

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

IN THE MATTER OF THE *COMPANIES' CREDITORS
ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS
AMENDED

AND IN THE MATTER OF THE *BANKRUPTCY AND
INSOLVENCY ACT*, R.S.C. 1985, c. B-3, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE
OR ARRANGEMENT OF SMURFIT-STONE
CONTAINER CANADA INC. AND THE OTHER
APPLICANTS LISTED ON SCHEDULE "A"

**FACTUM OF THE APPLICANTS
(returnable December 11, 2009)**

December 9, 2009

STIKEMAN ELLIOTT LLP
5300 Commerce Court West
199 Bay Street
Toronto, Ontario M5L 1B9

Sean F. Dunphy LSUC#24941J
Tel: (416) 869-5662
Alexander D. Rose LSUC#49415P
Tel: (416) 869-5261
Fax: (416) 947-0866

Lawyers for the Applicants

TO: SERVICE LIST

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

BETWEEN :

IN THE MATTER OF THE *COMPANIES' CREDITORS
ARRANGEMENT ACT*, R.S.C. 1985, c. C-26, AS AMENDED

AND IN THE MATTER OF THE *BANKRUPTCY AND
INSOLVENCY ACT*, R.S.C. 1985, c. B-3, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE
OR ARRANGEMENT OF SMURFIT-STONE
CONTAINER CANADA INC. AND THE OTHER
APPLICANTS LISTED ON SCHEDULE "A"

Applicants

**FACTUM OF THE APPLICANTS
(Returnable December 11, 2009)**

PART I - OVERVIEW

1. As part of a financing undertaken in 2004, Finance II¹ was established as a Nova Scotia unlimited liability company. Finance II issued 7 3/8% unsecured senior notes in the principal aggregate amount of US\$200 million due in 2014 (the "Notes"). The proceeds from the issuance of the Notes were advanced by Finance II to SSC Canada pursuant to a "Loan Agreement" which, by its terms, requires that upon an insolvency event of default, the loan "shall" be repaid in equity of SSC Canada. This

¹ Smurfit-Stone Container Canada Inc. ("SSC Canada") and Stone Container Finance Company of Canada II ("Finance II") are direct, wholly owned subsidiaries of Smurfit-Stone Container Enterprises Inc. ("SSCE", being the successor by amalgamation to Smurfit Container Corporation) and, together with their affiliates, are members of the "Smurfit Group" of companies.

motion seeks direction regarding the treatment of that loan in these CCAA proceedings.

2. The Notes were not marketed on the financial capacity of Finance II, which was clearly a special purpose vehicle, nor SSC Canada (whose status as recipient of the funds was not disclosed). Instead, they were sold principally as obligations of SSCE, which was the source of the cash for paying interest and principal on the Notes² and served as their guarantor. Given the nature of its role in the financing structure, SSC Canada was never intended to fund obligations to Finance II or the Noteholders. On insolvency, the obligation of SSC Canada to Finance II became repayable only in Class B shares, and not in cash. The creditors of Finance II had no basis to expect a “double dip” claim in bankruptcy but looked solely to SSCE. The intercompany structure was faithful to that design.

3. The holders of the Notes (the “Noteholders”) assert claims for \$200 million against Finance II and against SSCE on the basis of its guarantee. However, the Noteholders also seek to have Finance II assert a claim in respect of the same \$200 million against SSC Canada. The purpose of this motion is not to determine the validity of the Noteholders’ claim under the guarantee, but to determine the nature and value, if any, of Finance II’s Claim against SSC Canada.

² As is described below, the intercompany transactions put in place had the effect that SSCE was the sole source of funds to repay the notes *in all events*. Interest was paid via equity investments in Finance II (the “Subscription Agreement”). At term, principal was paid with proceeds of an equity investment in SSC Canada (the “Forward Purchase Agreement”). Upon default, the Notes had a direct claim upon SSCE via the guarantee. In each case, repayment was to be effected through claims upon SSCE.

4. The express provisions of the loan agreement between SSC Canada and Finance II are clear: upon insolvency, Finance II holds only equity in SSC Canada, namely, the Class C shares already received to date on account of interest and a claim for Class B shares. Finance II's Claim against SSC Canada is therefore in the nature of equity and does not constitute a "debt provable in bankruptcy". In the alternative, these provisions manifest a clear and unambiguous intent to subordinate repayment of this intercompany debt to other creditors which should be given effect to in any CCAA Plan.

PART II - THE FACTS

Finance II

5. Finance II is a Nova Scotia unlimited liability company that issued the Notes in 2004. The Offering Memorandum relating to the issuance of the Notes describes Finance II's role:

Stone Finance II is a wholly-owned special purpose finance subsidiary of Stone Container Corporation, formed as an unlimited company under the Company Act of Nova Scotia, Canada. Stone Finance II is a holding company whose only business is to access bank financing and capital markets on behalf of Stone Container. otherwise, Stone Finance II conducts no independent business or operations.

