No. S-120712
Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA

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

AND

IN THE MATTER OF THE *CANADA BUSINESS CORPORATIONS ACT*, R.S.C. 1985, c. C-44

AND

IN THE MATTER OF THE *BUSINESS CORPORATIONS ACT*, S.B.C. 2002, c. 57

AND

IN THE MATTER OF CATALYST PAPER CORPORATION AND THE PETITIONERS LISTED IN SCHEDULE "A"

PETITIONERS

APPLICATION RESPONSE

Application Response of: Ad Hoc Unsecured 2014 Noteholders' Committee (the "2014 Group").

To: The Service List

THIS IS A RESPONSE TO the Notices of Application of the Petitioners dated March 16, 2012 and March 19, 2012, to be heard on March 21, 2012 (the "Petitioners' Application").

All capitalized terms that are used but not defined herein are intended to bear their meanings as defined in the Petitioners' Application and the supporting materials filed therewith.

Part 1: ORDERS CONSENTED TO

1. None.

Part 2: ORDERS OPPOSED

1. The Meetings Order, to at least the following extent:

    a. paragraph 55 of the Meetings Order, which is proposed to allow certain 2016 Noteholders and another group that holds 2016 Notes and a small minority of the

2014 Notes (the latter group is referred to hereinafter as the "Crossover Group" and the two groups are collectively defined variously in the Petitioners' Application and supporting materials as the "Majority Initial Supporting Noteholders" and the "Initial Supporting Noteholders") to require the Petitioners to bring an application to deem the following two non-existent facts to exist, for the purpose of then asserting that the Plan will have been approved by the required majorities of unsecured creditors under the CCAA:

i. that unsecured creditors who have asserted claims but did not vote those claims have in fact voted ("Fictional Votes"); and

ii. that the Fictional Votes (which will not have been voted at all) were in fact cast in favour of the Plan ("Fictional Yes Votes"); and

b. paragraphs 4, 46(c), 54, 55, 59 and any other paragraphs of the Meetings Order and the Plan, which purport to grant the special rights of consultation and consent to the unsecured claims of the Crossover Group that are not equally granted to the Petitioners' other unsecured creditors (either the unsecured claims of the Crossover Group should not have preferential consent rights, or they should be categorized separately from the other unsecured creditors, who do not have such rights).

2. The Claims Procedure Order, to the following extent:

a. paragraph 12, to the extent that paragraph 12 exempts the 2016 Noteholders from proving the validity, enforceability, extent and priority of their claimed security.

3. The Sale and Investor Solicitation Order (hereinafter the "SISP Order"), to which the 2014 Group objects in its entirety and which the 2014 Group submits ought to be denied or alternatively adjourned, as set out below.

4. The Order regarding the Elk Falls Mill (the "Elk Falls Order"), to which the 2014 Group objects in its entirety and which the 2014 Group submits ought to be denied or alternatively adjourned, as set out below.

Part 3: ORDERS ON WHICH NO POSITION IS TAKEN

1. The Meetings Order and the Claims Procedure Order, to the extent not objected to above.

Part 4: FACTUAL BASIS

1. Despite repeated requests, the Petitioners have refused or neglected to provide to the 2014 Group certain information necessary for the unsecured creditors who do not have special access to information as part of the Crossover Group, to consider the impact of the proposed Orders, including but not limited to the impact of the proposed SISP Order, on the Unencumbered Assets (as defined below) and on their rights and position as unsecured creditors.

2. Finally, on March 16, 2012 (as evidenced in Mr. Kaplan's letter to counsel for the 2014 Group, attached as Exhibit "D" to the March 20, 2012 Affidavit of Wendy Morrison, hereinafter the "Morrison Affidavit") the Petitioners and/or the Monitor have now agreed to provide some of the requested information to the 2014 Group, but further information, including information relating to the Unencumbered Assets subject to the SISP Order, has not been provided and that information is critical to the 2014 Group and other unsecured creditors for evaluating the fairness of the proposed Sales and Investor Solicitation Process (hereinafter the "Sales Process") for which the Petitioners are seeking approval and for ensuring that the interests of unsecured creditors are protected thereunder.

3. It is apparent from the pleadings filed in this action that there are significant assets of the Petitioners that were not encumbered by the Petitioners prior to the commencement of these proceedings (collectively the "Unencumbered Assets"), including but not limited to the Excluded JV Interests (as defined in paragraph 39 of the February 3, 2012 Restated and Amended Initial Order).

4. As a result, as at the commencement of these proceedings, the Unencumbered Assets were available for the repayment of the Petitioners' unsecured claims.

