

**IN THE MATTER OF THE SECURITIES ACT,  
R.S.O. 1990, c. S.5, as amended**

**AND**

**IN THE MATTER OF  
PHILIP SERVICES CORP., ALLEN FRACASSI, PHILIP FRACASSI, MARVIN  
BOUGHTON, GRAHAM HOEY, COLIN SOULE, ROBERT WAXMAN AND JOHN  
WOODCROFT**

**AMENDED  
STATEMENT OF ALLEGATIONS<sup>1</sup>**

Staff of the Ontario Securities Commission ("Staff") make the following allegations:

**I THE RESPONDENTS**

1. Philip Services Corp. ("Philip" or the "Company") was, at all material times, a reporting issuer in Ontario, Alberta, British Columbia, Quebec, Saskatchewan, Nova Scotia and Newfoundland. Philip's common shares were listed for trading on the Toronto Stock Exchange (the "TSE"), the Montreal Exchange and the New York Stock Exchange under the symbol PHV. At all material times, Philip was a corporation amalgamated under the laws of the Province of Ontario, with its head office in the City of Hamilton, in the Province of Ontario. Prior to May, 1997, Philip operated its business under the name of Philip Environmental Inc.
2. Philip was, at all material times, an integrated resource recovery and industrial services company providing metal recovery and processing services to major industry sectors throughout North America. According to Philip's Annual Report (the "Form 10-K"), Philip "was one of North America's leading suppliers of metals recovery and industrial services". For the year ended December 31, 1997, Philip reported revenues of US \$1.75 billion, of which US \$1.1 billion was attributed to the Company's Metals Recovery Group (the "Metals Group"). On or around September 29, 1995, the President and Chief Executive Officer ("CEO") advised the Company's Board of Directors that the Company expected consolidated revenue to reach Cdn \$1.5 billion by the end of 1997 as a result of internal growth and acquisitions. At all material times, Philip's fiscal year-end was

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<sup>1</sup> Statement of Allegations amended to delete certain portions in accordance with the decision of *Philip Services Corp. (Receiver of) v. Ontario Securities Commission* (unreported, Ont. Sup. Ct. Jus. – Div. Ct., March 22-24, 2005)

December 31. All amounts referred to hereinafter are in U.S. dollars, unless otherwise indicated.

3. Allen Fracassi ("A. Fracassi") was, at all material times, the President, CEO and a Director of Philip.
4. Philip Fracassi ("P. Fracassi") was, at all material times, the Executive Vice-President, Chief Operating Officer and a Director of Philip. P. Fracassi and A. Fracassi are brothers and are the founders of the Company.
5. Marvin Boughton ("Boughton") was, at all material times, the Executive Vice-President and Chief Financial Officer ("CFO") of Philip. Boughton is a chartered accountant. Prior to joining Philip in or around 1991, Boughton was a partner in the accounting firm of Deloitte & Touche ("Deloitte"), in its Hamilton, Ontario office and had been employed by Deloitte for approximately 32 years.
6. Graham Hoey ("Hoey") was, at all material times, Senior Vice-President, Finance of Philip. Prior to joining Philip in 1996, Hoey was a partner with Deloitte.
7. Colin Soule ("Soule") was, at all material times, the General Counsel, Executive Vice-President and Corporate Secretary of Philip.
8. Robert Waxman ("Waxman") became a Director of the Company in January, 1994 and was the President of the Metals Group from February, 1996 until September, 1997, when he was relieved of all his duties and operating authority. Waxman's alleged resignation as a Director of Philip and as President of the Metals Group was publicly announced in a press release dated January 5, 1998. Details surrounding Waxman's departure from the Company are more fully described below in Part VI.
9. John Woodcroft ("Woodcroft") was, at all material times, the Executive Vice-President, Operations of Philip. Woodcroft is a chartered accountant.

## **II BACKGROUND**

10. In 1997, Philip's business was organized into two operating divisions - the Metals Group and the Industrial Services Group ("ISG"). Both of these divisions reported to Philip's head office, hereinafter referred to as "Corporate".
11. The Metals Group was Philip's largest operating division, accounting for more than 60% of the Company's revenue in 1997. The Metals Group was comprised of three key divisions - copper, ferrous and aluminum processing and recycling. As indicated above, Waxman was President of the Metals Group at all material times.
12. Deloitte, a firm of chartered accountants, was Philip's external auditor from 1990 until December, 1999. During 1997, the partners from Deloitte who were assigned to the

Philip audit engagement included the following: the Lead Client Services Partner 1997, the U.S. Audit Partner 1997, the Quality Control/Audit Partner 1997 and the National Office Partner 1997.

### **III OVERVIEW OF STAFF'S ALLEGATIONS**

13. The following allegations are being advanced by Staff:

**Failure to provide full, true and plain disclosure in a prospectus, dated November 5, 1997, (the "Prospectus") of material facts concerning Robert Waxman, a Director and President of Philip's Metals Group**

- 1) Philip filed and Messrs. A. Fracassi, P. Fracassi, Soule, Waxman and Woodcroft authorized, permitted or acquiesced in Philip filing the Prospectus, with the Ontario Securities Commission (the "Commission"), which failed to contain full, true and plain disclosure of all material facts relating to the securities offered, specifically, material facts relating to:
  - (i) financial losses incurred by Philip, in the amount of approximately \$20 million, which were allegedly caused by Waxman in connection with various unauthorized transactions;
  - (ii) Waxman being relieved of his duties and all operating authority he had at Philip in or around mid-September, 1997;
  - (iii) the \$10 million promissory note executed by Waxman on or about October 28, 1997, in favour of Philip (the "Waxman Promissory Note"); and
  - (iv) Waxman's admission in or around mid-September, 1997 that he had derived a personal benefit of approximately \$2 million from certain unauthorized transactions that he had instituted on behalf of the Company.

**Failure to provide full, true and plain disclosure in the Prospectus of material facts in respect of the Special Charges - the restructuring charge**

- 2) Philip filed and Messrs. A. Fracassi, P. Fracassi, Boughton, Hoey and Woodcroft authorized, permitted or acquiesced in Philip filing the Prospectus, with the Commission, which failed to contain full, true and plain disclosure of all material facts relating to the securities offered, specifically, material facts relating to a restructuring charge in the amount of \$155.720 million, which was not disclosed by Philip until 1998.

**Failure to provide full, true and plain disclosure in the Prospectus of material facts in respect of the Special Charges - the material financial transactions**

- 3) These material financial transactions amount to approximately \$110 million of the total \$234.992 million in charges taken by Philip, and are as follows:
- (i) that Philip filed and Messrs. A. Fracassi, P. Fracassi, Boughton, Soule, Waxman, and Woodcroft authorized, permitted or acquiesced in Philip filing financial statements contained in the Prospectus which failed to contain full, true and plain disclosure of approximately \$31 million for holding certificates in respect of inventory, which were issued by Philip in 1996 and were improperly recorded because Philip failed to record the underlying transactions as liabilities or, alternatively, failed to remove the inventory from the accounting records;
  - (ii) that Philip filed and Messrs. A. Fracassi, P. Fracassi, Boughton, Waxman and Woodcroft authorized, permitted or acquiesced in Philip filing financial statements contained in the Prospectus which failed to contain full, true and plain disclosure of approximately \$29 million of unrecorded liabilities for invoices issued by its customer, Pechiney World Trade Inc., in 1996 and settled by Philip in 1997;
  - (iii) that Philip filed and Messrs. A. Fracassi, P. Fracassi, Boughton, Waxman and Woodcroft authorized, permitted or acquiesced in Philip filing financial statements contained in the Prospectus which failed to contain full, true and plain disclosure of approximately \$30.222 million regarding a financing arrangement between Philip and Commodity Capital Group, finalized on or about August 13, 1997, which was not properly recorded in the financial statements;
  - (iv) that Philip filed and Messrs. A. Fracassi, P. Fracassi, Boughton, Hoey and Woodcroft authorized, permitted or acquiesced in Philip filing financial statements contained in the Prospectus which failed to contain full, true and plain disclosure of approximately \$10 million regarding a financing arrangement between Philip and Canadian Imperial Bank of Commerce, finalized on or about June 27, 1997, which was not properly recorded in the financial statements; and
  - (v) that Philip filed and Messrs. P. Fracassi and Woodcroft authorized, permitted or acquiesced in Philip filing financial statements contained in the Prospectus which failed to contain full, true and plain disclosure of the \$10 million Waxman Promissory Note which was improperly recorded in the financial statements in inventory.

