

**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"

Applicants

**FACTUM OF THE RESPONDING PARTIES
(returnable December 11, 2009)**

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TO: Service List

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PART I - INTRODUCTION

1. This motion relates to the characterization to be given to the Intercompany Loan Agreement (defined below) as debt or equity (the "Characterization Motion"). The Responding Parties, Aurelius Capital Management, LP and Columbus Hill Capital Management, L.P. (the "Fund Managers") have brought a motion to adjourn the Characterization Motion because, among other reasons, Stone Container Finance Company of Canada II ("Finance II"), one of the key parties, is unrepresented on this motion. Counsel for the Fund Managers does not, and cannot, represent Finance II in this matter. Nor should substantive rights of Finance II and its creditors be adjudicated in a process that does not follow normal legal process to allow for a full and fair adjudication of these issues. If the Characterization Motion proceeds in accordance with the currently proposed process and without separate representation for Finance II, the Fund Managers are proceeding under protest of the fact that Finance II is not properly represented in this matter nor is the process appropriate to allow the issues to be adjudicated fairly.

2. Finance II is an unlimited liability company formed under the laws of Nova Scotia (a "ULC").

3. Finance II is a financing vehicle for the Smurfit-Stone Group. Finance II raised US\$200 million of funds in the public debt market through the issuance of Notes (as defined below), which it lent (the "Intercompany Loan") to Smurfit-Stone Container Canada Inc. ("Smurfit Canada") pursuant to the terms of a Loan Agreement dated as of July 20, 2004 (the "Intercompany Loan Agreement").

4. On this motion, the Applicants acknowledge the following three crucial facts:

(a) The Intercompany Loan Agreement created a debt obligation from Smurfit Canada, the borrower, to Finance II, the lender,¹

(b) There has been an Event of Default under the Intercompany Loan Agreement caused by Smurfit Canada's CCAA filing and petition in the US under chapter 11 of the US Bankruptcy Code;²

(c) As a consequence of the Event of Default, section 7.2 of the Intercompany Loan Agreement applies, and provides that the entire amount of the Intercompany Loan then outstanding in principal and interest shall be immediately due and payable by Smurfit Canada and that:

...[Smurfit 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 the Lender and without presentment, demand, protest or 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 [Smurfit 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].³

5. The responding parties submit that the essential nature of the Intercompany Loan is clearly that of a debt obligation which is on its terms and intended to be provable in a bankruptcy or other insolvency proceeding of Smurfit Canada, by virtue of being debt and by virtue of its clear provisions.

¹ Affidavit of Malcolm Mercer dated December 9, 2009 ("Mercer Affidavit"), pages 3-4 and 7, paras. 7(k), 7(l),7(m) and 7(gg), Responding Motion Record, Tab 2, pages 7-8 and 11.

² Notice of Motion, page 3, para. 6, Motion Record of the Applicants, Tab 1, page 3.

³ Intercompany Loan Agreement, section 7.2, Compendium of the Responding Parties ("Compendium"), Tab 1.

6. The character of the obligation owing to Finance II under the Loan Agreement is clearly debt. Its character is demonstrated by all of the contextual evidence that has been disclosed, including:

- (a) The tax returns filed by both Finance II and Smurfit Canada,⁴ which treat it as debt for tax purposes;
- (b) On the books and records of both Finance II⁵ and Smurfit Canada,⁶ the Intercompany Loan is treated as debt.
- (c) The evidence provided by the drafter of the Loan Agreement, the Deputy Secretary of Finance II,⁷
- (d) The purpose of the transaction to provide favourable tax treatment through deductibility of the interest paid by Smurfit Canada,⁸
- (e) The words of the Intercompany Loan Agreement which clearly acknowledges that the \$200 million was borrowed under the Intercompany Loan Agreement,⁹
- (f) The sworn schedules that Smurfit Canada filed in its US Bankruptcy proceedings which stated that Finance II was a creditor of Smurfit Canada and coincident with its filing of these CCAA proceedings.¹⁰

7. The only evidence on which Smurfit Canada relies in support of its position that the claim of Finance II is not a claim provable in the CCAA proceedings is the last clause of

⁴ Finance II Tax Returns, Responding Motion Record, Tabs 2(A), 2(B), 2(C) and 2(D); Mercer Affidavit, pages 3-4 and 7, paras. 7(k), 7(l), 7(m) and 7(gg), Responding Motion Record, Tab 2, pages 7-8 and 11.

⁵ Mercer Affidavit, page 4 and 7, paras. 7(m) and 7(gg), Responding Motion Record, Tab 2, pages 8 and 11.

⁶ Transcript of the Cross-examination of Melissa Paz, December 9, 2009, pages 24-25, q. 104 and 109, Transcript Brief, Tab 1.

⁷ Mercer Affidavit, pages 3-4 and 7, paras. 7(k), 7(l), 7(m) and 7(gg), Responding Motion Record, Tab 2, pages 7-8 and 11.

⁸ Affidavit of Douglas R.A. McFadyen, sworn December 7, 2009 ("McFadyen Affidavit") at page 4, para. 18, Responding Motion Record, Tab 1, page 4.

⁹ Intercompany Loan Agreement, section 7.2, Compendium, Tab 1.

¹⁰ Schedules of Assets and Liabilities and Statements of Financial Affairs, Responding Motion Record, Tab 2(E).

section 7.2 which states that, in the event that such section applies, the currency in which that obligation will be satisfied will be shares of Smurfit Canada having a value no less than the dividend or other amount that otherwise would be received by Finance II. This position by Smurfit Canada ignores the wording of section 7.2 and does not accord with either the well-accepted principles of contractual interpretation or insolvency jurisprudence in Canada or the United States.