5. The Orders granted in these proceedings by this Honourable Court have not on their face granted any charges over the Unencumbered Assets, thereby properly maintaining the *status quo* regarding the Unencumbered Assets, for the benefit of unsecured creditors. However, the Monitor has advised the 2014 Group (as referred to in Exhibit "C" to the Morrison Affidavit) that some or all of the Unencumbered Assets may have been encumbered since the commencement of these proceedings.

6. The extent, nature and value of the Unencumbered Assets are not apparent from the pleadings filed in this action. Part of the information being requested by the 2014 Group is a list of the Unencumbered Assets and all information regarding any encumbrances granted on the Unencumbered Assets since the commencement of these proceedings. In the context of the currently-proposed hasty Sales Process, a lack of information to the unsecured creditors certainly benefits (in an unjustified manner) the 2016 Noteholders. It is not difficult to imagine how, for example, in a credit bid process in which the Unencumbered Assets are not being separately marketed, the 2016 Noteholders (*via* an *en bloc* bid that allocates little value to the Unencumbered Assets) could appropriate most or all of the value of the Unencumbered Assets to themselves, thereby materially altering the pre-filing *status quo*. This risk is very real in a process where the Unencumbered Assets are not clearly defined, independently valued and separately marketed. In addition, without adequate information regarding the Unencumbered Assets, the unsecured creditors will have no ability to protect their interests by pursuing these concerns.

7. The Plan currently being proposed by the Petitioners does not differ materially from the plan presented to creditors in their January 14, 2012 Restructuring and Support Agreement (as evidenced in Exhibit "F" to the Morrison Affidavit, and hereinafter the "Old Plan"). The Old Plan did not receive the support of the Petitioners' unsecured

creditors. The Petitioners have filed no evidence in support of this Application tending to prove that the Plan will not similarly be rejected by their unsecured creditors.

8. For this Honourable Court to deem that the Fictional Votes and the Fictional Yes Votes exist (when they do not) would:

   a. be illegal and contrary to the CCAA;

   b. undermine and bring into disrepute the sanctity of the CCAA voting process, contrary to prior decisions of this Honourable Court; and

   c. create a substantial, real and unavoidable conflict of interest in the claims review process, given that, for example, there will be an incentive for the Petitioners (who will have huge potential influence as to whether certain claims can be justified and should be accepted) to allow and accept unsecured claims that can then be deemed to be Fictional Votes and Fictional Yes Votes, thereby improperly increasing the likelihood that the Plan will succeed. Even the possibility of the proposed deeming process creates such an unavoidable conflict for the Petitioners in the claims review process.

   Allowing the deeming of non-existent facts in this manner, to effectively "stack the vote", would be especially egregious in light of the lack of any evidence indicating that the Plan will receive the support of unsecured creditors (support that the substantially identical Old Plan did not receive).

9. The Sales Process as currently proposed by the Petitioners lacks safeguards that are required to ensure its integrity, including:

   a. the Sales Process is not proposed to be conducted by an independent party like the Court-appointed Monitor and, in addition, the 2016 Noteholders are proposed to be granted extraordinary oversight, consultation and authority with respect to the Sales Process (far greater than they would enjoy even in a court-appointed Receivership sales process and far greater than those proposed for the Monitor) thereby usurping the legitimate role of the Monitor in the Sales Process and creating a conflict of interest with their declared role as a credit bidder;

   b. given the history of the close relationship of the 2016 Noteholders, the Crossover Group and the Petitioners, the fact that some or all of the 2016 Noteholders are proposed to be the Stalking Horse Bidder and the fact that the Petitioners are not adequately defending the interests of unsecured creditors in these proceedings, the Monitor's conduct of the Sales Process is absolutely necessary to ensure the integrity of the process (including the creation of a real and visible level playing field for the benefit of legitimate third party bidders), but the Monitor is not currently proposed to have any significant role in the proposed Sales Process;

   c. the fact that this extraordinary oversight, consultation and authority has been granted to the Stalking Horse credit bidder can be expected to have a detrimental effect on the Sales Process, by chilling legitimate participation by interested third

parties (who will recognize that the 2016 Noteholders' extraordinary role can or will lead, at the very least, to a non-level playing field). Legitimate third party bidders have to be able to see that the Sales Process is credible and has integrity, and that it is not just window-dressing for a *fait accompli* credit bid;

