Insolvency Proceedings Concerning Canadian-Based Retailers

Jeffrey Levine and Reuben Rothstein, McMillan LLP
August 24, 2018

Prepared for the
CBA Insolvency Law Conference
Sep. 13-14, 2018, Vancouver, BC

Jeffrey Levine is a Partner in the firm's Litigation Group. Reuben Rothstein is beginning his Articles with the firm.

Insolvency Proceedings Concerning Canadian-Based Retailers

1. At the end of 2017, one headline from a major Canadian news outlet read: "2017 was a terrible year for Canadian retailers – and 2018 could be even worse."[1] Marked by filings of Sears Canada Inc. and Toys "R" Us (Canada) Ltd., 2017 followed a decade in which retail trade accounted for a material portion of all business insolvencies in Canada.[2] Despite a slight uptick in retail trade for the last period in which Statistics Canada has reported,[3] the sector is relatively flat through the first half of 2018, suggesting retail continues to struggle.

2. Over the past few years, much has been written about the challenges that online retail poses to brick and mortar stores. More recently, millennials are being blamed for declining attendance in malls since they are apparently less likely to drive, and therefore more likely to shop online or stick closer to local stores, and in any event, spend more money on experiences like travel than on "stuff."[4]

3. All of this suggests that retail insolvencies in Canada will continue to find their way onto the docket in commercial courts across the country. Whether filing under the *Companies Creditors' Arrangement Act* (*CCAA*)[5] or the *Bankruptcy and Insolvency Act* (*BIA*),[6] the path for retail insolvencies from an initial court application through to the end of restructuring proceedings is similar to filings of insolvent businesses in all industry sectors. A stay of

[1] Erica Alini, "2017 was a terrible year for Canadian retailers – and 2018 could be even worse", *Global News* (19 December 2017) online: <www.globalnews.ca/news/3923176/retailers-canada-2018/>.
[2] Canada, Office of the Superintendent of Bankruptcy Canada, *Ten-Year Insolvency Trends in Canada 2007-2016*, modified December 2017 (Ottawa: Innovation, Science and Economic Development Canada, 2017).
[3] Canada, Statistics Canada: Retail and Service Industries Division, *The Daily, Friday, July 20, 2018* (Component of Statistics Canada catalogue no. 11-001-X).
[4] Aleksandra Sagan, "Online shopping isn't the only thing killing Canadian malls — it's millennials, too", *Financial Post* (11 March 2018) online <www.business.financialpost.com/real-estate/property-post/e-commerce-not-the-only-cause-of-death-for-canadian-malls>.
[5] *Companies' Creditors Arrangement Act*, RSC 1985, c C-36, as amended [*CCAA*].
[6] *Bankruptcy and Insolvency Act*, RSC 1985, c B-3, as amended [*BIA*].

proceedings to assist in maintaining the status quo is granted or deemed, funding for the proceeding and company operations in the short-term must be secured, a restructuring plan or liquidation must be executed, and claims against the estate must be determined then addressed. In recent years, several helpful articles have offered insight into the strategic restructuring choices made by retailers subject to insolvency proceedings.[7]

4. In this brief paper, we address four elements of an insolvency or restructuring proceeding that are common to many retail filings. Specifically, we (A) analyse the legislation and jurisprudence governing the assignment of agreements from which the debtor benefits, such as a lease for their retail premises; (B) identify options for valuing claims of the debtor's landlords, often forming material claims in an insolvency proceeding; (C) consider how suppliers may preserve their right to have their unsold merchandise returned; and (D) review special considerations for carrying out a liquidation of the insolvent retailer's inventory where a going concern sale is not viable.

A. Assignment of Contracts

5. The *CCAA* and *BIA* provide debtor companies and bankruptcy trustees a powerful tool to restructure their affairs and maximize value for stakeholders: the ability to assign contracts. In the right circumstances, a debtor company or bankruptcy trustee can, on notice to counterparties, assign valuable contracts to buyers who are prepared to pay for the rights

[7] See Natasha De Cicco & Dylan Chochla, "Desperate Times Call for Desperate Measures: A Review of Notable Developments in Recent Retail Insolvencies" (2017) ANNREVINSOLV 3; see also Linc Rogers & Aryo Shalviri, "Retail Insolvencies in Canada Series" (2017) Blakes Business Class.

conferred. In such circumstances, a counterparty's right to withhold its consent to an assignment can be overridden by court order.[8]