Offering Memorandum, Exhibit "H" to the Affidavit of Melissa Paz, sworn December 2, 2009 ("Paz Affidavit"), Motion Record of the Applicants ("Applicants' Motion Record"), Tab 2K, p. 197.

6. The Notes are guaranteed by SSCE and the overwhelming majority of the Offering Memorandum and associated marketing "green sheet" are devoted to SSCE

and its business and financial stability. Indeed, the Offering Memorandum confirms that Finance II has no significant assets and will depend on SSCE to make all payments under the Notes. The Offering Memorandum makes no reference to SSC Canada as recipient of intercompany advances or a possible avenue for repayment of the Notes. Thus, no creditor of Finance II could have had any reasonable expectation of looking to the assets of SSC Canada as an avenue for repayment.

Trust Indenture, Exhibit "D" of the Paz Affidavit, Applicants' Motion Record, Tab 2D, p. 165.

Offering Memorandum, Exhibit "H" to the Paz Affidavit, Applicants' Motion Record, Tab 2H, pp. 201, 210.

Morgan Stanley Green sheet, dated July 15, 2009, Exhibit "I" to the Paz Affidavit, Applicants' Motion Record, Tab 2I at pp. 394-396.

7. The Offering Memorandum describes the intended use of the proceeds from the sale of the Notes:

The net proceeds from the sale of the notes (after deduction of discounts and commissions, fees and other expenses associated with the sale of the notes) will be approximately \$197 million. We intend to use the net proceeds of the offering to redeem all of the \$185 million outstanding aggregate principal amount of the 11 ½ % Senior Notes due August 15, 2006 of Stone Finance I as soon as practicable after the closing of the offering of notes contemplated hereby and repay approximately \$12 million on our outstanding Tranche B term loan, which bears interest at 3.7% and matures on June 30, 2009.....

Offering Memorandum, Exhibit "H" to the Paz Affidavit, Applicants' Motion Record, Tab 2H, p. 215.

8. In fact, the green sheet clarifies that the funds will first be used to pay down a revolving loan balance, and then the revolver will subsequently be re-drawn and the proceeds used to call the 11.5% Notes on August 16, 2004.

Morgan Stanley Green sheet, Exhibit "I" to the Paz Affidavit, Applicants' Motion Record, Tab 2I, p. 394.

9. As part of the refinancing transaction described above, Finance II entered into a loan agreement dated July 20, 2004 (the "Loan Agreement") to advance the proceeds of the issuance of the Notes to SSC Canada. SSC Canada agreed to repay the outstanding balance on the advance in 2014 (coincident with the Notes), subject to certain events of default, including in circumstances of insolvency. SSC Canada also agreed to pay interest to Finance II through the issuance of (non-voting) Class C shares.

Loan Agreement, Exhibit "E" to the Paz Affidavit, Applicants' Motion Record, Tab 2E, pp. 174-180.

10. On the same day, SSC Canada and SSCE entered into an agreement (the "Forward Purchase Agreement") pursuant to which SSCE would provide SSC Canada with the cash to repay the US\$200 million advance from Finance II at term by purchasing Class A shares of SSC Canada. Thus, the source of funds to repay the intercompany debt was always intended to be the issuance of equity in SSC Canada whether by way of interest or principal with all funds being provided by SSCE.

Forward Purchase Agreement, Exhibit "F" to the Paz Affidavit, Applicants' Motion Record, Tab 2F, pp. 181-186.

11. Finally, SSCE and Finance II entered into a subscription agreement (the "Subscription Agreement") pursuant to which SSCE agreed to provide Finance II with the cash to pay interest on the Notes. Every six months until 2014, SSCE

subscribes for one common share of Finance II at a price of US\$7,375,000, being the amount of interest due on the Notes.

Paz Affidavit at para. 6, Applicants' Motion Record, Tab 2, p. 11.

Subscription Agreement, Exhibit "G" to the Paz Affidavit, Applicants' Motion Record, Tab 2G, pp.187-191.

12. The Loan Agreement, the Forward Purchase Agreement and the Subscription Agreement were all intercompany transactions entered into internally and were not disclosed to Finance II noteholders nor did they form any part of their investment decision. However, just as the Offering Memorandum was predicated solely upon SSCE's capacity to repay the Notes, so the intercompany transactions (Loan Agreement, Subscription Agreement and Forward Purchase Agreement) were structured around the same premise: that SSCE alone would provide any cash needed to repay the Notes.

US Tax Issues

13. The Respondents Aurelius et al. have filed an affidavit of a United States tax lawyer describing the tax intentions of the intercompany transactions. Although claimed to be at variance with the position advocated by the Applicants in these proceedings, Mr. McFadyen's affidavit corresponds quite closely with the position which the Applicants have at all times said in this proceeding. In essence, his affidavit confirms that:

- Finance II is a "disregarded entity" for US tax purposes;

- the intercompany loan transaction is treated as equity for U.S. federal income tax purposes; and
- the intercompany loan transaction is treated as debt for Canadian purposes.