#### **IV THE NOVEMBER 1997 OFFERING**

14. On November 6, 1997, Philip made a public offering of 20 million common shares (the "November Offering"), 15 million of which were sold in the United States and 5 million of which were sold in Canada and internationally. The November Offering raised approximately \$364 million and closed on or about November 12, 1997. The price per each offered common share was \$16.50.
15. In connection with the November Offering, Philip filed a Prospectus with the Commission and obtained a final receipt on November 6, 1997. As required pursuant to section 58 of the Securities Act, R.S.O. 1990, c. S.5, as amended (the "Act"), the Prospectus contained an Issuer's Certificate signed by A. Fracassi, the CEO, and Boughton, the CFO, and two directors, Waxman and Herman Turkstra, on behalf of Philip's Board of Directors. A registration statement (the "Registration Statement") was filed with the United States Securities and Exchange Commission (the "SEC") on or about November 6, 1997.
16. The Prospectus included audited financial statements for the Company for the years ended December 31, 1996 and December 31, 1995, for which Deloitte had issued unqualified audit opinions. Deloitte consented to the inclusion of these audit opinions in the Prospectus. Furthermore, the Prospectus contained unaudited interim financial statements for the six month periods ended June 30, 1997 and June 30, 1996. Deloitte provided a letter of comfort to the Commission dated November 5, 1997, with respect to the inclusion of the unaudited interim financial statements in the Prospectus. The Prospectus also included unaudited third quarter results for the three and nine month periods ended September 30, 1997.
17. In connection with the November Offering, Philip entered into a U.S. Underwriting Agreement dated November 6, 1997 with a syndicate of underwriters, which provided for the sale by the Company of 15 million common shares in the United States. Salomon Brothers Inc. and Merrill Lynch & Co. acted as the co-lead underwriters on behalf of the syndicate of underwriters. Philip also entered into an International Underwriting Agreement, dated November 6, 1997, with a syndicate of international underwriters which provided for the sale by the Company of 5 million common shares internationally, including Canada. Salomon Brothers International Limited and Merrill Lynch International acted as representatives on behalf of the international underwriters. The Canadian underwriters that participated in the international underwriting were as follows: Salomon Brothers Canada Inc., Merrill Lynch Canada Inc., CIBC Wood Gundy Securities Inc., Midland Walwyn Capital Inc., First Marathon Securities Inc., Gordon Capital Corporation, RBC Dominion Securities Inc. and TD Securities Inc. (the "Underwriters").

## **V PUBLIC DISCLOSURES AND REGULATORY FILINGS**

18. In a press release dated September 29, 1997, Philip announced that it had filed a Registration Statement in the United States and a preliminary prospectus ("Preliminary Prospectus") in Canada with respect to an offering of 20 million of its common shares.

19. On or about October 24, 1997, Philip filed an amended Preliminary Prospectus with the Commission.
20. In a press release dated November 5, 1997, Philip reported record net earnings of \$25.4 million for the three month period ended September 30, 1997, a 105% increase over the \$12.4 million from continuing operations for the same period in 1996. It also reported that its revenues for the three month period ended September 30, 1997 increased 246% to \$502.2 million from \$145.2 million for the same quarter in 1996. The financial information released on November 5, 1997 was incorporated into the Prospectus.
21. On or about November 6, 1997, Philip obtained a receipt for the Prospectus from the Commission.
22. In a press release dated November 18, 1997, Philip reported that total net proceeds from the November Offering amounted to approximately \$364 million.
23. In a press release dated January 5, 1998, Philip announced the resignation of Waxman as a Director and President of the Company's Metal Group.
24. Philip issued a press release dated January 26, 1998, approximately 11 weeks after the November Offering closed, announcing the following:

*... the Company will record a one time year end charge to earnings of between US \$250 million and US \$275 million, which on an after-tax basis, is between US \$175 million to US \$200 million. This one time charge will be comprised of two items. One item will be in the form of a restructuring charge, which on an after-tax basis will amount to between US \$100 million and US \$120 million. This restructuring charge includes a write-down of goodwill, which makes up 60% to 70% of this charge, severance payments, relocation costs and a variety of other items. The second component being US \$75 million to US \$80 million after-tax relates primarily to physical inventory adjustments and also to trading losses and charges relating to a market revaluation of inventory held for resale by our Metals Recovery Group.*
25. In a press release dated January 27, 1998, Philip clarified its January 26, 1998 announcement, stating that the goodwill write-down related to a number of acquisitions the Company concluded over the period from 1993 to 1996. It also stated that the physical inventory adjustment of approximately \$60 million after-tax involved the difference between book inventory and physical inventory in the Metals Group copper yard business.

26. On Friday, January 23, 1998, the closing price for Philip's shares on the TSE was \$18.90. On January 27, 1998, following the announcements of January 26 and 27, Philip's common shares on the TSE closed at \$12.00.
27. In a press release dated March 5, 1998, Philip announced its financial results for the year ending December 31, 1997 and the results of an audit conducted by external auditors into the copper inventory discrepancy. In this press release Philip made a number of disclosures, including that:
  - (i) its 1997 year-end audited financial results included a \$185.4 million (pre-tax), one-time special and non-recurring charge related to the write-down of certain assets;
  - (ii) it reported a loss of \$95.8 million for its 1997 year-end;
  - (iii) it was restating its earnings for fiscal year 1995 to \$3.2 million (rather than approximately Cdn \$32.7 million as originally disclosed) and for fiscal year 1996 to a \$20 million loss (rather than a profit of approximately Cdn \$39 million as originally disclosed); and
  - (iv) there was a discrepancy in the copper inventory in the audited financial statements for the year ended December 31, 1997 in the amount of approximately \$92 million (pre-tax) resulting from trading losses and a further amount of approximately \$32.9 million (pre-tax) caused by incorrect recording of copper transactions, which losses were incurred over a three year period as a result of speculative transactions done outside of Philip's normal business practices.
28. On or about March 31, 1998, Philip, pursuant to the United States Securities Exchange Act of 1934, filed the Form 10-K for its 1997 fiscal year with the SEC. The Form 10-K included an unqualified audit opinion signed by Deloitte on March 4, 1998.
29. In a press release dated April 1, 1998, Philip announced that on March 31, 1998, Philip had filed its Form 10-K for its 1997 fiscal year-end financial statements and reported that "as part of its final audit review" it was determined that an additional charge of \$13.6 million had to be added to the special and non-recurring charges of \$185.4 million (pre-tax), disclosed in its news release of March 5, 1998. These additional charges included \$10 million in unrealized losses from copper swap contracts and \$3.6 million in "other" costs relating to copper operations.
30. In a press release dated April 23, 1998, Philip announced that its 1997 Audited Financial Statements previously filed with its Annual Report on Form 10-K with the SEC "did not properly reflect the results of transactions in the Company's copper operation and as a result underestimated the Company's liabilities by an amount estimated to be approximately \$30 million". It also announced an adjustment to "certain balance sheet accounts" of approximately \$5 million.

31. On or about May 5, 1998, Philip filed a Material Change Report with the Commission, pursuant to section 75(2) of the Act, with respect to its announcement on April 23, 1998 as described in paragraph 30.
32. On or about May 14, 1998, Philip filed an amended Form 10-K (the "Form 10-K/A") with the SEC which reflected the further adjustments required to its 1997 audited financial statements as announced in its press release dated April 23, 1998.
33. On or about May 22, 1998, Philip filed its Annual Financial Statements for its fiscal year ended December 31, 1997 with the Commission.

## **VI ALLEGATIONS RELATING TO ROBERT WAXMAN - Paragraph 13 1)**

### **Background Facts**

34. In 1973, Waxman began working in the scrap metals industry for I. Waxman & Sons Limited, the Waxman family business. In or around September, 1993, I. Waxman & Sons Limited rolled all of its active operating assets into Waxman Resources Inc. ("Resources") and then sold all of the shares of Resources to Philip. At the time Philip purchased the shares of Resources, Waxman was the President and Chief Executive Officer of Resources.
35. In light of his substantial experience and contacts in the metals industry, Philip gave Waxman the responsibility of running the operations it had acquired from the Waxman family interests as well as other metals holdings of Philip. Waxman performed an integral role for Philip in both the operations of the Metals Group and the strategic planning for the numerous acquisitions by Philip in the metals industry.
36. In January 1994, Waxman became a Director of Philip. On February 28, 1996, Waxman was appointed President of the Company's Metals Group.
37. At all material times, Waxman reported to A. Fracassi. On a day-to-day basis, Waxman also reported to P. Fracassi and Woodcroft.
38. In 1996 and 1997, the Metals Group accounted for approximately 60% of Philip's revenues.

