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## Sears Canada Files for CCAA Protection: A Distressed Investor's Overview of US Bankruptcy and Canadian Insolvency Law

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On June 22, Sears Canada Inc. ("Sears Canada") and certain affiliates<sup>1</sup> (collectively, the "Sears Canada Group") sought and obtained insolvency protection under the Companies' Creditors Arrangement Act (CCAA) from the Ontario Superior Court of Justice (Commercial List) (the "Court"), which in turn appointed FTI Consulting Canada Inc. (FTI or the "Monitor") as monitor. During the restructuring process, Sears Canada's Board of Directors and management team will remain in control of the day-to-day operations of the business, subject to the supervision of the Monitor.

Sears Canada is an independent Canadian digital and store-based retail company. While primarily a company involved in the sale of goods, Sears Canada operates other business lines, including transportation and logistics services, call centers, sales of mobile phones and telephone plans, and warranty and maintenance programs. Despite troubled times, Sears Canada Group remains one of Canada's largest retailers with a presence in all 10 provinces. Although Sears Holdings, the owner of Sears US-based business, continues to own approximately 12 percent of Sears Canada's stock, Sears Canada operates as a separate entity since its spin off in 2012. Sears Canada has been shrinking for years. In fact, due in part to the implementation of operational restructuring measures, Sears Canada's 2016 revenues were nearly CA\$500 million less than its 2015 revenues. Further, Sears Canada's financial statements for the 2017 first fiscal quarter reflected a net loss of CA\$144 million, compared to a net loss of CA\$63.6 million for the same quarter last year. With little prospect of being able to successfully restructure out of Court given legacy components of its business, Sears Canada concluded that that it was in the best interest of all its stakeholders to request a CCAA proceeding.

### Uniquely Advantageous Aspects of the Sears Canada Proceedings

Sears Canada has piqued the interest of many savvy distressed investors for several reasons, primarily because the insolvency proceedings seemed to be an inevitable path to achieving profitability again.

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<sup>1</sup> Affiliates include: Corbeil Électrique Inc., S.L.H. Transport Inc., The Cut Inc., Sears Contact Services Inc., Initium Logistics Services Inc., Initium Commerce Labs Inc., Initium Trading and Sourcing Corp., Sears Floor Covering Centres Inc., 173470 Canada Inc., 2497089 Ontario Inc., 6988741 Canada Inc., 10011711 Canada Inc., 1592580 Ontario Limited., 955041 Alberta Ltd., 4201531 Canada Inc., 168886 Canada Inc., and 3339611 Canada Inc.

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First, it has always been the intention and desire of company management to reorganize. Over the last 18 months, Sears Canada engaged in a reinvention by, among other things, revamping its product assortment, redefining its brand position, recharging customer experience and service levels, and rebuilding its technology infrastructure. In addition, Sears Canada attempted to reduce overhead by decreasing catalog distribution, terminating existing revenue-generating licenses and prematurely closing some stores. However, even though this brand reinvention brought increased sales and the hope of making further progress towards the company's restructuring, liquidity pressures continued to loom.

With respect to its key employees, Sears Canada and the Monitor developed a key employee retention plan (KERP) intended to incentivize key employees to stay with Sears Canada through the CCAA proceedings. In addition, the KERP incentivizes key employees to assist with the dissolution and liquidation of the stores that will be shuttered as part of the reorganization plan. The KERP covers 159 employees, 43 of which are executives or senior management, with the balance being employees who are employed in various roles at the closing stores. All of the personnel covered by the KERP have been determined to be instrumental to the restructuring and unlikely to be replaced on a timely or more cost-effective basis. It is estimated to cost Sears Canada CA\$9.2 million to fund and maintain the KERP.

Lastly, Sears Canada has two outstanding primary credit facilities, under which it does not have sufficient availability to request funding to continue operations. This has resulted in Sears Canada having to request to enter debtor-in-possession (DIP) credit facilities with lenders that are believed to be sufficient to cover the duration of the Sears Canada restructuring process.

## Who Are the Creditors?

Given the breadth and size of Sears Canada's business and operations, the creditor pool is vast, listing thousands of creditors. The majority of creditors are trade vendors including many large, recognizable companies such as Adidas Canada, Clinique Laboratories, Electrolux Canada, Google Inc., LG Electronics Canada, Sealy Canada and Whirlpool Canada.

Other creditors of Sears Canada include landlords. As of April 29, Sears Canada's sales, distribution and logistics network included 161 owned and leased stores, distribution centers and warehouses; a network of 62 "Sears Hometown" store dealers; 16 Corbeil franchisees; and 514 independently operated direct-purchase pick-up counters. Sears Canada also leases a variety of warehouse and office spaces. Although these leases will be part of the sale of the debtor's real estate portfolio, it is unclear whether any third party will purchase these leases for value or whether Sears Canada can successfully develop and implement a plan that their stakeholders and landlords will accept.