McFadyen Affidavit at paras. 8, 18 and 19

14. Where Mr. McFadyen's affidavit is inadmissible (and wrong) is where his affidavit opines on matters of Canadian federal law which, of course, are not matters which may be the subject of "proof" by way of affidavit before a Superior Court in this country. The Applicants are not seeking to have the intercompany debt generally treated as equity "for Canadian commercial law purposes" and the gratuitous conclusion in paragraph 16 that this would be fatal from a Canadian income tax perspective is both wrong and irrelevant. Upon the occurrence of an Event of Default (which occurred in 2009 with the CCAA filing of SSC Canada), the Loan Agreement provides for the repayment thereof in equity. The Applicants' position is that from and after this default, the terms of the Loan Agreement ought to be given effect to as regards both SSC Canada and Finance II. The effect of this upon the 2009 tax position of SSC Canada or Finance II is beside the point (no such tax return having been prepared or due as the tax year is still running) and is utterly irrelevant.

Insolvency Proceedings

15. On January 26, 2009, SCC Canada, Finance II and the other Applicants and Partnerships listed on Schedules "A" and "B" hereto (respectively the "Applicants" and "Partnerships") obtained protection from their creditors pursuant to the

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended (the "CCAA") and the Initial Order of this Court as subsequently amended and restated. The CCAA proceedings of the Applicants and Partnerships are referred herein as the "CCAA Proceedings".

Paz Affidavit at para. 3, Applicants' Motion Record, Tab 2, pp. 10-11.

Seventh Report of the Monitor, dated October 2, 2009 ("Seventh Report") at para. 1.

16. Earlier that same day, Smurfit-Stone Container Corporation ("SSCC"), SSCE and the other members of the Smurfit Group listed on Schedule "C" hereto, including SSC Canada and Finance II, obtained protection from their creditors under Title 11 of Chapter 11 of the *United States Bankruptcy Code*, 11 U.S.C. §§ 101-1532 (the "U.S. Bankruptcy Proceedings").

Seventh Report at para. 3.

CCAA Proceedings and U.S. Bankruptcy Proceedings Constitute an Event of Default

17. Under the terms of the Loan Agreement, the commencement of the CCAA Proceedings, together with the related application under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (the "BIA"), and the U.S. Bankruptcy Proceedings constitute Events of Default. The Loan Agreement defines an "Event of Default" as follows:

6. The occurrence of any of the following events during the Term shall constitute an event of default (an "Event of Default"):
...

6.3 should [SSC Canada] or, its parent, [SSCE], make an assignment for the benefit of creditors, or file or consent to the filing of a petition in bankruptcy, a proposal or a notice of intention under the Bankruptcy and Insolvency Act (Canada) or any other equivalent Law of any other jurisdiction or be adjudicated insolvent or bankrupt, or petition or apply to any tribunal for any receiver, trustee, liquidator or sequestrator of or for all or substantially all of its property; or should [SSC Canada] or [SSCE] commence any proceeding relating to it or all or substantially all of its property under any reorganization, arrangement, readjustment, composition or liquidation Law of any jurisdiction; or should there be commenced against [SSC Canada] or [SSCE] any such proceeding and it remains undismissed for a period of sixty (60) days; or should any receiver, trustee, liquidator or sequestrator of or for [SSC Canada] or [SSCE] or all or substantially all of its property be appointed or should [SSC Canada] or [SSCE] consent to or approve or accept any such proceeding or the appointment of any receiver, trustee, liquidator or sequestrator of or for [SSC Canada] or [SSCE] or all or substantially all of its property; [Emphasis added]

Loan Agreement, section 6.3, Exhibit "E" to the Paz Affidavit, Applicants' Motion Record, Tab 2E, p. 176.

18. Consequently, the Loan Agreement provides that Finance II is only entitled to repayment through the issuance of Class B shares of SSC Canada, and not in cash:

7. If an Event of Default shall have occurred and in every such event: ...

7.2 upon the occurrence of an Event of Default specified in subsection 6.3, [SSC Canada] shall lose the benefit of the Term and the entire amount of the Loan then outstanding in principal and interest shall be immediately due and payable, all without any action by [Finance II] and without presentment, demand, protest, or any other notice of any kind, all of which are waived. Thereupon [Finance II] may exercise any and all of its rights and recourses under this Agreement, provided, however, that [SSC Canada] shall perform its obligations in this regard hereunder by the issuance to [Finance II] of Class B Shares having a value no less than the dividend or other amount that otherwise would be received by [Finance II]. [Emphasis added]

Loan Agreement, section 7.2, Exhibit "E" to the Paz Affidavit, Applicants' Motion Record, Tab 2E, pp. 176-177.