### **Relevant Portions of the Prospectus**

39. Page 5 of the Prospectus states the following under the heading "Forward-Looking Statements":

*Factors that may cause actual results to differ materially from those contemplated or projected, forecast estimated or budgeted in such*

*forward-looking statements include among others, the following possibilities...(6) loss of key executives... [Emphasis added.]*

40. Page 18 of the Prospectus states the following under the heading "Reliance on Key Personnel":

*The Company's operations are dependent on the abilities, experience and efforts of its senior management. While the Company has entered into employment agreements with certain members of its senior management, **should any of these persons be unable or unwilling to continue his employment with the Company, the business prospects of the Company could be materially and adversely affected.** [Emphasis added.]*

41. Robert Waxman is described on page 67 of the Prospectus under the heading "Management" as "President, Metals Recovery Group and Director". On page 68 of the Prospectus, Waxman is further discussed as follows:

*Mr. Waxman has been a director of Philip since January, 1994. Mr. Waxman has been the President, Metals Recovery Group, since February 28, 1996. Since September 1993, Mr. Waxman has been President and Chief Executive Officer of Waxman Resources Inc. From 1989 to 1993, Mr. Waxman was Chief Operating Officer of I. Waxman & Sons Limited.*

42. The only disclosure provided in the Prospectus regarding indebtedness to Philip by any person who is or was during the relevant time period an executive officer or senior officer of Philip is set out on page 71 as follows:

*As at November 4, 1997, the aggregate amount of indebtedness (other than routine indebtedness) due to the Company from all current or former officers, directors and employees was Cdn \$737,200, consisting of the outstanding balance of a loan made to Allen Fracassi, the President and Chief Executive Officer of the Company for the purpose of purchasing a home ... the largest aggregate amount outstanding under the loan during the fiscal year ended December 31, 1996 was Cdn \$787,200.*

43. As indicated in paragraph 15, Waxman was one of the directors who executed the Certificate of the Company (the "Certificate"), at page C-1 of the Prospectus, on behalf of the Board of Directors. The Certificate was in the form required pursuant to s.58(1) of the Act as follows:

*The foregoing constitutes full, true and plain disclosure of all material facts relating to the securities offered by this prospectus as required by Part XV of the Securities Act and the regulations thereunder.*

**Allegations Relating to Waxman's Unauthorized Transactions**

44. In early 1997, the Vice-President of Finance in the Metals Group ("VP Finance") commenced an investigation (the "Copper Investigation") into various copper cathode transactions entered into by the Metals Group. In June of 1997, after completion of the Copper Investigation, Woodcroft and A. Fracassi were advised of the VP Finance's suspicions about Waxman's involvement in the removal of approximately \$10 million worth of copper cathode from Philip's account.
45. At or around the same time as the Copper Investigation, an investigation was being conducted into Waxman's company expense account. By memo dated May 22, 1997, P. Fracassi and Woodcroft were advised that Waxman had improperly obtained payment from Philip for a number of expenses unrelated to Philip, and with no legitimate business purpose, such as: golf, rare wines and airfare for his wife on the Concorde. On or about July 7, 1997, Philip cancelled Waxman's Visa Corporate expense credit card.
46. In or around June 1997, the Executive Vice-President, Corporate and Government Affairs received information from a senior employee of the Metals Group about the attempted establishment of a "shrinkage programme" by Waxman and an employee of Philip who reported to Waxman (the "Waxman Employee") to improperly divert Philip inventory.
47. In or around July 1997, the Executive Vice-President, Corporate and Government Affairs became aware that the financial records of the Metals Group had been falsified in that they purported to acknowledge receipt of a higher grade of metal than Philip had in fact received, thereby causing Philip to pay for the higher grade.
48. In or around October 1997, the Executive Vice-President, Corporate and Government Affairs advised Messrs. A. Fracassi, P. Fracassi, Boughton, Soule and Woodcroft about the matters discussed in paragraphs 46 and 47.
49. At around the same time, the VP, Financial Operations of Philip was preparing a report for A. Fracassi regarding potential inappropriate copper cathode transactions being effected in the Metals Group. At the same time, the VP, Financial Operations was also advised of the details regarding the Copper Investigation.
50. As a result, the VP, Financial Operations prepared a handwritten memo dated September 12, 1997 to A. Fracassi (the "VP, Financial Operations' Memo"), advising of four transactions "controlled by Bob Waxman which appear[ed] to be of a fraudulent nature" as follows:
  - (1) *During late 96 and early 97, we borrowed 9.6 million lbs of cathode from GM. Of this, 5.4 million lbs was given to Pechiney but never invoiced. The balance was sold and properly invoiced. However, we paid Pechiney for 3.0 million lbs and MIT for 1.2*

*million lbs of cathode which was not received by us. The total loss on the scam at US 1.00 per lb is US 9.6 million.*

- (2) *During the one year period ended March 97 we lost US 10.0 million on cathode sales to Parametal Trading. These were predominantly paper, non-physical transactions. There is no valid reason, including borrowing, hedging or outright speculating that could explain a loss of this size based upon the average monthly trading volume of US 10.0 million. The only logical conclusion is that money is being taken from the Company.*
- (3) *In April of 97, we started buying UBC's from Pechiney. We brokered the scrap to various customers at market prices. The loss to date on these transactions is US 275,000. Madesker has modified the Pechiney invoices to reduce the loss to us. Experience has shown that this is just a delay tactic. Eventually the full amount of the loss will be realized. Initially, we sold to the UBC customers directly. Now MIT has been introduced as a middleman between us and our customers. A bad deal is about to get worse. There is no reason for these transactions other than to put money in other people's pockets.*
- (4) *In May 97, we started selling #2 copper scrap to MIT who in turn sells it to Southwire. We are supposed to be paid on the basis of copper recovered by Southwire. By accident, we have discovered that Southwire's recoveries are twice the amount reported to us by MIT. Based upon the initial order alone, we have been cheated out of US 175,000. It is clear that the reason for using a broker is to divert money to the principal of MIT...*

The memo concludes as follows:

*I have more examples as does [the Executive Vice-President, Corporate & Government Affairs] who has information on yard theft. But without going into more detail we are already up to CAD 27.0 million.*

*Bob must not be allowed to enter into any transactions. All people loyal to him should be fired and we should try to recover whatever we can without having the whole thing blow up.*

51. The VP, Financial Operations' Memo was provided to Woodcroft. Woodcroft advised the VP, Financial Operations that he had discussed the matters raised in the VP, Financial Operations' Memo with A. Fracassi. The VP, Financial Operations also provided a copy of the Memo to his wife.

52. As is more fully discussed at paragraphs 57 to 59, in or around mid-September 1997, Waxman admitted to Woodcroft that he had derived a personal benefit of \$2 million from certain transactions that he had instituted.
53. As a result of the matters concerning Waxman discussed in paragraphs 44 to 52 (the "Waxman Issues"), in or around September/October 1997, A. Fracassi, P. Fracassi, Soule and Woodcroft caused Philip to take a number of steps as follows:
- (a) Waxman was relieved of his duties and all operating authority that he had at Philip on or around September 16, 1997;
  - (b) Waxman's signing authority was removed;
  - (c) The VP, Financial Operations was re-positioned as head of the Metals Group, reporting to P. Fracassi and Woodcroft, on or around September 16, 1997;
  - (d) The Waxman Employee was terminated in or around late September or early October 1997, and was paid \$120,000 in return for his agreement not to compete with Philip for three years; and
  - (e) the Waxman Promissory Note was obtained from Waxman.
54. Notwithstanding that Waxman had been relieved of his duties and all operating authority, he continued to be held out, by Messrs. A. Fracassi, P. Fracassi, Soule, Waxman and Woodcroft, as President of the Metals Group to the remaining members of Philip's Board of Directors, other members of senior management, the employees of Philip and the general public. In fact, Waxman continued to attend Board meetings, represented the Company in connection with the finalization of certain acquisitions and executed the Certificate, on behalf of the Board of Directors.
55. Messrs. A. Fracassi, P. Fracassi, Soule, Waxman and Woodcroft failed, and caused Philip to fail, to advise the following:
- (a) Philip's Board of Directors;
  - (b) Philip's auditor, Deloitte;
  - (c) the Underwriters; and
  - (d) the public,
- of the Waxman Issues, the Waxman Promissory Note and of Waxman being relieved of his duties and all operating authority prior to filing the Prospectus.