8. The plain meaning of Section 7.2 is that the Intercompany Loan is a debt obligation that can be satisfied by the payment of shares in certain situation. Section 7.2 does not somehow convert the claim against Smurfit Canada into equity upon a bankruptcy proceeding. Nor does section 7.2 stipulate a specific number of shares, but only that the shares have a value no less than the amount that otherwise would be received by Finance II.

9. In fact, Section 7.2 does not state that the debt obligation is equity even in the situation in which that section applies. It states, instead, that, in certain circumstances, the debt obligation shall be “satisfied” by the issuance of equity to Finance II having a value no less than the amount that otherwise would be received by Finance II. The language of section 7.2 does not support the submission of Smurfit Canada that the loan from Finance II is “by its nature an equity claim.”¹¹

10. This provision does not alter the fundamental nature of the transaction which was intended, on all of the evidence disclosed in these proceedings, to be and was treated as debt for all purposes, including for the purposes of reporting its debt obligations in the US Bankruptcy Court.

11. Read as a whole, in accordance with fundamental principles of contractual interpretation, there is no question that the Intercompany Loan is a debt obligation giving rise to a claim of Finance II against Smurfit Canada in its CCAA proceedings.

¹¹ Notice of Motion, Motion Record of the Applicants, Tab 1, page 4.

12. This is consistent with the intention of the parties, which was plainly to treat this obligation as debt. Finance II recognized the payments of interest on the Intercompany Loan as interest income in its tax returns and Smurfit Canada deducted the interest paid to Finance II on the Intercompany Loan as interest in its tax returns.¹²

13. The intention of the parties that the Intercompany Loan be debt is made patently clear by the financing structure employed by the Smurfit Group, which required that it be a debt obligation. That structure, including Finance II – an unlimited liability company established under the laws of Nova Scotia (a “ULC”) – was intended to permit the deduction of interest for payments made by Smurfit Canada as interest in its Canadian tax returns. The Canadian tax treatment of such payments as interest eligible for deduction as an interest expense is dependent on the Intercompany Loan being a debt obligation, commercially and legally.¹³

14. The parties also acted on their intention that the Intercompany Loan be debt. In particular, Smurfit Canada effectively represented to the Canada Revenue Agency (“CRA”) in its tax filings that the Intercompany Loan was a liability and constituted borrowed money such that it was entitled to a tax deduction on *interest* it paid to Finance II on the Intercompany Loan.¹⁴

15. The only possible interpretation of the Loan Agreement is that it created a debt obligation that was and remained a debt obligation, including for the purposes of proving claims in these CCAA proceedings and in the corresponding Chapter 11 proceedings under the U.S. Bankruptcy Code. Section 7.2 simply provides that the debt obligation, when proved in the CCAA proceeding and/or the Chapter 11 proceeding, is to be satisfied by the issuance of equity having a value no less than the dividend or other amount that Finance II would otherwise receive.

¹² Mercer Affidavit, pages 3-4 and 7, paras. 7(k), 7(l), 7(m) and 7(gg), Responding Motion Record, Tab 2, pages 7-8 and 11.

¹³ McFadyen Affidavit, Responding Motion Record, Tab 1.

¹⁴ See 2007 Finance II Tax Return, Responding Motion Record, Tab 2(C); See also Mercer Affidavit, pages 3-4, paras. 7(k), 7(l) and 7(m), Responding Motion Record, Tab 2, pages 7-8.

16. Stipulation as to the manner of repayment in certain circumstances does not change the nature of the debt obligation or the nature of Finance II's claim against Smurfit Canada.

PART II - THE FACTS

A. The Parties

17. Finance II is an unlimited liability company formed under the laws of Nova Scotia (a "ULC") and a wholly owned subsidiary of Smurfit-Stone Container Enterprises, Inc. ("Enterprises").¹⁵

18. Smurfit Canada is a Nova Scotia corporation, which is also a wholly-owned subsidiary of Enterprises.¹⁶

19. Smurfit Canada is one of two principal Canadian operating entities of the Smurfit-Stone Group.¹⁷

20. On January 26, 2009, Smurfit Canada, Finance II and other related entities (the "Applicants") were granted protection under the *Companies' Creditors Arrangement Act* (the "CCAA") pursuant to an initial order (the "Initial Order") made by this Court (the "CCAA Proceeding").¹⁸

21. Also on January 26, 2009, each of Finance II, Smurfit Canada and Enterprises, among other entities, filed a voluntary petition for relief under chapter 11 of Title 11 of the United States Bankruptcy Code (the "US Proceeding").¹⁹

B. ULC Structures

22. ULC financing structures are used in cross-border financings due to the tax advantages they can provide for multi-national corporate groups in both Canada and the US.

¹⁵ Gropper Affidavit, para. 4, Compendium, Tab 2.

¹⁶ *Ibid*, para. 5; Simplified Corporate Chart, Compendium, Tab 2.

¹⁷ *Ibid*, para. 6, Compendium, Tab 2.

¹⁸ *Ibid*, para. 7, Compendium, Tab 2.

¹⁹ *Ibid*, para. 8, Compendium, Tab 2.

