

Title Page

BRE-X MINERALS LTD.

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However, in March 1997, rumors that Bre-X had not found any recoverable gold staggered the company's stock. By early May, the rumors were confirmed, revealing one of the largest gold frauds in history. How could it happen? How could a company without a single, independent audit of its gold claim be worth billions? How could so many red flags, clear in hindsight, be ignored? Some began to question whether the investment community, particularly the sell-side analysts, had done adequate due diligence and if not, should they be held accountable for what had happened?

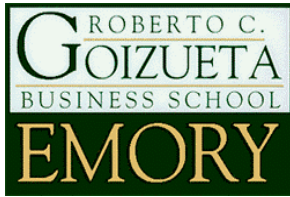
This package includes:

- a) **Title page**
- b) **Case including exhibits**
- c) **Teaching Note**
- d) **Possible teaching outline for an 80 minute class**
- e) **Useful Bre-X websites**

Keywords: Investments, Gold mining, securities fraud, securities regulation, financial analysts

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Bre-X Minerals Ltd.

“The lessons here are the old ones. No matter how tough the securities regulations or laws, perpetrators of deceit – and there now seems no doubt that deceit ... massive and unprecedented fraud were at play – those people will find a way to break the rules.” - Rowland W. Fleming, CEO and president of the Toronto Stock Exchange.¹

In June 1997, the Canadian financial markets were reeling from the effects of the Bre-X Minerals, Ltd. stock collapse. At one time, Bre-X claimed to have found the largest known gold deposit in the world. The company had been followed and recommended by some of the best known gold analysts in both Canada and the United States and had been added to the Toronto Stock Exchange’s TSE 300 index and traded on NASDAQ. At its peak, the market capitalization of Bre-X reached over C\$6 billion, all from a company that had been a penny stock with a market capitalization measured in the thousands just four years earlier.

However, in March 1997, rumors that Bre-X had not found any recoverable gold staggered the company’s stock. By early May, the rumors were confirmed, revealing one of the largest gold frauds in history. Mutual funds, pension plans, and private investors all over North America took heavy losses when the stock plummeted in value and was eventually delisted. Numerous class-action lawsuits were filed in Canada and the United States, some naming the Canadian and American investment firms as defendants because they had recommended the stock for so long.

How could it happen? How could a company without a single, independent audit of its gold claim be worth billions? How could so many red flags, clear in hindsight, be ignored? Some began to question whether the investment community, particularly the sell-side analysts, had done adequate due diligence and if not, should they be held accountable for what had happened?

Financial Analysts

Professional financial analysts are an important link in creating efficient financial markets. Financial analysts, also called **securities analysts** and **investment analysts**, process and supply valuable information for investors in the stock market. The most

¹ Washington CEO Network, Personal Perspective, June 1997.

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important pieces of information they supply are earnings forecasts, company growth rates, and stock price forecasts. All of these go toward determining the value of the company's stock. The analysts gather this information by analyzing company financial statements, interviewing corporate executives, and making on-site inspections.

The analyst compiles this information in a written report published by their investment firm that recommends what action investors should take regarding the stock. Usually those recommendations include buying, selling, or holding the security. There are two types of analysts: buy-side and sell-side. A buy-side analyst works for a money management or other type of investment management firm and makes recommendations to their firms' portfolio managers. Sell-side analysts typically work for brokerage firms and recommend stocks to the brokers' customers.

Recently, the activities of sell-side analysts have changed somewhat and this change has engendered controversy. Traditionally, sell-side analyst research had been a cost center at the brokerage firm. Brokers hoped to recoup the costs of the research department by receiving commission revenue from the brokers' clients, who, hopefully would demonstrate that they valued the services of the sell-side analyst by placing trades with their brokerage firm. Recently, sell-side analysts have taken a much more active role in the corporate finance activities of their brokerages. Today, a positive endorsement from the underwriters' analyst is considered vital to a successful offering. The increased role of the sell-side analyst has not been without its critics, as clients wonder if their sell-side analysts always have their best interests in mind when they recommend their broker's recent stock offerings.²

Analysts typically focus on companies within a certain industry; gold analysts therefore follow companies that conduct gold exploration, mining, and development. Junior gold exploration companies like Bre-X typically confine themselves to the drilling and measuring of potential gold resources in a designated site. If a significant find is made, the company can sell all or part of its rights to the site to a senior gold mining and development company.

Analysis in this industry is challenging given the analyst has no historical financial information on which to base their valuation. Analysts in industries such as oil exploration or pharmaceutical research face similar problems. Much of the valuation estimate of a mining exploration company hinges on reports of the findings by the company, typically verified by independent sources, that extrapolate total gold reserves based upon drilling results in a particular area. Based on the drilling results, a calculation can be made of the total value of the company's project(s), quantified in millions of ounces (moz) of recoverable gold. The greater the mineralization of gold, the higher the estimated gold reserves and therefore, the higher the stock price of the gold exploration company. Gold exploration company stock is usually considered to be a speculative investment, given the low probability of a gold exploration property ever becoming an operating gold mine.

