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Retail Insolvencies in Canada Series, #4: Lender Perspectives

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This is the fourth and final instalment in a series examining large retail insolvencies in Canada from the perspective of various stakeholders. This article discusses retail insolvencies from the perspective of lenders to distressed Canadian retailers.

This article trails the successful emergence of Toys "R" Us Canada from *Companies' Creditors Arrangement Act* (Canada) (CCAA) protection following the acquisition of its shares by Fairfax Financial Holdings Limited.

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 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.

The third article, exploring insolvencies from the perspective of corporate parents of distressed Canadian retailers followed in the shadow of Sears Canada's inventory liquidation and cessation of operations in January 2018 after unsuccessful efforts to secure a going concern sale.

OVERVIEW

Not all Canadian retailers will have third-party credit facilities. For example, Target Canada and Express Canada received financing through their U.S. corporate parent. Where Canadian retailers do have credit facilities with third-party lenders, they are most commonly asset-based lending (ABL) facilities. These may be stand-alone credit facilities or a part of a larger facility with the retailer's corporate parent. In the latter circumstances (as was the case in the Toys "R" Us Canada CCAA proceedings), even if the Canadian retailer does not share the full extent of its parent's financial woes, it may find itself without financing and unable to obtain further credit, other than through a court-approved debtor-in-possession (DIP) facility.

This article sets out some of the unique challenges, which may be faced by pre-filing and DIP lenders, in navigating the insolvency of a Canadian retailer.

PRE-FILING LENDERS TO CANADIAN RETAILERS

ABL Facilities

Retailers will typically have collateral (inventory and credit card receivables) that is comparatively easy to value and monetize. As a result, ABL financing is the financial product of choice for lenders to retailers as it provides a greater degree of certainty as to the minimum value of the retailer collateral in a liquidation. ABL lenders may also take a security interest in the leasehold interest of retailers but will not typically ascribe material value to these rights. Lenders will instead consider such collateral to be excess or "boot" collateral.

Availability under an ABL facility is subject to fluctuations to the debtor's "borrowing base", a metric informed by (among other things) a percentage of the assessed net orderly liquidation value (NOLV) of the retailer's inventory, which is subject to certain reserves.

Reductions to a debtor's borrowing base availability can result in a liquidity crisis that precipitates an insolvency filing. This was evidenced in the Sears Canada CCAA proceedings: in the affidavit filed in support of its application for an initial order, Sears Canada pointed to reduced availability under its ABL revolving credit facility (as a result of a reserve for certain potential pension priority claims) as one of the reasons for its CCAA filing.

A further drawback for retailers reliant upon ABL facilities is that market perception of distress can itself set in motion a cascading effect, which limits availability under the retailers' credit facility, reduces liquidity and contributes to the need for the retailer to avail itself of the protection afforded by insolvency legislation. Where suppliers to a retailer perceive distress, they may insist upon more stringent payment terms, leading to diminishing inventory levels and a concurrent reduction in NOLV, which in turn results in lower availability under the retailer's credit facility.

ENFORCEMENT

Priorities

Generally, Canadian insolvency law is protective of secured creditor rights and there is an ostensible recognition by Canadian courts that a stable lending environment is necessary for the continued provision of capital and economic growth.

There are however, a number of potentially applicable federal and provincial statutory liens and deemed trusts (both in favour of the federal and provincial governments, as well as third parties) that have priority over secured creditors. In insolvency proceedings, some but not all, continue to apply and the determination of which priority claims are applicable may involve a complex analysis, with results potentially varying by province.

Key statutory priority claims that may apply in CCAA proceedings involving a retailer include priority claims for: (i) unremitted deductions from employee wages for income and similar "payroll" taxes, (ii) unpaid wages (including accrued but unpaid vacation pay) up to a maximum of C$2,000 per employee, (iii) unpaid normal-course pension contributions, and (iv) the wind-up deficiency of a pension plan.

In addition to potential statutory priority claims, courts routinely order super-priority charges in CCAA proceedings, ranking ahead of the claims of secured creditors. For example:

- Administration charges to secure the payment of professional fees
- Directors and officers charges to secure the indemnity granted to directors and officers by the debtor company
- DIP charges
- Critical supplier charges to secure the obligations of the debtor company to pay for goods and services provided to it pursuant to a critical supplier order
- Key employee retention payment charges to secure obligations of the debtor company to key employees pursuant to a court-approved key employee retention plan
- Sale advisor charges to secure fees payable to sale advisers

