Company sought confirmations from the relevant local forestry bureau acknowledging its rights to the standing timber.

The IC Advisors reviewed forestry bureau confirmations for virtually all BVIs assets and non-Mandra WFOE purchased plantations held as at December 31, 2010. The IC Advisors, in meetings organized by Management, met with a sample of forestry bureaus with a view to obtaining verification of the Company's rights to standing timber in those jurisdictions. The result of such meetings to date have concluded with the forestry bureaus or related entities having issued new confirmations as to the Company's contractual rights to the Company in respect of 111,177 Ha. as of December 31, 2010<sup>8</sup> and 133,040 Ha. as of March 31, 2011,<sup>9</sup> and

<sup>6</sup> These 86,000 Ha. of WFOE purchased plantations are composed of approximately 84,000 Ha. of leases under Mandra and approximately 2,000 Ha. of standing timber under SP.

<sup>7</sup> These 43,000 Ha. of WFOE planted plantations are composed approximately of 31,000 Ha. of leases under SW and approximately 12,000 Ha. of leases under SP.

<sup>8</sup> Composed of 106,446 Ha. of BVI plantations and 4,731 Ha. of WFOE planted plantations, of which 60,707 Ha. were confirmed in the Hunan Forestry Entity Confirmation. This amount is, however, different from the total 60,696 Ha. shown on the confirmation, which appears to arise from an addition error.

have acknowledged the issuance of existing confirmations issued to the Company as to certain rights, among other things, in respect of 113,058 Ha. as of December 31, 2010.<sup>10</sup>

Forestry bureau confirmations are not officially recognized documents and are not issued pursuant to a legislative mandate or, to the knowledge of the IC, a published policy. It appears they were issued at the request of the Company or its Suppliers. The confirmations are not title documents, in the Western sense of that term, although the IC believes they should be viewed as comfort indicating the relevant forestry bureau does not dispute SF's claims to the standing timber to which they relate and might provide comfort in case of disputes. The purchase contracts are the primary evidence of the Company's interest in timber assets.

In the meetings with forestry bureaus, the IC Advisors did not obtain significant insight into the internal authorization or diligence processes undertaken by the forestry bureaus in issuing confirmations and, as reflected elsewhere in this report, the IC did not have visibility into or complete comfort regarding the methods by which those confirmations were obtained. It should be noted that several Suppliers observed that SF was more demanding than other buyers in requiring forestry bureau confirmations.

#### **Book Value of Timber**

Based on its review to date, the IC is satisfied that the book value of the BVIs timber assets of \$2.476 billion reflected on its 2010 Financial Statements and of SP WFOE standing timber assets of \$298.6 million reflected in its 2010 Financial Statements reflects the purchase prices for such assets as set out in the BVIs and WFOE standing timber purchase contracts reviewed by the IC Advisors. Further, the purchase prices for such BVIs timber assets have been reconciled to the Company's financial statements based on set-off documentation relating to such contracts that were reviewed by the IC. However, these comments are also subject to the conclusions set out above under "Timber Ownership" on title and other rights to plantation assets.

The IC Advisors reviewed documentation acknowledging the execution of the set-off arrangements between Suppliers, the Company and AIs for the 2006-2010 period. However, the IC Advisors were unable to review any documentation of AIs or Suppliers which independently verified movements of cash in connection with such set-off arrangements between Suppliers, the Company and the AIs used to settle purchase prices paid to Suppliers by AIs on behalf of SF. We note also that the independent valuation referred to in Part VIII below has not yet been completed.

#### **Revenue Reconciliation**

As reported in its First Interim Report, the IC has reconciled reported 2010 total revenue to the sales prices in BVIs timber sales contracts, together with macro customer level data from other businesses. However, the IC was unable to review any documentation of AIs or Suppliers which independently verified movements of cash in connection with set-off

<sup>9</sup> Composed of 128,309 Ha. of BVI plantations and 4,731 Ha. of WFOE planted plantations, of which 60,707 Ha. were confirmed in the Hunan Forestry Entity Confirmation. This amount is however different from the total hectare of 60,696 shown on the confirmation, which appears to arise from an addition error.

