

HOLLINGER INTERNATIONAL INC.

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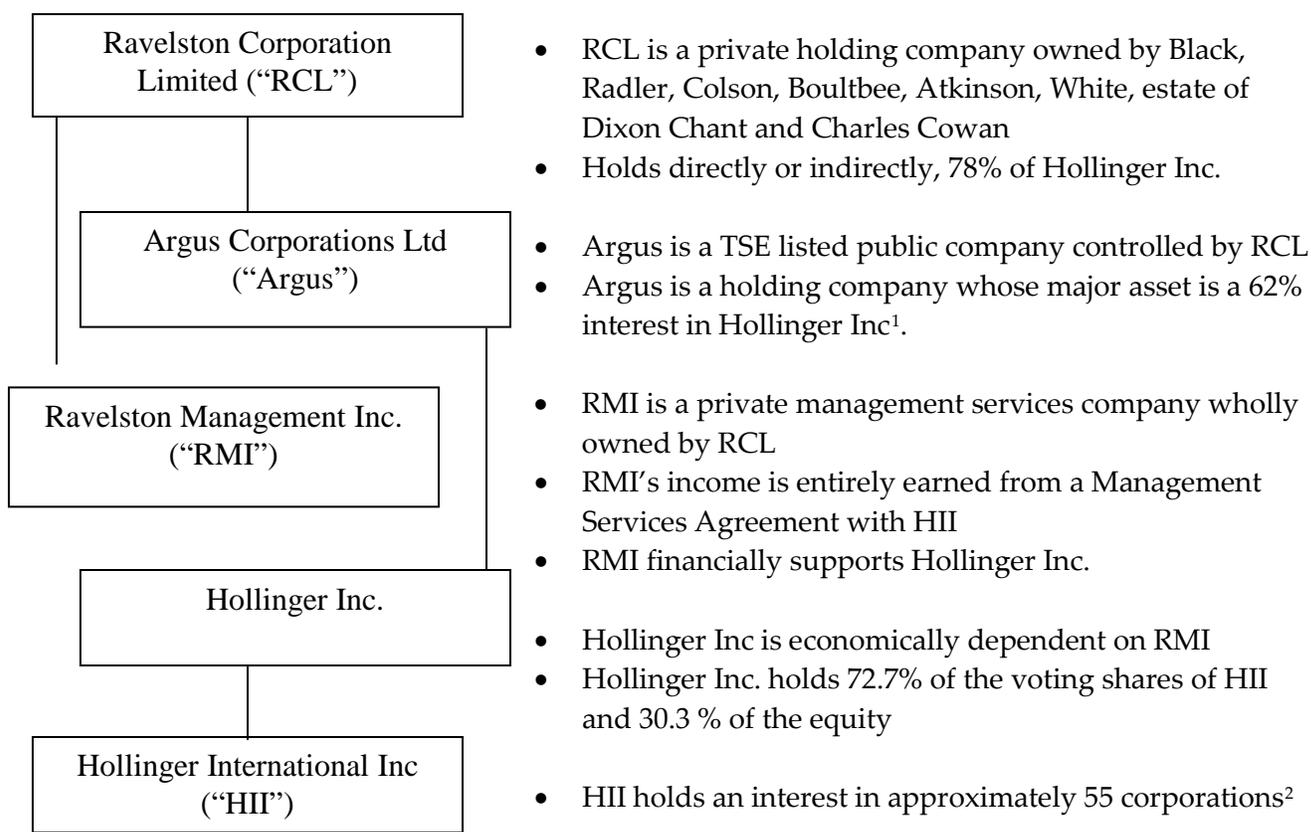
Hollinger International Inc.

Background

Hollinger International Inc. (“HII”) is a global newspaper publisher with English-language newspapers in the United States, Great Britain, and Israel. Its major assets include The Daily Telegraph, The Sunday Telegraph and The Spectator magazine in Great Britain, the Chicago Sun-Times and a large number of community newspapers in the Chicago area, The Jerusalem Post in Israel, a portfolio of new media investments and a variety of other assets. HII is a Delaware corporate based in Chicago, Illinois whose shares are listed on the NYSE and TSE, as well as other exchanges.