² See, for example the *Business Week* of October 5, 1998, for the article "Who can you trust?"

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Bre-X was created in 1988 by David Walsh to search for diamonds in the Northwest Territories of Canada. The company was unsuccessful at finding any significant deposits and its stock, listed on the Alberta Stock Exchange, averaged a price of 27 cents between 1989 and 1992. By March 1993, Walsh had declared personal bankruptcy under the weight of C\$60,000 in credit card bills. Scraping together \$10,000 from the sale of part of his Bre-X position, Walsh went to Indonesia. Looking for opportunities abroad, Walsh contacted John Felderhof, a geologist from the Netherlands that Walsh had met almost 10 years earlier. In the 1980's Felderhof worked for an Australian company, Jason Mining Ltd. Jason Mining participated in the first Indonesian gold rush, a search that left most Australian investors disappointed. Only one company, Mount Muro, found an economically feasible claim in Indonesia. Despite the Australian results, Felderhof continued to believe in Indonesian gold. Felderhof claimed that there was a unique opportunity in a site in Indonesia, which he was currently surveying for its seller, Montague Gold. In Indonesia, Walsh met with Felderhof and another geologist, Michael de Guzman, and eventually agreed to buy the site from Montague. It took Walsh several months to raise the initial payment of US\$80,100.

On July 19, 1993 Bre-X closed the deal on the site; a project encompassing 57,571 hectares in Samarinda, East Kalimantan, Indonesia, also known as Busang. By September 1993, drilling had begun on the site and Felderhof claimed soon after that they had found up to 2 moz of recoverable gold. As the drilling continued, Bre-X needed more capital to fund exploration and initiated its first private placement, with Loewen Ondaatje McCutcheon, Ltd., for C\$4.5 million in March 1994. The company spent the rest of 1994 drilling on the property, slowly improving the estimates of recoverable gold to 3 moz by October 1994.

During this time, Bre-X had extended its claim to a site southeast of their initial claim. As it began to explore the new site, the estimates of recoverable gold rose to 6-8 moz by November 1994. By March 1995, the stock price had increased to C\$2.05 and Walsh began making presentations to potential investors. In May 1995, Bre-X initiated its second private placement: this time Nesbitt Burns, ScotiaMcLeod, and McLean McCarthy Ltd. joined Loewen in the placement of C\$7.5 million of Bre-X common shares. The proceeds from the offering were designated for continued exploration and working capital.

But it was not until October 17, 1995 that Bre-X shares began their steep climb. The stock shot up to C\$14.87 that day when the company announced that while exploring a deep ore body in the southeast site, it had found a large gold deposit that raised their estimate of recoverable gold to 30 moz. By November, the company had gained the attention of gold analysts in both Canada and the United States. As analysts began to recommend the stock, and drilling results released by the company continued to confirm the large deposit, the stock price of Bre-X continued to climb dramatically. Even the

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Indonesian Mines and Energy Ministry touted the Bre-X site, stating that the deposit could be as large as 40 moz, an estimate not disputed by the company. A deposit of that size would be worth a potential US\$12 billion, comparable to the world's largest deposit, the 40 moz Freeport McMoRan find, also in Indonesia.

On February 20, 1996, Bre-X announced its third private placement. This time it was an over-subscribed C\$30 million offered by Nesbitt, ScotiaMcLeod, Levesque Beaubien Geoffrion, and First Marathon Securities. The following day, after the company raised its estimate of recoverable gold to 42.6 moz, Bre-X stock rose C\$13.875 to C\$153 per share, giving it a market capitalization of C\$3.2 billion. By March, almost 50 mining companies, mostly Canadian, were digging in the vicinity of the Bre-X site. Egizio Bianchi, Canada's top-ranked gold analyst from Nesbitt Burns, declared the site "in the elite class of deposits around the world."³

Bre-X continued to raise its estimates of recoverable gold. It joined the Toronto Stock Exchange on April 23, 1996 at C\$187.50 a share. Exchange regulators only asked that the company supply a prospectus and a listing statement. Yet Bre-X was allowed to submit a prospectus prepared in 1989, when the company was still a penny stock. The Bre-X listing statement claimed that the site held large gold reserves and provided a report by their consultant PT Kilborn in support of this claim. The listing statement did not state, however, that PT Kilborn had relied on data supplied by Bre-X data in its analysis. Nevertheless, Bre-X continued to collect endorsements from some of the most recognized brokerage firms in Canada, including Nesbitt Burns, Levesque Beaubien, CIBC Wood Gundy, First Marathon, and Gordon Capital.

Analysts visited the site in Indonesia, talked with the geologists, and toured the assay labs where the ore samples were tested. Gold analyst Chris Bradbrook of Loewen stated "I continue to be really impressed by the (gold) deposit. It keeps getting bigger and bigger. The upside is substantial."⁴ Gold analysts continued to recommend the stock despite the fact that Bre-X kept information to a minimum. Felderhof refused to have the site independently assessed, even though junior mining companies are usually eager to have their gold strikes confirmed so that mining rights can be sold. No senior mining companies were permitted to view the site, which would be a necessary step before prospective purchasers could bid for the right to mine and develop the project.