56. In fact, with respect to Philip's auditor, a representation letter dated November 6, 1997 (the "Representation Letter"), the same date that the Prospectus was filed, states: "No shortages or irregularities have been discovered that have not been disclosed to you and **to our knowledge there is nothing reflecting upon the honesty or integrity of personnel of our organization**". [Emphasis added.] The Representation Letter is signed by A. Fracassi and Boughton.

#### **Allegations Relating to the Waxman Admission**

57. In or around mid-September 1997, Waxman admitted to Woodcroft that he had derived a personal benefit of \$2 million from certain transactions that he had instituted (the "Waxman Admission").
58. The day after the Waxman Admission, Woodcroft advised Soule and A. Fracassi about what Waxman had confessed to him. Immediately after the Waxman Admission, Waxman was relieved of his duties and any operating authority that he had at Philip. Messrs. P. Fracassi and Soule were also advised of the Waxman Admission and that Waxman had been relieved of his duties and operating authority prior to the issuance of the Prospectus.
59. The Board of Directors was not advised about the Waxman Admission until December 23, 1997, at a meeting of the Board of Directors. The minutes of this meeting reflect the following with respect to the circumstances surrounding the Waxman Admission:

*Allen Fracassi advised the Board that in the late spring of 1997, the Company became concerned about certain copper transactions that Robert Waxman, the President of the Company's Metal Recovery Operations, had entered into. The Company had commenced a review of the transactions and though questionable in nature, the Company had been unable to conclude that the transactions were anything other than bad business judgement or poor management. Subsequently, in mid-September of 1997, Mr. Waxman admitted to Mr. John Woodcroft, Executive Vice-President, Operations, that he had derived a personal benefit of US \$2 million from certain transactions that he had instituted. Mr. Woodcroft reported Mr. Waxman's admission to Mr. Fracassi. Mr. Waxman was immediately relieved of his duties and any operating authority that he had. The Company intensified its review of Mr. Waxman's actions. Pending the completion of the review, Mr. Waxman as an indication of his willingness to reimburse the Company, executed a US \$10 million promissory note. Mr. Fracassi apprised [the Chairman of the Board of Directors],[and two outside directors] of the Waxman admission.*

*Mr. Fracassi advised that the Company's subsequent review of the Waxman transactions indicated that invoices for approximately US \$5*

*million had not been rendered. H[e] noted that Mr. Waxman had caused US \$1.5 million of the un-invoiced transactions to be repaid and was prepared to guaranty an additional US \$2.5 million of receivables due from Parametals.*

*... The Board concluded that the Company should request Mr. Waxman's immediate resignation from his position as an officer and director. [Emphasis added.]*

60. Messrs. A. Fracassi, P. Fracassi, Soule, Waxman and Woodcroft failed, and caused Philip to fail, to advise the following:
- (a) Philip's Board of Directors;
  - (b) Philip's auditor, Deloitte;
  - (c) the Underwriters; and
  - (d) the public,

of the Waxman Admission and of Waxman being relieved of his duties and all operating authority prior to filing the Prospectus.

61. Allegations concerning the adjustments which were taken to the Company's financial statements as a result of the Waxman irregularities are more fully discussed below.

#### **Waxman's Alleged Departure from Philip**

62. Almost four months after Waxman had been relieved of his duties and operating authority, Philip issued the following misleading press release dated January 5, 1998 relating to Waxman's "departure" from Philip:

*Philip Services Corp. ("Philip") today announced that as part of the Company's consolidation and restructuring program, a senior management structure has been established within each of the four key divisions of its metals operations ... **As part of this consolidation, Philip has accepted the resignation of Robert Waxman, as a Director & President of the Company's Metals Services Group, effective January 5, 1998.** [Emphasis added.]*

## VII ALLEGATIONS RELATING TO THE SPECIAL CHARGES - Paragraph 13 2) and 3)

### Background Facts

63. The second deficiency in the disclosure made in the Prospectus involved the financial statements. In particular, Philip failed to disclose in the Prospectus that the Company had identified and quantified items to be included in the restructuring charge. Philip's process of identifying and calculating items to be included in the restructuring charge commenced in the late summer of 1997. Also, the financial statements contained in the Prospectus were incorrect because of inappropriate accounting treatments for many material transactions. They were subsequently corrected in 1998 as part of the Special Charges.
64. On January 17, 1998, the Globe and Mail reported that Philip would be taking a one-time restructuring charge and would disclose the amount of the restructuring charge on January 26, 1998.
65. On January 26 and 27, 1998, only 11 weeks after the Prospectus was filed with the Commission, Philip issued two press releases announcing that the Company would be taking a restructuring charge. As set out in paragraph 24, in a January 26, 1998 press release, Philip disclosed that it would be taking a restructuring charge and a charge relating to material transactions (the "Special Charges"). According to the press release:

*...the company will record a one time year end charge to earnings of between US \$250 million and US \$275 million, which on an after tax basis, is between US \$175 million to US \$200 million. This one time charge will be comprised of two items. One item will be in the form of a restructuring charge, which on an after tax basis will amount to between US \$100 million and US \$120 million. This restructuring charge includes a write-down of goodwill, which makes up 60% to 70% of this charge, severance payments, relocation costs and a variety of other items. The second component being US \$75 million to US \$80 million after tax relates primarily to physical inventory adjustments, and also to trading losses and charges relating to a market revaluation of inventory held for resale by our Metals Recovery Group.*

66. In the late summer of 1997, Philip commenced a process to identify and calculate items to be included in a restructuring charge. The restructuring charge calculated during the course of this process is very similar to the amounts announced on January 26 and 27, 1998, as set out in paragraph 106.
67. In the final audited financial statements for the year ended December 31, 1997, Philip recorded various Special Charges relating primarily to its copper business, including a restructuring charge of \$155.720 million and Special Charges relating to material transactions of \$234.992 million.

68. The Special Charges relating to material transactions impacted on previously reported earnings by Philip in the years ended December 31, 1995 and 1996 and the three quarters ended March 31, June 30 and September 30, 1997 respectively.

## **THE RESTRUCTURING CHARGE - Paragraph 13 2)**

### **Background Facts**

69. In the 10-K filed with the SEC on April 1, 1998, Philip explained the restructuring charge as follows:

*As at December 31, 1997, the Company recorded a pre-tax charge of \$155.7 million (\$117.1 million after tax) reflecting the effects of (i) restructuring decision made in its Industrial Services Group following the mergers of All Waste and Serv-Tech, (ii) integration decisions in various of its acquired Metals Services Group businesses, the most significant of which were acquired in late October 1997 and (iii) impairments of fixed assets and related goodwill resulting both from decisions to exit various business locations and dispose of the related assets, as well as assessments of the recoverability of fixed assets and related goodwill of business units in continuing use.*

*All businesses assessed for asset impairment were acquired in purchase business combinations and, accordingly, the goodwill that arose in those transactions was included in the test for recoverability. Assets to be disposed of were valued at the estimated net realizable value while the assets of the business units to be continued were assessed at fair value principally using discounted cash flow methods.*

*Special and non-recurring charges relate to the impairment of fixed assets and related goodwill and comprised of the following items:*

|   | (\$US '000) |
|---|-------------|
| Business units, locations or activities to be exited:                   |             |
| Goodwill written off  | \$ 10,032   |
| Fixed assets written down to estimated net realizable value of \$4,843K | 47,584      |
| Unavoidable future lease and other costs associated with properties     | 9,358       |
| Other assets to be disposed, including \$7,800K accrued disposal costs  | 17,740      |
| Business units to be continued:   |             |
| Goodwill impairment   | 49,558      |

|   |              |
|---|--------------|
| Fixed assets written down to estimated net realizable value of \$8,810K | 10,984       |
| Severance, \$2,000K paid before year-end                                | 4,464        |
| Accrued costs   | <u>6,000</u> |
| TOTAL   | \$ 155,720   |

70. Philip had identified and quantified most of these items that were written off as a restructuring charge prior to filing the Prospectus. However, there was no specific disclosure in the Prospectus that Philip intended to take a restructuring charge or in the alternative, the minimal disclosure provided was not representative of what was known at the time the Prospectus was filed.
71. Deloitte's management letters, prepared at the conclusion of the 1994 and 1995 engagements, indicate that the accounting for acquisitions, the capitalization of costs (especially start-up costs and losses) and the recognition of accounting for goodwill were serious concerns for its auditor on an annual basis.

