CANADA

PROVINCE OF QUÉBEC
DISTRICT OF MONTRÉAL

No. : 500-11-036133-094

SUPERIOR COURT

Commercial Division
(Sitting as a court designated pursuant to the
Companies' Creditors Arrangement Act,
R.S.C., c. C-36, as amended)

IN THE MATTER OF THE PLAN OF COMPROMISE OR ARRANGEMENT OF:

ABITIBIBOWATER INC.,

and

ABITIBI-CONSOLIDATED INC.,

and

BOWATER CANADIAN HOLDINGS INC.,

and

the other Petitioners named in the Note Restructuring Motion referred to herein

Petitioners

and

ERNST & YOUNG INC.,

Monitor

MEMORANDUM OF ARGUMENT OF THE PETITIONERS ON THEIR MOTION TO AUTHORIZE PETITIONERS ABITIBI-CONSOLIDATED INC. AND ABITIBI-CONSOLIDATED COMPANY OF CANADA TO IMPLEMENT CERTAIN RESTRUCTURING STEPS

All capitalized terms not otherwise defined herein shall have the meaning ascribed thereto in the following documents:

- the *Initial Order* (as amended and restated) issued by this Court on April 17, 2009; and

- the Petitioners' *Motion for the Issuance of an Order Authorizing Petitioners Abitibi-Consolidated Inc. and Abitibi-Consolidated Company of Canada to Implement Certain Restructuring Steps* (the "**Note Restructuring Motion**") dated November 17, 2009.

I. INTRODUCTION

1. On April 1, 2008, as part of a refinancing and restructuring of ABH and related entities, ACCC sold the shares of stock of DCorp to ABH LLC in consideration for the ABH LLC Note under which ABH LLC promised to pay the sum of U.S. $201,614,222.50, together with any Principal Increase (as defined in the ABH LLC Note) and all accrued and unpaid interest thereon.

   - *ABH LLC Term Promissory Note*, Exhibit R-1 to the Note Restructuring Motion.

2. As of April 16, 2009, an amount of approximately U.S. $250 million remained outstanding under the ABH LLC Note.

3. As further described below, under Canadian tax laws, a non-resident person (such as ABH LLC) who is connected with a shareholder of a particular corporation (such as ACCC) may become indebted to the particular corporation without triggering adverse Canadian tax consequences if the indebtedness is repaid within one year after the end of the taxation year of the creditor in which the indebtedness arose. However, if the indebtedness is not repaid within this grace period, the indebtedness is recharacterized as a dividend as of the date of incurrence, which would result in a Canadian withholding tax.

4. While in the normal course, ACCC and ABH LLC would have been in a position to arrange their affairs so as to avoid this outcome within the time permitted, in this particular case, bankruptcy proceedings affecting both parties intervened before this could be done.

5. In order to repay the indebtedness represented by the ABH LLC Note within the grace period provided for by Canadian tax laws, the ABH LLC Note must be repaid on or before December 31, 2009.

6. Should the ABH LLC Note not be repaid by the end of this calendar year, a withholding tax of approximately U.S. $55.25 million (the "**Withholding Tax**"), being 25% of the outstanding principal amount of the ABH LLC Note, would have to be remitted by ACCC, as withholding agent for ABH LLC, to the Canadian tax authorities by January 15, 2010. If ACCC were to fail in making such remittance, the Canadian tax authorities would have the right to collect the amount by way of set-off against GST refunds that ACCC otherwise receives periodically.

II. NECESSITY OF IMPLEMENTING THE REPAYMENT STEPS

7. If the ABH LLC Note is not repaid within the grace period referred to above, ACCC will be liable to pay, as withholding agent for ABH LLC, the Withholding Tax.

8. Such a substantial liability would adversely impact ACCC's liquidity position and thus, on the Petitioners' ability to reorganize their affairs in Canada and in the United States. The success of the Petitioners' reorganization is in the interest of the Petitioners, as well as that of their creditors and other stakeholders.

   - *Twenty-Second Report of the Monitor* dated November 19, 2009 ("**Monitor's 22nd Report**") at paras. 36-37.

9. As appears from the Note Restructuring Motion and the Monitor's 22nd Report, the implementation and completion of the Repayment Steps will permit the repayment of the ABH LLC Note within the grace period.

