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Retail Insolvencies in Canada Series, #3: Parent Perspectives

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This is the third instalment in a series examining large retail insolvencies in Canada from the perspective of various stakeholders. This article discusses insolvencies from the perspective of corporate parents of distressed Canadian retailers.

The first article in the series, focusing on the landlord perspective, was published shortly after Sears Canada Inc.'s (Sears Canada) June 2017 filing under the *Companies' Creditors Arrangement Act* (Canada) (CCAA) (Canada's principal restructuring statute for large debtor companies and the functional equivalent to Chapter 11 of the *U.S. Bankruptcy Code*).

The second article, discussing the perspective of suppliers to insolvent retailers, was published in the wake of Toys "R" Us Canada Ltd.'s (Toys "R" Us Canada) cross-border insolvency filing in September 2017. This article follows in the shadow of Sears Canada's inventory liquidation and cessation of operations in January 2018. The Sears Canada shut-down followed a failed attempt to secure a going concern sale.

In recent years, there has been an upward trend in the utilization of the Canadian insolvency regime as a mechanism to "detach" an unprofitable Canadian subsidiary from a larger corporate enterprise. In circumstances where an economically viable parent is hemorrhaging losses as a result of its Canadian subsidiary operating unprofitably, it is not uncommon for the healthy parent to affect an orderly wind-down through an insolvency filing. On the other hand, in circumstances where the entire corporate enterprise is in financial distress, a Canadian insolvency filing may be a financial necessity rather than a strategic option. In these circumstances, value maximization, rather than the preservation of good will, can be the driving force behind the insolvency proceedings. Accordingly, the manner in which a Canadian insolvency filing transpires is heavily influenced by the financial condition of the corporate parent.

BRAND VALUE

Sears Canada, a publicly traded company, was largely spun off from its former U.S. parent Sears Holdings Corp. in 2012. Many other distressed Canadian retailers, however, are wholly owned subsidiaries of foreign domiciled parent retailers that have established their brand abroad (typically in the United States), before expanding into the Canadian market. In these circumstances, if the parent remains economically viable, formulating a graceful exit that preserves brand value may be of paramount concern. This was the approach taken in the Target Canada Co. (Target Canada) and Express Fashion Apparel Canada Inc. (Express Canada) CCAA proceedings.

In the Target Canada CCAA case, in order to incentivize creditors to support a CCAA plan, Target Corp. and certain related parties (Target US) subordinated billions of dollars of intercompany debt to the claims of third-party creditors (many of whom were inventory suppliers to Target US as well) and agreed to fund the severance obligations owing to Target Canada's terminated employees through the novel method of establishing an employee trust fund. Express, Inc. (Express Canada's U.S. parent), which was not experiencing any financial hardship, also agreed to subordinate intercompany debt, which helped to facilitate the payment of third-party trade creditors in full. In both the Target Canada and Express Canada cases, following a highly successful inventory liquidation, the CCAA plans filed by the distressed retailers (which provided for a distribution of realization proceeds) passed with unanimous support of voting creditors and was approved by the court.

JURISDICTIONAL ISSUES

When both a Canadian retailer and its U.S. parent are facing financial distress and must seek creditor protection, one of the fundamental questions that must be addressed is in what jurisdiction or jurisdictions should proceedings be commenced? This engages an analysis of, among other factors, the distressed retailer's centre of main interests or COMI. The COMI of the debtor will influence the jurisdiction in which the primary filing takes place.

One approach is for the distressed Canadian retailer to file for Chapter 11 protection along with its U.S. parent and then have the U.S. proceedings recognized in Canada, under the recognition provisions of the CCAA (the equivalent to Chapter 15 of the *U.S. Bankruptcy Code*). This was the route taken in the recent Payless Holdings LLC et. al. (Payless Shoes Canada) insolvency proceedings. Payless Shoes Canada's COMI was found to be in the United States, where management resided and corporate decisions were made. In that case, Payless Shoes Canada, along with its U.S. parent, filed in Chapter 11 proceedings, which were thereafter recognized in Canada, as a foreign main proceeding.

