

**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 A PLAN OF
COMPROMISE OR ARRANGEMENT OF
JTI-MACDONALD CORP.**

**SECOND REPORT OF THE MONITOR
APRIL 1, 2019**

INTRODUCTION

1. On March 8, 2019, JTI-Macdonald Corp. (“**JTIM**” or the “**Applicant**”) filed for and obtained protection under the *Companies' Creditors Arrangement Act* (the “**CCAA**”). Pursuant to the Order of this Court (the “**Court**”) granted on March 8, 2019 (the “**Initial Order**”), Deloitte Restructuring Inc. (“**Deloitte Restructuring**”) was appointed as the Monitor in these proceedings (in such capacity, the “**Monitor**”). The Initial Order provided for a stay of proceedings with respect to the Applicant until and including April 5, 2019 (the “**Stay Period**”). These proceedings commenced by the Applicant will be referred to herein as the “**CCAA Proceedings**”.
2. Imperial Tobacco Canada Limited, Imperial Tobacco Company Limited (together, “**ITL**”) and Rothmans, Benson and Hedges Inc. (“**RBH**”) have also each filed for CCAA protection. ITL, RBH and JTIM are collectively referred to herein as the “**Co-Defendants**”. The comeback motion in respect of the Initial Order and the initial orders

granted in respect of the other Co-Defendants has been scheduled for April 4 and 5, 2019 (the “**Comeback Motion**”), at which the Applicant will, among other things, seek to extend the Stay Period to June 28, 2019.

3. In connection with JTIM’s application under the CCAA, Deloitte Restructuring filed a report (the “**Pre-Filing Report**”) of the proposed monitor (the “**Proposed Monitor**”) dated March 8, 2019. The Monitor served and filed the First Report of the Monitor dated March 28, 2019 (the “**First Report**”) which, among other things, described the activities of the Monitor and JTIM since the granting of the Initial Order, disclosed JTIM’s cash receipts and disbursements for the three-week period ended March 22, 2019, provided a cash flow projection for the 27-week period from March 25, 2019 to September 27, 2019 and set out the Monitor’s support for the extension of the Stay Period to June 28, 2019.
4. On March 28, 2019, Conseil Québécois sur le tabac et la santé, Jean-Yves Blais and Cécilia Létourneau (the “**Quebec Class Action Plaintiffs**”) filed a motion in the CCAA Proceedings returnable at the Comeback Motion seeking variations of the Initial Order and other relief in connection with these CCAA Proceedings (the “**Quebec Class Action Motion**”). The heads of relief in the Quebec Class Action Motion listed below are those to which the Monitor believes it is appropriate to provide further information for the Court’s consideration, namely, the Quebec Class Action Plaintiffs’ request to:
 - A. Rescind the appointment of Deloitte Restructuring as Monitor;
 - B. Prohibit the payment of principal and interest by JTIM to JTI-Macdonald TM Corp. (“**TM**”) in respect of certain debentures granted in favour of TM by JTIM (the “**TM**

Term Debentures”) and the security granted in respect thereof (the “**TM Security**”);

- C. Prohibit the payment by JTIM of royalties in respect of certain licensed trademarks from related parties;
 - D. Prohibit the payment to related parties in respect of services provided by those related parties; and
 - E. Rescind the appointment of the JTIM chief restructuring officer (the “**CRO**”) or in the alternative, have the fees of the CRO paid by a company that is not party to these CCAA Proceedings.
5. Also on March 28, 2019, the Provinces of British Columbia, Manitoba, New Brunswick, Nova Scotia, Prince Edward Island and Saskatchewan, in their capacities as plaintiffs in the health care cost recovery legislation claims (collectively, the “**Consortium of Provinces**”) filed a notice of objection (the “**Consortium Objection**”, and together with the Quebec Class Action Motion, the “**Objections**”) in the CCAA Proceedings raising concerns about, among other things, “the ability of Deloitte Restructuring to fulfill the neutral and independent role required of a court-appointed monitor”.¹

¹ On March 29, 2019, the Ministry of the Attorney General for Ontario filed a motion in the CCAA Proceedings seeking a lifting of the stay of proceedings, as provided for in the Initial Order, in order to proceed with Action No. CV-09-387984 bearing the title of proceedings *Her Majesty the Queen in right of Ontario v. Rothmans Inc. et al.* The Monitor understands that the Applicant will be opposing such relief so as to maintain the status quo while it seeks a resolution of all creditor and litigation claims against it.