   - Monitor's 22nd Report at paras. 36-37.

10. The Repayment Steps would not materially affect the Petitioners' corporate structure nor affect the Petitioners interest (and that of their creditors and other stakeholders) in the residual value of the ABH LLC Note.

III. REPAYMENT STEPS

(a) General Canadian Tax Analysis

11. Subsection 15(2) of the *Inco me Tax Act* ("**ITA**") provides generally that, where a person is a shareholder of a particular corporation or is connected with a shareholder of the particular corporation and the person has received in a taxation year a loan from or has become indebted to the particular corporation, the amount of the loan or indebtedness is included in computing the income of the person for the year. Subsection 15(2) of the ITA does not apply to debt and indebtedness between Canadian corporations, but applies to persons that are, amongst others, individuals and non-resident corporations.

    - *Income Tax* Act, 1985, c. 1 (5th Supp.), subsection 15(2), **[TAB 1]**.

12. Where the person who received a loan or who became indebted is a non-resident person, the ITA deems the amount of loan or indebtedness that would otherwise be included in the income of such person by virtue of subsection 15(2) of the ITA to be <u>a dividend</u> paid by the Canadian corporation who made the loan. Under the ITA, the dividend payer (the Canadian corporation) must withhold, as withholding agent for the non-resident person, a withholding tax of 25%, unless the rate is otherwise reduced by a tax treaty, and remit that amount of tax to the Canadian tax authorities on or before the 15th day of the 13th month following the end of the taxation year of the creditor in which the indebtedness arose (being January 15, 2010 in the present circumstances).

13. The ITA provides for an exception (and thus no withholding **tax**) where among others the loan or indebtedness is repaid within one year after the end of the taxation year of the lender or creditor in which the loan was made or the indebtedness arose (being December 31, 2009 in the present circumstances).

14. The transactions contemplated in the Note Restructuring Motion are intended to result in a deemed repayment of the ABH LLC Note as a result of the merger of the issuer and holder thereof, consistent with the ITA.

(b) ACI Reduction of Capital and ACCC Reduction of Capital

15. The Repayment Steps consist, among other steps, in the ACI Reduction of Capital and the ACCC Reduction of Capital.

16. ACCC and ACI are currently, and will at the time of the said reductions continue to be, insolvent. Both are Petitioners in these proceedings under the CCAA.

17. ACI is a corporation incorporated under the *Canada Business Corporation Act*, R.S.C. c. C-44. (the "**CBCA**") and ACCC is a company incorporated under Part 1A of the *Companies Act*, R.S.Q. c. C-38 (Québec) (the "**QCA**").

18. Both the CBCA and QCA contain express provisions (section 38(1) CBCA and 123.62 QCA) authorizing a corporation or company to reduce the amount of its stated capital ("issued share capital" pursuant to the QCA), including for the distribution of an amount to its shareholders.

- CBCA, op. cit., s. 38(1) **[TAB 2]**:

> "*Subject to subsection (3), a corporation may by special resolution reduce its stated capital for any purpose including, without limiting the generality of the foregoing, for the purpose of (a) extinguishing or reducing a liability in respect of an amount unpaid on any share; (b) distributing to the holder of an issued share of any class or series of shares an amount not exceeding the stated capital of the class or series; and (c) declaring its stated capital to be reduced by an amount that is not represented by realizable assets.*"

- QCA, op. cit., s. 123.62 **[TAB 3]**:

> "*A company may also reduce the amount of its issued share capital, in particular to limit or remove the shareholder's obligation to pay for the shares issued, or to reimburse any portion of the share capital exceeding its needs to the shareholders, if a by-law to that effect is adopted by the company.*"

19. These enabling provisions reversed the early common law position whereby corporations had no power to reduce their stated capital even where the articles of the corporation provided for such a right at the time of the issuance of those shares.

- Kevin P. McGuinness, *Canadian Business Corporation Law*, 2d ed. (Ontario: LexisNexis, 2007) **[TAB 4]** at. 7.275 & 7.276.