Hollinger Inc., is a Canadian Public company, whose major asset is its interest in HII. Hollinger Inc. owns 30.3% of the equity and 72.6% of the voting shares of HII. The major shareholder of Hollinger Inc. is Ravelston Corporation Limited (RCL) through Argus Corporation Ltd. (Argus).

Corporate Structure



¹ Argus Corporation Limited, Annual Information Form, May 20, 2003, Sedar

Who is Lord Black of Crossharbour?

Conrad Moffat Black (Black) was born into a life of privilege in Montreal in 1944. His father, George Montague Black, was a wealthy brewery executive. Black received part of his education at Toronto's most prestigious boys' school, Upper Canada College. But, he was expelled from UCC for selling exam papers to other students³. He went on to Carlton University where he majored in History, then Laval for Law, and finally McGill for a MA in history.

After graduating from Carlton, he immediately began acquiring newspaper publishers. In 1978 Black, took over control of Argus which held a controlling block of Hollinger Inc.⁴ When acquired, Argus was a giant holding company, but over the years Black has divested the assets of Argus piecemeal for profit. It was these profits that provided the capital to focus on newspaper acquisitions. While Hollinger Inc. has been in existence in one form or another since 1909, it was only after 1985 that the company focused on newspapers. At one time Black controlled the third largest newspaper publisher in the world with revenue of \$2 billion in 1999.

As a newspaper owner, he had a reputation for making deep cuts in costs in order to turn a profit⁵. Black's views of journalists are well known. He has described journalists as "ignorant, lazy, opinionated, intellectually dishonest and inadequately supervised hacks"⁶. Black is a hands-on owner who is known to routinely intervene in editorial policy-making⁷. Radler explained the Hollinger's editorial policy as "if editors disagree with us they should disagree with us when they are no longer in our employ⁸..."

Black holds extremely right-wing political views. Among his well-publicised opinions is that Canada should become part of the USA. Black is famous for his clever use of the English language and his aggressive wit. He has written three books including biographies on: Franklin D. Roosevelt, 2003; Maurice Duplessis, 1976 and an autobiography, 1993. Among the adjectives used to describe Black are charming,

² HII 2002 10K lists 55 companies that they identify as "Significant Subsidiaries"

³ Newman, Peter C. "The Establishment Man" McClelland and Stewart, 1982 page 36 - 37

⁴ <http://www.hollingerinternational.com/annual/annual.htm>

⁵ CBC 11/13/03 revised 1/19/04

⁶ Chicago Tribune 3/6/94

⁷ Maude Barlow, chair of the Council of Canadian

⁸ Maclean's 2/3/92

erudite, eloquent and impeccably mannered. According to an article in Vanity Fair, Black can also be arrogant, self-righteous, snobbish and thin skinned.⁹

Black likes to surround himself with famous people. He counts Margaret Thatcher and the Toronto Roman Catholic Bishop, the late Emmet Cardinal Carter among his friends. He included on the board of directors of HII Henry Kissinger, Former Secretary of State of the US. And Nobel Peace Prize recipient, James R. Thompson, Former Illinois Governor and Richard Burt, former ambassador to Germany. These types of directors are referred to as 'grey' directors, being outsiders with special ties to the company. They were not necessarily selected for their business acumen but rather for their status.

Black was not above cutting corners to get what he felt was his due. He was caught for breaching US federal and Ohio state securities laws during a takeover bid. In 1982 he signed an agreement not to violate provisions of the Securities and Exchange Act¹⁰. In 1986 the Ontario Supreme Court ordered Black to return \$56 million of pension plan surplus that he had removed from Dominion Stores employee's pension funds. Black acquired the Dominion grocery store chain through Argus.

Black is known to enjoy the good life. He has a home in London valued at US\$26 million, Palm Beach US\$36 million, a huge 7 acre estate in the Bridle Path of Toronto and a New York apartment on Park Avenue. He and his wife, Barbara Amiel, a former journalist, are known to throw lavish parties. But all this is expensive. Black is quoted as telling Peter C. Newman over 20 years ago, "greed has been severely underestimated and denigrated, unfairly so in my opinion. It is a motive that has not failed to move me from time to time¹¹"

Black always saw himself a cut above the common man. He was offered a Lordship by the British government in 1999, but was unable to accept as the "Nickle Resolution", passed in 1919 by Canada's House of Commons, directed that the practice of bestowing titles of honour by foreign governments on Canadians be discontinued. Therefore as a Canadian citizen Black was not permitted to hold the title of Lord.