Concerns were also raised in the minds of some analysts regarding the company's treatment of drill cores, which involved crushing the entire core instead of the usual practice of dividing them, saving half for subsequent tests. This practice is considered an essential safeguard against disputes arising from questionable assay results. The company countered these concerns by stating that the samples had to be crushed because the gold fell off the brittle cores. Thus, according to Bre-X, core samples were not halved and stored because too much gold would be wasted. When questions began to be

³ *Asia Times*, [Canadians find a pot of gold at the end of the rainbow](#), Brenda Bouw, March 7, 1996.

⁴ *Reuters Limited*, Reuters Toronto Bureau, [Financial Report \(Canada\)](#), September 5, 1996.

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raised in the press, Bre-X released a press statement that PT Kilborn had reported in its most recent report that their gold estimates may have been understated by as much as 12.9%.

By May 1996, Bre-X had a market capitalization of over C\$4 billion, largely due to Canadian pension fund managers adding the company to their portfolios. Late in May, Bre-X completed a 10 for 1 stock split, deemed necessary because the capitalization of the firm had peaked at \$6.2 billion, or \$286.50 per share, on a pre-split basis. In July, the share price of Bre-X continued strong and reserve estimates continued to increase. Nesbitt Burns and Levesque Beaubien estimated the reserves of the site at 60 moz and increased their projected value of the stock accordingly.

On August 19 1996, Bre-X began trading on NASDAQ and closed the day at US\$17.875, gaining the attention of American investors.⁵ Between August and October, Walsh, his wife, and Felderhof had sold more than 1.25 million Bre-X shares for over C\$60 million and used the proceeds to buy property in the Caribbean tax havens of the Bahamas and the Cayman Islands.

Bre-X gained attention from other sources as well. Bre-X had become embroiled in a dispute with one of its Indonesian partners, PT Krueng Gasui, who claimed a 40% stake in the entire site and threatened to file a C\$1.9 billion lawsuit in Canada if its demands were not met. It was also revealed that Bre-X's preliminary license to build a site at Busang had been quietly cancelled back in August. Bre-X did not report the loss of the license until October. The Indonesian government also refused to renew the firm's contract of work, a necessary requirement for further exploration and development, due to allegations that the company had drilled illegally, violated foreign ownership laws, and had unfairly treated PT Krueng Gasui. The Indonesian government stated that it would not sign a contract of work until these outstanding issues were resolved.

Another threat to Bre-X's claim on the site came in the form of Barrick Gold Inc., a Canadian-based gold mining and development company. In 1994, Barrick had tried to buy a minority stake in Bre-X but had been rejected. In a renewed attempt, Barrick enlisted the help of Indonesian President Suharto's eldest daughter, Siti, by promising her the contract to build roads into Busang. Bre-X countered Barrick by hiring Suharto's eldest son, Sigit, promising him US\$40 million and 10% ownership of the southeast site in return for his assistance in ensuring that Bre-X received approval to control the Busang project. However, in November Bre-X, outmaneuvered in the intricate world of Indonesian politics, was told by the Indonesian government to give Barrick 75% control of the site.⁶ The Indonesian government also stated that they would appreciate a 10% stake in the site.

⁵ See **Exhibit 1** for a graph of Bre-X's price history.

⁶ Barrick's international advisory board members included former Canadian Prime Minister Brian Mulroney and former US President George Bush.

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Negotiations began between Bre-X and Barrick, but failed to reach any permanent agreement. The dispute did not stop positive recommendations by mining analysts; on December 3, Lehman Brothers released a Buy recommendation describing the Busang site as “the gold discovery of the century.”⁷ In January 1997, another Canadian gold mining company, Placer Dome, Inc., raised the stakes of the negotiations by offering C\$6.4 billion for Bre-X in a stock-for-stock merger. It was through Placer’s CEO that Walsh met Muhammad ‘Bob’ Hasan, who had just purchased one of Bre-X’s Indonesian partners. Hasan was a confidant of Suharto and politically well connected, as well as being good friends with Jim Moffet, the CEO of Freeport McMoRan. Amid all of this activity, it was hardly noticed when a fire destroyed the Busang office that held de Guzman’s geological records of the site and almost all of the drill results.

On February 16, an agreement was announced between Hasan, Bre-X, and Freeport McMoRan. Through his political connections, Hasan had created a deal that gave him a 30% stake and reduced Bre-X’s stake from 90% of the Busang site to a 45% stake. In addition, Freeport McMoRan received a 15% stake and the Indonesian government was given a 10% stake in the site. For their part, Freeport committed to provide 25% of the funds to cover exploration costs, up to US\$400 million, and arrange US\$2.1 billion in financing from Chase Manhattan Bank for the remaining estimated exploration costs. These funds, however, were contingent on an independent analysis of the site by Freeport McMoRan. A day after the deal was announced, Bre-X raised its estimate of the Busang gold reserve to 70.95 moz.