23. Typically, the Nova Scotia-based ULC is a financing entity for the corporate group, which borrows funds and then loans those funds on to a related Canadian corporation (the “Canadian Sister Company”).²⁰

24. The parent company of the ULC will be a company incorporated in the US (the “US Parent”). Under US tax laws, the ULC is a disregarded entity such that the US Parent and the Nova Scotia ULC are treated as a single entity for US tax purposes. As a result, income and expenses of the ULC flow through to the US Parent, which allows the US Parent to enjoy U.S. tax deductions for interest paid by the ULC.²¹

25. Because the ULC and the Canadian Sister Company are separate Canadian entities and taxpayers, the ULC is entitled to separately deduct the interest it pays from the taxable income derived from the interest it earns on its loan to its related Canadian Sister Company, and the related Canadian Sister Company is entitled to deduct from its tax obligations the interest it pays to the ULC.²² This tax treatment is dependent upon the loan from the ULC to the Canadian Sister Company being debt for all commercial and legal purposes under Canadian law.²³

C. The Smurfit Group ULC Structure

26. The Smurfit Group structure was set up in accordance with the typical ULC structure.²⁴

27. Finance II, the ULC in the Smurfit Group structure, is a financing vehicle for the Smurfit Group. It is not an operating company and carries on no trade.²⁵

²⁰ McFadyen Affidavit, at para. 8, Responding Motion Record, Tab 1, page 2.

²¹ *Ibid*, Responding Motion Record, Tab 1, page 2.

²² *Ibid*, para. 9, Responding Motion Record, Tab 1, page 2.

²³ *Ibid*, para. 9, Responding Motion Record, Tab 1, page 2.

²⁴ *Ibid*, page. 12, Responding Motion Record, Tab 1, page 3.

²⁵ Gropper Affidavit, para. 9, Compendium, Tab 2.

28. In or about 2004, Finance II raised funds in the public debt market by issuing certain 7 3/8% Senior Notes due July 15, 2014 (the “Notes”) with a principal aggregate amount outstanding of US\$200 million pursuant to an Indenture dated as of July 20, 2004.²⁶

29. The US\$200 million proceeds from the issuance of the Notes were loaned to Smurfit Canada pursuant to the Intercompany Loan Agreement.²⁷ The obligation to pay interest on the Intercompany Loan was satisfied by the issuance of Class C Shares of Smurfit Canada (the “Class C Shares”).²⁸

30. The Intercompany Loan Agreement was “negotiated” between related parties and it is apparent from the document that it was signed by the same person for both Smurfit Canada and Finance II. It was not publicly disclosed; indeed, the details of the Intercompany Loan were not disclosed to potential purchasers of the Notes or the public in any public disclosure prior to the bankruptcy filing, and the terms of the Intercompany Loan Agreement were disclosed only after the Fund Managers filed a motion.²⁹

31. It is wrong and misleading to suggest that it is important that the Intercompany Loan constitute equity for Canadian law purposes, or that the provision in 7.2 for the satisfaction of the Intercompany Loan in certain circumstances with shares was necessary, to bolster the US tax treatment of the financing structure.³⁰

32. Recharacterizing the Intercompany Loan as equity for Canadian law purposes is not necessary to the US federal income tax treatment of the financing structure and is fatal from a Canadian income tax perspective.³¹

33. Under US law, the commercial law treatment of a transaction does not determine its treatment for US federal income tax purposes. The fact that the Intercompany Loan is treated as debt under Canadian commercial law (which is necessary to obtain the Canadian tax

²⁶ Indenture for 7 3/8% Senior Notes due July 15, 2014, Compendium, Tab •.

²⁷ Intercompany Loan Agreement, Compendium, Tab 1; Gropper Affidavit, para. 11, Compendium, Tab 2.

²⁸ Gropper Affidavit, para. 11, Compendium, Tab 2.

²⁹ Affidavit of John Dash, sworn September 28, 2009, Compendium, Tab 3.

³⁰ McFadyen Affidavit, paras. 14-15, Responding Motion Record, Tab 1.

³¹ *Ibid*, para. 16.

benefits intended by the transaction), does not prevent it from being treated as equity for US federal income tax purposes.³²

34. Accordingly, characterizing the Intercompany Loan as equity is not necessary for Enterprises to achieve the US tax benefits intended by the ULC structure but would be fatal from a Canadian income tax perspective.³³

PART III - ISSUES

35. On this motion, the Court is asked to determine whether the essential nature of the debt obligation owed by Smurfit Canada to Finance II can be transformed into equity simply because a term in the Intercompany Loan Agreement says that in certain circumstances the debt obligation is to be satisfied by the issuance of shares having a value no less than the amount that would otherwise be received. The responding parties submit that the answer is plainly “no”.

PART IV - THE LAW

A. Contractual Interpretation: Meaning of Intercompany Loan Agreement

36. The fundamental goal of contractual interpretation is to give effect to the intention of the parties as expressed in the words of the contract in their proper context. The intention of the parties is to be determined at the date the contract was made.

37. The key question for contractual interpretation is as follows:

Bearing in mind the relevant background, the purpose of the document, and considering the entirety of the document, what would the parties to the document reasonably have understood the contested words to mean?³⁴

³² McFadyen Affidavit, para. 19, Responding Motion Record, Tab 1, page 4.

³³ *Ibid*, para. 16, Responding Motion Record, Tab 1, page 4.

³⁴ *Toronto-Dominion Bank v. Leigh Instruments Ltd.*, 1999 CanLII 3778 (Ont. C.A.) at para 9, Brief of Authorities of the Responding Party at Tab 1.