<sup>10</sup> Composed of 90,905 Ha. of BVI plantations and 22,153 Ha. of WFOE planted plantations.

arrangements used to settle purchase prices paid, or sale proceeds received by, or on behalf of SF.

### Relationships

- Yuda Wood: The IC is satisfied that Mr. Huang Ran is not currently an employee of the Company and that Yuda Wood is not a subsidiary of the Company. However, there is evidence suggesting close cooperation (including administrative assistance, possible payment of capital at the time of establishment, joint control of certain of Yuda Wood's RMB bank accounts and the numerous emails indicating coordination of funding and other business activities). Management has explained these arrangements were mechanisms that allowed the Company to monitor its interest in the timber transactions. Further, Huang Ran (a Yuda Wood employee) has an ownership and/or directorship in a number of Suppliers (See Section VI.B). The IC Advisors have been introduced to persons identified as influential backers of Yuda Wood but were unable to determine the relationships, if any, of such persons with Yuda Wood, the Company or other Suppliers or AIs. Management explanations of a number of Yuda Wood-related emails and answers to E&Y's questions are being reviewed by the IC and may not be capable of independent verification.
- Other: The IC's review has identified other situations which require further review. These situations suggest that the Company may have close relationships with certain Suppliers, and certain Suppliers and AIs may have cross-ownership and other relationships with each other. The IC notes that in the interviews conducted by the IC with selected AIs and Suppliers, all such parties represented that they were independent of SF. Management has very recently provided information and analysis intended to explain these situations. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board. Some of such information and explanations may not be capable of independent verification.
- Accounting Considerations: To the extent that any of SF's purchase and sale transactions are with related parties for accounting purposes, the value of these transactions as recorded on the books and records of the Company may be impacted.

### Cash

As reported in the IC's First Interim Report, as a precautionary measure, the IC requested that PwC confirm SF's cash balances. PwC did this as of June 13, 2011 for both China accounts and "offshore" accounts. A total of 293 accounts controlled by SF in Hong Kong were confirmed, representing 100% of the expected cash position. There are a very significant number of accounts held by SF in China (in excess of 260) and the logistics and requirements of in-person/in-branch verification in that country led the IC to confirm only a portion of the China accounts (28 accounts, representing approximately 81% of the expected China cash position). The IC was satisfied that SF's expected cash position existed as at the date of the confirmation. The Board should be aware that at the time of the cash confirmation process, SF only updated the details of its cash position quarterly, so the confirmation results must be considered in that context. The IC has instituted certain additional controls over cash

movements in excess of \$1 million held in SF Hong Kong bank accounts in order to provide the IC with some precautionary comfort during the examination process. Further, Management has advised that cash balances are now updated on a more frequent basis. See Part XII.

**BVI Structure**

The BVI structure used by SF to purchase and sell standing timber assets could be challenged by the relevant Chinese authorities as the undertaking of “business activities” within China by foreign companies, which may only be undertaken by entities established within China with the requisite approvals. However, there is no clear definition of what constitutes “business activities” under Chinese law and there are different views among the IC’s Chinese counsel and the Company’s Chinese counsel as to whether the purchase and sale of timber in China as undertaken by the BVIs could be considered to constitute “business activities” within China. In the event that the relevant Chinese authorities consider the BVIs to be undertaking “business activities” within China, they may be required to cease such activities and could be subject to other regulatory action. As regularization of foreign businesses in China is an ongoing process, the government has in the past tended to allow foreign companies time to restructure their operations in accordance with regulatory requirements (the cost of which is uncertain), rather than enforcing the laws strictly and imposing penalties without notice. See Section II.B.2.