On February 19, Bre-X hosted a conference call with both analysts and the media. The conference call was important to Bre-X, as some analysts had expressed criticism of the Freeport deal. The conference call became acrimonious when Walsh stated that the company had known for some time that it would never really get to keep 90% of the mine. This statement seemed to contradict earlier statements from the company. There were complaints by some analysts that they were not allowed to participate in the call.⁸ Bre-X officials countered the uncertainty with higher reserve forecasts, hinting that the estimate of gold reserves would be raised to around 95 moz. Felderhof even made a comment during the conference call that 200 moz was feasible. The conference call seemed to placate the analyst community and the stock price held up. The market capitalization of Bre-X on February 21 stood at C\$5.4 billion, down only slightly from its peak of C\$6.2 billion. On March 14, gold analyst Daniel McConvey of Lehman Brothers raised his recommendation on Bre-X from neutral to outperform.

The Crash in Bre-X

As part of their independent analysis of the Busang site, Freeport drilled seven holes in an area that supposedly contained significant amounts of gold. Freeport

⁷ *Calgary Herald Online*, “The Bre-X Saga: Fortune or Folly?” [Bre-X Shareholders Sue Investment Houses](#), Vicki Barnett and Paul Brent, July 29, 1997.

⁸ *The Financial Times*, [Busang critics say Bre-X barred questions](#), Bernard Simon, February 21, 1997.

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controlled the drilling and stayed with the cores, some of which were sent to PT Indo Assay Laboratories in Indonesia and some of which were sent to Freeport's headquarters in New Orleans. Freeport found that the cores they had drilled and controlled contained no significant amounts of gold. In an effort to find out why, Freeport obtained some cores that Bre-X had stated contained a significant mineralization of gold. Freeport sliced thin layers of the cores and placed them beneath an electron microscope. What they found was alluvial gold, or gold that originates from rivers, rather than any gold that would have originated from a volcanic deposit.

Moffett, when notified of the results, immediately contacted Walsh in Toronto, where he was attending the annual Prospectors and Developers Convention. Felderhof was being honored as Prospector of the Year and de Guzman was delivering a lecture on Busang to a full audience. Walsh told Moffett that he was more of a finance person and that Felderhof would be better suited to answer Moffett's questions. Felderhof responded to Moffett's inquiries by stating that Freeport must have its samples confused and that it would all be sorted out. Moffett responded that there was no confusion and that someone had better come down to straighten out the matter. Felderhof then sent de Guzman to Indonesia to confer with Freeport's representatives.

According to Indonesian authorities, while on his way to meet with Freeport's representatives on March 19, de Guzman jumped out of the helicopter he was riding in and fell 240 meters, or the equivalent of eighty stories, to his death into the jungles of Borneo. In his suicide note, he claimed his ongoing struggle with hepatitis B was a major factor. Two days after his death, an Indonesian newspaper, citing unnamed sources, reported that Freeport's tests on the site did not match Bre-X's results. Following the report, shares of Bre-X plummeted, cutting C\$800 million off of Bre-X's market capitalization.

At first, Walsh defended the Bre-X results, alleging that the company was under attack from short-sellers. On March 24, Walsh stated that he was confident the assay results were accurate and threatened legal action against any unsubstantiated allegations. Analysts' opinions on the company were mixed; Andrew Racz of Bishop, Rosen & Co. said that Bre-X was the victim of short sellers attempting to sabotage the stock.⁹ McConvey of Lehman Brothers dropped his rating from outperform to neutral, but stated that "while shaken by recent events, we believe that the Busang discovery exists as Bre-X has disclosed it."¹⁰

On March 26, a bombshell dropped in the form of two reports issued by Bre-X and Freeport simultaneously. Bre-X admitted that the test results from the Busang site may have been overstated because of invalid samples and the assaying of those samples. Bre-X also announced that an independent analyst, Strathcona Mineral Services, Ltd., had been hired to review the Busang program. In a separate statement, Freeport

⁹ *The Toronto Sun*, Is Bre-X Victim of Sabotage: \$493M Lost in 1 Day, Liza Sardi – *Calgary Sun*, March 24, 1997.

¹⁰ *Reuters Limited*, Reuters World Service, Financial Report: Research Alert, March 24, 1997.

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announced that its drilling results had uncovered “insignificant amounts of gold.”¹¹ Trading in Bre-X was halted on the TSE following these reports. NASDAQ also halted trading in Bre-X. Shares of Bre-X closed at \$1 31/32 the following day, a drop of \$9 13/32 from March 25 on 6,854,100 shares traded.