6. This Second Report of the Monitor (the “**Second Report**”) has been prepared to provide the Court with the Monitor’s views and recommendations on the relief sought in the Quebec Class Action Motion set out in paragraph 4 above and discussed below. The Second Report is intended to be read in conjunction with the Affidavit of Robert McMaster (the “**McMaster Affidavit**”) and the Affidavit of William E. Aziz (the “**Aziz Affidavit**”) both sworn on April 1, 2019, on behalf of the Applicant.

TERMS OF REFERENCE AND DISCLAIMER

7. This Second Report is subject to the terms of reference and qualifications set out in paragraphs 6 through 10 of the First Report, which terms of reference are hereby incorporated by reference.

RELIEF SOUGHT IN THE OBJECTIONS

Concerns About Deloitte Restructuring as Monitor

8. As noted in the Pre-Filing Report, Deloitte Restructuring is not subject to any restrictions on who may be appointed as monitor pursuant to section 11.7(2) of the CCAA in respect of these CCAA Proceedings, and no party has suggested otherwise.
9. Even when there is no statutory impediment to accepting a monitor appointment, Deloitte Restructuring as a matter of standard practice also considers whether there are any material connections with entities related to a CCAA debtor, as it did in this case. In the interest of full transparency, Deloitte Restructuring believes it is important to disclose such connections to the Court even though it has assessed that such connections do not impair

its ability to act in a neutral, impartial and independent manner. Accordingly, in the Pre-Filing Report, the Proposed Monitor disclosed material points of contact between the Deloitte Global Network (defined below) and the domestic and international affiliates and related parties of JTIM (the “**Global Japan Tobacco Group**”).

10. As a result of these points of contact between the Deloitte Global Network and the Global Japan Tobacco Group, the Objections express concerns with Deloitte Restructuring acting as Monitor. The Quebec Class Action Motion specifically seeks an order rescinding Deloitte Restructuring’s appointment as Monitor.
11. The Monitor notes the following to assist the Court in determining the ability of Deloitte Restructuring to continue its mandate as Monitor.

(i) Deloitte Global Network & Global Japan Tobacco Group

12. The global professional services network to which Deloitte Restructuring is a part is extensive, consisting of approximately 286,200 employees in more than 150 countries and territories around the world (the “**Deloitte Global Network**”) and provides audit, tax, enterprise risk and financial advisory services. Deloitte Restructuring, the entity that was appointed Monitor of JTIM by the Initial Order, is a discrete Canadian entity and wholly owned subsidiary of Deloitte LLP (“**Deloitte Canada**”) that undertakes domestic engagements involving financial advisory and insolvency services only.
13. Deloitte Canada is a member firm of Deloitte Touche Tohmatsu Limited (“**DTTL**”), a UK entity. The member firm structure reflects the fact that the member firms are not subsidiaries or branch offices of a global parent, but instead are separate and distinct legal

entities. Accordingly, Deloitte Canada's management protocols, including client and engagement acceptance, mandate and file management, as well as data and document retention are independent of other member firms of DTTL.