6. Section 11.3(1) of the *CCAA* states that, on application by a debtor company and on notice to every party to an agreement and the monitor, the court may assign the company's rights and obligations under the agreement to any person.[9] Section 84.1(1) of the *BIA* allows a bankruptcy trustee to make a similar application.[10]

7. These provisions do not apply to post-bankruptcy or *CCAA* filing agreements, collective bargaining agreements, eligible financial contracts (i.e. derivatives and certain other financial agreements) or to other rights and obligations that are not assignable by reason of their nature.[11] Significantly, however, these provisions do permit the assignment of commercial leases, notwithstanding any prohibition on assignment that may be contained in a relevant lease.[12]

8. In deciding whether to approve a proposed assignment, courts consider, among other things, (a) whether, in a CCAA proceeding, the CCAA monitor approved the proposed assignment; (b) whether the person to whom the rights and obligations are to be assigned would be able to perform the obligations; and (c) whether it would be appropriate to assign the rights and obligations to that person.[13]

---

[8] Adam C. Maerov & Mitchell Allison, "Assigning Contracts in Canadian Insolvency Proceedings" (July 2014) McMillan Restructuring and Insolvency Bulletin, online: < www.mcmillan.ca/Assigning-contracts-in-Canadian-insolvency-proceedings>.
[9] *CCAA*, *supra* note 5, s. 11.3(1).
[10] *BIA*, *supra* note 6, s. 84.1(1).
[11] *Supra* note 5, s. 11.3(2).
[12] *TBS Acquireco Inc., Re*, 2013 ONSC 4663 at paras 19-25 [*TBS Acquireco*]; *White Birch Paper Holding Co., Re*, 2010 CarswellQue 11311, 72 C.B.R. (5th) 63, EYB 2010-181372 at para 16.
[13] Supra note 5, s 11.3(3).

9. Furthermore, courts will not approve the assignment unless satisfied that all pre-filing monetary defaults in relation to those agreements are remedied on or before the assignment.[14]

10. In the retail context, this test was applied in *TBS Acquireco Inc., Re*.[15] In that case, the applicants, who operated a chain of general merchandise retail stores across Canada, sought approval for the assignment of certain store leases and designated contracts. The court granted the applicant's motion largely because it was satisfied that the purchaser would be able to perform the obligations under the contracts, resulting in the "continuation of business in the greatest number of stores and the continued employment of the greatest number of people."[16]

11. While language in the *CCAA* and *BIA* suggests that the purchaser's ability to perform the debtor company's obligations is just one of the factors that courts consider when deciding whether to approve an assignment, *Dundee Oil and Gas Limited (Re)* strongly suggests that this is a necessary precondition that must be satisfied before such an order will be granted.[17]

12. In *Dundee,* although Justice Dunphy had some concern given that the purchaser was largely a shell company and substantially all of the purchase price would be debt financed, he accepted the following information as being sufficient to demonstrate the purchaser's capacity to meet its obligations under the contracts to be assigned:

---

[14] *CCAA*, *supra* note 5, s. 11.3(4).
[15] *TBS Acquireco.*
[16] *TBS Acquireco, supra* note 15 at para 25.
[17] *Dundee Oil and Gas Limited (Re),* 2018 ONSC 3678 [*Dundee*] at para 30; see also Trevor A. Courtis, "Robust Information About Purchasers/Assignees May Be Required Before Contracts Will Be Assigned Under the CCAA" (4 July 2018), McCarthy Tetrault Restructuing Roundup, online: <www.mccarthy.ca/en/insights/blogs/restructuring-roundup/robust-information-about-purchasersassignees-may-be-required-contracts-will-be-assigned-under-ccaa>.

- the debtor's cash flow from operations had been positive – its insolvency was not a result of operating losses;

- forecasts indicated that cash flow from operations would continue to be positive;

- the purchaser had a plan to reduce operating costs to provide a further cushion and a level of institutional experience to make that plan credible; and

- no counterparties whose contracts were being assigned had opposed the motion.[18]

13. In addition to the statutory factors which the court is required to consider, courts have also considered the following factors in determining whether overriding the contractual rights of third parties was warranted. In *Primus Telecommunications Canada Inc., Re.*, the court considered whether the assignment and the debtor company's conduct met the "baseline considerations" of appropriateness, good faith and due diligence that a court should always bear in mind when exercising *CCAA* discretion.[19] In *Veris Gold Corp., Re*, the court considered whether the assignment met the "twin goals of assisting the reorganization process and treating the counterparty fairly and equitably."[20] And in *Re Nexient Learning Inc.*, the court considered whether the proposed assignment only adversely affected the counterparty's contractual rights "to the extent absolutely required to further the reorganization process."[21]