In the weeks leading up to the Strathcona report, shares of Bre-X fluctuated widely on rumors and controversy. Bre-X tried to maintain some confidence in the Busang site by releasing a mining report on April 4 which claimed that the Busang property still appeared to contain large quantities of gold. Walsh went so far as to state that he believed Bre-X was the target of a takeover attempt. On April 7, the Indonesian government announced that its two senior mining officials, the Director General of General Mining and the Director General of Electricity and Energy Development, had been replaced. Freeport requested an extension of its review of Busang “to allow for consideration of the findings of the Strathcona audit.”¹²

The Strathcona audit report was released on May 4 and confirmed that Busang not only did not meet Bre-X’s estimates, but in fact held no recoverable gold at all. According to the report:

“only trace amounts of gold have been found in the sample assayed, and there were no samples that gave gold values of economic interest.”
“... the magnitude of the tampering ... and resulting falsification of assay values at Busang, is of a scale and over a period of time and with a precision that, to our knowledge, is without precedent in the history of the world anywhere.”¹³

The effects of the report were devastating. The day following the release of the audit, TSE computers crashed after an hour of trading as Bre-X shares opened at 6 cents. On May 7, the Indonesian government froze the operations of Bre-X and its subsidiaries indefinitely, and the TSE delisted shares of Bre-X. Police investigations of the fraud began soon after the release of the Strathcona report when the Royal Canadian Mounted Police sent an investigation team to Indonesia. The two independent directors of Bre-X, Hugh Lyons and Paul Kavanagh resigned from the board.

Bre-X then fired Felderhof, who had moved into his home on Grand Cayman island on April 22. The company also voluntarily delisted its stock from NASDAQ and filed for bankruptcy protection. On May 23, the Alberta and Ontario exchanges prohibited trading in Bre-X, and on May 30, the Alberta Securities Commission extended its Bre-X trade ban indefinitely. The Ontario Securities Commission followed suit two days later. Both trading bans were a result of Bre-X failing to file audited financial statements for 1996.¹⁴

¹¹ Freeport McMoRan, March 26, 1997.

¹² Freeport McMoRan, May 1, 1997.

¹³ Strathcona Mineral Services Ltd. Report Summary.

¹⁴ In Canada, provincial securities commissions regulate securities’ trading rather than the nationwide responsibilities assigned to the Securities and Exchange Commission in the United States.

Busang

A theory that has resulted from current investigations indicates that de Guzman and several handpicked Filipino geologists appear to have been part of a salting operation that added alluvial, or river source, gold to the sample rock cores. The salting operation was based in Loa Duri and later in Samarinda, downstream from Busang. The altered rock cores were sent to the warehouse for storage before being forwarded by truck to PT Indo Assay Laboratories for crushing and testing. When the samples were barged or sent by speedboat down the river, Cesar Puspos, the nominal project manager at Busang, would often accompany them. Both de Guzman and Puspos appear to have been buying alluvial gold from a local tribesman as far back as December 1993, when the first major gold sample was taken.

By December of 1996, it is reported that the salting increased so much that Bre-X metallurgists Rudy Vega and Jerry Alo hired laborers from a construction project to help with the mixing. The processing went on day and night, with the proportions carefully measured by the Bre-X supervisors. While there does not appear to have been any direct contact between the salting operation and Felderhof, it has been alleged that he should have at least confirmed the increasing reserves and the reports of alluvial gold in the samples. Both Walsh and Felderhof were aware of, and failed to disclose, the fact that three separate consulting firms cited serious irregularities with the rock samples from the Busang site.

The reports discovered mineralization that showed characteristics unusual or even unprecedented for bedrock deposits. It appears that Bre-X executives and PT Kilborn were aware of reports by Normet Pty of Australia, Hazen Research Inc., and PetraScience Consultants of Vancouver showing alluvial gold and unusual characteristics in the Bre-X samples from Busang.¹⁵ These results would seem to indicate that the gold came from a different site; yet PT Kilborn verified Bre-X's reserves without taking its own samples. In fact, PT Kilborn created the engineering model and compiled the resource calculations for Busang based on Bre-X's data. Two reports in particular noted that the gold was alluvial, or came from a river, and was recoverable at a rate of more than 90% through gravity alone. That level of recovery without further processing is at least twice the rate expected from bedrock gold and more consistent with the addition of outside gold.

A possible motive behind the salting was that Felderhof and de Guzman truly believed that the Busang site contained gold and wanted to ensure the capital necessary to find it. However, the salting operation had to grow to keep pace with the expectations of Bre-X shareholders. These high expectations also raised the stakes to find actual gold on the site. Nevertheless, the financial rewards the principals received from the fraud cannot be ignored. Walsh invested an estimated C\$35 million of his Bre-X stock proceeds in his tax-exempt home of the Bahamas and John Felderhof sold C\$42 million of Bre-X stock.

¹⁵ *The Financial Post*, Lack of Bre-X data made danger signs hard to read, David Thomas, May 9, 1997.

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Other officers of Bre-X with substantial sales include McAnulty (C\$6.2 million), John Thorpe (C\$1.5 million), and Rolando Francisco (C\$1.25 million). Almost all of the sales occurred between April and October of 1996.¹⁶ After De Guzman's death, it was confirmed that he held 250,000 options on Bre-X stock and had sold 150,000 options worth C\$4 million.