14. Deloitte Restructuring acts independently from the other entities in the Deloitte Global Network. Neither Deloitte Restructuring nor Deloitte Canada share or participate in the revenue generated by other members of the Deloitte Global Network.
15. Paragraph 11 of the Pre-Filing Report detailed all points of contact between the Deloitte Global Network and the Global Japan Tobacco Group that the Monitor determined were relevant for the Court's consideration, including the fact that a member of the Deloitte Global Network acted as auditor of Japan Tobacco Inc., JTIM's ultimate parent.
16. In consenting to act as Monitor, Deloitte Restructuring considered that no member of the Global Japan Tobacco Group other than JTIM was to be an applicant in these CCAA Proceedings and was advised by the Applicant's counsel that no member of the Global Japan Tobacco Group was included in any of the legal proceedings in Canada involving JTIM, including the HCCR Actions and the Quebec Class Actions (as defined in the Pre-Filing Report). Further, Deloitte Restructuring has not had contact with, advised, or been instructed by any member of the Global Japan Tobacco Group.
17. In accordance with its standard practice, Deloitte Restructuring has put in place confidentiality protocols with respect to its staff involved with the Monitor appointment in these CCAA Proceedings.

(ii) Disclosure of Relevant Facts

18. The Monitor notes the following for the Court's consideration in connection with concerns expressed by the Quebec Class Action Plaintiffs regarding appropriate disclosure in the Pre-Filing Report.
19. The Quebec Class Action Plaintiffs have expressed concern that the Pre-Filing Report fails to mention that certain intercompany transactions (the "**Integration Transactions**") undertaken almost twenty years ago² were set-up as a creditor proofing exercise. The Quebec Class Action Plaintiffs also state that the Monitor "rubber stamped" JTIM's request to continue to pay interest in respect of the TM Term Debentures resulting from the Integration Transactions.
20. In respect of the Integration Transactions, the Pre-Filing Report refers to the Fourth Report of Ernst & Young Inc. ("**EY**") in its capacity as Monitor in JTIM's 2004 CCAA proceedings (the "**EY Fourth Report**") at paragraph 11(v) and directs readers to the document as an exhibit to the affidavit of Robert McMaster sworn March 8, 2019 (the "**Initial McMaster Affidavit**"). The EY Fourth Report is a detailed report prepared by EY, in its capacity as monitor of JTIM in 2004, after extensive investigations and inquiries into the Integration Transactions. The nature and specifics of the Integration Transactions, the advisors involved, and the specific role of Deloitte & Touche LLP (a predecessor to Deloitte Canada) in providing a valuation of RJR Macdonald Corp's brand equity, is

² The Integration Transactions are the intercompany financing and related arrangements pursuant to which the TM Term Debentures were issued and the TM Security was granted.

discussed in the EY Fourth Report. Deloitte & Touche LLP's role in providing such valuations is disclosed at paragraph 11(v) of the Pre-Filing Report.

21. The Quebec Class Action Plaintiffs express concern that the Monitor did not disclose its relationship with entities related to ITL and RBH (who were not CCAA debtors at the time of JTIM's CCAA filing) or its alleged "long-time activities on behalf of the tobacco industry". As noted above, the Deloitte Global Network is an extensive one. Like many large global accounting networks, it is actively involved in providing its audit and advisory services to a variety of industries including mining, automotive, agriculture, oil and gas and tobacco among many others. Deloitte Restructuring's conflicts clearing practice and disclosure practices in connection with court-appointed mandates focusses on the debtor company and parties related to it and not exhaustive inquiries on broader industry mandates that do not directly involve the debtor. In the Monitor's view, this is consistent with accepted practice of proposed court officers.

Concerns about Interest Payments

22. At paragraph 72 of the Pre-Filing Report, the Monitor advised that it did not object to the authorization in the Initial Order for the ordinary course payment of interest by JTIM to TM under the TM Term Debentures for the reasons described therein which continue to apply. The Initial Order does not permit payment of principal.
23. In the course of evaluating the proposed payment of interest under the TM Term Debentures, the Monitor, with the assistance of its counsel, considered the validity of the TM Security. Legal opinions (collectively, the "**Security Opinion**") were provided to the

Monitor concluding that TM holds a valid security interest in the personal property of JTIM located in Nova Scotia, Ontario, Alberta and British Columbia and in the personal property and real property of JTIM located in Quebec, subject to the assumptions and qualifications set out in the Security Opinion. The Monitor understands that the foregoing provinces are where the material portion of the Applicant's assets are located.