In addition to the debtor's direct lease obligations, landlords also may have an additional potential claim in connection with their leases with third-party tenants sharing retail spaces in the same center as Sears Canada, where Sears Canada may have served as the "anchor tenant." Typically, leases of non-anchor tenants provide for some tenant recourse in the event the anchor tenant becomes insolvent or ceases operations. To the extent that such non-anchor tenants seek damages from the landlord, the landlord may have additional claims against Sears Canada. Given that Sears Canada leased numerous stores, landlord claims may be a significant factor in creditor recoveries. Landlords will continue to play a significant role in the course of the Sears Canada proceedings and their actions should be monitored closely.

When purchasing and diligencing lease claims against Sears Canada, claim traders should keep these potential additional sources of recovery in mind. To the extent that lease claims are acquired, claim purchasers must ensure that any associated guarantee is enforceable by third parties, and that the right to assert claims for contingent and ancillary recoveries is explicitly included in the bundle of "transferred rights" described in the assignment agreement. Finally, there are significant tax implications that a US entity must be aware of if purchasing a "service" or "damage" based claim from a Canadian selling entity.

## Key Differences Between Canadian and US Insolvency Law

The Companies' Creditors Arrangement Act (CCAA) is Canadian federal law that allows insolvent corporations with debts in excess of \$5 million to restructure their business and financial affairs. The main purpose of the CCAA is to enable financially distressed companies to avoid bankruptcy, foreclosure or seizure of assets, while maximizing returns for creditors and preserving jobs and the company's value as a functioning business. CCAA proceedings are carried out under the supervision of a presiding

court, with the involvement of a monitor whose role is to oversee the debtor's business and financial affairs to ensure compliance with the law, court orders and terms of a restructuring plan.

The majority of cross-border restructurings in Canada are administered under the CCAA, which is generally used for more complex, longer restructurings as compared to those under the Bankruptcy and Insolvency Act (BIA). Proceedings under the CCAA are very similar to those under Chapter 11 of Title 11 of the US Bankruptcy Code, but differ in several noteworthy respects.

When contrasting the CCAA to the US Bankruptcy Code, note that the CCAA has **no** analogous rules addressing: (1) adequate protection of a secured creditor's interest in collateral; (2) administrative expense claims under 503(b)(9) of the US Bankruptcy Code for vendors delivering goods within a window of insolvency; (3) restrictions on the debtor use of cash collateral or property subject to an existing security interest; (4) authority to create unsecured creditor committees, or impose disclosure requirements similar to Rule 2019 of the Federal Rules of Bankruptcy Procedure; or (5) an absolute priorities rule. Nonetheless, enough similarities do remain.

Below is an overview of certain key restructuring principles under the CCAA compared to those under the US Bankruptcy Code, which may be of concern to investors seeking to invest in claims against Sears Canada.

Issue	US Chapter 11 Reorganization	Companies' Creditors Arrangement Act
<b>Automatic Stay</b>	Commences as of the petition date; effective for the duration of the bankruptcy proceedings, except to the extent creditors may be granted relief for "cause" or with respect to their collateral if the debtor has no equity in the collateral and does not need it to reorganize.	The stay is not automatic, but courts usually issue an initial stay of 30 days (the debtor must move to extend the stay) at the commencement of the case. The scope of the stay is in the discretion of the court but will generally stay all claims and proceedings against the debtor and its property.
<b>General Priority Rules</b>	<ol style="list-style-type: none"> <li>1. Secured creditors are entitled to be paid first from proceeds of their collateral, subject to competing liens;</li> <li>2. Administrative expense claims, including the debtor's post-petition operating expenses and professional fees, and claims for goods shipped within 20 days prior to the petition date;</li> <li>3. Priority claims, including claims for certain wages and benefits, tax claims, and other claims under Section 507 of the Bankruptcy Code (not generally a significant component of total claims);</li> <li>4. <b>General unsecured claims</b> (including all non-priority claims), such as trade claims, unsecured bonds, deficiency claims, contract rejection damages; and</li> <li>5. Equity interests.</li> </ol>	<p>With certain exceptions, there are no express priority rules under the CCAA, but plan priorities generally reflect the following scheme:</p> <ol style="list-style-type: none"> <li>1. Post-filing priority charges (generally includes professional costs, director and officer indemnification for certain post-filing, tax and employee liabilities, and can include DIP financing and critical supplier obligations);</li> <li>2. Priority claims for certain tax, pension and employee obligations;</li> <li>3. Secured claims;</li> <li>4. <b>Unsecured claims</b>; and</li> <li>5. Equity holders.</li> </ol> <p>Note, unlike the US Bankruptcy Code, the CCAA does <b>not</b> provide for reclamation rights for vendors.</p>