d. there is no need whatsoever for a Stalking Horse Bidder in the Sales Process (given the total lack of the factual circumstances that are customarily present and that justify the extraordinary rights granted to stalking horse bidders, namely: the significant time, expense and financial exposure taken on by a stalking horse bidder, to help a debtor advance a sales process expeditiously). The 2016 Noteholders' bid is a credit bid (effectively, a foreclosure), and there is no need to make a credit bid *via* a Stalking Horse Bid. Of course, in a foreclosure, the 2016 Noteholders would have no rights to take the Unencumbered Assets in satisfaction of their secured claim, but they are trying to do that by way of a Stalking Horse Bid. Whereas legitimate stalking horse bids are designed to effectively set a high bar for other bidders, this Stalking Horse Bid has the opposite effect for the Unencumbered Assets, by giving the impression to the market that there is a "package deal" in place which will succeed, that the Unencumbered Assets do not have high value, and by incentivizing the Stalking Horse Bidder to allocate as little value as possible to the Unencumbered Assets;

e. even if the Sales Process continues to include a Stalking Horse Bidder, the proposed Stalking Horse Expense Reimbursement Charge, which is of an indeterminate amount, is unnecessary and would represent a confiscation of the value of the Unencumbered Assets by the 2016 Noteholders; and

f. such further and other factual matters as counsel may advise at the hearing of the Petitioners' Application.

10. The Sales Process as currently proposed by the Petitioners lacks safeguards that are necessary to ensure that the Unencumbered Assets are properly and adequately exposed to the appropriate markets, so as to obtain fair market value therefor, including:

a. the Unencumbered Assets are not even identified in the materials filed in support of the SISP Order;

b. there is no provision for the proper valuation of the Unencumbered Assets by an independent qualified third party, nor any provision to make such valuation available to the 2014 Group (not even on a confidential basis);

c. the Unencumbered Assets are not proposed to comprise separate Parcels in the Sales Process;

d. the Monitor, the Petitioners and the Financial Advisor are not authorized or directed to identify and notify as "Known Potential Bidders" any purchasers or investors who would have a specific or particular interest in the Unencumbered Assets;

e. the Sales Process does not contain clear and transparent rules inviting bidders to bid separately on the Unencumbered Assets;

f. the Sales Process does not contain clear and transparent rules clarifying that a bid for the Unencumbered Assets cannot be rejected for the benefit of a "superior" *en bloc* bid unless the value of such *en bloc* bid is reallocated so as to pay from the total value thereof an amount in cash for the Unencumbered Assets, matching the best alternative bid for the Unencumbered Assets (given the unprecedented powers given to the 2016 Noteholders in the Sales Process, this concern is more than theoretical); and

g. such further and other factual matters as counsel may advise at the hearing of the Petitioners' Application.

11. The application for the SISP Order is academic and premature, since the Sales Process will only commence, if at all, no earlier than April 23, 2012. The bringing of the application to approve the Sales Process at this time is inappropriate because, among other things:

a. the application is being brought in a very truncated time period, although the Sales Process will not have effect until over a month from now;

b. the information necessary for the unsecured creditors to consider their position and the impact of the Sales Process on their position (as described above), has not been provided; and

c. the Stalking Horse Bidder and Stalking Horse Agreement have not been disclosed.

In other words, this Honourable Court is being asked to prematurely and unnecessarily approve an application on an unreasonably truncated timeline and in the face of an extreme dearth of absolutely necessary information, the combined net result of which is a greatly heightened risk that the Sales Process can be abused by the 2016 Noteholders *via* their Stalking Horse credit bid, to confiscate value that properly belongs to the unsecured creditors. The only apparent reason for this extremely truncated timeline is that the 2016 Noteholders have imposed it, in the Revised RSA. The imposition of an unfair Sales Process is far too high a price for the Petitioners (and their unsecured creditors) to pay for the co-operation of the 2016 Noteholders, given that the 2016 Noteholders already agreed to the same deal **absent** the Sales Process, in the Old Plan, and given that there is no evidence that the current Plan will receive any more support than the failed Old Plan.

12. As a result of the foregoing deficiencies in the currently proposed Sales Process, a revised Sales Process ought to be formulated, brought to this Honourable Court with full information and disclosure and approved on or prior to April 23, 2012 (thereby occasioning no delay and no possible prejudice to the Petitioners). Such a revised Sales Process should include the following fundamental characteristics, all of which are necessary to ensure the integrity of the process and ensure that the value of the Unencumbered Assets is maximized for the benefit of the unsecured creditors:

a. the Monitor must have sole conduct of every step of the Sales Process;

b. prior to the approval of any process or rules related to a credit bid, the Monitor must provide an independent opinion affirming the validity, enforceability, extent and priority (subject to Court-ordered charges enjoying priority) of the 2016 Noteholders' security. The opinion, and the opining party, should be accessible to the 2014 Group and any other unsecured creditors wishing to have such access;

c. the 2016 Noteholders must not have a role in the conduct of the Sales Process, in keeping with their status as a key bidder and so as to avoid any conflict of interest;