The Aftermath

On the same day Bre-X fired Felderhof, Nesbitt Burns and gold-mining analyst Bianchi were served notice of a suit to be filed by an unnamed investor for \$3 billion under the Class Proceedings Act, which meant it could be certified as a class-action suit. Bianchi continued to recommend the stock until rumors in late March alleged that there was negligible gold at the site.¹⁷ Both the Ontario Securities Commission and the TSE set up a task force to look at the mining industry, which would be coordinated by a committee made up of the chairs of the Alberta, British Columbia, Quebec, and Ontario commissions.¹⁸

The TSE listing standards allowed Bre-X to be added to the TSE 300 index on December 16, 1996, raising its visibility to mutual and pension funds and placing Bre-X in the company of some of the largest and most respected firms in Canada.¹⁹ Index funds tracking the TSE 300 had to buy Bre-X, which became the 47th largest stock in the index at its peak of C\$6.2 billion.²⁰ Following the Bre-X debacle the Pension Investment Association of Canada (PIAC) and the Ontario Teachers' Pension Plan Board (OTPPB) petitioned for changes in the process that decides the composition of the TSE 300 Index.²¹

The objective of the petition is to allow independent representation on the committee that decides the components of the index and sets the listing rules on the TSE. Bre-X was unique since it was never anticipated that a junior mining exploration company would be worth billions in market capitalization. In fact, the TSE made an exception for Bre-X, waiving its standard requirement that it be listed for at least one year before being placed on the TSE 300. The exchange has already started a review of its index rules, policies, and criteria.

During its remarkable rise, American and Canadian gold-mining analysts churned out a barrage of bullish reports on Bre-X. A frequent complaint about sell-side analysts is that too much pressure is put on analysts to churn out positive reports because the

¹⁶ *The Financial Times*, [Busang critics say Bre-X barred questions](#), Bernard Simon, February 21, 1997.

¹⁷ Other analysts and their firms that also recommended Bre-X include Michael Fowler of Levesque Beaubien Geoffrion, Kerry Smith of First Marathon Securities, Bruno Kaiser of CIBC Wood Gundy, Daniel McConvey of Lehman Brothers, Chris Bradbrook of Loewen Ondaatje McCutcheon, and Barry Allan of Gordon Capital.

¹⁸ *Calgary Herald Online*, "The Bre-X Saga: Fortune or Folly?" [Samples Said Falsified](#), Canadian Press, May 16, 1997.

¹⁹ *The Financial Post*, [Bre-X debacle spawns assault on TSE's listing standards](#), Dan Westall, July 3, 1997.

²⁰ *Calgary Herald Online*, "The Bre-X Saga: Fortune or Folly?" *Southam Newspapers*, [Bre-X likely to have short-term impact](#), Peter Hadekel, May 25, 1997.

²¹ *The Financial Post*, [Bre-X debacle spawns assault on TSE's listing standards](#), Dan Westall, July 3, 1997.

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corporate finance divisions of their employers believe a positive report increases the firm's financing opportunities. This complaint is particularly relevant in this case since several of the analysts worked for securities firms that participated in Bre-X's financings. There were also allegations that an influx of young, inexperienced analysts diluted the quality of the research on Bre-X. More worrisome, however, is that analysts in Canada are allowed to buy the stocks they promote in their own research reports. According to analyst Vic Lazarovici of Smith Barney, "I've seen brokers buy stock and then (have their in-house analyst) write a report on it. It does not provide confidence in a transparent and fair market."²²

What is surprising is that almost no one in the investment community really questioned the numbers until right before the fall. A review of several research reports on Bre-X from 1995 to 1997 reveal a strong sense of confidence in the ever-increasing estimates of gold reserves.²³ The only fundamental basis of value that was reflected in Bre-X's stock price was the estimates of gold deposits in the Busang site. Bre-X went from reporting estimated reserves of only 3 moz in late 1994 to 200 moz in April 1997, making the site the largest known gold deposit in the world. All of the analysts knew that these estimates were not independent, yet took comfort in the fact that other gold companies were rushing to drill near the Busang site and several were attempting to gain control over the site outright.

The Bre-X situation had all the characteristics of a bull market that has lost its foundation of valuation. Individual investors, institutions, and analysts got caught up in the market move of Bre-X without looking behind the numbers or questioning how a company that had bought a site that had already been rejected by another gold exploration firm could find so much gold so near to the surface. There is no doubt that some information was withheld from the public, particularly the reports of alluvial gold, but the fact that some of the most respected gold mining analysts in the industry were duped by the fraud reflects how much the situation had gotten out of control. Perhaps New York analyst Ashoke Vasvani said it best when he stated "Beware of small companies with big numbers."²⁴

²² *The Vancouver Sun*, Analysts must shoulder some Bre-X blame, Gary Lamphier, May 12, 1997.

²³ *The Financial Post*, Lack of Bre-X data made danger signs hard to read, David Thomas, May 9, 1997.

²⁴ Ferris, Baker Watts, Inc., Bre-X Minerals – Company Report, R. Brown, May 1, 1997.