Black attempted to sue Prime Minister Jean Chretien for \$25,000 for abuse of power for blocking his appointment, arguing that Chretien's motivation was strictly personal, as Black's newspapers were known to be critical of him and the Liberal Party. The Ontario Superior court dismissed the claim by Black against Chretien. The Ontario Court of Appeal upheld this action.

⁹ Vanity Fair April 2004

¹⁰ CBC News – Conrad Black: Timeline February 20, 2004

¹¹ ibid

Black surrendered his Canadian citizenship to accept his peerage. On October 30, 2001 he was inducted into the House of Lords under the sponsorship of Margaret Thatcher and Lord Carrington, former Secretary General of NATO. Black was given the title Lord Black of Crossharbour.

Since mid-2003 Black has had a rapid descent from grace. He has been accused of using HII as a personal bank account at minority shareholders' expense. He claims his friends have abandoned him and that he has become a pariah of his society. Black not only faces personal bankruptcy if unsuccessful in defending a \$1.25 billion lawsuit files against him by HII¹² but also could end up in jail if found guilty of all the misdealing he has been accused of by the SEC as discussed below.

SEC Complaint

On January 16, 2004, the SEC filed a complaint¹³ against HII alleging among other things that:

- From at least 1999 and continuing through at least 2001, HII failed to disclose material information in required filings with the SEC regarding the transfer of corporate assets¹⁴
- In order to cause some of the transfer of corporate assets, HII personnel falsified corporate books and records;
- HII failed to keep books, records and accounts which accurately reflect transactions;
- HII failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions were recorded in such a way to permit preparation of financial statements in conformity with GAAP; and
- At least US\$32 million was transferred to the benefit of insiders and related entities to the detriment of other shareholders.

The SEC cited a specific example of their allegations, which involved the 1998 sale of assets, including the publication American Trucker, to Intertec Publishing Corporation

¹² Globe & Mail May 8, 2004. The SCOB amended their earlier lawsuit of \$200 million to \$1.25 billion. The original law claimed that Black and others took money from HII in a continuing conspiracy to improperly enrich themselves. The revised lawsuit included a new allegation of racketeering.

¹³ See <http://www.sec.gov/litigation/complaints/comp18550.htm>

¹⁴ Ibid, the specifics of the allegations are set out in para 14 - 52

("Intertec"). The sale was disclosed in HII's 10-Q second quarter filings in August 1998. In connection with the sale, HII entered into a non-competition agreement¹⁵ with Intertec. Approximately \$2 million of the purchase price was allocated as a non-competition payment. In 1999 the approximately \$2 million was transferred to Hollinger Inc. Therefore, although the non-competition agreement was between Intertec and HII, the payment was made to Hollinger Inc. even though there was no signed non-competition agreement between Intertec and Hollinger Inc. As a result, the shareholders of HII did not benefit from this payment; rather it was Hollinger Inc. that benefited. As well, HII did not disclose the approximately \$2 million payment to Hollinger Inc. made in connection with the sale of American Trucker in their filings with the SEC until November 2003.¹⁶

Another example cited was a 2000 sale of HII assets to Newspaper Holdings, Inc., a CNHI subsidiary. In connection with the transaction, HII, Hollinger Inc., Black, Radler and other Hollinger related executives entered into a non-competition agreement with CNHI. Hollinger Inc. received \$750,000, Black and Radler each received \$4.3 million and other Hollinger related executives received a total of \$1 million. HII failed to disclose the payment to Hollinger Inc until November 2003. HII first disclosed the payment made to Black, Radler and other Hollinger related executives in their 10K filed on March 28, 2002. The SEC alleges the disclosure was false and mischaracterized the nature of the payments. The disclosure stated that the non-competition payments were made to satisfy a closing condition and the independent directors of the HII board had authorized the payment. However, the payments were not made to satisfy a closing condition and there was no authorization by the independent board members. Finally, the amounts listed on the 10K as paid during the year were inaccurate, yet no additional disclosure was made in subsequent filings to correct the information¹⁷.