38. When interpreting a contract, the contract should be construed as a whole and effect given to all provisions in the contract: words are presumed to have meaning.³⁵ An interpretation that is commercially absurd is to be avoided.³⁶

39. It is unnecessary to go beyond the words of the contract when the wording of the contract is unambiguous. The Court shall not adopt an interpretation that is inconsistent with the commercial interests of the parties; however, the parties are presumed to have intended the legal consequences of their words.³⁷

40. Still, because words always take their meaning from context, evidence of the circumstances surrounding the making of the contract is admissible in every case. Evidence of the surrounding circumstances, or “factual matrix”, includes evidence of the genesis of the transaction, the background, the context and the market.³⁸

41. When determining whether an agreement provides for debt or equity, the Supreme Court of Canada has described the legal analysis as follows:

As in any case involving contractual interpretation, the characterization issue facing this Court must be decided by determining the intention 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

³⁵ *Scanlon v. Castlepoint Development* (1992), 11 OR (3d) 744 at 770-771, Brief of Authorities of the Responding Party at Tab 2.

³⁶ *Ibid*, Brief of Authorities of the Responding Party at Tab 2.

³⁷ *Eli Lilly & Co. v. Novopharm Ltd.*, [1998] S.C.J. No. 59 (S.C.C.) at paras. 54 to 56, Brief of Authorities of the Responding Party at Tab 3.

³⁸ *Hi-Tech Group v. Sears Canada Inc.*, [2001] O.J. No. 33 (Ont. C.A.) at para. 24, Brief of Authorities of the Responding Party at Tab 4.

characterization is required, a consideration of admissible surrounding circumstances may be appropriate.³⁹

42. When the essential nature of a financial arrangement is that of debt, the presence of an equity component does not lead to the characterization of the arrangement as equity. The Supreme Court of Canada in *CCB* considered whether emergency financial assistance provided to the failing Canadian Commercial Bank by a group of banks and the Government was properly regarded as a loan or as an equity investment. The Court found that the arrangement was hybrid – both debt and equity – but *in substance* a loan and not a capital investment. Iacobucci J. wrote:

...Although the transaction did have an equity component (the warrants), **this aspect alone does not, in the circumstances of this case, transform the essential nature of the advance from a loan to an investment.** Put another way, while it is true that this transaction does have "investment features", these features were incidental to the debt features of the arrangement and do not alter the substance of the debtor-creditor relationship that was created by the parties with respect to the \$255 million advanced by the Participants to CCB.⁴⁰

43. The Court also stated:

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 with 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. It is permissible, and often

³⁹*Canada Deposit Insurance v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at p. 405, Brief of Authorities of the Responding Party at Tab 5. ("*CCB*")

⁴⁰*Ibid*, at p. 400, Brief of Authorities of the Responding Party at Tab 5.

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 such an agreement must be given the exact same weight when addressing a characterization issue. 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.⁴¹

44. Accordingly, if the agreement contains features of both debt and equity, the Court must determine the “substance” or “true nature” of the relationship.⁴² To do so, the Court looks at what the parties intended.⁴³

45. In *Central Capital*, Justice Laskin of the Court of Appeal noted that the parties’ intention to treat the instruments in question in that case as equity could be seen in the instrument itself and also in related documents such as the articles of incorporation and the way the company treated the instruments in its financial statements.⁴⁴

46. The essential nature of an instrument does not change. In *Central Capital*, the majority rejected the contention that the document could change from equity to debt, in that case upon the exercise of retraction rights. The majority in the Court of Appeal upheld the decision of Feldman, J. in which she held that the right of retraction “does not change the nature of those shares from equity to debt.”⁴⁵

47. Laskin, J. noted that while there were debt and equity components in that case, the substance is either debt or equity but not both: “[i]t seems to me that these appellants must be either shareholders or creditors. Except for declared dividends, **they cannot be both**. Once

⁴¹ *Ibid*, at p. 406, Brief of Authorities of the Responding Party at Tab 5.

⁴² *Re Central Capital Corporation* (1996), 27 O.R. (3d) 494 (Ont. C.A.), at pp. 519 and 536, Brief of Authorities of the Responding Party at Tab 6. (“*Central Capital*”)

⁴³ *Ibid*, at p. 537; *CCB, supra*, at p. 405, Brief of Authorities of the Responding Party at Tab 5.

⁴⁴ *Central Capital, supra* at p. 537, Brief of Authorities of the Responding Party at Tab 6.

⁴⁵ Decision of Feldman J. at p.48, cited in *Central Capital, supra* in dissent at p.509, Brief of Authorities of the Responding Party at Tab 6.

they are characterized as shareholders, their rights of retraction do not create a debtor-creditor relationship.[emphasis added]”⁴⁶

48. There must be strong evidence to rebut the parties’ own characterization of the transaction. As Feldman J. stated in *Central Capital*, “[t]he parties have characterized the transaction as a share transaction. The court would require strong evidence that they did not intend that characterization in order to hold that they rather intended a loan.”⁴⁷

B. Essential Nature of Smurfit Canada Obligation is Debt

49. In this case, there is no dispute that the Intercompany Loan Agreement was a debt instrument. It was created to evidence a debt from Smurfit Canada to Finance II.

50. “Debt” is broadly defined. The Court of Appeal in *Central Capital* cited the following definitions of “Debt”:

A sum of money due by certain and express agreement. A specified sum of money owing to one person from another, including not only the obligation of debtor to pay but right of creditor to receive and enforce payment... A fixed and certain obligation to pay money **or some other valuable thing or things**, either in the present or in the future. [emphasis added]

...

1. That which is owed or due; anything (as money, goods or service) which one person is under obligation to pay or render to another. 2. A liability to pay or render something; the being under such liability.⁴⁸

⁴⁶ *Ibid*, at p. 540. See also p. 519, Brief of Authorities of the Responding Party at Tab 6.