24. The Security Opinion was in standard form resulting from a review of the loan and security documents and related filings in public registries and, as a result, expressly did not comment on the statements in respect of the Integration Transactions and the TM Term Debentures in the Judgment on Motion for a Safeguard Order of Mr. Justice Mongeon dated December 4, 2013 (the "**Mongeon Decision**") and the Judgment of Mr. Justice Riordan publicly released on June 1, 2015 and subsequently amended on June 9, 2015 (the "**Riordan Decision**"). As noted in the Pre-Filing Report, the Security Opinion is available to interested parties upon request, provided appropriate arrangements are made in respect of confidentiality, privilege and reliance.
25. Although the Security Opinion did not discuss the Mongeon and Riordan Decisions, the Monitor, however, considered the statements made in those decisions about the Integration Transactions generally in advising the Court in the Pre-Filing Report that it did not object to interest payments being made in respect of the TM Term Debentures.
26. The Mongeon Decision was rendered in respect of the Quebec Class Action Plaintiffs' motion for an order under the *Quebec Civil Code* to enjoin payments by JTIM to TM. In

his reasons, Justice Mongeon stated that, unless a subsequent judgment invalidates the TM Security, the underlying secured obligation would be unaffected:

The only way the Plaintiffs could ever benefit from the safeguard order sought would be to amend their proceedings, implead the party (or parties) to whom these payments are due and attack the contracts pursuant to which these payments are due.

Unless and until those conclusions are sought, the Plaintiffs have no *right or appearance of right* to protect or safeguard.³**[emphasis in original]**

27. There is no doubt that the commentary in the Riordan Decision is critical of the Integration Transactions and that such criticism formed a basis for assessing punitive damages against JTIM. Justice Riordan, however, in making these critical comments, did not invalidate the TM Security. That security has been in place for almost twenty years and, after making inquiries of the Applicant, the Monitor is not aware of any outstanding proceeding seeking to challenge its validity. In fact, as noted in the McMaster Affidavit and referred to in the Aziz Affidavit, Justice Riordan noted at paragraph 1099 of the Riordan Decision that “no one has attacked the validity or the legality of the tax planning behind the Interco Contracts, or the contracts themselves”. Justice Riordan later noted at paragraph 1102 that the legality of such contracts was not before the Quebec Court. As noted in the McMaster Affidavit, the decision of the Quebec Court of Appeal upholding the Riordan Decision (the “**QCA Decision**”) also did not invalidate the Integration Transactions or the TM Security. Accordingly, in deciding not to object to the continued payment of interest on the secured

³ Safeguard decision at paras 82-83

debt, the Monitor took guidance from the Riordan Decision, the Mongeon Decision and the QCA Decision.

28. The Monitor's position was also informed by the Reimbursement Agreement (as defined in the McMaster Affidavit) provided by a credit-worthy party, which was put in place by the Applicant to provide comfort to the stakeholders that funds would be returned if judicial scrutiny resulted in a court determining that payments should not be made post-filing under the TM Term Debentures.
29. The Monitor further notes that both the McMaster Affidavit and the Aziz Affidavit describe tax and other consequences that will adversely impact JTIM and its stakeholders should interest payments be suspended for a lengthy period of time. The Monitor concurs that any erosion of value due to adverse tax consequences described therein could be detrimental to JTIM's stakeholders and its restructuring efforts.

Royalty Payments

30. The Monitor has reviewed the discussion of the royalty payments in the McMaster Affidavit wherein the affiant notes that trademarks licensed by JTIM from TM are critical to the operation of the business of JTIM and if such license arrangements were terminated that the operations of JTIM would cease in its current form. The Monitor notes that McMaster Affidavit and the Aziz Affidavit set out the commercial rationale for the transfer of the trademarks to TM by JTIM, which is essentially to achieve tax efficiencies. The Monitor understands that the CCAA requires CCAA debtors to make post-filing payments for the use of licensed property.