[18] *Dundee*, supra note 6 at paras 32-37.
[19] *Primus Telecommunications Canada Inc., Re*, 2016 ONSC 5251 at para 36, citing *Ted Leroy Trucking (Century Services) Ltd., Re*, 2010 SCC 60.
[20] *Veris Gold Corp., Re*, 2015 BCSC 1204 (B.C. S.C.) at para 58.
[21] *Re Nexient Learning Inc. (2009), 2009 CarswellOnt 8071, 62 C.B.R. (5th) 248 (Ont. S.C.J.)* at para 59.

B. Landlord Claims

14. Leases for space occupied by stores the debtor plans to close as part of a liquidation or restructuring may, as discussed above, be a marketable asset of the debtor if calling for below-market rents. However, where rents are at or above market, or finding a buyer for the space is unlikely, leases for closed premises with terms extending for a material time are likely to be disclaimed. Under both insolvency statutes, the disclaimer may be carried out with the approval of the trustee or monitor, as the case may be, or with the court's blessing.[22]

15. Landlords' claims against the estate have the potential to dwarf claims of other unsecured creditors in a *CCAA*. No formula automatically applies to the valuation of a landlord's claim, and a valuation of a landlord's claim for lost rent under common law principles may amount to the present value of the unpaid rent for the unexpired period of the lease at the time of repudiation.[23] Therefore, where a lease is repudiated with years remaining on its term, the landlord's claim may be quite substantial.

16. However, in a bankruptcy, a landlord's claim is limited to its claim under the relevant provincial commercial tenancies legislation. And in Ontario, for example, such legislation limits a landlord's claim to three months arrears of rent and 3 months future rent.[24] In certain circumstances, therefore, the potential for a cap on a landlord's claim if the debtor is assigned into bankruptcy may offer some leverage over landlords in developing a plan. In any case,

---

[22] Under the *CCAA*, the disclaimer is pursuant to section 32. Under the *BIA*, disclaimer may be authorized pursuant to section 65.11.
[23] *Highway Properties Ltd v Kelly, Douglas & Co*, [1971] SCR 562 at para 570.
[24] Section 136 of the *BIA* and section 38(1) of the *CTA*; *Lava Systems Inc (Receiver & Manager of) v Clarica Life Insurance Co*, 2001 CanLII 28280 (ON SC) at para 43; reversed on other grounds *Richter & Partners Inc v Clarica Life Insurance Co*, 2002 CanLII 41968 (ON CA).

landlords claims in insolvencies of retailers with multiple stores will have a material impact on the proceeding.

17. To save time and estate resources in quantifying landlord claims, a claims procedure order in a *CCAA* may employ a formula to simply the quantification process. In *San Francisco Gifts Ltd., Re,* for example, the claims procedure order established a mechanism for quantifying landlord claims reflecting the methodology established by the Supreme Court of Canada in *Highway Properties Ltd v Kelly, Douglas & Co*.[25] In *San Francisco Gifts*, each of the variables over which landlord valuation cases are typically fought (i.e., cut-off periods for mitigation efforts and discount rates to be used in calculating the present value of future rent) were baked into the valuation mechanism.[26]

18. Where the debtor is a retailer that may be described as an anchor tenant, a landlord may advance a claim based not merely on lost rents from disclaimed leases, but also for damages suffered as a result of store closings permitting other smaller retailers in the same shopping centre to exercise co-tenancy rights common in retail leases. *T. Eaton Co., Re*[27] and *Target Canada (Re)*[28] offer examples of where a court has approved a stay against enforcement of such rights.

19. In *Eatons*, Dylex argued - in connection with a motion that would permit a plan to be put to creditors - that the requested order should be free from a proposed clause preventing retailers in shopping centres in which Eatons was an anchor tenant from terminating their leases

[25] *San Francisco Gifts Ltd, Re*, 2004 ABQB 705 (QB) [*San Francisco Gifts*] at para 39.
[26] *Ibid* at para 39.
[27] *T Eaton Co, Re*, 1997 CanLII 12405 (ON SC) [*Eatons*].
[28] *Target Canada Co (Re),* 2015 ONSC 303 [*Target*].

during the restructuring period provided for in the plan.[29] Justice Houlden held that the restriction on the other retailers was appropriate. Section 11 of the *CCAA* and the court's inherent jurisdiction offered sufficient latitude to restrict the rights of non-creditor third parties where the benefit of maintaining the stay outweighed the prejudice to the objecting retailer.[30]