19. SSC Canada's Memorandum of Association provides for five classes of shares, including the Class B shares, issuable upon an Event of Default. The rights, privileges, restrictions and conditions of the Class B shares, which are described at section 2 of Annex 1 of the Memorandum of Association, include the following [Emphasis added]:

(a) Issuance. No class B shares shall be issued unless an Event of Default (as defined in paragraph 2(b)) shall have occurred.

(b) Event of Default. For the purposes of the foregoing paragraph 2(a) an "Event of Default" shall be deemed to have occurred should either of [SSC Canada] or Stone Container Corporation make an assignment for the benefit of creditors, or file a consent to the filing of a petition in bankruptcy, a proposal or a notice of intention under the Bankruptcy and Insolvency Act (Canada) or any other equivalent law or any other jurisdiction or be adjudicated insolvent or bankrupt, or petition or apply to any tribunal for any receiver, trustee, liquidator or sequestrator of or for all or substantially all of its property; or should either of [SSC Canada] or Stone Container Corporation commence any proceeding relating to it or all or substantially all of its property under any reorganization, arrangement, readjustment, composition or liquidation law of any jurisdiction; or should there be commenced against either of [SSC Canada] or Stone Container Corporation any such proceeding and it remains undismissed for a period of sixty (60) days; or should any receiver, trustee, liquidator or sequestrator of or for either of [SSC Canada] or Stone Container Corporation or all or substantially all of its property be appointed or should either of [SSC Canada] or Stone Container Corporation consent to or approve or accept any such proceeding or the appointment of any receiver, trustee, liquidator or sequestrator of or for either of [SSC Canada] or Stone Container Corporation or all or substantially all of its property.

...

(d) Dividends. The holders of the class B shares shall be entitled to receive, as and when declared by the board of directors, but always in preference and priority to any payment of dividends on the class C shares, the class D shares, the class E shares and the class A shares or any other shares ranking junior to the class B

shares, cumulative dividends at a fixed rate of eight percent (8%) per annum calculated on the Class B Amount (as defined in paragraph 2(g)) of each such share payable in money, property or by the issue of fully paid shares of any class of the capital of [SSC Canada]. The holders of the class B shares shall not be entitled to any dividend in excess of the dividend hereinbefore provided for.

(e) Liquidation, Dissolution and Winding-up. In the event of the liquidation, dissolution or winding-up of [SSC Canada], whether voluntary or involuntary, or other distribution of assets of [SSC Canada] among shareholders for the purpose of winding-up its affairs, the holders of the class B shares shall be entitled to receive for each class B share, in preference and priority to any distribution of the property or assets of [SSC Canada] to the holders of the class C shares, the class D shares, the class E shares and the class A shares, or any other shares ranking junior to the class B shares, an amount equal to the Class B Amount of each such share plus all accrued and unpaid dividends thereon, but shall not be entitled to share any further in the distribution of the property or assets of the Company.

...

(g) Class B Amount. For the purposes of the foregoing paragraphs 2(d), (e) and (f), the "Class B Amount" of each class B share shall be an amount equal to the aggregate of (i) the monetary consideration received by [SSC Canada] upon the issuance of such share (denominated in the currency in which such consideration was paid to [SSC Canada], if such share has been issued for money, and (ii) the fair market value of the consideration received by [SSC Canada] (including, without limitation, shares of another class of [SSC Canada]) upon the issuance of such share, if such share has been issued for a consideration other than money, less (iii) all amounts paid in respect of such share on account of reductions of paid up capital. Subject to the provisions of the following subparagraph, such fair market value is to be determined by the directors on the basis of generally accepted accounting and valuation principles.

The fair market value determined as hereinabove provided for shall be subject to revision in accordance with any binding agreement with, or decision by, the appropriate taxation authorities, or any judgment of a court of competent jurisdiction....

SSC Canada's Memorandum of Association, at paras. 2(a), (b), (d), (e) and (g), Exhibit "J" to the Paz Affidavit, Applicants' Motion Record, Tab 2J, pp. 400-401.

20. At every turn in this proceeding, the Applicants have conceded the plain and obvious fact that the Loan Agreement, by its terms, was debt for all commercial purposes *prior to the occurrence of an insolvency event of default*. As such, Canadian taxes of both Finance II and SSC Canada were always prepared on that basis. Despite this admission, the respondents have continued to pursue discovery to obtain admissions of uncontested facts, demanded tax returns to establish this admitted fact, etc. What is at issue in this motion is not the commercial or tax characterization of the Loan Agreement in 2008 or prior years before the occurrence of an insolvency Event of Default in 2009. The sole issue on this motion is the proper characterization of the Loan Agreement in light of the existence of an insolvency Event of Default and whether the plain and obvious direction contained in the Loan Agreement that the intercompany debt should, after this fact, be repaid in equity (and at all events behind ordinary unsecured creditors) should be given effect to.