### C. Challenges

Throughout its process, the IC has encountered numerous challenges in its attempts to implement a robust independent process which would yield reliable results. Among those challenges are the following:

(a) Chinese Legal Regime for Forestry:

- national laws and policies appear not yet to be implemented at all local levels;
- in practice, none of the local jurisdictions tested in which BVIs hold standing timber appears to have instituted a government registry and documentation system for the ownership of standing timber as distinct from a government registry system for the ownership of plantation land use rights;
- the registration of plantation land use rights, the issue of Plantation Rights Certificates and the establishment of registries, is incomplete in some jurisdictions based on the information available to the IC;
- as a result, title to standing timber, when not held in conjunction with a land use right, cannot be definitively proven by reference to a government maintained register; and
- Sino-Forest has requested confirmations from forestry bureaus of its acquisition of timber holdings (excluding land leases) as additional evidence of ownership. Certain forestry bureaus and Suppliers have indicated the confirmation was beyond the typical diligence practice in China for acquisition of timber holdings.

(b) Obtaining Information from Third Parties: For a variety of reasons, all of them outside the control of the IC, it is very difficult to obtain information from third parties in China. These reasons include the following:

- many of the third parties from whom the IC wanted information (e.g., AIs, Suppliers and forestry bureaus) are not compellable by the Company or Canadian legal processes;
- third parties appeared to have concerns relating to disclosure of information regarding their operations that could become public or fall into the hands of Chinese government authorities: many third parties explained their reluctance to provide requested documentation and information as being “for tax reasons” but declined to elaborate; and
- awareness of MW allegations, investigations and information gathering by the OSC and other parties, and court proceedings; while not often explicitly articulated, third parties had an awareness of the controversy

surrounding SF and a reluctance to be associated with any of these allegations or drawn into any of these processes.

(c) Small Management Team: The Company has a very small executive management team and it is stretched by:

- demands from the IC, the OSC and E&Y;
- the placement on administrative leave in late August 2011 of certain members of Management by the Company, based upon the advice of BJ. These employees remained available to assist Management upon request on a supervised basis, which further stretched the remaining management;
- the appointment of a new Chief Executive Officer part way through the IC process; and
- the fact that Management is dispersed among Canada, Hong Kong and various parts of China.

(d) Cultural/Language/Geographic Issues:

- vast majority of operational documents are in Chinese;
- most Asia-based Management employees' first language is Chinese;
- business practices in China and the SF business model:
  - rely heavily on personal relationships; and
  - documentation of contractual arrangements is not as comprehensive as would be typical in Western jurisdictions, is often not done until after the transaction is agreed and is frequently incomplete;
- geographic and time distances for the North American-based teams;
- SF's operations in China are widely and remotely geographically dispersed, a number of plantations are close to sensitive border areas and some are accessible only by overland vehicle travel; and
- public records in China are more limited than in Western jurisdictions and are often not complete, accessible, up to date or accurate.

(e) Corporate Governance/Operational Weaknesses: Management has asserted that business in China is based upon relationships. The IC and the IC Advisors have observed this through their efforts to obtain meetings with forestry bureaus, Suppliers and AIs and their other experience in China. The importance of relationships appears to have resulted in dependence on a relatively small group of Management who are integral to maintaining customer relationships, negotiating and finalizing the purchase and sale of

plantation fibre contracts and the settlement of accounts receivable and accounts payable associated with plantation fibre contracts. This concentration of authority or lack of segregation of duties has been previously disclosed by the Company as a control weakness. As a result and as disclosed in the 2010 MD&A, senior Management in their ongoing evaluation of disclosure controls and procedures and internal controls over financial reporting, recognizing the disclosed weakness, determined that the design and controls were ineffective. The Chairman and Chief Financial Officer provided annual and quarterly certifications of their regulatory filings. Related to this weakness the following challenges presented themselves in the examination by the IC and the IC Advisors:

- operational and administration systems that are generally not sophisticated having regard to the size and complexity of the Company's business and in relation to North American practices; including:
  - incomplete or inadequate record creation and retention practices;
  - contracts not maintained in a central location;
  - significant volumes of data maintained across multiple locations on decentralized servers;
  - data on some servers in China appearing to have been deleted on an irregular basis, and there is no back-up system;
  - no integrated accounting system: accounting data is not maintained on a single, consolidated application, which can require extensive manual procedures to produce reports; and
  - a treasury function that was centralized for certain major financial accounts, but was not actively involved in the control or management of numerous local operations bank accounts;
- no internal audit function although there is evidence the Company has undertaken and continues to assess its disclosure controls and procedures and internal controls over financial reporting using senior Management and independent control consultants;
- SF employees conduct Company affairs from time to time using personal devices and non-corporate email addresses which have been observed to be shared across groups of staff and changed on a periodic and organized basis; this complicated and delayed the examination of email data by the IC Advisors; and
- lack of full cooperation/openness in the ICs examination from certain members of Management.

- (f) Complexity, Lack of Visibility into, and Limitations of BVIs Model: The use of AIs and Suppliers as an essential feature of the BVIs standing timber business model contributes to the lack of visibility into title documentation, cash movements and tax liability since cash settlement in respect of the BVIs standing timber transactions takes place outside of the Company's books.
- (g) Cooperation and openness of the Company's executives throughout the process: From the outset, the IC Advisors sought the full cooperation and support of Allen Chan and the executive management team. Initially, the executive management team appeared ill-prepared to address the IC's concerns in an organized fashion and there was perhaps a degree of culture shock as Management adjusted to the IC Advisors' examination. In any event, significant amounts of material information, particularly with respect to the relationship with Yuda Wood, interrelationships between AIs and/or Suppliers, were not provided to the IC Advisors as requested. In late August 2011 on the instructions of the IC, interviews of Management were conducted by the IC Advisors in which documents evidencing these connections were put to the Management for explanation. As a result of these interviews (which were also attended by BJ) the Company placed certain members of Management on administrative leave upon the advice of Company counsel. At the same time the OSC made allegations in the CTO of Management misconduct.

Following the implementation of these administrative leaves and the subsequent appointment of Judson Martin as the new Chief Executive Officer of the company on August 26, 2011, the cooperation received by the IC Advisors from the Company improved significantly. As a result of Mr. Martin's direction, meetings have been arranged and held with Suppliers, AI's and additional forestry bureaus. In addition, as noted above, very recently, Management presented information regarding AIs and Suppliers and relationships among the Company and such parties. The IC is reviewing this material from Management and intends to report its findings in this regard in its final report to the Board.

- (h) Independence of the IC Process: The cooperation and collaboration of the IC with Management (operating under the direction of the new Chief Executive Officer) and with Company counsel in completing certain aspects of the IC's mandate has been noted by the OSC and by E&Y. Both have questioned the degree of independence of the IC from Management as a result of this interaction. The IC has explained the practical impediments to its work in the context of the distinct business culture (and associated issues of privacy) in the forestry sector in China in which the Company operates. Cooperation of third parties in Hong Kong and China, including employees, depends heavily on relationships and trust. As noted above, the Company's placing certain members of Management on administrative leave, as well as the OSC's allegations in the CTO, further hampered the IC's ability to conduct its process. As a result, the work of the IC was frequently done with the assistance of, or in reliance on, the new Chief Executive Officer and his Management team and Company counsel. Given that Mr. Martin was, in effect, selected by the IC and BJ was appointed in late June 2011, the IC concluded that, while not ideal, this was a practical and appropriate way to proceed in the circumstances. As evidenced by the increased number of

scheduled meetings with forestry bureaus, Suppliers and AIs, and, very recently, the delivery to the IC of information regarding AIs and Suppliers and relationships among the Company and such parties, it is acknowledged that Mr. Martin's involvement in the process has been beneficial. It is also acknowledged that in executing his role and assisting the IC he has had to rely on certain of the members of Management who had been placed on administrative leave.