(i) ACI Reduction of Capital

20. An exception to the authority of a CBCA corporation to reduce its stated capital is set out in section 38(3) CBCA.

- CBCA, op. cit., s. 38(3) **[TAB 2]**:

> "*a corporation shall not reduce its stated capital for any purpose [...] if there are reasonable grounds for believing that (a) the corporation* ***<u>is, or would after the reduction be,</u>*** *unable to pay its liabilities as they become due, or (b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities*" [Emphasis added].

21. The consequences of a breach of s. 38(3) of the CBCA are instructive. In a manner similar to the Ontario *Bulk Sales Act*, s. 38(4) of the CBCA provides that the remedy for breach of the Act is to grant creditors a right to follow the asset transferred in violation of the Act. In the case of the *Bulk Sales Act*, unsecured creditors are given the right to pursue a buyer who acquired assets in contravention of that statute; in the case of s. 38(4), creditors are given the right to pursue the shareholder who received a distribution from an unlawful reduction of capital.

- *Bulk Sales Act*, R.S.O. c. B-14, s. 16, **[TAB 5]**.

- CBCA, op. cit., s. 38(4) **[TAB 2]**.

22. The *Bulk Sales Act* contains provisions authorizing a court to exempt a transaction from the application of that Act. In similar fashion, s. 191 of the CBCA also permits the court to authorize an arrangement effecting amendments to the articles of the corporation, including amendments providing for a reduction of capital, without reference to the limits in s. 38.

- *Bulk Sales Act*, op. cit., s. 3, **[TAB 5]**.

- CBCA, op. cit., s. 191, **[TAB 2]**.

23. In effect, s. 38(3) and s. 191 are complementary pieces of a comprehensive legislative scheme. Shareholders, in effect, are given the power to effect capital reductions except where insolvency either exists or would ensue. At that point, Parliament recognizes that other interests - those of creditors - come into play. Under s. 191, where creditor rights have been recognized and are placed under court supervision

in formal proceedings under the CCAA, the Court is granted the power to authorize the steps which the shareholders alone are no longer enabled to do.

24. The case law dealing with the intersection of CCAA proceedings and the Ontario *Bulk Sales Act* provides a useful guide to instruct the Court in when it is appropriate to exercise its discretion under s. 191 to approve a reorganization. In the case of *Re Canadian Red Cross Society*, Blair J. (as he then was) considered a motion to approve the sale of a substantial portion of the assets of the debtor Red Cross Society. Justice Blair determined that he did indeed have jurisdiction to approve said sale prior to a Plan being brought forward for approval and that he should exercise his discretion to exempt the proposed transaction from the provisions of the *Bulk Sales Act*.

   - *Re Canadian Red Cross Society*, (1998) 5 C.B.R. (4th) 299 (Ont. Gen. Div.) **[TAB 6]** at para. 49:

     > *"While there were submissions about whether or not the sale would impair the Society's ability to pay its creditors in full, I do not believe that the sale will impair that ability. In fact it may well enhance it."*

25. In *National Trust Co. v H. & R. Block Canada Inc.* the Supreme Court of Canada considered an application by a creditor to require a purchaser of property in a non-compliant transaction to account for the value of the goods purchased under s. 16 of the *Bulk Sales Act*. The majority opinion of Bastarache J. noted that:

   - *National Trust Co. v H. & R. Block Canada Inc.* [2003] S.C.R. 160 (S.C.C.) **[TAB 7]** at para. 26:

     > *"The process to be followed by the application judge in applying the s. 16(2) remedy provision is similar to the process used in determining whether an exemption should be granted under s. 3 of the Act. In other words, the application judge will turn his or her mind to similar considerations when deciding on a course of action under either s. 3 or s. 16(2) of the Act. Specifically, the application judge should consider, inter alia, how the creditors, both secured and unsecured, would be affected by the sale; whether the sale would be detrimental or beneficial to the creditors; and whether it would have the same impact on each of the creditors, or whether certain creditors would be differentially affected... Generally speaking, after considering such factors, if it is reasonable to believe that an application judge would have granted an exemption (i.e. the value of the sale is not detrimental to the creditors), then it is also unlikely that the buyer will be able to account to unpaid creditors under s. 16(2), providing the proceeds of the sale are paid to the creditors ratably."*

26. While not relying exclusively upon these criteria, the court went on to find that, having regard to the fact that the proceeds were paid to a higher ranking secured creditor, an "accounting" by the buyer of the value of the goods acquired should take

such payments into account and should not result in an unjust enrichment to creditors who would not otherwise have recovered money from a compliant sale.