The SEC charges go on to detail numerous other examples of transactions similar to the two summarized above where HII sold assets and non-competition payments were made to Hollinger Inc or Black, Radler and other Hollinger executives personally. On many of these occasions there was no signed non-competition agreement with the purchaser. The independent board members of HII were not aware of or did not approve the payments. These payments were not disclosed in filings to the SEC until later.

The reason for so many similar payments is that since the late 1990s HII has been

¹⁵ A non-competition agreement is simple an agreement not to compete. Usually an agreement not to entering into a similar business is the same jurisdiction. A non-competition payment would be the consideration given in exchange for the agreement.

¹⁶ <http://www.sec.gov/litigation/complaints/comp18550.htm> para. 22 - 24

¹⁷ Ibid para. 33 - 39

divesting itself of many of its subsidiaries as a means of reducing its crippling debt load and service obligations, which it had accumulated as a consequence of earlier acquisitions. Based on the 2002 10K HII had \$510 million of debt classified as current. When many assets were sold to reduce the debt, a portion of the proceeds was set-aside as “non-competition” payments owing to Hollinger Inc. or senior executives of HII personally.

As a result of these payments the minority shareholders of HII suffered. As an example of a transaction, if the sale proceeds from the sale of a subsidiary publishing company were \$100 million with a carrying value of \$90 million, normally the gain for HII would be \$10 million. But, a portion of the gain, say \$2 million, was allocated to a non-competition expense to be paid to Hollinger Inc. Thus, the actual gain for HII was only \$8 million. Consequently, the minority shareholders would benefit from only a portion of the gain.

Background to the SEC complaint

Among HII’s shareholders are large Institutional investors, which include Tweedy, Browne Company, LLC. In letters¹⁸ sent to the board of HII on May 19, June 11, and again on July 8, 2003, Tweedy, Browne complained about the activities of HII. Tweedy, Brown demanded HII’s board of directors investigate and take corrective action regarding:

- Payments received directly or indirectly by executives of HII relating to non-competition agreements;
- Payments made pursuant to management service agreements; and
- The sale of assets by HII to entities affiliated with some of HII’s executives.

It is the contention of Tweedy, Browne and other shareholders, that while the financial condition of HII had suffered over the previous few years, Black and other insiders had not. For example, in 2000 HII sold Canadian newspaper assets to CanWest Global for \$1.8 billion. CanWest paid an additional \$28 million to Black and three other executives plus another \$25 million to Revelston¹⁹. The minority shareholders believe that any - moneys resulting from the sale of HII assets should be paid to the company and not executives personally.

Tweedy, Browne’s complaints led to the establishment in June 2003 of a Special

¹⁸ See Schedule 13D files with the SEC on Edgar

¹⁹ Forbes, May 26, 2003

Committee of the Board of Directors (“SCOB”) of HII²⁰. The SCOB was to conduct an independent review and investigation of allegations raised by Tweedy, Browne. The SCOB retained Richard C. Breeden, a former Chairman of the US SEC, to represent and advise it in its review. Gordon A. Paris, a newly elected independent board member, was the Chairman of the SCOB. Two additional independent board members rounded out the SCOB. The SCOB concluded that between 1999 and 2000 US\$16.55 million was paid by HII to Hollinger Inc. for non-competition. These payments were not authorized or approved by either the audit committee or the full board of HII²¹. Black signed a restitution agreement that required that he and others, including Radler, repay US\$32.2 million by June 1, 2004. The first payments of US\$850,000 on December 31, 2003 and US\$7 million on January 4, 2004 were not made by Black to HII.

The audit committee of Hollinger Inc. commenced its own investigation into these payments, which culminated in a report submitted to their board. The Board did not accept all their recommendations to make certain board changes. A resolution approving the recommendations of the audit committee was defeated. Immediately following the defeat of the resolution, the members of the audit committee resigned²². On December 23, 2003 the external auditors of Hollinger Inc., KPMG resigned. KPMG remains the external auditor of HII.