Privileged & Confidential

**APPENDIX J - PRESS RELEASE (JULY 31, 2012)**

*(See Attached)*



Sino-Forest Corporation

## **Sino-Forest Provides Update on the Status of its Accounts Receivable**

**TORONTO, CANADA – July 31, 2012** – Sino-Forest Corporation ("Sino-Forest" or the "Company") today provided a status update regarding its efforts to collect accounts receivable owing to subsidiaries of the Company.

In support of the Company's March 30, 2012 application under the *Companies' Creditors Arrangement Act* ("CCAA"), Sino-Forest filed an affidavit (the "Initial Affidavit") that, among other things, described the two business models used by the Company to carry on business in the People's Republic of China (the "PRC")<sup>1</sup>. One business model involves the use of subsidiaries incorporated in the British Virgin Islands ("BVI"), and the other involves subsidiaries incorporated in the PRC as a wholly foreign-owned enterprise ("WFOE").

As disclosed in the Initial Affidavit, owing to historic restrictions on foreign companies carrying on business in the PRC, a substantial portion of the Company's business in the PRC has been conducted through "authorized intermediaries" that acted as sales agents for Sino-Forest in the PRC. Under this model, standing timber forestry assets are acquired by Sino-Forest through its subsidiaries incorporated in the BVI. Authorized intermediaries receive payments due to Sino-Forest from the sale of standing timber forestry assets owned by certain of the Company's BVI subsidiaries and, at the Company's direction, make payments to the Company's suppliers on account of other standing timber forestry assets purchased by the Company's BVI subsidiaries. Under these set-off arrangements, no cash flows directly through the Company's BVI subsidiaries.

As disclosed in the Initial Affidavit, after foreign ownership restrictions were relaxed, the Company established WFOE subsidiaries that carry on the forestry business directly in the PRC. Under the WFOE model, WFOEs directly pay suppliers for the purchase of forestry assets and directly receive payment from customers when forestry assets are sold.

The Initial Affidavit discussed difficulties faced by the Company in collecting accounts receivable owing to subsidiaries of the Company. The affidavit reported that Sino-Forest's counsel in the PRC had sent demand letters to 17 entities and that further demand letters were in preparation.

As at March 30, 2012, according to the Company's records, a total of \$79.6 million was owing to WFOE subsidiaries of Sino-Forest, a total of \$887.4 million was owing to BVI subsidiaries of Sino-Forest from authorized intermediaries arising from the sale of standing timber forestry assets and a total of \$126.2 million was owing to other BVI

---

<sup>1</sup> The affidavit is publicly available on the web site of the Company's court-appointed Monitor, FTI Consulting Canada Inc. ("FTI Consulting"), <http://cfcanada.fticonsulting.com/sfc>.

subsidiaries of Sino-Forest from certain PRC and BVI domiciled corporate customers from the sale of imported logs and wood products.

Subsequent to March 30, 2012 the Company has continued efforts through its PRC counsel and otherwise to collect receivables owing to its WFOE subsidiaries and to preserve receivables owing to the Company's BVI subsidiaries held by authorized intermediaries and other PRC and BVI domiciled corporate customers. In taking these steps, the Company has learned that certain of the entities with receivables owing to the Company's subsidiaries have recently deregistered under PRC law. Deregistration has the effect of terminating the existence of the entity.

Of the \$887.4 million the Company's records show as owed to BVI subsidiaries from authorized intermediaries, approximately \$504.8 million is owed by three authorized intermediaries that the Company has learned have been deregistered.

Of the \$126.2 million the Company's records show as owed to other BVI subsidiaries from certain PRC and BVI domiciled corporate customers, approximately \$63.8 million is owed by six PRC corporate customers that Sino-Forest has learned have been deregistered. One of these six companies also is one of the three authorized intermediaries that deregistered.