III ISSUES AND THE LAW

Issues

21. Having regard to the insolvency of both SSCE and SSC Canada, there are three principal issues on this motion:

- (a) Whether the true nature of Finance II's Claim is that of a "debt provable in bankruptcy" or that of an equity investment.
- (b) If Finance II's Claim, in its true nature, is debt, what is the amount, if any, of Finance II's Claim?

- (c) Furthermore, if Finance II's Claim is considered as debt, has it been subordinated to the claims of general unsecured creditors?

"Debt Provable in Bankruptcy"

22. To constitute a "claim" for purposes of the CCAA, section 12(1) of the CCAA requires that an obligation be "a debt provable in bankruptcy" within the meaning of the BIA.

CCAA, s. 12(1).

23. Section 121(1) of the BIA defines "debt provable in bankruptcy" as follows:

All debts and liabilities, present and future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, as amended, s. 121(1).

24. Shareholders in a company do not have a claim constituting a "debt provable in bankruptcy". Moreover, to qualify, the debt must be one which the debtor company is subject to (as debt) on the day on which the debtor company obtains protection under the CCAA. It is the nature of the parties' relationship at the time of insolvency that is determinative of whether an obligation constitutes a debt provable in bankruptcy.

Central Capital Corp., (Re) (1996), 38 C.B.R. (3d) 1 (Ont. C.A.) at para. 67 ["*Central Capital Corp.*"], Book of Authorities of the Applicants "Applicants' Book of Authorities", Tab 1.

Whether Finance II's Claim is Debt or Equity Depends on Its Nature and Substance

25. In the case of *CDIC v. CCB*, the Supreme Court of Canada analyzed a complex transaction in which six major banks had purchased a portfolio of non-performing loans from the defendant, Canadian Commercial Bank ("CCB"). It was agreed that the money advanced for the portfolio would be repaid out of money recovered on those assets and 50 percent of CCB's pre-tax income. The purchasing banks were also granted warrants to buy 75 percent of CCB's common shares, subject to regulatory and shareholder approval. If the warrants were not approved by a certain date, CCB would pay 100 percent of its pre-tax income to repay the amount advanced, plus interest on that amount at a prime rate. Upon the ultimate failure of CCB, the liquidator applied for advice on the validity and ranking of the participants' claims, which in turn depended on whether the advance to CCB was in the nature of a loan or a capital investment. The Supreme Court analyzed the terms of the documents to determine whether the transactions should be characterized as equity or debt and described the analysis to be undertaken as follows:

As in any case involving contractual interpretation, the characterization issue facing this Court must be decided by determining the intentions of the parties to the support agreements. This task, perplexing as it sometimes proves to be, depends primarily on the meaning of the words chosen by the parties to reflect their intention. When the words alone are insufficient to reach a conclusion as to the true nature of the agreement, or when outside support for a particular characterization is required, a consideration of the admissible surrounding circumstances is appropriate. [Emphasis added]

Canadian Deposit Insurance v. Canadian Commercial Bank, [1992] 3 S.C.R. 558 at pp. 590-591 ["*CDIC v. CCB*"], Applicants' Book of Authorities, Tab 2.

26. Commercial contracts are to be interpreted in accordance with the language of the written document and based on the "cardinal presumption" that the parties have intended what they said. If the contract is clear and unambiguous on its face, it is unnecessary to consider any extrinsic evidence and the Court should not stray beyond the four corners of the agreement.

Ventas, Inc. v. Sunrise Senior Living Real Estate Investment Trust (2007), 85 O.R. (3d) 254 (C.A.) at para. 24, Applicants' Book of Authorities, Tab 3.

Certicom Corp. v. Research in Motion Ltd. (2009), 53 B.L.R. (4th) 286 (Ont. S.C.J.) at para. 38, Applicants' Book of Authorities, Tab 4.

Eli Lilly & Co. v. Novopharm Ltd., [1998] 2 S.C.R. 129 at para. 55, Applicants' Book of Authorities, Tab 5.

KPMG Inc. v. Canadian Imperial Bank of Commerce, 1998 CarswellOnt 4422 (C.A.) at para. 5, leave to appeal refused [1999] 2 S.C.R. vi., Applicants' Book of Authorities, Tab 6.

See also *Civil Code of Quebec*, Arts. 2863-2865 C.C.Q.

27. The Supreme Court commented that the surrounding circumstances in *CDIC* were somewhat unique, giving rise to a complex transaction containing features of both equity and debt. Justice Iacobucci held for the Court:

As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of \$225 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing, the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is

not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of the agreement must be given the exact same weight. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement. [Emphasis added]

CDIC v. CCB at pp. 590-591, Applicants' Book of Authorities, Tab 2.

28. In *CDIC* the Supreme Court found that the words chosen by the parties in their agreements clearly supported the Court of Appeal's conclusion that the assistance program involved, in substance, a loan of \$255 million and not a capital investment. The surrounding circumstances provided additional support for, rather than detracted from, this conclusion.