20. In *Target*, Regional Senior Justice Morawetz considered whether a co-tenancy stay was appropriate to grant as part of an initial order. Relying on sections 11 and 11.02 of the *CCAA*, Morawetz R.S.J. was satisfied that the court had jurisdiction to provide for such relief in an initial order, and carried out a similar weighing of prejudices as did Justice Houlden in *Eaton's* to arrive at the conclusion that the requested stay was appropriate.[31]

C. Rights of Unpaid Sellers to Repossess Goods Supplied Before Filing

21. Merchandise suppliers often supply on credit. Thus, upon an insolvency filing, suppliers immediately become creditors for the cost of the goods supplied to the debtor company, but not paid for. Under the *BIA*, section 81.1 sets out a mechanism through which the supplier can have access to and repossess supplied goods at its own expense. That right ranks in priority to every other claim against the debtor company in respect of the goods (except for a *bona fide* purchaser for value without notice of any demand by the supplier), but is only available where, among other things, the goods were delivered within 30 days before the debtor company became bankrupt or subject to a *BIA*-receivership.

[29] *Supra* note 27 at para 3.
[30] *Ibid* at para 7.
[31] *Target*, *supra* 28 at para 46.

22. As a practical matter, the 30-day restriction on the availability of section 81.1 means that unpaid suppliers generally have nothing more than a normal unsecured claim within a restructuring proceeding (as opposed to a *BIA* liquidation). Even if a *CCAA* proceeding is converted into a bankruptcy, the 30-day period will by then have long run its course, and no opportunity to claim under section 81.1 in respect of goods supplied pre-filing will remain. While the absence of any 30-day rights makes sense where the viability of a going-concern restructuring depends in part on the debtor's ability to sell its merchandise on hand, there is a concern about statute shopping where there is no reasonable prospect for anything other than a liquidation.

23. Suppliers to Woodward's Stores Limited and Abercrombie & Fitch Co. first tested the applicability of section 81.1 in *CCAA* proceedings in a 1992-case heard not long after the *BIA* was amended to provide for the 30-day goods rights.[32] Justice Tysoe observed that whereas Parliament decided not to hold any period of attempted restructuring against suppliers if the restructuring was done in proposal proceedings under the *BIA*, no such provision was made for attempted restructurings under the *CCAA* or if an interim receiver was appointed.[33]

24. Nevertheless, His Honour held that potential rights of suppliers under a *CCAA* reorganization should be preserved in the same fashion as Parliament decided to preserve them under the *BIA*, reasoning this would avoid an attempt to defeat the potential rights of suppliers by utilizing the *CCAA* to circumvent protection given to suppliers by section 81.1 of the *BIA*.[34]

---

[32] *Woodward's Ltd, Re*, 1993 CarswellBC 75 (SC) [*Woodward's Ltd., Re*] at para 23; leave to appeal refused, *Woodward's Ltd, Re*, 1993 CarswellBC 564 (CA).
[33] *Ibid.*
[34] *Woodward's Ltd, Re*, 1993 CarswellBC 531 (SC) at para 8.

He ordered, essentially, that the 30-day period within which section 81.1 rights would be available would toll, pending any conversion of the *CCAA* filing to a bankruptcy.[35]

25. The relief granted in *Woodwards Ltd. Re* was not of much help to suppliers, however, because nothing prevented the retailer from selling the merchandise in the normal course while the *CCAA* proceeding moved forward. The suppliers were denied any trust claim in respect of their 30-day goods on the basis that they were entitled to no advantage over other creditors of Woodwards, a result that was consistent with the maintenance of the status of quo intended to be effected by a *CCAA* stay.[36]

26. In *Thomson Consumer Electronics Canada, Inc. v. Consumers Distributing Inc. (Receiver of)*, Justice Farley, noticing a trend in the application of section 81.1 wrote: "The functionality of s. 81.1 of the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3, as amended has been otherwise questioned; one wonders if it presents an illusory hope to suppliers."[37] Since *Consumers*, there have been a handful of *CCAA* initial orders tolling the 30-day period set out in section 81.1 of the *BIA*.[38] Indeed, it appears to be incorporated into a model order used in Quebec. There is no reported instance, however, of a *CCAA* court granting any preferential treatment to suppliers who delivered, but were not paid for, goods to the debtor company in the weeks leading up to its filing for relief under the *CCAA*.