Another, more common approach is to have a full-blown plenary case in the United States and Canada, for the parent and the subsidiary, respectively. This was the approach taken in Bombay Furniture Company of Canada Inc. (the first restructuring), InterTAN Canada Ltd. (Circuit City) and Linens 'N Things Canada Corp. (although Linens 'N Things Canada Corp. did not file for protection under the CCAA, but rather became subject to receivership and bankruptcy proceedings in Canada while its U.S. corporate parent liquidated while under Chapter 11 protection).

A third and more unique approach is for the Canadian distressed retailer to file under Chapter 11 and the CCAA, thus being subject to two plenary proceedings in two different jurisdictions. This was the case in the recent Toys "R" Us Canada proceedings (the court material filed in the case indicated that Toys "R" Us Canada's COMI was in Canada as it had relatively autonomous management). Notably, the CCAA requires that a debtor be insolvent on either a balance sheet or cash flow basis. Prior to its Chapter 11 filing, Toys "R" Us Canada was neither. The Chapter 11 filing, however, triggered an event of default under the joint credit facility with its parent, resulting in Toys "R" Us Canada losing access to its operating line at a critical time when such credit availability was needed to fund its holiday inventory build. Thus, the Chapter 11 filing precipitated Toys "R" Us Canada's insolvency, qualifying it for relief under the CCAA. The first-day hearings in Canada and the U.S. took place on the same day, starting only a few hours apart.

CORPORATE GOVERNANCE

In many circumstances, the preponderance of pre-filing corporate decision-making rests with the U.S. parent. The rights and interests of a corporate parent and its insolvent subsidiary, however, may not always be aligned. For example, the entities may be in a debtor/creditor relationship (discussed below) and the optimal outcome for the Canadian entity may differ from the desired result sought by the U.S. parent.

Canadian creditors and the court supervising the proceeding will require some assurance that decisions are being made in the best interest of the Canadian entity and its stakeholders as a whole, and that Canadian interests are not being subordinated for the benefit of another creditor constituency.

In both the Target Canada and Express Canada CCAA proceedings, a U.S.-based corporate officer was designated at the outset of the proceedings as an autonomous decision-maker for the Canadian subsidiary. The move was made to provide further decision-making independence to the Canadian subsidiaries and provide additional comfort to stakeholders that there was an executive voice speaking on behalf of the insolvent Canadian subsidiary within the broader corporate family.

The American Apparel Canada Retail Inc. et. al. (American Apparel Canada) insolvency proceeding provides a more complex example. Prior to entering into Chapter 11 proceedings in the U.S., American Apparel Canada's U.S.-based affiliates (although not its immediate parent) advised that they would no longer provide all stock and inventory to the American Apparel Canada entities and would cease to provide all other critical support functions. Most of the administrative functions for the American Apparel Canada entities were performed out of Los Angeles, Calif., by the U.S. affiliates. This left a corporate governance vacuum. After filing a notice of intention (NOI) to make a proposal under the *Bankruptcy and Insolvency Act* (Canada) (BIA) — a summary proceeding that provided for an immediate stay of proceedings — American Apparel Canada sought and obtained the appointment of an interim receiver over itself, pursuant to the provisions of the BIA. An interim receiver is a court-appointed officer, a licensed insolvency professional and a fiduciary. It is unusual for a debtor company to seek the appointment of an interim receiver over itself following the filing of an NOI, but nothing in the BIA forbids it. Pursuant to its appointment order, the interim receiver filled the corporate governance void and supervised the inventory liquidation.

SHARED SERVICES AND LICENCE AGREEMENTS

It is common for the Canadian retailer to share and be dependent upon the back office support of its parent. Indeed, it is often the case that the Canadian retailer could not function autonomously without a whole host of management services provided by the corporate parent, which often include shared finance, legal departments and licensing arrangements (e.g., trademarks and information technology licences). In the Target Canada and Express Canada CCAA proceedings, these shared services agreements were terminated prior to the CCAA filing and replaced with agreements specifically designed to facilitate the liquidation.