CDIC v. CCB at pp. 581-582, Applicants' Book of Authorities, Tab 2.

29. Similarly, in *Central Capital Corp.*, the Ontario Court of Appeal analyzed a transaction containing characteristics of both debt and equity. In that case, the appellants had sold shares to Central Capital and in return received preferred shares. These preferred shares contained a provision entitling the holder to retract the shares at a certain date at a specified price per share plus interest and unpaid dividends but providing that the redemption would not be contrary to law. Subsequently, Central

Capital became insolvent and obtained CCAA protection. In holding that the right of retraction attached to the shares constituted an equity investment, Laskin J.A. stated:

If the certificate or instrument contains features of both debt and equity – in other words if it is hybrid in character – then the court must determine the “substance” of the relationship between the holder of the certificate and the company. This is the lesson of Justice Jacobucci’s judgment in [*CDIC v. CCB*].

Central Capital Corp. at para. 119, Applicants’ Book of Authorities, Tab 1.

30. Laskin J.A. cited *CDIC* for the proposition that, in determining the substance of the relationship, as in any other case of contractual interpretation, the Court should look to what the parties intended.

Central Capital Corp. at paras. 120-121, Applicants’ Book of Authorities, Tab 1.

31. Section 7.2 of the Loan Agreement is unambiguous; and its terms are the best indication of what the parties intended. Section 7.2 provides that, on the date of insolvency, SSC Canada is required to perform its obligations under the Loan Agreement “by the issuance to [Finance II] of class B shares.” Indeed, it is only upon an Event of Default that the Class B shares are issuable. Unlike the case in *CDIC*, the equity component is not a “sweetener” or “kicker” layered on top of a loan. On insolvency, Finance II will hold only equity: the Class C shares received to date plus an entitlement to Class B shares pursuant to section 7.2 of the Loan Agreement.

Central Capital Corp. at para. 122, Applicants’ Book of Authorities, Tab 1.

32. As in *Central Capital Corp.*, Finance II chose to accept equity from SSC Canada if and when an Event of Default occurred. Pursuant to the Loan Agreement, an Event of Default triggered the repayment to Finance II – a repayment that could only be realized through the issuance of Class B shares. Indeed, Finance II’s right as an equity holder was triggered on the date when the U.S. Bankruptcy Proceedings and CCAA Proceedings commenced.

Central Capital Corp. at paras. 79 and 128, Applicants’ Book of Authorities, Tab 1.

33. The Loan Agreement provides that the obligation to issue Class B shares “having a value no less than the dividend or other amount that otherwise would be received by [Finance II].” This provision is to be read in conjunction with the terms of the Class B shares. The Class B shares are ascribed a notional value so that the 8% dividend can be calculated and the relative preferences of the equity holders on liquidation or winding up can be determined.

34. If the terms of the Loan Agreement are somehow held to be unclear, the Courts have held that there are various indicia generally considered to be indicative of either a debt or an equity investment.

Central Capital Corp. at paras. 79, 87, 121-128, Applicants’ Book of Authorities, Tab 1.

CDIC v. CCB at p. 596-597, Applicants’ Book of Authorities, Tab 2.

Big Comfy Corp. v. Canada, [2002] T.C.J. No. 247 (TCC) (QL), Applicants’ Book of Authorities, Tab 7.

35. While the Loan Agreement has features suggestive of debt during the ordinary course, namely repayment of the advance in cash in 2014 and the absence of profit-sharing and risk-taking, these indicia become only secondary or incidental aspects once an event of insolvency has occurred. Instead, the following indicia reflect the parties' intention to have the obligation constitute equity when assessed at the time of insolvency:

- (a) the express requirement that, on the insolvency of SSC Canada or SSCE, Finance II is only entitled to receive class B shares of SSC Canada;
- (b) the prior payment of interest during the term of the Loan Agreement by the issuance of Class C shares SSC Canada;
- (c) the absence of an express provision stating that SSC Canada's obligation constitutes indebtedness; and
- (d) the absence of an express provision stating that Finance II is entitled to share *pari passu* with SSC Canada's unsecured creditors upon insolvency, which was identified by the Supreme Court in *CDIC* as one of the most important features of that transaction.³

36. Furthermore, the circumstances surrounding the refinancing transaction as a whole support the conclusion that, upon insolvency, the true nature of Finance II's Claim is equity and the sole intended source of repayment of the Notes (being the only creditors of Finance II) would be SSCE.

³ Indeed, the fact the debt is payable with shares upon an insolvency of SSC Canada *or* of SSCE (the intended source of funds to repay the Notes) clearly demonstrates the precise opposite intention (i.e. that the intercompany claims will not be *pari passu* with creditors of SSC Canada).