Issue	US Chapter 11 Reorganization	Companies' Creditors Arrangement Act
<b>Executory Contracts and Unexpired Leases</b>	<p>In order to maximize the value of the estate, the debtor has the option to:</p> <ol style="list-style-type: none"> <li>1. Assume (must cure pre-filing defaults and provide adequate assurance of future performance;</li> <li>2. Reject; or</li> <li>3. Assume (and cure pre-filing defaults) and assign the contract or lease to a third party (who must provide adequate assurance of future performance).</li> </ol> <p>Debtor must continue to perform post-filing real property lease obligations and may continue to perform under other executory contracts. Cannot compel counterparty to provide financial accommodations.</p>	<p>A debtor must continue to fulfill its post-filing contractual obligations unless the debtor disclaims (rejects) the agreement. A debtor may also seek to assign a contract (even if the contract does not permit such assignment), so as long as, among other criteria, any pre-filing monetary defaults are cured.</p>
<b>Voidable Transfers</b>	<p><b>Preferences:</b> Payments on account of an antecedent debt to insiders made within one year before filing petition and, in the case of non-insiders, made within 90 days before filing petition if debtor was insolvent at the time of the payment. Rebuttable presumption of insolvency during 90 days prior to filing.</p> <p>Defenses to preferences include payments made in the ordinary course of business; provision of "new value" by the creditor subsequent to the payment at issue;</p> <p><b>Fraudulent Transfers:</b> Payments made up to six years prior to filing (depending on state law):</p> <ol style="list-style-type: none"> <li>1. made with intent to hinder, delay or defraud creditors, or</li> <li>2. made for less than reasonably equivalent value while debtor was insolvent or rendered insolvent by the transfer (e.g., dividends made while debtor was insolvent).</li> </ol>	<p><b>Preferences:</b></p> <ol style="list-style-type: none"> <li>1. If the transfer is made by the debtor to an <b>arm's length</b> creditor, the transfer must (a) occur within three months prior to the commencement of the proceeding; and (b) made with a view to giving such creditor a preference.</li> <li>2. If the transfer is made by the debtor to a <b>non-arm's length</b> creditor, the transfer must (a) occur within 12 months prior to the commencement of the proceeding; and (b) such transfer had the effect of preferring one creditor over another. (Note: There is a presumption of intent to prefer if the transfer had the effect of giving the creditor a preference.)</li> </ol> <p><b>Transfers at Undervalue:</b></p> <ol style="list-style-type: none"> <li>1. If the transfer is made by the debtor to an <b>arm's length</b> creditor, it must be proven that (a) the transfer occurred within one year of the day on which the proceeding commenced; (b) the debtor was insolvent at the time or was rendered insolvent by the transfer; and (c) the debtor intended to defraud, defeat or delay a creditor.</li> <li>2. If the transfer is made by the debtor to a <b>non-arm's length</b> creditor, it must be proven that the transfer (i) occurred within one year of the day on which the proceeding commenced; or (ii) occurred within five years of the day on which the proceeding commenced, and the debtor (a) was insolvent at the time or was rendered insolvent by the transfer; or (b) intended to defraud, defeat or delay a creditor.</li> </ol>

Issue	US Chapter 11 Reorganization	Companies' Creditors Arrangement Act
<b>Plan of Reorganization: Key Parties</b>	Creditors can file competing plans of reorganization after exclusivity period expires. This incentivizes the debtor to timely file its plan and to submit a plan that is "fair and equitable" to creditors.	There is no exclusivity period and the debtor or a creditor may file a plan, although the court will generally defer to the debtor in the first instance.
<b>Voting: Required Classes</b>	All "impaired" classes of claims and equity interests are entitled to vote on the plan.	Each class of creditors to which the plan is proposed is entitled to vote.
<b>Voting: Rules of Acceptance</b>	<p>Plan must be approved by each impaired class of claims or equity interests, subject to the debtor or other plan proponent's right to "cram down" non-accepting classes, provided that if an unimpaired class of claims exists there must be at least one impaired accepting class of claims to confirm plan.</p> <p>An impaired class of creditors is deemed to accept if:</p> <ul style="list-style-type: none"> <li>(a) More than 50 percent in number of allowed claims actually voting, vote to accept; and</li> <li>(b) More than two-thirds in dollar amount of the allowed claims actually voting, vote to accept.</li> </ul> <p>An impaired class of equity interests is deemed to accept if more than two thirds of such interests actually voting, vote to accept.</p>	<p>Plan approval requires acceptance by all classes.</p> <p>A class is deemed to accept if:</p> <ul style="list-style-type: none"> <li>(a) approved by at least two-thirds in value of voting claims; <b>and</b></li> <li>(b) approved by a majority in number of voting creditors.</li> </ul> <p>Under the CCAA, there is no "cram down."</p>
<b>DIP Financing</b>	Entitles DIP lender to increasingly extraordinary protections depending on circumstances, up to and including superpriority administrative claims and priming liens.	The CCAA provides for a post-filing lender to obtain a priority charge for post-filing loans to a debtor over some or all of the debtor's property that primes existing lender's [liens].
<b>Cross-Border Provisions</b>	<p>Chapter 15 recognizes main and non-main proceedings administered in foreign courts (based on UNCITRAL model).</p> <p>Comity recognizes foreign proceedings even when substantive laws differ from the United States, provided foreign laws are not offensive to US public policy.</p>	The CCAA provides for the recognition of a foreign main proceeding as well as a foreign non-main proceeding (based on UNCITRAL model).