

News & Publications



Northern Exposure: A Tale of Two Canadian Recapitalizations With Precedential Value for Future Canadian and U.S. Transactions

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On February 29, 2008, *Tembec Industries, Inc.* successfully completed a recapitalization involving complete conversion of its bond debt to equity and a new money facility provided by existing bondholders on a backstopped basis. On March 31, 2008, *Abitibi Consolidated Inc.* successfully completed a recapitalization involving an exchange offer for its maturing bond debt and three concurrent new financings. Both recapitalizations involved extraordinary circumstances and novel business and legal strategies that may serve as important precedents for future recapitalization and restructuring transactions both in Canada and in the U.S.

Tembec Industries – A New Approach to Old Problems

Tembec was hit with a triple whammy. First, the housing slump triggered by the subprime crisis materially reduced demand for Tembec's timber products. Second, the increasing strength of the Canadian dollar reduced the profitability of Tembec's substantial sales into the U.S. market. Third, like so many other companies today, Tembec took advantage of the pre-2007 credit markets to lever up its balance sheet to the point that there was little margin for error.

Tembec's \$1.2 billion in public debt securities consisted of three separate issuances that matured in 2009, 2011 and 2012, respectively. Anticipating that it was unlikely that Tembec could meet its 2009 maturity, a group of 2009 bondholders made a proposal to Tembec that, according to market rumors, would extend the 2009 maturity in exchange for securing the 2009 bonds.

Needless to say, Tembec's 2011 and 2012 bondholders were not enamored with the prospect of securing the 2009 bonds while leaving the 2011 and 2012 bonds outstanding on an unsecured basis. This caused a group of 2011 and 2012 bondholders to approach Tembec with the proposition that Tembec would be better served by a global deleveraging transaction than by a band-aid approach that only addressed the 2009 bonds.

Recognizing that it needed to do "something," Tembec set up a process for interested parties to make "bids" as to a recapitalization and invited both groups of bondholders, as well as Tembec's largest shareholder, to bid against each other.

In formulating their proposal, the 2011/2012 group defined a series of objectives:

- The proposal should address all of Tembec's bonds, rather than just one issue of bonds, because this would be in the best interests not only of the 2011/2012 bonds but also of Tembec itself.
- The proposal should convert 100% of the bond debt to equity in order to provide Tembec with the best opportunity for succeeding in the difficult forest products environment, while at the same time providing bondholders with an equity upside to compensate for their increased risk.

- The proposal should include a commitment for new money in order to incentivize Tembec with "one-stop shopping" convenience while properly capitalizing Tembec for the challenges ahead.
- The proposal needed to incentivize shareholders to support the proposal, both in lieu of the anticipated proposal from Tembec's largest existing shareholder and with the goal of achieving a fully consensual transaction.
- The proposal needed to be capable of consummation by February 29, 2008, which was the last day of the grace period on an interest payment and, therefore, the last day before the substantial market CDS exposure would be triggered, potentially throwing a monkey wrench into the entire process.
- The proposal needed to reward the group with extra compensation for taking the lead, but without running afoul of indenture "equal treatment" provisions.
- The proposal needed to provide incentives to all bondholders, including the 2009 bondholders, because the 2011/2012 group controlled only 20% of the overall bond debt but needed two-thirds of the bonds to consent to the recapitalization.

A tall order indeed, but it was an order that the 2011/2012 group was able to fulfill. In summary, the proposal (i) converted all bond debt to equity, but provided just enough new equity to the existing shareholders to obtain their support as well, and (ii) included a commitment to a new \$300 million secured facility.

The two most important features of the proposal were the backstopped nature of the new facility and the novel utilization of a Canadian corporate recapitalization regime rather than the more typical insolvency regime.

The backstop feature provided the members of the 2011/2012 group with both a cash fee and an equity fee for backstopping the \$300 million commitment. At the same time, all other bondholders were also invited to backstop the \$300 million commitment in exchange for a healthy fee, but less than was payable to the group members. Also, in order to reduce the extent to which the backstops were actually called upon, the new \$300 million facility was offered to all bondholders with both a market rate of interest and a substantial share of the new equity. This approach presented other bondholders with a choice. On the one hand, they could participate in the proposal and receive both a backstop fee and substantial compensation for participating in the new facility. On the other hand, they could fight the proposal and take the risk that the proposal would still obtain approval, in which case they would lose out on both the backstop fee and the extra compensation. In the end, the requisite percentage of bondholders chose to support the proposal.