Exhibit 1 -- Bre-X Stock Price History

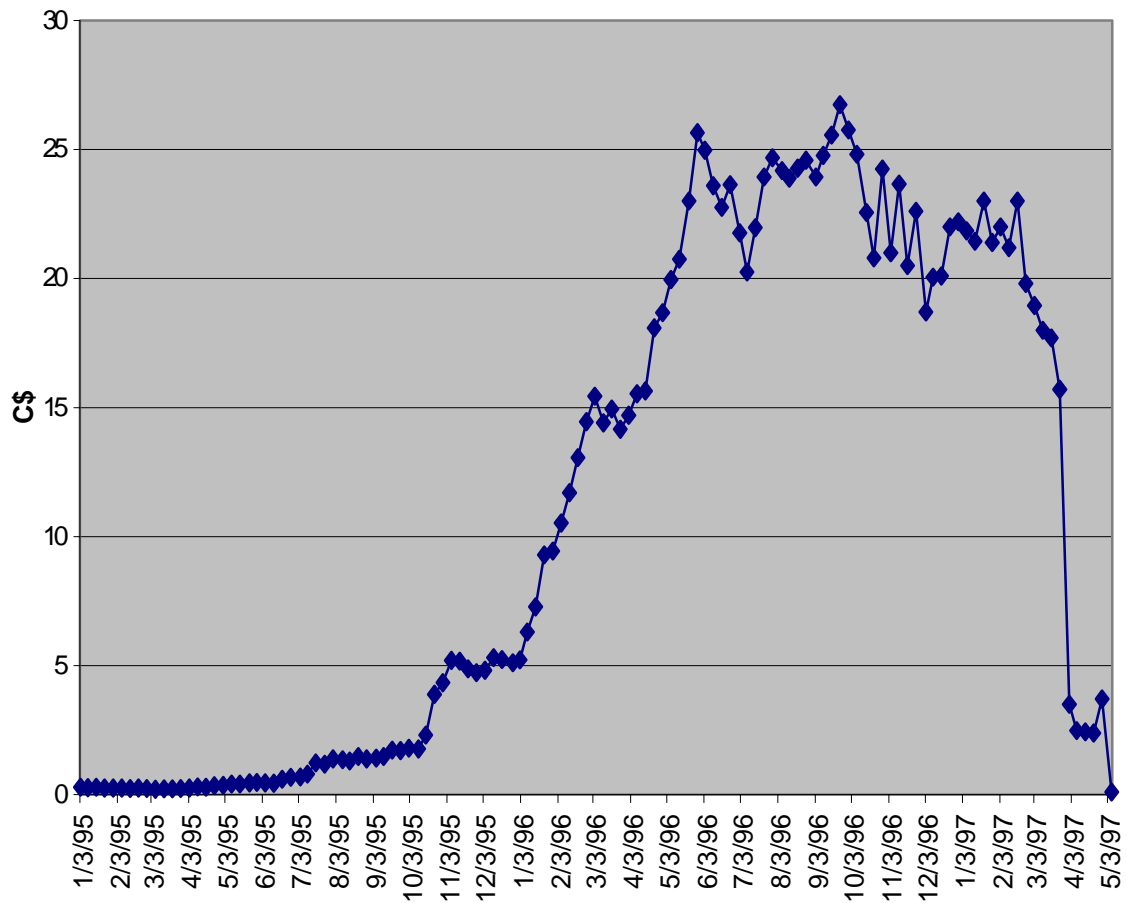


Exhibit 2 -- Bre-X Income Statements (in C\$000s)

Fiscal years (ended Nov. 30)	1996	1995	1994	1993	1992
Revenue	2113	237	116	33	0
Operating expenses	4665	604	324	112	61
Depr./Dept./Amort.	53	0	0	0	0
Net Income	-2605	-367	-208	-68	-52
Balance sheet					
Current assets		12301	3902	36	1
Long-term investments		505	25	25	25
Explor./develop. Properties		12712	3582	843	0
Total Assets	92490	25518	7509	904	26
Total liabilities	3224	1707	173	72	13
Capital stock		0	0	1576	808
Common stock		25283	8441	0	0
Retained earnings		-1472	-1105	-897	-829
Shareholder's equity	89226	23811	7336	679	-21
Earnings per common*		-0.002	-0.002	-0.001	-0.001
No. shares outstanding*		195698	139568	87617	

*Note: Adjusted for 10-for-1 split effective May 1996

Teaching Note: The lessons learned²⁵

Bre-X was a more than an unprecedented gold fraud, it is a lesson in hubris. No one involved with Bre-X comes away with an enhanced reputation. The Canadian mining industry, whose major companies actively pursued Bre-X; the Toronto Stock Exchange, who added a junior mining company to their TSE 300 Index; and the brokerage analysts; that consistently recommended Bre-X, all come in for their share of blame. Perhaps the herd mentality is the most likely explanation why so many were fooled. The ultimate basis for the valuation of Bre-X was based on testing of samples provided by Bre-X that were not independently confirmed. However, the participants were convinced that Bre-X was a once in a life time opportunity that couldn't be passed up; no-one wanted to miss the fabulous opportunity for wealth that Bre-X represented.