### Relevant Portions of the Prospectus

72. The following excerpts from the Prospectus are the only references made by Philip that may possibly relate to the restructuring charge that the Company was contemplating:

- (a) The Preamble to the Financial Information

*The selected historical consolidated financial data ... is derived from the audited Consolidated Financial Statements ... and ... is from the unaudited interim consolidated financial statements of Philip, which in the opinion of management include all adjustments (**consisting solely of normal recurring adjustments**) necessary to present fairly the financial information for such periods. [Emphasis added.]*

- (b) Risk Factors

The Prospectus noted that Philip may record additional charges, at a later date, resulting from acquisition or integration issues. However, the Prospectus does not disclose that the Company had already quantified the significant components of the restructuring charge.

*In particular, reserves established or charges recorded in connection with acquisitions or the integration thereof may be insufficient and the Company **may be required** to establish additional reserves or **record additional charges** at a later date. [Emphasis added.]*

(c) Notes to the Unaudited Pro Forma Consolidated Financial Statements - Note 8

The following Note to the Unaudited Pro Forma Consolidated Financial Statements contemplated non-recurring costs, but only in relation to integration costs arising from the AllWaste and Serv-Tech acquisitions and not to the restructuring charge that was being contemplated by Philip during 1997.

*Philip expects that it will incur non-recurring costs relating to severance, relocation and other integration costs. These costs are **not quantifiable** at this time. [Emphasis added.]*

**The Quantification of the Restructuring Charge during 1997**

73. In January and/or February of 1997, during the course of the finalization of the 1996 engagement, the Lead Client Services Partner 1997 advised A. Fracassi to consider a restructuring charge as synergies would be realized from the previous pattern of acquisitions, and the United States marketplace was not reacting adversely to restructuring charges at the time.
74. In early 1997, at least P. Fracassi, Woodcroft and the VP Finance were aware that inappropriate accounting had taken place in finalizing the 1996 results. It was agreed that earnings targets for 1997 would be reduced in order to manage the expectations of the public and enable corrective accounting action to be taken. The expectations, however, were not reduced and it was decided that the corrections would take place as part of the restructuring charge being considered.
75. On February 24, 1997, a meeting was held to discuss the finalization of the 1996 audit engagement. In attendance were A. Fracassi, Boughton, the Partner - National Office and the Lead Client Services Partner 1997. Notes of the meeting record that, amongst other points,
  - *"divisions" structure going forward[:] services - metals, and*
  - *[o]ut of this 're-org' - the Company is contemplating a restructuring charge in Q2/3 [of] 97.*
76. During the course of the next few months, Deloitte continued to provide advice to Philip on the issue of a restructuring charge and discussed the charge with Philip on a conceptual basis.
77. During the late spring or summer of 1997, various staff of Philip were made aware that a restructuring charge was going to take place. At the same time, in the early summer of 1997, the Underwriters began meeting with Philip to discuss equity financing.

78. On August 1, 1997, the Executive Vice-President, Corporate Development received a fax from Merrill Lynch containing an analysis of the impact of extraordinary charges on the stock price of other publicly listed companies. Attached to the fax were graphs illustrating the impact of "extraordinary charges" on the price of three separate public companies.
79. Shortly after August 5, 1997, Deloitte became aware that a prospectus was going to be issued in the United States and that Deloitte would be required to provide an opinion on the Philip financial results for January to June, 1997 (the "Q2 Review"). The Q2 Review was conducted by Deloitte in September, 1997. The main participants from Philip in the Q2 Review were Boughton, Hoey, the Corporate Controller and the Manager, Financial Reporting.
80. Deloitte, however, was not aware that staff at Philip were attempting to quantify the charge.
81. By August 25, 1997, Philip had decided to raise an equity financing.
82. Prior to August 25, 1997, the Corporate Controller met with at least Boughton and the VP Finance to identify and quantify items to be included in a restructuring charge. At the meeting, Boughton assigned the Corporate Controller the responsibility of identifying items in Corporate and ISG to be included in the restructuring charge. Boughton asked the VP Finance to provide suggestions of components that may form part of a possible restructuring charge in the Metals Group.
83. On August 25, 1997, the VP Finance submitted a memo addressed to Waxman, and copied Boughton and the Corporate Controller. In the memo entitled "Write-off", the VP Finance summarized what had been discussed at the meeting. The memo included a list of "items to consider" for a restructuring charge/write-off. The VP Finance included the following on the list: the "closure of Centennial yard" and the "cost of exiting the solids copper business in Hamilton. Take hit on inventory".
84. Shortly after August 25, 1997, the VP Finance gave the Financial Analyst this memo and asked her to complete a restructuring charge based on the items in it.
85. In early September, 1997, the Financial Analyst prepared schedules quantifying the items to be included in the restructuring charge. The Financial Analyst prepared several iterations of a list comprising items that the Metals Group were suggesting should be included in a restructuring charge or write-down. In spreadsheets dated September 2, 1997, the Financial Analyst quantified the "Metals Recovery Restructure Costs" as at July 31, 1997. The spreadsheets included the amount of Cdn \$127 million under the heading of "cathode". The items that the Financial Analyst included in this category were primarily losses that had been inappropriately deferred on the books of the Metals Group and improperly recorded as an asset. These items would ultimately form part of the

Special Charges disclosed by Philip in 1998. The Financial Analyst submitted the analysis, totalling Cdn \$158 million, to the VP Finance.

86. On September 4, 1997, the VP Finance prepared a second memo. This memo, addressed to Boughton and copied to Waxman, was entitled "Restructuring". The memo commences with the sentence "... these are a number of items we would consider as part of a restructuring charge". The schedule attached to the memo, totalling Cdn \$193 million, refers to several items that were later included in the restructuring and Special Charges subsequently recorded in the 1997 annual financial statements.
87. The VP Finance's estimate of Cdn \$193 million included an amount of Cdn \$167 million for inventory at Centennial. Items related to inventory at Centennial comprised most of the Special Charges which were subsequently recorded in the 1997 financial statements. Originally, all these accounting irregularities formed part of the proposed restructuring charge. It was not until January of 1998 that these items were accounted for separately as a Special Charge and not as a restructuring charge. Most of the items other than Centennial were much smaller, and had come from assorted plans to consolidate yards and operations, and to move out of certain businesses.
88. In September of 1997, at the time that the Waxman Issues discussed in Part VI were being dealt with, Philip management was considering exiting the cathode trading and copper brokerage business located at Centennial. Since early 1997, Philip had been exploring whether they could replace the Centennial yard with another location. Waxman and Woodcroft would have been aware of these significant changes to the business. Waxman's operational authority was removed on or about September 16, 1997 and the Waxman Employee was terminated on September 23, 1997. When the Treasurer was re-positioned as head of the Metals Group (the "New President of the Metals Group"), he was instructed to close out all cathode trades and not enter into any new ones. The New President of the Metals Group reported to P. Fracassi and Woodcroft.
89. During the first week of September, 1997, the Financial Analyst received the VP Finance's second memo dated September 4, 1997. At that time, the Financial Analyst prepared another list of items in the Metals Group to be included in the restructuring charge. On approximately September 9, 1997, the VP Finance and the Financial Analyst met briefly with Hoey and the Corporate Controller. The VP Finance distributed copies of one of the Financial Analyst's list of items totalling Cdn \$194 million, which was based on the estimates at July 31, 1997.
90. On September 5, 1997, a spreadsheet totalling \$137 million in respect of restructuring items for ISG was prepared by the Corporate Controller and given to Boughton. The Corporate Controller continued to refine the list and faxed a slightly revised version to the President, ISG Group on September 30, 1997. The list faxed to the President, ISG Group totalled \$128 million.

