Some Recent Insolvencies in Singapore

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China Aviation Oil *(CAO)*

- PwC appointed by the CAO on the direction of the Stock Exchange of Singapore to investigate CAO's oil trading losses of about USD550 million and to report its findings to SGX.

- TKQP retained by PWC as counsel to advise and assist PWC in the investigation.

Events Leading to CAO's Losses

- CAO took a bearish view of oil prices after 3 Q 2003.
- 4Q 2003 – Marked-to-Market ("MTM") value of CAO's speculative options deteriorated as oil prices rose.
- Options maturing in 1Q 2004 – CAO's view was that if losses were not realized, no requirement to account for losses in its financial statements. This was incorrect.
- First restructuring of options on 26 January 2004.

Restructurings (1)

- Restructuring effected by the purchase of option contracts to close out the loss making options. CAO financed this by selling longer dated options with higher strike prices and volumes which stretched out to 4Q 2005.
- Intent was to achieve zero net cashflow.
- However, MTM value of new options also deteriorated as oil prices continued to rise. Margin calls made against CAO from May 2004 onwards.

Restructurings (2)

- Second restructuring undertaken in June 2004 with same intent of achieving zero net cashflow.
- However, the continued rise in oil prices resulted in a further deterioration of the MTM. Further margin calls were made.
- Third restructuring exercise was undertaken in September 2004.
- CAO eventually ran out of funds to meet the margin calls.

Critical Failures

Critical failures at every tier of CAO's risk control structure:

- Front office
- Middle Office
- Back Office
- Risk Management Committee ("RMC")
- Internal Audit Division ("IAD")
- Managing Director ("MD") and Chief Executive Officer ("CEO")
- Audit Committee ("AC")
- Other Directors

In this presentation, we will look specifically at the IAD, the MD and CEO, the AC and the other Directors.

IAD

IAD *e*xisted in name only and did not make regular reports to the AC. Its reports were repetitive and perfunctory. They were inaccurate in giving the impression that CAO's internal controls were operating satisfactorily.

MD and CEO

Mr Chen Jiulin bore primary responsibility for:

- commencing options trading without understanding precisely what it entailed and without ensuring there was proper and prior evaluation of the risks involved
- committing CAO to imprudent risks in the restructurings
- failing to report CAO's MTM losses in its financial reports
- fostering a culture of secrecy.

Impression of those working with Mr Chen was that he was propelled by a need to surpass past achievements. Evidence suggested that he was motivated to conceal the MTM losses as a matter of personal ambition.

AC

Amongst other things, AC failed to ensure that there was an effective system of internal controls and risk management to identify, evaluate and manage the business risks for speculative trading of options after being told of such activity. AC did not request for regular management reports and monitor periodically CAO's speculative derivatives positions, its financial exposure to such positions and the MTM value of such positions.

Other Directors

Nominee directors on the Board knew or ought to have known of the fact that the CAO was speculating in futures and swaps. They could have learnt of the options trading from information that was publicly available. However, they did not take steps to enforce controls on such trading. This was a serious corporate governance failure.

Rehabilitating CAO

- Application for creditors meeting to be convened to consider Scheme of Arrangement filed in November 2004
- First proposal for repayment announced in January 2005 – 41c to the $ - upfront payment of $100m and repayment of $120m in instalments over 8 years
- Creditors dissatisfied. April 2005 - one creditor petitioned for judicial management (“JM”)
- Hearing of Petition however did not proceed
- May 2005 - CAO proposed revised offer of 54c to the $ - $130 m upfront and $145 m in instalments over 8 years. This was accepted.

Need for Cross Border Insolvency Law

With SGX's push for overseas companies to list in Singapore, the potential for insolvencies with cross border elements has increased dramatically. CAO is one example of a overseas company that listed in Singapore and was subsequently insolvent. Asia Pulp & Paper Co Ltd ("APP") is another. In APP, the need for the law to provide for cross border insolvency elements was amply demonstrated.

Asia Pulp & Paper Co Ltd (APP)

- APP, which was controlled by the Widjaja family,
  - had more than 150 subsidiaries worldwide
  - had debts in excess of US$13 bn as of 2001
  - was the biggest debt defaulter in Asia
  - was the largest debtor in emerging markets
- It made a Debt Standstill Announcement on 12 March 2001 which creditors called “unilateral”
- Deutsche Bank and BNP Paribas petitioned for JM.

In responding to the petition, APP in essence argued that:

- Its operating subsidiaries located in Indonesia and China would ring fence its assets, stop paying APP management fees, enter into separate restructurings
- JM would not be able to discharge their duties to take control of the company's assets outside Singapore
- JM had no rights under Indonesia and Chinese law
- JM could not secure cooperation from the ground
- JM would jeopardize the "cheap" supply of wood from Sinar Mas companies which were associated with the Widjaja family
- JM would not have specialized knowledge
- IBRA, owed US$604 m of debt by the operating subsidiaries, would enforce its security over the assets of the subsidiaries if JM appointed
- Appointment of JM would sound APP's death knell.

- At first instance, High Court of Singapore disallowed the Petition
- Court of Appeal agreed but pointed out the difficulties faced by the JM could not be a permanent barrier to a JM order if the consensual restructuring stalled or questionable transactions continued to be entered into by the APP group.

In both CAO and APP, the JM petitions failed. The CAO restructuring however has been successfully completed whereas the APP restructuring is still ongoing. Much of the success of the CAO restructuring can be credited to CAOHC's commitment to CAO and the restructuring. It is questionable if the same may be said of APP.

The Company Legislation and Regulatory Framework Committee has considered the UNCITRAL Model Law but has decided to adopt a “wait and see” approach. It stated that:

“In the course of our review we have also reviewed developments relating to the UNCITRAL Model Law on Insolvency and would recommend that we await further developments which would indicate how these would impact the insolvency legislation of the major common law jurisdictions.”

THE END

Thank you

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