There were many red flags that should have served as warnings to careful investors and analysts. Bre-X was a secretive company, and Bre-X raised funds through private placements, financing aimed at sophisticated investors that do not require a full prospectus. Bre-X was loath to reveal uncomfortable information. A good example of this was that a newspaper, *The Globe and Mail* revealed the cancellation of the company's exploration permit, not the company itself. Felderhof's refusal to have Busang independently assessed reflected this secrecy. Typically, junior mining companies are eager to have gold strikes confirmed so that mining rights can be sold.

There should have been more concern expressed over the fact that Bre-X crushed its entire drill cores. The practice of dividing cores and saving half for subsequent tests is usually considered an essential safeguard against disputes arising from questionable assay results. The mid-January fire at the Busang offices that destroyed Michael De Guzman's geological records was suspicious, as was De Guzman's bizarre death.

The PT Kilborn report, used as the only independent confirmation of Felderhof's reserve claims, was not truly independent. Instead the consultants relied on data supplied by Bre-X.

Everyone seemed blinded by the size of the find, without recognizing how unlikely the find actually was. A good deal of wishful thinking went into the Bre-X story. Bre-X escalated its estimate of reserves at Busang from 3 million ounces to 200 million ounces over a two-year period. 200 moz of gold has a market value of approximately US\$60 billion! The peak market value of C\$6.2 billion may have influenced the Toronto Stock Exchange's decision to put Bre-X into their Index. Brokerage analysts were engaged in cash flow calculations based on reserve estimates when the company was years away from producing its first ounce of gold.

Major gold producing companies like Barrick Resources and Placer constantly face the problem of remaining major producers, simply because they are necessarily

²⁵ Excellent summaries of the lessons learned from Bre-X are included in [The Bre-X Fraud](#), McLelland & Stewart, 1997 and [Bre-X, Gold Today, Gone Tomorrow](#) The Northern Miner, 1997.

Bre-X Minerals Ltd.

reducing their assets as they mine gold from their properties. Ownership of the resource that Busang promised could provide the raw material for decades of production. In a classic example of herding, the desire of each major producer to own Bre-X rested in part on the desire of other major producers to own Bre-X. Independent verification of the deposit had to wait until Freeport McMoran, the US-based major that finally won the right to develop Busang, explored the site. This occurred too late for many analysts and investors, who relied on the reputation of major gold mining producers in the Bre-X chase for reassurance that Bre-X was the real thing.

The story of Bre-X is a story of a gold-mining fraud and admittedly the industry has had more than its share of frauds. Perhaps the most enduring lessons from the Bre-X fraud are lessons about expectations of wealth. Everyone wanted to believe in the wealth of Busang. Investors relied on others beliefs rather than sound evidence that Bre-X was worth a fortune. Today, many Internet companies are selling with valuations based on incredible growth forecasts. Who is to say whether those beliefs will come true? We couldn't blame any former Bre-X investors for having their doubts.

A Potential 80 minute Teaching Plan

Using the case to look at risk management in equity markets.

5 minutes Open - have one student briefly open with a statement of what went wrong.

10 minutes Introduction

High Concept: How do we establish trust in markets?

On what can we rely for the identification of risk and opportunity?

What are the classes of risk in this case?

What are the rights and expectations of market participants?

10 minutes Stakeholders - General roles and risk management responsibilities

- Analysts

- Company

- Board of Directors

- Buyers - Institutions and individuals

- Stock Market

- Others

20 minutes Sequence of Events

Build a Timeline

Nexus of fiduciary failures

At what point(s) could/should something have happened?

Highlight red-flag points

15 minutes Pathologies

What are the problems in this system?

What are the concerns?

10 minutes Remedies

What should be done?

10 minutes Wrap-up

Plans, Actions and Governance Responsibilities

Additional Materials

1) Bre-X Websites:

a) Bre-X Canadian Class Action Lawsuit Web Page

'www.brexcanact.com'

This site offers a complete picture of the Canadian class actions lawsuits filed by Canadian investors in Bre-X

b) Calgary Herald Bre-X Archive

'www.calgaryherald.com/brex/'

This site contains a comprehensive set of articles on the Bre-X fraud. Includes articles on recent events such as David Walsh's passing.

2) CNN Money Line Video Airdates

Video can add color to a case discussion. CNN Money Line contained segments on Bre-X Minerals on at least 4 occasions:

- 1) May 5th 1997 – Bre-X 'Fool's Gold'. First of a 3-day look at the Bre-X fraud. Good introduction to the case. The video shows footage of Busang in Indonesia, lists some of the major institutional investors that lost money Bre-X and includes some comments on the scope of the fraud.**
- 2) May 6th 1997 – Discussion of the final share crash in Bre-X. One analyst raises the question of adequate oversight. An analysis of political brokering and influence peddling in Indonesia provides an interesting perspective on doing business internationally.**
- 3) May 7th 1997 – A discussion of the future of Indonesian mining. The question of whether the Bre-X fraud will affect foreign investment in Indonesian projects.**
- 4) July 31st 1997 – Freeport McMoran CEO James Moffett is quizzed on his company's involvement with Bre-X.**