Additional Information on HII

HII’s performance below market expectations over the previous few years may have exacerbated Tweedy, Browne’s dissatisfaction with HII. HII suffered significant losses in 2001 and 2002. By December 31, 2002 HII had a Retained Deficit of \$100 million²³ As a consequence, HII cut its quarterly dividend from 11 cents to 5 cents. HII also had significant intangible assets – based on the 2002 10K, 30% of the assets were identified as goodwill or intangibles. These intangible assets were created by an acquisition binge in the 1990. But as a result of these acquisitions, HII found itself with a huge debt load that already dwindling profits were needed to service. In order to reduce the debt load, HII had to sell off assets. While the sale of assets did free up capital to repay debt it also created substantial potential tax liability as a result of gains on the sale of certain operations. It was the sale of these HII assets that led to the non-compete payments that were made to Hollinger Inc. and executives personally.

The relationship between HII, Hollinger Inc., Ravelston, and the executives was so

²⁰ See Press release of HII dated June 17, 2003

²¹ Interim report of Hollinger Inc 9 months ended September 30, 2003

²² Interim report of Hollinger Inc 9 months ended September 30, 2003

²³ 2002 Balance sheet per to 10 K

intertwined that it is difficult to determine where one party's interests end and the others' begin. HII had a close-knit management group that had worked together for many years, including Black, Radler,

- J.A. Boulton ("Boulton"), Executive Vice-president and CFO of HII, Executive VP, CFO and director of Hollinger Inc.
- Peter White ("White"), co-COO and director and secretary of Hollinger Inc.
- Lady Barbara Amiel Black ("Black"), Director of HII and Hollinger Inc., Spouse of Black
- Daniel W. Colson ("Colson"), CEO of the Telegraph, Vice Chairman and director of HII, Vice Chairman and director of Hollinger Inc.
- Richard N. Perle ("Perle"), director of HII, co-chairman of Hollinger Digital Inc.
- Peter Y. Atkinson ("Atkinson"), former executive Vice-president and director of HII, executive VP and general counsel and director of Hollinger Inc.

As at December 31, 2002, of the 12 HII directors, 6 were insiders including Black, Atkinson, Black's wife Barbara Amiel, Colson, Perle, and Radler. Of the independent directors, a number were chosen for their names and position rather than their business acumen, including Kissinger, Thompson, and Burt.

In 2002 the full board of Directors of HII met only 4 times because the 3 person executive committee of board made all the significant decisions. This committee was made up of Black, Radler and Colson.

There were extensive related party transactions including:

- A management service agreement with Ravelston that is owned by a number of the members of the board of HII. RMI and RCL billed HII and its subsidiaries US\$23.7 million in 2002. According to the agreement, RCL acts as manager of HII and carries out head office and executive responsibilities. The service agreement was assigned to RMI.²⁴
- A management service agreement with executives resulting in costs to HII subsidiaries of US\$1.9 million in 2002
- HII paid some of Hollinger Inc.'s expenses in 2002 to the tune of US\$2.2 million

There were significant inter-company loans including \$30.3 million payable by HII at December 31, 2002; \$45.8 receivable from a subsidiary of Hollinger Inc.

HII's share structure also may not be in the best interest of the investing public. HII class B are multiple voting shares where as Class A is single voting. As a result of this share structure Black, through Hollinger Inc, is able to control 72.6% of HII while owning only 30.3% of the equity. Consequently, although HII is a public company, one individual controls it.

Timeline

The following is a timeline of significant events throughout the fall of 2003 and 2004:

- November 14 – HII failed to file Q3 report with the SEC on schedule.
- November 17 – HII issues a press release advising the public of three matters
 - i. Black resigns as CEO of HII effective November 21. Other resignations include Radler and Mark Kipnis, corporate counsel. Boulton, the CFO, was fired;
 - ii. HII announces that certain amounts (non-competition payments) had been incorrectly categorized in financial disclosures to the SEC and the public; and
 - iii. HII engages Lazard Freres & Co. LLC to review and evaluate its strategic alternatives, including a possible sale of HII, a possible

²⁴ 2002 10 K footnote 19.

combination of HII with Hollinger Inc. or a sale of one or more major properties.