⁴⁷ Decision of Feldman J. at p.48, cited in *Central Capital*, *supra* in dissent at p.509, Brief of Authorities of the Responding Party at Tab 6.

⁴⁸ *Ibid*, at p. 508, Brief of Authorities of the Responding Party at Tab 6.

51. “Indicia of debt” include provisions setting interest rates, payments dates, and requiring principal payments out of any “excess cash flow”. These indicators “point to true debt, not an equity acquisition.”⁴⁹

52. To the contrary, indicia of “equity” include: “[r]isk taking, profit sharing, transferability of investment, and the right to participate in a share of the assets on a liquidation after the creditors have been paid.”⁵⁰

53. When the Intercompany Loan Agreement is read as a whole in accordance with the basic principle of contractual interpretation, it is clear that it creates a debt obligation, with all the indicia of a debt obligation and none of equity. This is consistent with the intentions of the parties.

54. Both parties characterized the transaction a loan, explicitly calling the agreement a “Loan” agreement and characterizing Smurfit Canada as the “Borrower” and Finance II as the “Lender.”

55. The “indicia” of debt in the Intercompany Loan Agreement include provisions for payment of interest, and explicit statements that Smurfit Canada “wishes to borrow certain monies” and “undertakes to repay to the Lender in the manner hereinafter provided.”

56. Indeed, the essential purpose behind the Intercompany Loan was to comply with the requirements of a ULC financing structure to obtain the available tax benefits for Smurfit Canada. To obtain that benefit for Smurfit Canada, the Intercompany Loan had to be debt.

57. Consistent with this purpose, the evidence is clear that the parties treated the Intercompany Loan as debt⁵¹:

⁴⁹ *Harbert Distressed Investment Fund, L.P. v. General Chemical Canada Ltd.*, [2006] O.J. No. 3087 (O.S.C.J.) at para. 88, Brief of Authorities of the Responding Party at Tab 7.

⁵⁰ *Central Capital, supra*, at p. 523, citing R.M. Bryden, “The Law of Dividends” contained in Ziegel ed. *Studies in Canadian Company Law* (1967) at p.270, Brief of Authorities of the Responding Party at Tab 6.

(a) In tax filings: The tax returns filed by Finance II⁵² and Smurfit Canada treated the Intercompany Loan as debt. Dean Jones, senior counsel of International Affairs for Smurfit Canada and assistant corporate secretary for Finance II, admitted that he believed the Intercompany Loan was debt when he filed the 2008 tax return for Finance II. With respect to the 2006 and 2007 tax returns, which were signed by another individual no longer at the company, Mr. Jones admitted he had no reason to believe the Intercompany Loan was not included in the Finance II tax returns as a loan in the 1006 and 2007 tax years.⁵³ Counsel for the Applicants also admitted that the interest payments on the Intercompany Loan were deducted by Smurfit Canada from income for tax purposes as interest on debt, and that the deductibility of interest for tax purposes is what was intended.⁵⁴

(b) On the books and records of Finance II: Counsel for the Applicants admitted that the \$200 million, which is the subject of the Intercompany Loan Agreement, was carried on the books and records of Finance II as debt.⁵⁵

(c) On the books and records of Smurfit Canada: Melissa Paz, Senior Tax Counsel at Smurfit-Stone Container Corporation admitted on cross-examination that the

⁵¹ While Enterprises treated the Intercompany Loan as equity in its tax filings in accordance with the ULC financing structure, as a matter of US law as set out in the McFadyen Affidavit, that treatment results from the fact that for U.S. federal income tax purposes, the Intercompany Loan is not viewed as a discrete instrument but, rather, is integrated with the Forward Purchase Agreement. It is only by reason of that integration, which does not occur for Canadian law purposes, that the Intercompany Loan is treated as equity for U.S. federal income tax purposes. Re-characterizing the Intercompany Loan as equity in this Court is not necessary to the US federal income tax treatment and is fatal from a Canadian income tax perspective. Moreover, the treatment of the Intercompany Loan in the US for tax purposes does not determine the treatment in Canada, which depends on the actual commercial treatment by the parties, which in this case was plainly debt. See *Canada Trustco Mortgage Co. v. Canada*, [2005] S.C.J. No. 56 (S.C.C.), Brief of Authorities of the Responding Party at Tab 7.

⁵² Finance II Tax Returns, Responding Motion Record, Tabs 2(A), 2(B), 2(C) and 2(D).

⁵³ Mercer Affidavit, pages 3-4, paras. 7(k) and 7(l), Responding Motion Record, Tab 2, pages 7-8.

⁵⁴ Mercer Affidavit, page 4 and 7, paras. 7(m) and 7(gg), Responding Motion Record, Tab 2, pages 8 and 11.

⁵⁵ *Ibid.*

Intercompany Loan was shown as debt on the Smurfit Canada books and records and that the payments from Smurfit Canada to Finance II in relation thereto are referred to as interest:

Q. 104: In the books and records of Smurfit-Stone Container Canada, is the \$200 million amount in the loan agreement shown as debt as between it and Finance 2?

MR. ROSE: I am sorry...

THE DEPONENT: Yes, it is. My apologies.

...

Q. 109. So the question, I will just go back to the original question which is: Could you confirm that the books and records of Smurfit-Stone Container Canada show payments on the \$200 million loan amount as interest payments to Finance 2?