➢ *National Trust Co. v H. & R. Block Canada Inc.*, op. cit., **[TAB 7]** at para. 35.

27. In the present case, the reasoning of Blair J. in *Red Cross* in granting an exemption from the provisions of the *Bulk Sales Act* as well as the factors commended by Bastarache J. in considering *Bulk Sales Act* exemptions in the *National Trust* case both offer a very close analogy to the situation before this Court. Section 191, in effect, authorizes a court exercising bankruptcy jurisdiction, to exempt transactions from the effect of s. 38(3).

28. The transaction brought before this Court for approval, and in particular the reorganization provisions sought to be approved pursuant to s. 191 of the CBCA, are necessary in order to prevent the creation of an unnecessary new claim (the withholding tax claim) and the prospect of off-sets being asserted in the future which would challenge the liquidity of the Debtors in a manner not currently provided for in their cash flows.

29. While the transaction, viewed as a whole, is neutral to the estate of ACI since its patrimony remains effectively unchanged before and after the intended transaction on a net basis, the potential liability, if no repayment were to occur on time, would on the other hand be material.

30. The scheme of this particular tax provision is to provide a period of time during which certain types of loans must be repaid. As such, the tax authorities are deprived of no tax revenue and have no right to the tax revenue provided that the repayment transaction proceeds and occurs on time. Transfers of capital can quite legitimately be either taxable or non-taxable, depending upon the level of paid up capital or shelter the transferor has. The Act deems the transaction which was in form a loan from to ABH LLC as if it were a return of capital (in this case, by way of dividend) if the loan is not repaid within a specified period of time. In this case, the intervention of bankruptcy proceedings has prevented the normal working out of the transaction (which at its inception was not intended to give rise to this tax obligation). In other words, Canada Revenue Agency is not a creditor with an expectation which is being defeated in this instance.

31. Stated differently, the *Income Tax Act* is, in effect, telling ACCC that the transaction which was established as a loan is going to be treated as a taxable return of capital (i.e. dividend) unless something is done by year end. This Court is merely being asked to assist the debtor in choosing the option least harmful to its creditors (using a small portion of its tax shelter versus potentially paying significant cash taxes) by exempting it from provisions designed to protect creditors in the first place.

(ii) ACCC Reduction of Capital

32. As regards ACCC, the situation is slightly different. Under the transaction as proposed, ACCC must also reduce its capital. However, as a QCA Company, ACCC

is subject to a regime which, while different in form from the combination of s. 38, s. 173 and s. 191 of the CBCA, nevertheless pursues the same general policy goals. An exception to the authority of a QCA company to reduce its issued share capital is set out in section 123.63 QCA which reads as follows:

➢ QCA, op. cit., **[TAB 3]**, s. 123.63:

"*a company may in no case reduce the amount of its issued share capital if there is reasonable ground to believe that, **as a consequence**, (1) it could not discharge its liabilities when due, or (2) the book value of its assets would, after the reduction, be less than the sum of its liabilities and its issued and paid-up share capital account*" [Emphasis added.].	"*Une compagnie ne peut toutefois réduire le montant de son capital-actions émis s'il y a des motifs raisonnables de croire **qu'en raison de ce fait**: (1) elle ne pourrait acquitter son passif à échéance; ou (2) la valeur comptable de son actif serait inférieure au total de son passif et de son compte de capital-actions émis et payé après cette réduction.*" [Emphasis added.].

33. Section 123.63 does not apply in the present circumstances.

34. As noted above, ACCC is currently, and will at the time of the ACCC Reduction of Capital continue to be, insolvent. As such, it is not "*as a consequence/en raison de ce fait*" [i.e. the ACCC Reduction of Capital], that ACCC will not meet the financial tests provided for in section 123.63. Section 123.63 is expressly designed to prohibit a reduction in share capital which *causes* the tests not to be met, as opposed to a reduction in capital which occurs at a time where the tests are not met at the outset. The transaction is not, in this case, "*la goutte qui fait déborder la vase*" – the company is already insolvent and has placed itself under the protection and supervision of the Court.