**The Prospectus & The Continuing Effort at Philip to Quantify the Restructuring Charge**

91. On September 24, 1997, a due diligence conference call session was held concerning the Preliminary Prospectus. Philip management was represented by Boughton, Hoey and the Corporate Controller. The participants (the representatives of the Underwriters) were told that Philip was going to take charges to write off goodwill. They were also advised that while the amount was not quantifiable, it would be sizeable. No further explanation of the approximate magnitude was given.
92. On September 25, 1997, the Board of Directors of Philip discussed and approved the share offering.
93. On September 26, 1997, the Preliminary Prospectus was filed with the Commission.
94. As noted at paragraphs 89 and 90, above, at September 30, 1997, Philip had identified approximately Cdn \$194 million for the Metals Group and \$128 million for ISG in respect of a potential restructuring charge.
95. In October 1997, the Financial Analyst, on the instructions of the VP Finance, made certain recalculations to the restructuring schedules as at September 30, 1997. Subsequently, the Financial Analyst gave this analysis to the VP Finance.
96. In mid-October 1997, A. Fracassi advised Deloitte that Philip was considering a charge.
97. On November 5, 1997, Philip held a due diligence session by conference call concerning the Prospectus. During the conference call, Hoey advised that Philip was considering a restructuring charge but was not close to a decision. Boughton's notes of the conference call indicate that he informed the meeting that there "may be write-downs - looking at it - W/B of size".
98. At the time of the Prospectus, the U.S. Audit Partner 1997 had discussions with Soule and Hoey regarding the restructuring charge. In fact, Deloitte continually inquired as to the status of the restructuring charge. Soule and Hoey confirmed that the decision of whether to take a restructuring charge had not been made and that the asset impairments had not yet occurred. Deloitte was advised that Philip had consulted legal counsel regarding the appropriate disclosure of the possible charge in the Prospectus.
99. The schedules prepared by the Financial Analyst and the VP Finance were not disclosed to Deloitte prior to 1998.
100. Prior to filing its Prospectus on November 5, 1997, Philip had sufficient information to conclude that it would be taking a material charge to earnings but did not disclose this fact to Deloitte, its auditor, or the Underwriters in connection with the public offering and did not disclose that it would be taking a material charge to its earnings, in the Prospectus.

101. The final restructuring charge taken by the two operating divisions, ISG and the Metals Group, amounted to \$101.298 million and \$54.422 million respectively for a total of \$155.720 million. Many of these restructuring costs were identified prior to September 30, 1997.
102. In particular, the following items were identified as of September 30, 1997, as of January 26, 1998 (the date of a press release by Philip regarding the charge), and actually recorded for the December 31, 1997 year-end and prior years:

| \$US '000  | Quantification at<br>September 30, 1997 | Press Release<br>January 26, 1998 | Adjustment<br>Recorded for<br>December 31, 1997<br>and prior years |
|--|---|-----------------------------------|--|
| Industrial Services Group                          |   |                                   |  |
| Quebec   | \$ 20,000                               | \$ 10,400                         | \$ 17,532  |
| Tech Services                                      | 26,000                                  | 23,700                            | 21,868   |
| Burlington Environmental                           | 40,000                                  | 31,500                            | 29,000   |
| Kansas City  | 11,000                                  | 11,400                            | 9,897  |
| Other  | <u>31,400</u>                           | <u>27,400</u>                     | <u>23,001</u>  |
| TOTAL  | <u>\$ 128,400</u>                       | <u>\$ 104,400</u>                 | <u>\$ 101,298</u>  |
| Metals Group                                       |   |                                   |  |
| Centennial Plant Closure                           | (Cdn \$168,900 ) 122,214                | 45,600                            | 3,775  |
| Other  | <u>(Cdn \$ 23,770 ) 17,200</u>          |                                   | <u>50,647</u>  |
|  | <u>(Cdn \$192,670 ) 139,414</u>         | <u>45,600</u>                     | <u>\$54,422</u>  |
| Special Charge -<br>Restructuring                  | \$267,814                               | \$ 150,000                        | \$155,720  |
| Special Charge - Inventory<br>and related accounts |   | 125,000                           | 234,992  |
|  | _____                                   | _____                             | _____  |
| Total Special<br>Charges (pre-tax)                 | <u>\$ 267,814</u>                       | <u>\$ 275,000</u>                 | <u>\$ 390,712</u>  |

#### November to December 1997

103. The VP Finance prepared a spreadsheet dated November 27, 1997 which calculated the restructuring charge for the Metals Group at approximately Cdn \$201.599 million. The Corporate Controller relied on this spreadsheet in preparing her list. The Corporate Controller's list consolidated the spreadsheet of the Metals Group with the ISG list. It also contained an item for "Metals" as \$146.087 million (Cdn \$201.599 million) and the amount of approximately \$128 million for ISG. This was also noted in the list that the

Corporate Controller faxed to the ISG President on September 30, 1997. The Corporate Controller gave the spreadsheet to Boughton and Hoey on November 27, 1997.

104. Subsequently, the Corporate Controller met with Boughton and Hoey to discuss the spreadsheet.
105. On December 2, 1997, Boughton and Hoey attended a meeting to discuss a list entitled "Restructuring Charge", listing charges totalling \$267 million. An amount of \$121 million is included in the list and is described as "Centennial Redundant Assets". Handwritten notes on two separate copies of the list reflect the amount being changed to \$100 million, suggesting that this item was discussed at the meeting.
106. In late December, 1997, Boughton informed the Lead Client Services Partner 1997 of "ball-park" numbers of the restructuring charge (\$200 million). On December 22, 1997, the Lead Client Services Partner 1997, the U.S. Audit Partner 1997, Boughton and Hoey attended a meeting held in Boughton's office. Boughton outlined the proposed restructuring charge in general terms, but did not provide supporting detail. Boughton indicated that a charge would be taken of approximately \$100 million for ISG and \$100 million for Metals.
107. On December 23, 1997 the Corporate Controller distributed a memo and schedule at a meeting attended by P. Fracassi, Boughton, Woodcroft, the New President of the Metals Group and Hoey. This meeting was convened to discuss the restructuring charge. According to the spreadsheet, Centennial is noted as having redundant assets of \$150 million with the action required being to "close yard and liquidate inventory".

### **January 1998**

108. As indicated above at paragraph 102, a significant component of the restructuring charge initially related to inventory at the Centennial yard. According to the minutes of an Audit Committee meeting held on January 19, 1998, Boughton argued that Centennial was a "discontinued" operation and therefore should be dealt with as a separate charge outside of normal operations. However, Deloitte disagreed. As set out in paragraph 27, on March 5, 1998, Philip issued a press release which stated that the trading losses that were incurred were due to "speculative transactions done outside of Philip's normal business procedures".
109. By March, 1998, the items at Centennial had been eliminated from the restructuring charge and were as written in the Special Charges.

### **Philip Discloses the Restructuring Charge**

110. On January 26, 1998, Philip issued a news release, as described at paragraph 24, announcing that Philip planned to take a "one-time year-end charge to earnings" of

approximately \$250 million to \$275 million. One component of the charge related to a copper inventory adjustment of approximately \$60 million after tax.

111. On January 27, 1998, as described at paragraph 25, Philip issued another news release explaining a \$90 million inventory loss in its scrap operations in Hamilton.
112. The matters described in paragraphs 69-102 were known to Messrs. A. Fracassi, P. Fracassi, Boughton, Hoey and Woodcroft, prior to filing the Prospectus.