The Company believes that the deregistrations were improper under PRC law, and that remedies are available to it as a result of the actions taken. The Company intends to take all steps necessary to collect receivables owing to it, and to enforce its rights against persons and entities responsible for the deregistrations. In addition, as part of its efforts to collect receivables, the Company is closely monitoring the registrations and status of its counterparties.

## **Inquiries**

All inquiries regarding the Company's proceedings under the CCAA should be directed to the Monitor, FTI Consulting, via email at: [sfc@fticonsulting.com](mailto:sfc@fticonsulting.com), or telephone: (416) 649-8094. Information about the CCAA proceedings, including copies of all court orders and the Monitor's reports, are available at the Monitor's website <http://cfcanada.fticonsulting.com/sfc>.

This news release contains forward-looking information within the meaning of applicable securities laws ("forward-looking statements"), including forward-looking statements relating to: the Company's belief that the deregistration of certain entities with receivables owing to the Company's subsidiaries was improper under PRC law and the Company's belief that remedies are available to it as a result of the actions taken; the Company's intention to take all steps necessary to collect receivables owing to it and to enforce its rights against persons and entities responsible for the deregistrations; and the Company's intention to closely monitor the registrations and status of its authorized intermediaries and suppliers. The forward looking statements expressed or implied by this news release are subject to important risks and uncertainties. When used in this news release, the words "believes", "intends" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such words. Forward-looking statements are based on estimates and assumptions made by the Company in light of its experience and its perception of historical trends, current conditions and expected future developments, as well as other factors that the Company believes are appropriate in the circumstances. The results or events predicted in these statements may differ materially from actual

results or events and are not guarantees of future performance of Sino-Forest. Factors which could cause results or events to differ from current expectations include, among other things: the interpretation and enforcement of applicable PRC laws and regulations by applicable governmental and regulatory entities in the PRC; actions taken against the Company by governmental agencies and securities and other regulators; actions taken by the Company's noteholders, lenders, creditors, shareholders, and other stakeholders to enforce their rights; the outcome of examinations and proceedings currently underway by law enforcement and securities regulatory authorities; the outcome of class action or other proceedings which have been or may in future be initiated against the Company; the accuracy and outcome of the results of tree asset testing undertaken by the Company; the Company's reliance on key employees; the Company's ability to acquire rights to additional standing timber; the Company's ability to meet its expected plantation yields; the cyclical nature of the forest products industry and price fluctuation in and the demand and supply of logs; the Company's reliance on the relationship with local plantation land owners and/or plantation land use rights holders, authorized intermediaries, key customers, suppliers and third party service providers; the Company's ability to operate its production facilities on a profitable basis; changes in currency exchange rates and interest rates; the evaluation of the Company's provision for income and related taxes; economic, political and social conditions and government policy in China, the Republic of Suriname and New Zealand; and other factors not currently viewed as material that could cause actual results to differ materially from those described in the forwarding-looking statements. Sino-Forest Corporation disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

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

**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**

**ONTARIO**  
**SUPERIOR COURT OF JUSTICE**  
(Commercial List)  
(PROCEEDING COMMENCED AT TORONTO)

**SIXTH REPORT OF THE MONITOR**

**GOWLING LAFLEUR HENDERSON LLP**  
Barristers and Solicitors  
1 First Canadian Place  
100 King Street West, Suite 1600  
Toronto ON M5X 1G5

**Derrick Tay (LSUC No. 21152A)**  
Tel: (416) 369-7330 / Fax: (416) 862-7661  
Email: derrick.tay@gowlings.com

**Jennifer Stam (LSUC No. 46735J)**  
Tel: (416) 862-5697 / Fax: (416) 862-7661  
Email: jennifer.stam@gowlings.com

Lawyers for the Monitor,  
FTI Consulting Canada Inc.