d. the Unencumbered Assets must be identified, in advance, in the Sales Process;

e. the Unencumbered Assets must be valued by an independent qualified third party, and that valuation must be made available to the 2014 Group on a confidential basis;

f. the Unencumbered Assets must comprise separate Parcels (or at least one separate Parcel) in the Sales Process;

g. the Monitor must be directed to identify and notify as "Known Potential Bidders" any purchasers or investors who might have a specific or particular interest in any or all of the Unencumbered Assets,;

h. the Sales Process must contain clear and transparent rules inviting bidders to bid separately on the Unencumbered Assets;

i. there should be no Stalking Horse Bid relative to the Unencumbered Assets;

j. the Sales Process must contain clear and transparent rules clarifying that a bid for the Unencumbered Assets cannot be rejected for the benefit of a "superior" *en bloc* bid unless the value of such *en bloc* bid is reallocated so as to pay from the total value thereof an amount in cash for the Unencumbered Assets, matching the best alternative bid for the Unencumbered Assets;

k. the Sales Process, if it includes a Stalking Horse Bid, must disclose the identity of the Stalking Horse Bidder and provide the Stalking Horse Agreement for consideration and approval, and should not contain a Stalking Horse Expense Reimbursement Charge that charges the Unencumbered Assets; and

l. such further and other factual matters as counsel may advise at the hearing of the Petitioners' Application.

13. The Elk Falls Order ought not to be granted, absent the 2014 Noteholders being provided with a copy of the Construction Agreement and other relevant documents on a confidential basis and the Monitor first providing an independent opinion affirming that the Construction Agreement is in the best interests of CPC and its creditors and will not

burden the CPC estate and unsecured creditors with additional costs relating to disposal, clean-up or rectification of the Elk Falls site and an independent opinion from the Monitor confirming the validity, enforceability, extent and priority (subject to Court-ordered charges enjoying priority) of the 2016 Noteholders' security, including over the Elk Falls assets and their proceeds as at the date of the Initial Order. The opinion, and the opining party, should be accessible to the 2014 Group and any other unsecured creditors wishing to have such access. The Elk Falls motion materials were not served until March 19, 2012, do not enclose the Construction Agreement or any relevant provisions thereof and the Monitor's 5th Report does not address the Elk Falls motion at all.

14. Such further and other factual grounds as counsel may advise at the hearing of the application.

Part 5: LEGAL BASIS

1. *Supreme Court Civil Rules* 8-1 and 13-1.

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

3. The inherent and equitable jurisdiction of this Honourable Court.

4. Such further and other legal bases as counsel may advise.

Part 6: MATERIAL TO BE RELIED ON

1. The pleadings and proceedings filed herein.

2. The Affidavit of Wendy Morrison, sworn March 20, 2012.

3. Such further and other materials as counsel may advise and this Honourable Court may permit.

The Application Respondent estimates that the application will take: 30 minutes.

[ ] The application respondent has filed in this proceeding a document that contains the application respondent's address for service.

[X] The application respondent has not filed in this proceeding a document that contains an address for service. The application respondent's ADDRESS FOR SERVICE is:

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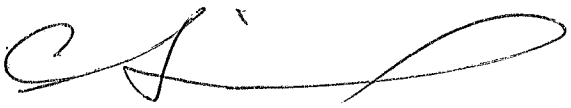
Date: March 20, 2012



Signature of Chris Simard, S. Richard Orzy, Raj Sahni
[ ] Applicant [X] Lawyer for Applicant

SCHEDULE "A"

LIST OF ADDITIONAL PETITIONERS

Catalyst Pulp Operations Limited

Catalyst Pulp Sales Inc.

Pacifica Poplars Ltd.

Catalyst Pulp and Paper Sales Inc.

Elk Falls Pulp and Paper Limited

Catalyst Paper Energy Holdings Inc.

0606890 B.C. Ltd.

Catalyst Paper Recycling Inc.

Catalyst Paper (Snowflake) Inc.

Catalyst Paper Holdings Inc.

Catalyst Papers U.S. Inc.

Pacifica Papers U.S. Inc.

Pacifica Poplars Inc.

Pacifica Papers Sales Inc.

Catalyst Paper (USA) Inc.

The Apache Railway Company

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IN THE MATTER OF CATALYST PAPER CORPORATION AND THE PETITIONERS LISTED IN SCHEDULE "A"

PETITIONERS

UNITED STEEL, PAPER AND FORESTRY, RUBBER, MANUFACTURING, ENERGY, ALLIED INDUSTRIAL AND SERVICE WORKERS INTERNATIONAL UNION

RESPONDENT

APPLICATION RESPONSE

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