A. Yes.⁵⁶

(d) In the Schedules of Assets and Liabilities and Statements of Financial Affairs filed by the Debtors in the U.S. Chapter 11 Proceeding, the Intercompany Loan is referred to as debt in the chart of net receivables and payables.⁵⁷ Moreover, Finance II is listed as a creditor holding an unsecured non-priority claim in Schedule F and the Intercompany Loan balance of \$200,677,778.00 is listed as a payable.⁵⁸

(e) In the Intercompany Loan Agreement itself, which is called a "Loan Agreement" and is replete with references to "lenders", "borrower", "interest", etc.

⁵⁶ Transcript of the Cross-examination of Melissa Paz, December 9, 2009, pages 24-25, q. 104 and 109, Transcript Brief, Tab 1.

⁵⁷ Schedules of Assets and Liabilities and Statements of Financial Affairs, page 4, Responding Motion Record, Tab 2(E), page 118.

⁵⁸ *Ibid*, Schedule F, Responding Motion Record, Tab 2(E), page 268.

Mr. Jones, who prepared the Intercompany Loan Agreement, believed the Intercompany Loan to be debt.⁵⁹

(f) Counsel to the Applicants also made clear that the Intercompany Loan was treated as a debt by the Smurfit Group internally, the income was treated as interest income and there is no dispute that the Intercompany Loan is debt and that deductibility of interest for tax purposes was intended.⁶⁰

58. Given this plain characterization by the parties, strong evidence is required to prove that the Intercompany Loan is anything other than debt. There is no such evidence.

59. Instead, the only reference to equity appears in one single provision of the Intercompany Loan Agreement – section 7.2 – which, as described below, does nothing more than describe the currency in which the debt obligation is to be repaid upon an insolvency-related Event of Default. None of the “hallmarks” of equity such as risk taking or profit sharing are present.

C. Section 7.2 Does Not Transform the Essential Nature of the Debt Obligation

60. While section 7.2 refers to shares, this provision is secondary to the main purpose of the agreement and does not define the essence of the transaction, which, as set out above, is plainly a debt obligation.

61. There is only one “true nature” of a transaction, even though there may be debt and equity components. In this case, the Intercompany Loan has always been and remains debt.

⁵⁹ Intercompany Loan Agreement, Compendium, Tab 1; Mercer Affidavit, pages 4 and 7, paras. 7(l) and 7(i), Responding Motion Record, Tab 2, pages 8 and 11.

⁶⁰ Mercer Affidavit, page 7, para 7(gg), Responding Motion Record, Tab 2, page 11.

The proviso to section 7.2 does not change the essential nature of the Intercompany Loan Agreement from debt to equity.⁶¹

62. Even if it were possible to change the essential nature of a contract upon bankruptcy (which as described below, it is not), a careful reading demonstrates that section 7.2 does not even purport to alter the nature of the agreement in this case.

63. Section 7.2 of the Intercompany Loan Agreement provides that on the occurrence of an insolvency-related Event of Default:

...[Smurfit 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 the Lender and without presentment, demand, protest or 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 [Smurfit 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].

64. First, this provision is only invoked upon the insolvency of Smurfit Canada and, as such, there is absolutely no question that Finance II has a “claim” as defined in the CCAA:

(a) Section 12(1) of the CCAA defines a claim as “any indebtedness, liability or obligation of any kind that, if unsecured, would be a debt provable in bankruptcy within the meaning of the Bankruptcy Act.”

(b) Section 121(1) of the Bankruptcy and Insolvency Act states that “[a]ll debts and liabilities, present or future, to which the bankrupt is subject **at the date of the bankruptcy** or to which he may become subject before his discharge by reason of any

⁶¹ *Central Capital, supra*, Brief of Authorities of the Responding Party at Tab 6.

obligation incurred before the date of the bankruptcy shall be deemed to be claims provable in proceedings under this act.”

65. At the date of the CCAA filing, section 7.2 was not yet invoked and unquestionably Finance II possessed a debt obligation at that time. Accordingly, Finance II plainly had a claim in accordance with the definition in the CCAA. Any reference to the manner of payment of that claim in a distribution is entirely irrelevant to the fundamental fact that Finance II has a claim against Smurfit Canada.

66. Second, in any event, the words in this section continue to provide for a debt obligation.

67. In particular, this section provides unambiguously that “the Loan” becomes due and payable, that Finance II remains entitled to exercise any and all of “its rights and recourses” and that Smurfit Canada is to perform “its obligations.” As such, the essential rights and obligations under the Intercompany Loan Agreement are not altered by this provision.

68. Among the most fundamental “rights and recourses” of a lender of a Loan is to file a claim in insolvency proceedings. That right is clearly included in the acknowledgement in the Loan Agreement itself that Finance II was at all times entitled to all of “its rights and recourses”. In fact, the Loan Agreement mechanics depend on proof of the claim in the event of the insolvency of Smurfit Canada in order to determine the **value** of that claim for the purpose of determining the **value** of the property that is agreed to be issued in satisfaction of that claim.

69. The provision does not provide that Smurfit Canada shall no longer have the obligations set forth in the agreement; rather, it maintains those (debt) obligations but simply provides for the currency for repayment of those obligations: Class B Shares having a specific value.

70. The wording of section 7.2 demonstrates that the indicia of debt also remain, including that Smurfit Canada continues to have a “fixed and certain obligation to pay ...some other valuable thing or things” and Finance II remains entitled to enforce that obligation.

71. The provision itself makes crystal clear that Smurfit Canada continues to be liable for its obligation and that the payment will be of a ‘valuable thing’ because it states explicitly that the shares must have a **value** no less than the dividend or other amount that would otherwise be received by Finance II.