Related Party Payments for Services

31. The Monitor has carefully reviewed material related party contracts for ongoing services as described in the Pre-Filing Report, the material receivables and payables thereunder, the results of the 2013 CRA audit and the status of the ongoing CRA audit. The pricing terms included in material related party contracts entered into after 2013 are consistent with the pricing terms of material related party contracts in effect in 2013. The Monitor has also reviewed the analysis provided in the McMaster Affidavit and the Aziz Affidavit of the related party contracts for ongoing services. The Monitor has also reviewed their analysis of the consequences if such payments were withheld, which the Monitor believes are reasonable assessments. Accordingly, the Monitor supports the maintenance of the status quo and the continuation of the inter-company payments for services rendered to the Applicant to ensure that the Applicant can continue in business in the ordinary course as required by the Initial Order.

The Role of the CRO

32. The Monitor advised in the Pre-Filing Report at paragraphs 59 through 64 that it supported the appointment of the CRO. The Monitor continues to support the assistance of the CRO in these CCAA Proceedings.
33. JTIM is in the business of manufacturing, marketing and selling tobacco products, not negotiating complicated, multi-party settlements. The Monitor accepts the Applicant's position that it requires additional professional assistance to represent its interests effectively in the impending complex settlement negotiations.

34. The CRO sets out his qualifications and relevant experience in the Aziz Affidavit. The CRO appears to be well qualified for the proposed role. Accordingly, in the Monitor's view, the central matter for its consideration is whether the CRO's fee structure is reasonable in light of all the circumstances.
35. The Monitor considered the unredacted CRO engagement letter (the "**CRO Engagement Letter**"), attached to the Initial McMaster Affidavit as Confidential Exhibit "1", and discussed it in the Pre-Filing Report. The Monitor notes that the success fee, which is not secured by the Administration Charge, is only payable in circumstances where a global settlement is reached with the Quebec Class Action Plaintiffs or a CCAA plan is implemented following requisite creditor and court approval. The Monitor investigated court approved fee structures for financial advisors that assisted in large, complex restructurings (some of which it had access to but are not publicly available). Many such fee structures employ formulas related to transaction value or the quantum of compromised debt, others provide for fixed fees and several have a combination of both. The Monitor was comfortable with the financial terms of the CRO Engagement Letter because (i) the monthly work fee and success fee were reasonable based on its analysis of similar, complex engagements; and, (ii) as noted above, the success fee would only be payable as part of a global settlement in which stakeholders would be participants.

CONCLUSIONS & RECOMMENDATIONS

36. The Monitor serves at the pleasure of the Court and seeks only to play a constructive role with the Applicant and its stakeholders as an independent court officer in the CCAA

Proceedings and will continue to do so should its appointment continue. In its view, it has made full disclosure of matters relevant to its suitability.

37. As noted above, for considered reasons, the Monitor:
- (i) does not object to the payment of interest on the TM Term Debentures, which have been suspended pending the Comeback Motion;
 - (ii) supports the continued payment of royalties to TM, in accordance with the CCAA;
 - (iii) supports the continued payment for services provided by related parties, in accordance with the CCAA; and
 - (iv) supports the continued professional assistance of the CRO to assist the Applicant in the pursuit of a global resolution of claims facing the Applicant.
38. The Monitor supports the maintenance of the status quo, particularly in these early stages of the CCAA Proceedings, while the Applicant with the assistance of the CRO and the Monitor seeks to engage the stakeholders in a global resolution of the claims against the Applicant.

All of which is respectfully submitted this 1st day of April, 2019.

**Deloitte Restructuring Inc.,
Solely in its capacity as Court-appointed Monitor
of JTIM and not in its personal capacity**



Per:
Paul M. Casey, CPA, CA, FCIRP, LIT
Senior Vice-President