The statutory feature focused on the Canada Business Corporations Act (CBCA). Pursuant to the CBCA, a solvent Canadian corporation can restructure certain financial debt obligations pursuant to a creditor vote that binds hold-out creditors subject to shareholder approval and to court approval for general fairness. The CBCA is not an "insolvency" statute and, in fact, is not available to insolvent companies. For insolvent companies, the typical approach would be to use the Companies' Creditors Arrangement Act (CCAA), but CCAA proceedings take longer, are more court intensive, are more expensive and implicate more contractual rights. For example, a CCAA filing triggers "bankruptcy defaults" under a company's contracts with major vendors. However, by proceeding under the CBCA, Tembec was able to equitize 100% of its bond debt without disrupting key trade relationships and governmental licenses (particularly critical in the highly-regulated forest products industry). The disadvantages, as alluded to above, were that shareholder approval was needed and that the process was open to dissenting creditors to assert that Tembec was insolvent and, therefore, not eligible for a CBCA transaction. However, the built-in incentives of the Tembec recapitalization proposal paved the way for a quick and smooth process that did not meet with material opposition at the end of the day.

Before the Tembec recapitalization, the CBCA had not been used to implement a financial restructure of a company of Tembec's magnitude. After Tembec, one should expect to see more use of the CBCA for pre-negotiated deleveraging transactions, particularly when the transaction appropriately incentivizes other bondholders, lenders and shareholders to support the transaction.

Abitibi Consolidated – Overcoming the Odds

In late 2007, Abitibi Consolidated merged with Bowater to form AbitibiBowater, one of the world's largest news print and timber products companies. Both Abitibi and Bowater brought substantial debt to the merger, making it almost inevitable that Abitibi would need to recapitalize its balance sheet prior to its 2008 and 2009 bond maturities. Unfortunately, there were substantial delays in obtaining audited financials for the merged companies, thus effectively precluding Abitibi from accessing the capital markets on a timely basis. This problem was compounded by the same factors that affected Tembec – weakening demand for timber, unfavorable exchange rate movements, very high leverage and a concurrent crisis in the credit markets.

Unable to wait any longer for its audited financials and in light of the weakening credit markets, Abitibi announced in early March 2008 a proposed recapitalization that would involve a new short-term bank facility, a substantial issue of new high-yield senior secured notes, a major convertible note placement, and an exchange of the 2008 and 2009 bonds for cash and longer-maturity unsecured bonds. The bond exchange offer was clearly well below par, resulting in a group of 2008 and 2009 bondholders forming to discuss their options.

All of this needed to be consummated prior to the April 1 maturity of a substantial portion of the 2008 bonds, otherwise all \$5 billion of Abitibi's bonds, regardless of maturity date, could have cross-accelerated, not to mention the substantial turmoil that would have been caused as a result of the multiple billions of CDS exposure written on Abitibi's bonds. And all aspects of the transaction needed to be consummated in the context of the continuing credit crunch, compounded by the Bear Stearns melt-down in the middle of the capital raising efforts.

The bondholder group was thus faced with several major challenges. First, they needed to persuade Abitibi to amend the exchange offer to provide appropriate consideration. As challenging as such a negotiation is in a bilateral context, the challenges were compounded by the need for Abitibi to raise the bank, secured note and convertible financing, all of which were dependent on approval of the terms of any amended exchange offer.

Second, the bondholder group needed to deliver 90% of the 2008 bonds and 75% of the 2009 bonds into the offer in order to minimize the risk of "free riders." This presented the logistical problem of identifying the holders of the widely-held public bonds, as well as ensuring that bonds on loan were recalled so that they could be tendered in time.

Third, they needed the other components of the recapitalization transaction to fall into place prior to the April 1 bond maturity.

As reflected in the low trading price of the bonds, the market bet heavily against the likelihood that all of this could be achieved within three weeks. Nevertheless, the bond group proceeded with its efforts to negotiate an improved exchange offer, on the theory that slim odds were better than no odds at all. At the same time, the group privately engaged in substantial contingency planning, including the possibility of providing interim funding in order to refinance the near-term maturities so that Abitibi would have a breathing space in which to raise the financing for a longer-term recapitalization.

The good news was that the bondholder group was able to negotiate a substantially improved exchange offer – \$550 in cash and \$550 in new 15.5% notes for each \$1000 of the April maturity bonds – and Abitibi obtained its audited financials and was able to raise the new bond, note and convertible financing, all in compliance with Canadian and U.S. legal requirements and all consummated within the space of three weeks from the date of Abitibi's original proposal. In addition, the new bonds received the benefit of enhanced guarantees and the same tight high-yield covenant package provided for the new senior secured notes.

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Bracewell & Giuliani LLP was pleased to represent both the Tembec bondholders and the Abitibi bondholders in the above transactions. These were the latest in a series of Canadian restructurings led by members of the Bracewell team, including AT&T Canada, Loewen Group International, Singer Canada, Teleglobe and Consumers Packaging.

Robert T. Carey
Phone: 212.508.6109
Email: robert.carey@bgllp.com

Evan D. Flaschen
Phone: 860.256.8537
Email: evan.flaschen@bgllp.com

Kurt A. Mayr
Phone: 860.256.8534
Email: kurt.mayr@bgllp.com

Ilia M. O'Hearn
Phone: 860.256.8536
Email: ilia.ohearn@bgllp.com