72. The reference to the value of the shares in the final phrase in section 7.2 is entirely ignored by Smurfit Canada in its materials on this motion. However, the fact that Smurfit Canada is to perform its obligations under the Intercompany Loan Agreement 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]” is extremely significant.

73. Not only does this make clear that Smurfit Canada continues to have an obligation to deliver items of value (therefore meeting the definition of “debt”) but also, the provision is premised upon Finance II sharing – *as a creditor* – in the distribution of Smurfit Canada’s assets in an insolvency. It simply adds that the currency of the distribution shall be shares.

74. In addition, this requirement further belies the problems with Smurfit Canada’s proposed interpretation and treatment of Finance II in its draft plan of arrangement (the “Plan”).

75. The Plan does not comply with the Loan Agreement as it does not provide for the issuance to Finance II of Class B Shares of Smurfit Canada having a value no less than the amount that would otherwise be received by Finance II.

76. In providing for shares having the specified value, section 7.2 does not provide for the issuance of a specific, fixed number of shares that would be issuable at any time the provision is invoked. Rather, it requires Smurfit Canada to deliver shares having a value no less than the specified amount. The Applicants in their Plan do not comply with this obligation.

77. Simply stated, until the debt owing to Finance II under the Loan Agreement is paid or satisfied, it remains owing as debt.

78. At the time of the CCAA filing, the debt owing under the Loan Agreement had not been paid or otherwise satisfied. It remains unpaid and unsatisfied and it is still debt now.

79. The fact that Smurfit Canada has not complied with the terms of the Loan Agreement in its Plan is not a reason for holding that the Loan Agreement has changed its essential nature.

80. Accordingly, the interpretation proposed by Smurfit Canada is

(a) inconsistent with the contract as a whole (which is plainly a debt obligation in its essential nature);

(b) inconsistent with the wording of section 7.2;

(c) inconsistent with the actions of both Finance II and Smurfit Canada who have treated the loan under the Loan Agreement as debt in all of their records and in their tax filings;

(d) inconsistent with the factual matrix of the transaction including the intended tax treatment in both Canada and the United States;

(e) inconsistent with the sworn statement of the Smurfit Canada in its Chapter 11 filings; and

(f) inconsistent with the principles of contractual interpretation uniformly applied by the courts of Canada.

81. The interpretation proposed by the Fund Managers, *that until satisfied, the loan owing under the Loan Agreement is simply a debt and is a claim provable in these CCAA proceedings*, is the only sensible and correct interpretation of the Intercompany Loan Agreement.

D. Specific Responses to Smurfit Canada's Factum

82. At paragraph 21 of its factum, Smurfit Canada admits that to qualify as a claim, the relevant date on which Finance II must have a debt is the day on which Smurfit Canada obtained protection under the CCAA. As set out above, there is no question that on the date of filing, the obligation was debt.

83. In its factum, Smurfit Canada argues that the equity that is to be issued in satisfaction of the Loan is valueless equity. Smurfit Canada also argues that the Intercompany Loan is equity because it can be satisfied with equity. These contentions are not supported by either the law or the language of the Intercompany Loan Agreement on which it relies.

84. Section 7.2 provides that the Finance II is to receive "Class B Shares having a **value** no less than the dividend or other amount that otherwise would be received by [Finance II]". Accordingly, the equity to be issued to Finance II must have **value** that is **equal** to the **value** that otherwise would be distributed to Finance II.

85. As stated elsewhere in this factum, in interpreting a contract, a court is required to give effect to the clear language of the parties to the agreement. By its clear and unambiguous terms, the Intercompany Loan Agreement is a clear and is an agreement to borrow and to repay US\$200 million. There is no language contained in the agreement to the contrary.

86. Indeed, Section 7.2 of the Agreement, which forms the entire basis for Applicants' arguments, recognizes the obligations as a loan, but provides for the repayment of the loan in the form of shares having a value equal to the distribution the loan would otherwise be paid in

a bankruptcy. Section 7.2 does not purport to alter the nature of the obligation of the loan as a debt. It in fact confirms the validity of the debt in a bankruptcy and provides the form of currency in which the debt will be satisfied.

87. Therefore, the proper way to interpret the Intercompany Loan Agreement as it applies in the circumstances that invoke section 7.2 because of the insolvency of Smurfit Canada is as follows:

- (a) Finance II has a debt claim as of the date of the insolvency event;
- (b) Finance II files its debt claim in the insolvency of Smurfit Canada;
- (c) Finance II's debt claim ranks pro rata with all other debt claims and its entitlement to a distribution in the insolvency process is calculated by reference to the pool of other unsecured creditors;
- (d) Section 7.2 provides that Finance II shall receive the same value that it would otherwise receive as an unsecured creditor of Smurfit Canada.⁶²;
- (e) All unsecured creditors would receive their distribution *pari passu* in value;
and
- (f) If Smurfit Canada does not comply with its obligation, for any reason⁶³, to issue class B shares as provided in the Intercompany Loan Agreement, the Intercompany Loan simply remains outstanding and unsatisfied.

⁶² Smurfit Canada may not be able to assume the obligation to issue class B shares in repayment of the Loan as a debtor in possession under a Chapter 11 case under the U.S. Bankruptcy Code

⁶³ Including, for example, that Smurfit Canada may not be entitled to issue class B shares because of provisions of the *Bankruptcy and Insolvency Act*, (Canada) or the US Bankruptcy Code.