- November 21 – HII files Q3 Financial Statements but without the required certification from top executives and without a review by KPMG.
- November 21 – The independent directors of Hollinger Inc. -- Maureen Sabia, Fredrik Eaton, Allan Gotlieb and Douglas Bassett -- resign.
- December 22 – Black asserted his Fifth Amendment Privilege against self-incrimination and refused to testify pursuant to the SEC’s investigative subpoena²⁵. The Fifth Amendment is a right under the US constitution which provides a defendant the right to refuse to speak to an authority if what he says may incriminate him.
- December 31 – Black fails to make an initial instalment of \$850,000 to repay unauthorized amount received from HII
- January 6, 2004 – Black fails to make a \$7.2 million instalment to repay unauthorized amounts received from HII
- January 16 – SEC obtained a US Federal Court Order to protect shareholders and preserve the corporate assets of HII²⁶. The complaint was filed under various sections of the Securities and Exchange act of 1934.
- January 18 – Black announces sale of his stake in Hollinger Inc. to Press Holding International for \$600 million. The deal would allow Press Holding to take over Black’s interest in HII, therefore it would effectively control 72.7% of the voting shares of HII.
- January 26 – HII adopts a shareholders’ rights plan (AKA “poison pill” defence) to block the sale of Hollinger Inc. to Press Holding. The shareholders’ rights plan had two features. Firstly, the Class B shares are to be converted to Class A shares. The Class B shares are multiple voting shares while the Class A shares are single-voting shares. This is why Hollinger Inc. which owns 30% of the equity of HII can control 72.6% of the votes. With the “Poison Pill,” if Press Holding succeeded in their purchase of Hollinger Inc. their voting rights would be reduced so they would effectively lose their control over HII. The second feature of the shareholders’ right plan provides

²⁵ SEC complaint #18550 para 12 files January 16, 2004. <http://www.sec.gov/litigation/complaints/comp18550.htm>

²⁶ *ibid*

for the issue of preferred share purchase rights to existing shareholders, which would flood the company with additional equity. The SCOB of HII felt a shareholders' rights plan was necessary for a number of reasons including:

- i. HII was looking to sell assets to reduce its debt load. Having a new major shareholder (Press Holding) would impact HII's ability to make these decisions; and
 - ii. If Black no longer held an interest in HII this would limit its ability to force him to repay the amounts he had received pursuant to the non-compete payments, as well as management fees paid previously that HII was suing to have returned.
- February 13 – Black issues a statement of claim in Ontario against the members of the SCOB and others independent board members for defamation of character, conspiracy to injure, interference with economic relationships and intimidation and intentional misrepresentation for Cdn\$850 million. The lawsuit said "The Defendants sought to destroy Black personally, professionally and financially and to transform him (Black) from a respected owner of a successful media chain into a loathsome laughing stock."²⁷
 - February 18 – 20 Court hearing over HII's attempt to enact a "poison pill" defence
 - February 27 – HII's "Poison Pill" is upheld by the US court. The Judge said "if you're a controlling shareholder, you still have a duty of loyalty ... You can't go barging around doing whatever you want if it's going to be hurtful to other shareholders. Controlling shareholders are just being put on notice that they don't have a free ride when they're controlling a public company – at least not in the US."²⁸
 - March 2, 2004 – Press Holding withdraws their offer to purchase Black's interest in Hollinger Inc.

²⁷ Press release form Hollinger Inc and Forbes (reference?)

²⁸ G&M February 28, 2003 Derek DeCloet

Further Research

For additional information the following Internet sites should be reviewed:

SEC charges - <http://www.sec.gov/litigation/complaints/comp18550.htm>

HII - <http://www.hollingerinternational.com/annual/annual.htm>

Hollinger Inc - <http://www.sedar.com>

Required:

1. As an auditor of HII what red flags exist and should be considered when assessing the risk factors of this engagement?
2. Why might the payments from HII to Hollinger Inc. have been structured as non-competition services?
3. Evaluate the oversight role of the Board of Directors of Hollinger Inc. Is the situation different at HII?
4. How would Sarbanes-Oxley rules impact HII?