37. Reading the Loan Agreement together with the Subscription Agreement and the Forward Purchase Agreement, it is apparent that payment to Finance II and the noteholders was always intended to be funded in all respects by SSCE through the Forward Purchase Agreement and the Subscription Agreement and that Finance II would never have an enforceable debt against SSC Canada. The interest on the Notes would be paid to Finance II by SSCE, and SSCE would be responsible for providing SSC Canada with capital to repay the Notes in 2014 through an equity investment in SSC Canada. Similarly, upon insolvency, SSCE would cease to provide SSC Canada with cash to repay the principal to Finance II. In that case, SSC Canada's obligation would convert to equity and the noteholders would look to SSCE under the guarantee, preventing a "double dip" claim against both SSC Canada and SSCE for the same obligation. The intercompany arrangements thus faithfully tracked the Notes as described in the Offering Memorandum.

Alternatively, the Amount of Finance II's Claim is \$0

38. If this Court finds that the true nature of the Loan Agreement is that of debt, and not equity, it is clearly a debt to be repaid in Class B shares. Those shares do not rank *pari passu* with the unsecured debt. They are simply equity. As Finance II's Claim is for shares of SSC Canada that currently have no value, the value of the Finance II claim must therefore be \$0.

Finance II's Claim, If Debt, Is Subordinate to the Claims of General Unsecured Creditors

39. In the event that Finance II's Claim is determined to be a debt with a value greater than \$0, it is **nonetheless** subordinate to the claims of the general unsecured creditors.

40. The Loan Agreement evidences Finance II's intention to subordinate its claim to the general unsecured creditors by agreeing to be repaid in Class B shares. As outlined above, the Class B shares do not rank *pari passu* with the unsecured debt, providing the best possible evidence that Finance II intended that, upon an Event of Default (including an insolvency event), its claim would rank behind those of the general unsecured creditors. In other words, if the Court does not give effect to the provisions of the Loan Agreement that require payment in Class B shares upon an Event of Default (discussed above), it must at least recognize the parties' intention to subordinate the Finance II Claim and treat section 7.2 of the Loan Agreement as a subordination provision.

41. Canadian courts have considered subordination provisions in the context of bankruptcy, CCAA proceedings and winding-up proceedings. These courts have expressed a willingness to acknowledge the enforceability of such contractual subordination provisions in an insolvency context. As expressed by Farley J. in *Air Canada*, there is no impediment within a bankruptcy context "to a creditor agreeing to subordinate his claim to that of another creditor". Furthermore, the courts have

held that such subordination provisions do not terminate as a result of an intervening insolvency proceeding.

Air Canada, (Re), (2004), 2 C.B.R. (5th) 4 (Ont. S.C.J.), at paras. 10, 11-13 Applicants' Book of Authorities, Tab 8.

Rico Enterprises Ltd., (Re), (1994), 24 C.B.R. (3d) 309 (B.C.S.C.) at paras. 38-39, Applicants' Book of Authorities, Tab 9.

Shoppers Trust Corp. (Liquidator of) v. Shoppers Trust Co., [2005] O.J. No. 1081 (C.A.) (QL) at paras. 25-27, Applicants' Book of Authorities, Tab 10.

Bank of Montreal v. Dynex Petroleum Ltd. (1997), 145 D.L.R. (4th) 499 at 529 (Alta. Q.B.) (reversed on appeal on other grounds, [1999] A.J. No. 1463), Applicants' Book of Authorities, Tab 11.

42. There is nothing in the CCAA that prohibits a creditor from agreeing to subordinate its claim.

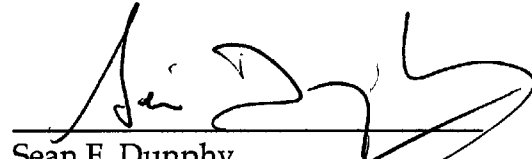
43. Finance II, in agreeing to the terms of the Loan Agreement, contractually agreed to subordinate its claim to the general unsecured creditors. This Court, in line with Canadian jurisprudence, can enforce the subordination of Finance II's Claim and, in the given circumstances, ought to in order to realize the intention of the parties.

PART III - ORDER REQUESTED

44. An order declaring that the intercompany claim of Finance II against SSC Canada is in the nature of equity and that the amount of such claim which is a "provable claim" within the meaning of section 12(1) of the CCAA is \$0.

45. The Applicants' costs of this motion.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 9th day of December, 2009.



Sean F. Dunphy
Stikeman Elliott LLP



Alexander D. Rose
Stikeman Elliott LLP

Lawyers for the Applicants

**SCHEDULE "A"
APPLICANTS**

Smurfit-Stone Container Canada Inc.

3083527 Nova Scotia Company

MBI Limited/Limitée

639647 British Columbia Ltd.

B.C. Shipper Supplies Ltd.

Specialty Containers Inc.