**THE SPECIAL CHARGES IN RESPECT OF MATERIAL FINANCIAL TRANSACTIONS - Paragraph 13 3)**

113. In the final audited financial statements for the year ended December 31, 1997, Philip recorded Special Charges relating primarily to its copper business. In addition to the restructuring charge, the major components of the Special Charges regarding the Inventory and Related Accounts (the "material financial transactions"), disclosed by Philip in the Form 10-K and the Form 10-K/A, are detailed as follows:

|  | (\$US '000)              |
|--|--------------------------|
| Non-recurring charges recorded as operating expenses<br><b>(including CIBC \$10 million and CCG \$30 million)</b>  | \$ 78,260                |
| Costing errors recorded as operating expenses  | 32,875                   |
| Previously incurred but unrecorded trading losses resulting from speculative trading of copper cathode, recorded as special charges<br><b>(including Holding Certificates \$31 million, Pechiney \$29 million and other "Cathode Trading Losses" (including Waxman Promissory Note) \$32.13 million)</b> | 92,235                   |
| Overstatement of revenue and accounts receivable, recorded as adjustments to revenue, of which \$22.114 million is separately identified.  | <u>31,622</u>            |
| <b>TOTAL</b>   | <b><u>\$ 234,992</u></b> |

114. The Special Charges caused Philip to restate its comparative financials for the fiscal years ending December 31, 1996 and December 31, 1995, as they were inaccurate. The inaccurate financial statements for the fiscal years ending December 31, 1996 and December 31, 1995 were contained in the Prospectus.

**Discovery of an Inventory Shortfall**

115. The Special Charges were discovered by Deloitte as a result of the significant "shortfall" in the inventory of the Metals Group, of which Deloitte was informed in January of 1998.
116. Deloitte and another accounting firm, which was also conducting an investigation into the inventory discrepancy, identified many significant accounting irregularities which

accounted for the inventory shortfall and also other accounting irregularities which did not impact on the inventory account. Some of these are outlined below.

117. The accounting irregularities amount to approximately \$110 million of the total \$234.992 million, noted at paragraph 113 and are discussed as follows:
- Holding Certificates
  - Reversal of Invoices from Pechiney World Trade (USA), Inc. ("Pechiney")
  - Commodity Capital Group Metals Inc. ("CCG")
  - Canadian Imperial Bank of Commerce ("CIBC")
  - Waxman Promissory Note
118. None of the items that are discussed below was properly disclosed in the financial statements that were contained in the Prospectus.

### **1. Holding Certificates**

119. At various times during the material time, Philip financed its operations with the use of holding certificates. Philip issued holding certificates signifying that the inventory being held by Philip was the property of the customer. The holding certificates issued in 1996 represented a total invoice value of approximately \$31 million and were issued to the following customers: \$8.8 million to Conversion Resources; \$7.2 million to Pechiney; \$3.5 million to Pechiney; \$1.2 million to MIT International LLC; \$3.4 million to Parametal Trading Inc. ("Parametal"); \$1.9 million to Kataman Metals Inc. ("Kataman") and \$4.7 million to Southwire Company.
120. The majority of the holding certificates were signed by Waxman and Woodcroft. Soule, on behalf of Philip, executed a "Purchase Money Security Agreement (Inventory)" in respect of Kataman.
121. The inventory was never sold and never left the premises of Philip. Philip issued holding certificates to these customers. Philip recorded each transaction involving the holding certificates as a "sale", despite the fact that these were financing transactions.
122. These transactions were not properly recorded in the Company's financial statements for the year ended December 31, 1996.
123. The financial statements that were contained in the Prospectus were misleading and not accurate due to the inappropriate accounting treatment of the holding certificates, recorded in 1996. A special charge to the 1996 statement of earnings was required to be made because either, a) the liability to repurchase this inventory was not recorded, or b) the inventory remained in the books and records as being owned by Philip, at the date of the Prospectus.

124. The matters described in paragraphs 119-123 in respect of the holding certificates were known to Messrs. A. Fracassi, P. Fracassi, Boughton, Soule, Waxman and Woodcroft, prior to filing the Prospectus.

## **2. Reversal of Invoices - Pechiney**

125. Philip bought and sold copper cathode at various times during the material time.
126. In early 1997, the VP Finance made an adjustment to the 1996 results in the amount of approximately \$29 million. He did so to increase profits pursuant to a request by Woodcroft. The VP Finance achieved this by reversing seven invoices for the purchase of copper cathode from Pechiney. The invoices were not recorded as liabilities in the results for 1996, despite the fact that the inventory had been received and was recorded as an asset in the 1996 results.
127. In April of 1997, Philip paid these invoices, but the unrecorded liability continued to be deferred until written-off at year-end, when their write-off formed part of the Special Charges.
128. The purchases and repayments involving Pechiney were not properly recorded in the Company's financial statements for the year ended December 31, 1996 and for the quarters ended March 31, 1997, June 30, 1997 and September 30, 1997.
129. A special charge to the 1996 statement of earnings was required in respect of these transactions because the liability to purchase this inventory was not recorded.
130. The financial statements that were contained in the Prospectus were misleading and not accurate due to the inappropriate accounting treatment of the Pechiney purchases and repayment in 1996 and 1997.
131. The matters described in paragraphs 125-130 were known to Messrs. A. Fracassi, P. Fracassi, Boughton, Waxman and Woodcroft prior to the filing of the Prospectus.

## **3. Commodity Capital Group Metals Inc. ("CCG")**

132. In early 1997, Philip began negotiating a financing transaction with CCG, a corporation based in New York. In August and September of 1997, CCG provided approximately \$31 million in financing to Philip. In addition to the amount advanced from CCG, Philip also paid to CCG interest payments totalling approximately \$1.6 million.

### **The Agreements**

133. On or about August 13, 1997, Philip finalized the financing arrangement with CCG. In summary, the arrangement consisted of the following:

- (a) Philip agreed to sell "commodity lots" (scrap metal) to CCG at the market value of the commodity;
  - (b) In the "letter of assurance" addressed to the consortium of banks, Philip also acknowledged that it was aware that CCG financed these purchases by obtaining loans from a consortium of banks;
  - (c) Philip was obliged to repurchase the commodity lots from CCG at the same prices at which Philip sold the commodity lots to CCG, plus interest. Philip's obligation to repurchase the commodity lots was "absolute and unconditional". Philip also acknowledged that CCG's obligations to Philip were, at all times, subordinated to CCG's obligations to the banks; and,
  - (d) According to the holding certificates, "Philip agrees to indemnify and hold harmless CCG, the agent, the banks... from and against all claims and liabilities... as a result of holding such commodity lot at the location referred to above."
134. The invoices, backdated to June 30, 1997, were issued by Philip to CCG for the sale of 27 million pounds of inventory. On the same date, June 30, 1997, Philip issued holding certificates for 27 million pounds of inventory held on behalf of CCG.

#### **The August 19, 1997 and September 16, 1997 Transactions**

135. On August 19, 1997, (the "first transaction"), Philip "sold" 27 million pounds of various inventory (commodity lots) to CCG for US \$26.550 million, by invoice dated June 30, 1997. In return, on August 22, 1997, CCG paid Philip US \$25.225 million, which represented 95% of the purchase price. The 5% balance (net of interest and handling fees) was retained by CCG as a hold-back and was to be paid to Philip at the date Philip "repurchased" the commodity lot from CCG.
136. According to the Treasurer's memo, he was,
- ...requested by Marvin Boughton to control the receipt of funds at Corporate and ensure other liabilities of the Metals Recovery group were extinguished with the funds, namely amounts due to Pechiney Inc.*
137. On the same day, CCG issued a postdated invoice to Philip for the sale to Philip of the same quantity of inventory and for the same price, with a due date of November 19, 1997. This invoice, dated August 19, 1997, was "approved for payment" by Woodcroft and Waxman. On November 19, 1997, as agreed to in the Purchase and Sale Agreement, Philip was obligated to repurchase the inventory from CCG.
138. On September 16, 1997, (the "second transaction") Philip "sold" 5.4 million pounds of various inventory (commodity lots) to CCG for approximately US \$4.752 million. In

return, Philip received approximately US \$4.5 million which represented 95% of the purchase price. The balance was retained by CCG as a hold-back.