As there was some risk that Target Canada could forcibly assign the "Target" trademark in connection with CCAA proceedings, Target US paid the insolvent Canadian estate to consensually terminate the licence agreement, essentially buying back its own trade-mark.

In the (first) Bombay Canada CCAA case, the corporate parent, Bombay Co. (Bombay US) failed to secure a going concern solution, but its more viable Canadian subsidiary was acquired by a Canadian-based strategic buyer that was able to replicate the back office support functions previously provided by Bombay US. While the matter was ultimately resolved consensually, there was uncertainty at one point as to whether Bombay US would agree to the assignment of its trademark to the Canadian buyer.

INTERCOMPANY DEBT

Canadian retailers will often be funded by their corporate parent, which can be by way of more traditional intercompany financing or through the supply of inventory on credit. The provision of shared services may also be recorded as a payable on the books and records of the Canadian subsidiary.

In its court material, Target Canada stated that Target US had invested a total of C$7-billion into the failed Canadian venture, much of it recorded as intercompany debt. Prior to a comprehensive settlement being reached and affected by way of a CCAA plan, a number of arguments were proffered by aggrieved creditors asserting that much of the intercompany debt on the books should be re-characterized as equity. The theory advanced was that such characterization more accurately reflected the intention of the parties at the time the funds were advanced and services were provided. An alternate theory was that the debt should be equitably subordinated — a U.S.-based doctrine that holds that, in certain circumstances, because of the conduct of the lender, the court should exercise its equitable authority to subordinate the lender's debt claims to the claims of third parties. In the U.S. Steel Canada Inc. CCAA proceedings, the Ontario Court of Appeal largely shut the door on the application of this doctrine in CCAA cases (this decision had not been released at the time that the Target Canada CCAA proceedings commenced). As noted above, these allegations were all resolved consensually through a plan that provided for the subordination of billions of dollars of intercompany debt, which was unanimously approved by creditors and the court.

REVIEWABLE TRANSACTIONS

A CCAA monitor — the court-appointed officer that supervises the case and acts as the "eyes and ears of the court" — has statutory authority to review and scrutinize pre-filing transactions, to determine if the company transferred any assets for "conspicuously" less than fair market value or preferred certain creditors over others through the repayment of debt. If certain criteria can be established, among other things, the impugned transactions can be voided by the court. When such transactions are made between related parties, the transactions may garner heightened attention. A corporate parent needs to be cognizant of the flow of funds between itself and its subsidiary and the movement of collateral between the two entities, and carefully consider any issues that may arise following a CCAA filing.

On a variety of theories, a monitor also has the ability to review the efficacy of dividends paid to shareholders, prior to the CCAA filing. In the Sears Canada CCAA proceedings, the monitor indicated that it is reviewing the payment of a C$102-million dividend payment on December 31, 2012 and a C$509-million dividend payment on December 6, 2013. At the time of publication, the monitor had not reached a conclusion.

THIRD-PARTY RELEASES

The Target Canada plan, like the Express Canada plan, provided comprehensive releases in favour of the parent companies, officers, directors and other related parties. In order to get the benefit of a third-party release (i.e., a release in favour of a party other than the debtor), it must be demonstrated that the release is reasonably connected to the plan. The court will also want to see that the beneficiaries of the release contributed to the plan in a meaningful way. Subordination of debt is a form of contribution.

Third-party releases can include releases from claims related to reviewable transactions and claims relating to any alleged improper conduct by the controlling shareholder.

TAKEAWAY

There are myriad approaches that a parent retailer may adopt when dealing with a distressed subsidiary. Each option must be reviewed and considered by a corporate parent prior to supporting the CCAA filing of its distressed subsidiary. Its own financial condition and capacity to provide ongoing support are primary considerations. The cases show that a diligent parent that carefully weighs the options available to it and executes a strategic plan in a thoughtful and balanced way is best positioned to avail itself of the benefits of Canada's robust and flexible insolvency regime.

The next article in this series will examine retail insolvencies from the perspective of another important stakeholder group: lenders.

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