[35] *Ibid* at para 14.
[36] *Supra* note 32 at para 32.
[37] *Thomson Consumer Electronics Canada, Inc v Consumers Distributing Inc (Receiver of)*, 1996 CarswellOnt 4295 (Gen Div – Commercial List) [*Consumers*] at para 2.
[38] See *Bloom Lake, gpl (Arrangement relative à)*, 2015 QCCS 169; *Strateco Resources Inc (Sindic), Re* 2015 QCCS 2545.

D. Liquidation Sales

27. Even where a restructuring of a retailer is a viable option, the company will typically have underperforming stores it will close before a plan is put to creditors. In *TBS Acquireco Inc. (Re)* ("*The Bargain! Shop*"), Justice Brown described the process typically undertaken where the number of stores to be liquidated makes it impractical for the debtor to coordinate the liquidation on its own, and the interests of stakeholders are better addressed by having a professional liquidator act as agent for the debtor in carrying out the store-closing sale of the debtor's merchandise.[39] In sum, it is common to arrange for an electronic dataroom with information about the inventory to be sold, and then to solicit and review bids from liquidators. Often, the bids provide for a net minimum guarantee anchored to the retail value of the inventory at the stores being liquidated.

28. While there are few examples of decisions rendered in the context of opposed motions for approval of a liquidation, Justice Brown observed in *The Bargain! Shop* that the liquidation sale, being a sale of the company's assets outside the ordinary course of business, attracted the attention of section 36 of the *CCAA*.[40] That section mandates that secured creditors likely to be affected by the sale must be given notice of the motion for court approval of the sale, and that the court consider a list of factors in deciding whether the sale ought to be approved.

29. One of the factors concerns whether the consideration to be received for the assets is reasonable and fair.[41] Justice Brown explained that, as a matter of course, parties to a section 36-related *CCAA* motion should file a comparison chart detailing the various bids received

[39] *TBS Acquireco Inc (Re),* 2013 ONSC 1847 at paras 4-10.
[40] *Supra* note 39 at para 18.
[41] *CCAA*, *supra* note 5, s. 36(3)(a).

from potential liquidators to assist the court in assessing whether the bid for which approval is sought is reasonable and fair.[42]

30. In *T. Eaton Co., Re*, several of Eaton's landlords argued that the agency agreement providing for the liquidation of Eaton's merchandise was offside several of Eatons' lease agreements.[43] In particular, the landlords asserted that the leases specifically prohibited any liquidation, bankruptcy or fire sale. As a factual matter, Justice Farley found that this assertion simply wasn't true.[44] He also held that the carrying out a liquidation sale was not incompatible with Eaton's obligations under a number of its leases to function as a "first class department store."[45]

31. There was, however, one item in the agency agreement of concern to the court: the right of the liquidator to augment Eaton's merchandise with other merchandise of similar quality and category.[46] This right, if interpreted broadly, would have the effect of licensing the liquidator to carry on business as a principal, rather than merely as an agent for Eaton's and its interim receiver, a right not provided for in Eaton's leases, because no limitation on where the "other merchandise" may originate was provided for. Justice Farley thus permitted the sale to proceed with augmentation rights limited to goods that were already on order by Eaton's and effectively paid for.[47]

---

[42] *Supra* note 39 at para 20.
[43] *T. Eaton Co., Re*, 1999 CanLII 15008 (ON SC) at para 1.
[44] *Ibid* at paras 2 and 5.
[45] *Ibid* at para 7.
[46] *Supra* note 43 at para 8.
[47] *Ibid* at para 10.

Conclusion

32. There is no doubt that an insolvency proceeding concerning a debtor operating in the retail sector will raise issues common to filings touching many other industries. Large businesses have extensive needs for operating lines of credit, have many employees that will be impacted by a change in structure or liquidation of the company, and will likely have pension obligations. Issues of corporate governance and retention of key members of management also need to be addressed.

33. But, while the framework for *retail* insolvencies is not materially different from any other, it is apparent that the concerns of suppliers and landlords likely feature more prominently when the debtor is a retailer operating multiple stores as compared to debtors operating in other sectors. As described above, section 81.1 of the *BIA* may offer protection to unpaid suppliers in limited circumstances, but would appear to be of little relevance in any proceeding other than one commenced to effect a straight liquidation. Once the debtor's operations are stabilized, the company's landlords became a key stakeholder. The potential size of a landlord's claim, and its interest in what may be a material asset of value for the debtor, makes landlords a constituency commanding attention when it comes time to formulate a plan.