139. On the same day, CCG invoiced Philip for the sale to Philip of the same quantity of inventory and for the same price, due on December 17, 1997.
140. Prior to December 17, 1997, the VP Finance alerted Hoey that repayment to CCG would create a charge of approximately \$29 million which would have to be taken to earnings or otherwise dealt with. This arose when, in accounting for the loans from CCG, Philip offset an amount of approximately \$29 million which had arisen in 1997 when a payment of a previously unrecorded and unrelated liability was made (the unrecorded Pechiney invoices discussed at paragraphs 125-130). As a result of this offset, no liability to CCG was apparent.
141. In November, 1997, Messrs. A. Fracassi, Boughton and Hoey made certain representations to Deloitte for the purposes of the Prospectus. At that time, Philip management did not disclose the liability to CCG.
142. On November 19, 1997, Philip and CCG "rolled" the first transaction; that is, Philip received an extension of the repayment of the loan. Philip and CCG agreed to repeat a transaction that was identical in its terms to the transaction executed on August 19, 1997.
143. On November 19, 1997, according to the Treasurer's memo,

*I [the Treasurer] co-ordinated the movement of funds to facilitate the roll of the transaction by Bob Waxman for another 90 days to February 17, 1998.*

*I also facilitated the transfer of funds on December 17, 1997 to close out the second transaction as I was informed by [VP Finance] it was not to be rolled.*

144. On December 17, 1997, Philip repurchased the inventory underlying the "second transaction", from CCG for approximately \$4.7 million.
145. A December, 1997 journal entry processed a payment to CCG but inappropriately capitalized the payment by charging it to acquisition expenses. The journal entry was authorized by Hoey.

## **1998**

146. On or about February 17, 1998, Philip was obligated to repurchase the inventory underlying the "first transaction" from CCG. Philip paid to CCG the resulting interest and fees and a new agreement was put in place, resulting in the rolling of the transaction. The

new agreement required Philip to provide a greater amount of inventory and pay an additional hold-back of \$393,694.

147. On March 19, 1998, Philip terminated its involvement with CCG and repurchased the remaining inventory (58.2 million pounds) from CCG. Philip paid approximately \$150,000 in interest and fees.

#### **Deloitte's Discovery of the Transaction**

148. In early February, 1998, at the time that he resigned from Philip, the VP Finance informed A. Fracassi and Hoey that Deloitte was unaware of two further adjustments that should be taken by Philip. One of these related to the CCG transaction.
149. In mid-February and again in mid-March, 1998, the new President of Metals informed Hoey that there was no liability recorded for CCG.
150. Prior to the end of March of 1998, A. Fracassi and Hoey were made aware that there was no liability on the books of the Metals Group for the CCG transaction. Sometime in mid-April, 1998, Deloitte was informed of the unrecorded liability.

#### **The Adjustment**

151. The financial statements that were contained in the Prospectus were misleading and not accurate due to the inappropriate accounting treatment of the CCG transaction.
152. After Philip filed its Form 10-K in March of 1998, an adjustment of approximately \$30 million was taken by Philip regarding the CCG transaction. The discovery of the unrecorded liability relating to the CCG transaction triggered the recall of Philip's Form 10-K and Deloitte's opinion on the financial statements contained in the Form 10-K.
153. The matters described in paragraphs 132-145 were known to Messrs. A. Fracassi, P. Fracassi, Boughton, Waxman and Woodcroft prior to the filing of the Prospectus.

#### **4. Canadian Imperial Bank of Commerce ("CIBC")**

154. In or around May of 1997, Philip and CIBC began negotiation of a complex financing arrangement, the purpose of which was to provide Philip with funds as a result of the "sale" of copper inventory to CIBC. At the same time, Philip agreed to:
- (a) process the inventory and store it on its premises; and
  - (b) market and sell the inventory on behalf of CIBC, remitting the proceeds to the bank.

155. Philip wanted to record this series of agreements as a sale of inventory despite the fact that this was a financing transaction.
156. The fact that CIBC also insisted that Philip enter into swap agreements effectively meant that all of the risks of ownership of the inventory remained with Philip. As a result, the transaction should properly have been recorded as a financing transaction.
157. On or about June 27, 1997, Philip finalized a financing agreement with CIBC. The Purchase, Sales Agency and Processing agreements ("the Agreements") were signed by the Treasurer and Hoey on behalf of Philip. Pursuant to the Agreements,
  - (a) Philip agreed to sell to CIBC "commodities" (unprocessed copper) representing the equivalent of 31.5 million pounds of finished product;
  - (b) Philip agreed to retain physical possession of the inventory;
  - (c) CIBC "directed" Philip to process the commodities pursuant to a prescribed schedule - 2 million pounds per month between July 1997 and April, 1998 and 11½ million pounds in May, 1998;
  - (d) CIBC "authorized and directed" Philip to sell the commodities in 11 monthly tranches - 2 million pounds per month between July, 1997 and April, 1998 and 11½ million pounds in May, 1998;
  - (e) CIBC "directed" Philip to remit the sales proceeds, at the COMEX price at the date of the sale, to CIBC, on each settlement date; and,
  - (f) Philip received \$26.8 million in cash, net of prepaid interest and net of a hold-back of the processing and sales agency fees due to Philip.
158. Simultaneously, on June 27, 1997, Philip entered into a swap agreement with CIBC. The swap agreement was signed by the Treasurer on behalf of Philip. The swap contract ensured that Philip would remit to CIBC proceeds of at least the amount initially paid by CIBC, plus interest, thus eliminating the risk to CIBC of future fluctuations in the copper prices.
159. CIBC provided Philip with an accounting opinion indicating that the transaction, as initially contemplated, could be recorded as a sale.
160. Philip sought Deloitte's advice on the accounting of this transaction. On the basis of the information that was provided to Deloitte, and after considerable debate, they found that recording the transaction as a sale was acceptable. The existence of the swap agreement was not disclosed to Deloitte.

### **The Accounting for the Transaction**

161. Philip did not process any of the inventory, as required pursuant to the agreements. Rather, as swap agreements came due every month, Philip "rolled" the transaction. The "rolls" necessitated a net payment from Philip to CIBC or vice-versa.
162. Hoey instructed the VP Finance to record the transaction as a sale with a corresponding reduction in inventory which would result in an increase in the cost of sales. The VP Finance also recorded the accounting for the swaps and the rolls.
163. Philip recorded the sale of its inventory and did not record the transaction as a finance arrangement. As a result, a gross profit of \$3.2 million in the second quarter of 1997 was realized due to the manner in which the transaction was recorded.

### **The Disclosure of the Swap Agreements to Deloitte**

164. During that time, Philip continued to fail to disclose the existence of the swap agreements to Deloitte.
165. In early February 1998, at the time that he resigned from Philip, the VP Finance informed A. Fracassi and Hoey that Deloitte was unaware of two further adjustments that should be taken by Philip. One of these related to the CIBC transaction.
166. On March 5, 1998, Philip issued a press release indicating that,

*[t]he amount of the discrepancy was confirmed at \$92.2 million pre-tax caused by trading losses and \$32.9 million pre-tax caused by the incorrect recording of copper transactions within the copper division.*

These figures did not include an adjustment for CIBC.

167. On or about March 19, 1998, while finalizing the audit, Deloitte discovered that there were no accounting entries for certain transactions. In particular, Deloitte identified the swap agreements, their impact on the CIBC transaction and the lack of recognition of a liability. As a result, further adjustments to the financial statements were made by Philip.

### **The Adjustments**

168. As a result, the financial statements that were contained in the Prospectus were misleading and not accurate due to the inappropriate accounting treatment of the CIBC transaction.
169. In the Form 10-K, the financing arrangement with CIBC formed a component of the adjustments, the Special Charges, announced by Philip and made to its financial

statements for the year-end December 31, 1997. The adjustment was in the amount of \$10 million.

170. The matters described in paragraphs 154-164 were known to Messrs. A. Fracassi, P. Fracassi, Boughton Hoey and Woodcroft, prior to filing the Prospectus.

#### **5. Waxman Promissory Note**

171. As indicated in paragraph 13 1) iii), the Waxman Promissory Note was in the amount of \$10 million. On the instructions of Woodcroft, the Waxman Promissory Note was improperly recorded in the 1997 Q3 financial statements in inventory. The Waxman Promissory Note was, however, later written off as uncollectible and was also not included as an amount due from, or guaranteed by Waxman in his termination agreement dated January 5, 1998. Messrs. Woodcroft and P. Fracassi were aware that the Waxman Promissory Note had been improperly recorded in the financial statements which were contained in the Prospectus.
172. The Waxman Promissory Note was included in the Special Charges as an item relating to cathode trading activities.

#### **VIII CONDUCT CONTRARY TO THE PUBLIC INTEREST**

173. The Respondents' conduct, as set out above, contravened sections 56 and 122 of the Act and was contrary to the public interest.

#### **IX OTHER**

174. Such further and other allegations as Staff may make and the Commission may permit.

**DATED AT TORONTO** this 12<sup>th</sup> day of October, 2005.