605681 N. B. Inc.

Francobec Company

Stone Container Finance Company of Canada II

SCHEDULE "B"

Smurfit-MBI

SLP Finance General Partnership

SCHEDULE "C"
U.S. DEBTORS

Smurfit-Stone Container Canada Inc.
3083527 Nova Scotia Company
MBI Limited/Limitée
639647 British Columbia Ltd.
B.C. Shipper Supplies Ltd.
Specialty Containers Inc.
605681 N. B. Inc.
Francobec Company
Stone Container Finance Company of Canada II
Smurfit-MBI
SLP Finance General Partnership
Smurfit-Stone Container Corporation
Smurfit-Stone Container Enterprises, Inc.
Lot 24D Redevelopment Corporation
Atlanta & St. Andrews Bay Railroad Co.
Cameo Container Corporation
Stone International Services Corporation
Calpine Corrugated LLC
Stone Global, Inc.
Stone Connecticut Paperboard Properties, Inc.
Smurfit-Stone Puerto Rico, Inc.
Smurfit Newsprint Corporation
SLP Finance I, Inc.
SLP Finance II, Inc.
SMBI Inc.

SCHEDULE "D"
LIST OF AUTHORITIES

1. *Central Capital Corp. (Re)* (1996), 38 C.B.R. (3d) 1 (Ont. C.A.)
2. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558 (S.C.C.)
3. *Ventas, Inc. v. Sunrise Senior Living Real Estate Investment Trust* (2007), 85 O.R. (3d) 254 (C.A.)
4. *Certicom Corp. v. Research in Motion* (2009), 53 B.L.R. (4th) 286 (Ont. S.C.J.)
5. *Eli Lilly & Co. v. Novopharm Ltd.*, [1998] 2 S.C.R. 129
6. *KPMG Inc. v. Canadian Imperial Bank of Commerce*, [1998] O.J. No. 4746 (C.A.) (QL), leave to appeal refused [1999] 2 S.C.R. vi
7. *Big Comfy Corp. v. Canada*, [2002] T.C.J. No. 247 (T.C.C.) (QL).
8. *Air Canada, (Re)*, (2004), 2 C.B.R. (5th) 4 (Ont. S.C.J.)
9. *Rico Enterprises Ltd., (Re)*, (1994), 24 C.B.R. (3d) 309 (B.C.S.C.)
10. *Shoppers Trust Corp. (Liquidator of) v. Shoppers Trust Co.*, [2005] O.J. No. 1081 (C.A.) (QL)
11. *Bank of Montreal v. Dynex Petroleum Ltd.* (1997), 145 D.L.R. (4th) 499 (Alta. Q.B.)

SCHEDULE "E"

RELEVANT STATUTES

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended

Definition of "claim"

12. (1) For the purposes of this Act, "claim" means any indebtedness, liability or obligation of any kind that, if unsecured, would be a debt provable in bankruptcy within the meaning of the *Bankruptcy and Insolvency Act*.

Determination of amount of claim

(2) For the purposes of this Act, the amount represented by a claim of any secured or unsecured creditor shall be determined as follows:

(a) the amount of an unsecured claim shall be the amount

(i) in the case of a company in the course of being wound up under the *Winding-up and Restructuring Act*, proof of which has been made in accordance with that Act,

(ii) in the case of a company that has made an authorized assignment or against which a bankruptcy order has been made under the *Bankruptcy and Insolvency Act*, proof of which has been made in accordance with that Act, or

(iii) in the case of any other company, proof of which might be made under the *Bankruptcy and Insolvency Act*, but if the amount so provable is not admitted by the company, the amount shall be determined by the court on summary application by the company or by the creditor; and

....

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, as amended

Claims provable

121. (1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.

....

Civil Code of Quebec

2863. The parties to a juridical act set forth in a writing may not contradict or vary the terms of the writing by testimony unless there is a commencement of proof.

2864. Proof by testimony is admissible to interpret a writing, to complete a clearly incomplete writing or to impugn the validity of the juridical act which the writing sets forth.

2865. A commencement of proof may arise where an admission or writing of the adverse party, his testimony or the production of a material thing gives an indication that the alleged fact may have occurred.

IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, c. C-26, AS AMENDED
AND IN THE MATTER OF THE BANKRUPTCY AND INSOLVENCY ACT, R.S.C. 1985, c. B-3, AS AMENDED
AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF SMURFIT-STONE CONTAINER
CANADA INC. AND THE OTHER APPLICANTS LISTED ON SCHEDULE "A"

Court File No: CV-09-7966-00CL

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

Proceeding commenced at Toronto

**FACTUM OF THE APPLICANTS
(Returnable December 11, 2009)**

STIKEMAN ELLIOTT LLP
Barristers & Solicitors
5300 Commerce Court West
199 Bay Street
Toronto, Canada M5L 1B9

Sean F. Dunphy LSUC#: 24941J
Tel: (416) 869-5662
Alexander D. Rose LSUC#: 49415P
Tel: (416) 869-5261
Fax: (416) 947-0866

Lawyers for the Applicants