88. Under the bankruptcy law that applies in this case⁶⁴, the provisions of section 7.2 would not result in the claim of Finance II being asserted as a claim for equity. Rather, the claim is only for the loan which must be allowed as a claim for \$200 million, plus accrued interest as the bankruptcy filing date.⁶⁵

89. As an alternative, the Applicants argue that if the claim of Finance II is a debt, it should be subordinated in repayment to the claims of other creditors. This argument is entirely devoid of merit both as a matter of contract interpretation and as a matter of bankruptcy law.

90. Applicants concede that at all times the Intercompany Loan Agreement has been considered and treated as debt. They nonetheless contend that because the Agreement provides for a distribution in shares in the event of bankruptcy that evidences an intent that the debt be subordinated to the claims of other creditors. Their arguments are baseless.

91. If the parties to the Agreement had intended that the Loan convert to equity upon a bankruptcy they should have written the Agreement to say so. They did not so provide, though they certainly had the ability to write the Agreement that way if that was intended.

92. Likewise, if they had intended that the Loan be subordinated in payment in the event of a bankruptcy, they should have written it to say so. Under no rule of contract interpretation can the provisions of section 7.2 be read to be a subordination agreement.

⁶⁴ The Applicants are all also debtors in possession under the US Bankruptcy Code.

⁶⁵ 11 U.S.C. sec 502(b), for example which provides that, "If such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of filing of the petition, and shall allow such claim in such amount." Courts construing this provision have held that section 502(b) trumps any contractual provision to the contrary and requires that all claims must be reduced to a dollar amount

93. Finally, even if there had been an agreement to convert the Loan to equity upon a bankruptcy filing, it would be unenforceable under the US Bankruptcy Code, a law to which both Applicants have voluntarily subjected themselves by filing Chapter 11 cases in the US.⁶⁶

94. The next argument advanced by Smurfit Canada, that the Applicants are entitled to deprive Finance II of its rights under the Intercompany Loan Agreement because of statements made in the disclosure provided under Securities Laws, should be disregarded entirely. The disclosure does not disentitle Finance II from having assets and does not remove the obligation of Finance II to pursue its rights for the benefit of the creditors or release Smurfit Canada from its obligations.

95. In any event, the disclosure to which Smurfit Canada refers also states that the proceeds of the Loan will be lent to related parties with the inevitable result that Finance II would have assets, as it does. The terms of the Intercompany Loan Agreement itself was not

⁶⁶ Section 365(c) of the US Bankruptcy Code provides, in relevant part, that:

The trustee [or debtor in possession] may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegations of duties, if

xxx

(2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or **to issue a security of the debtor**; or

[Emphasis added]

disclosed nor was any statement made that the Loan would be treated as equity or otherwise postponed to other debt claims in any insolvency proceeding of Smurfit Canada.

96. Further, there is no factual basis for drawing any conclusions about the reliance of investors who bought the Notes. Investors may very well have bought the Note because they understood the tax structure of the transactions and expected that their advances to Finance II would result in valuable investments by Finance II in other Smurfit companies.

97. Finally, Smurfit Canada argues that it and Enterprises always intended that it would be Enterprises alone that would provide cash to repay Finance II. However, the outcome that would occur if all of the agreements were performed and there were no defaults is irrelevant to the issue before this Court. As it always does, the Court must now consider the rights of the parties arising from **defaults** under the Intercompany Loan Agreement and the contractual rights that arise when parties do not perform their agreements. Moreover, even under this argument, it is clear that the parties intended for the Intercompany Loan to be paid in cash at maturity.

PART V - ORDER REQUESTED

98. Accordingly, the Responding Parties respectfully request that this Honourable Court provide directions to the parties by declaring that the Intercompany Loan is debt and that Finance II has a claim against Smurfit Canada for the full amount of the US\$200 million Intercompany Loan plus interest.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 10th day of December, 2009.

A handwritten signature in black ink, consisting of several loops and a long horizontal stroke extending to the right.

Kevin McElcheran/ Malcolm Mercer/ Heather L.
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SCHEDULE "A"
LIST OF AUTHORITIES

1. *Toronto-Dominion Bank v. Leigh Instruments Ltd.*, 1999 CanLII 3778 (Ont. C.A.)
2. *Scanlon v. Castlepoint Development* (1992), 11 O.R. (3d) 744 (Ont. C.A.)
3. *Eli Lilly & Co. v. Novopharm Ltd; Eli Lilly & Co. v. Apotex Inc.*, [1998] S.C.J. No. 59 (S.C.C.)
4. *Hi-Tech Group Inc. v. Sears Canada Inc.*, [2001] O.J. No. 33 (Ont. C.A.)
5. *Canada Deposit Insurance v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) (S.C.C.)
6. *Re Central Capital Corporation* (1994), 27 O.R. (3d) 494 (Ont. C.A.)
7. *Harbert Distressed Investment Fund, L.O. v. General Chemical Canada Ltd.*, [2006] O.J. No. 3087 (O.S.C.J.)
8. *Canada Trustco Mortgage Co. v. Canada*, [2005] S.C.J. No. 56 (S.C.C.)

SCHEDULE "B"
RELEVANT STATUTES

Companies' Creditors Arrangement Act

Section 12(1):

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*.

Bankruptcy and Insolvency Act

Section 121(1)

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.

IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, c. C-36
AND IN THE MATTER OF THE BANKRUPTCY AND INSOLVENCY ACT, R.S.C. 1985, c. B-3
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"

ONTARIO
SUPERIOR COURT OF JUSTICE -
COMMERCIAL LIST

Proceeding commenced at Toronto

FACTUM OF THE RESPONDENTS
(DECEMBER 11, 2009 MOTION)

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