35. The ACCC Reduction of Capital as well as the ACI Reduction of Capital form an integral part of the Repayment Steps, which in turn are designed to ensure that the financial situation of ACCC is not adversely affected and its right in the residual value of the ABH LLC Note preserved.

36. While there is no equivalent of s.191 CBCA in the QCA, the insolvency test is materially different from that found in s. 38(3) and, we submit, the result is the same.

37. As noted above, s. 38(3) applies where the corporation is *or* would be rendered insolvent. This bar is more stringent than s. 123.63 of the QCA which applies a causation test, however it is more stringent in the context of a statute which has a built in mitigation feature (a court order under s. 191) to ensure creditor interests are not damaged in the interest of better protecting them. The QCA, on the other hand, restricts its solvency limitation to transactions which cause insolvency. Where insolvency *already exists* there is no need for the QCA to stipulate how to protect

creditor interests - the Court exercising insolvency jurisdiction (in this case, under the CCAA) can consider all the facts and circumstances and make an appropriate order taking creditor interests into account.

38. In fact, the QCA generally does not address bankruptcy and insolvency matters. This is not necessary for a number of reasons.

39. First, the Civil Code of Québec ("**CCQ**"), which comprises a body of rules which lays down the *jus commune* and as such is the foundation of all other laws, provides for appropriate protection of all interested parties in the event of current <u>and</u> prospective insolvency.

   - *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461 as per Major and Deschamps JJ. **[TAB 8]** at para. 29;

   - *CCQ*, *Preamble* and Art. 300.

40. For example, any prejudicial juridical act while a company is insolvent would give rise to the broad protective remedies provided for in the CCQ in connection with paulian actions. In addition, any directors authorizing a reduction of capital by an insolvent company, if in breach of their duty of care to the company, may find themselves potentially liable to creditors.

   - *CCQ*, Art. 1631;

   - *QCA*, op. cit., s. 123.83 **[TAB 3];**

   - *Peoples Department Stores Inc. (Trustee of) v. Wise,* [2004] 3 S.C.R. 461 as per Major and Deschamps JJ., **[TAB 8]** at para. 57:

     > "[...] *if breach of the standard of care, causation and damages are established, creditors can resort to art. 1457 to have their rights vindicated.*"

41. Second, if insolvent, a company is likely to be governed by one of the federal statutes relating to bankruptcy and insolvency, and, if it has sought Court protection, any actions contemplated by it will be subject to Court supervision in the interest of all stakeholders.

42. We note that Québec companies law is currently in the process of reform. If Bill 63 is adopted in its current form, it would include, among other things, the two following sections:

   - Section 101(2) Bill 63, *Business Corporations Act*, 1st Sess., 39th Leg., Québec, 2009 ("**Bill 63**") **[TAB 9]**:

     > "*A corporation may, if authorized to do so by special resolution, reduce the amount of its issued share capital, in particular to reduce or extinguish the shareholders' obligation to pay for the*

> *shares issued, or to repay any part of the issued share capital exceeding its needs to the shareholders.*
>
> *However, a corporation may not reduce the amount of its issued share capital if there are reasonable grounds for believing that it **is, or would after the reduction** be, unable to pay its liabilities as they become due."* [Emphasis added]

- Section 411 Bills 63:

> *"When ruling on an application for approval of a proposal under the Bankruptcy and Insolvency Act (Revised Statutes of Canada, 1985, chapter B-3) or any other application under the Companies' Creditors Arrangement Act (Revised Statutes of Canada, 1985, chapter C-36), the court may make any order it thinks fit, including an order directing*
>
> *(1) the amendment of the articles of the corporation in order to add, change or remove any provision that is permitted by this Act to be set out in the articles;*
>
> *(2) the issue by the corporation of debt obligations, whether or not convertible into shares of any class of the corporation or carrying any rights or options to acquire shares of any class, and fixing the terms of such issue; and*
>
> *(3) the appointment or replacement of directors of the corporation."*

43. The foregoing proposed sections 101(2) and 411 Bill 63 would accordingly change the regime currently in place under the QCA by expanding the scope of the prohibition on reductions of issued share capital, but would concurrently introduce a reorganization procedure for insolvent companies.

THE WHOLE RESPECTFULLY SUBMITTED

Montréal, November 20, 2009

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