Where CCAA proceedings involve a distressed retailer, it is not unusual for the courts to also grant a liquidation agent charge (typically with the consent of the DIP lender) where there is no sale of a business as a going concern and operations discontinue. In such cases, an experienced third-party liquidator that is engaged by the debtor will often carry out a liquidation of inventory (this is also the case where the business in general may continue, but inventory in a subset of underperforming stores is liquidated). An "agency agreement", "liquidation services agreement" or "consulting agreement" governs the terms of these engagements, including the liquidator's compensation scheme. These agreements are subject to court approval and it is not unusual for courts to grant an order declaring that all of the retailer's property, or a subset thereof are subject to a charge to secure the obligations of the debtor to compensate the third-party liquidator. That was the case in the Target Canada, Sears Canada, Comark, InterTAN, Payless Canada, Laura's Shoppe Inc. and Sterling Shoes CCAA proceedings.

DIP FINANCING

Although the CCAA expressly prohibits securing pre-filing obligations with a DIP charge, there have been a handful of cases where Canadian courts have approved DIPs that have the substantive effect of paying out pre-filing facilities:

1. **Roll-up or Creeping Roll-up DIP:** Effectively, this type of DIP "rolls up" the pre-filing facility into the post-filing DIP facility (where the pre-filing and post-filing DIP lender are the same), by providing for the payment of the pre-filing credit facility from post-filing proceeds of operations. Since the debtor does not have access to its post-filing cash receipts (which are used to repay the pre-filing facility), the debtor company has to borrow more funds under its DIP facility (examples include the DIPs approved in the 2015 CCAA proceedings of Comark and the recent Golf Town and Sears Canada CCAA proceedings). The gradual pay down of the pre-filing facility and the incremental increased borrowings under the DIP facility ultimately provides for the "roll up" of the pre-filing facility into the DIP facility.
2. **Take-out DIP:** Effectively, this type of DIP "takes out" the pre-filing facility by using the proceeds of the DIP to pay out the pre-filing credit facility (the Toys "R" Us Canada CCAA proceeding provided for a take-out DIP of a pre-filing lender that was not the DIP lender).

Typically for roll-up or take-out DIPs to be approved, the court must be satisfied that doing so will not disrupt the *status quo* by prejudicing any creditor groups of the debtor and/or improving the security position of an existing lender. These concerns of the court are demonstrated in the 2009 decision in the CCAA proceedings of U.S.-based Circuit City's (Circuit City) Canadian subsidiaries, InterTAN Canada Ltd. and Tourmalet Corporation (InterTAN), the 2017 decision in the CCAA proceedings of U.S.-based Payless Shoes' (Payless U.S.) Canadian subsidiary (Payless Canada), and the 2017 decision in the Toys "R" Us Canada CCAA proceedings.

Circuit City and InterTAN

The Circuit City and InterTAN cross-border proceedings involved two plenary insolvency filings: Chapter 11 proceedings by Circuit City before the U.S. Bankruptcy Court for the district of Virginia and CCAA proceedings before the Ontario Superior Court of Justice (Commercial List). Prior to the commencement of the CCAA proceedings, InterTAN was only liable under Circuit City's larger corporate credit facility for its own borrowings (i.e., it had not guaranteed the obligations of its corporate parent under the facility). As part of the initial order commencing the CCAA proceedings, InterTAN sought approval of a roll-up DIP containing a guarantee by InterTAN of Circuit City's obligations under the roll-up DIP and would, in effect, result in InterTAN being liable for both the pre-filing amounts (which were not previously guaranteed) as well as new advances under the DIP facility. Justice G. Morawetz approved the roll-up DIP and granted the initial order on the basis of:

1. The evidence before the court that a failure to do so would result in a liquidation of InterTAN as it lacked working capital to operate;

2. The potential upside of a going concern transaction was generally viewed as more beneficial for creditors than a liquidation; and

3. Protection provided for InterTAN's unsecured creditors in the initial order by way of a C$25-million charge, which ranked behind the charge to secure the amounts actually advanced to InterTAN under the roll-up DIP, but ahead of the charge to secure the amounts advanced only to Circuit City but guaranteed by InterTAN (Subordinated Guarantee Charge).

After the court granted the initial order, the monitor learned that Circuit City and the DIP lenders intended to enter into a DIP amendment. Under the proposed amendment, 50 per cent of any value obtained from the Subordinated Guarantee Charge would be paid to unsecured creditors of Circuit City, and certain assets of Circuit City would be exempt from the collateral subject to the DIP liens in the U.S. (Removed Collateral). Therefore, the DIP lenders would be more likely to look to InterTAN on account of its guarantee and pursue recourse against the Subordinated Guarantee Charge. On subsequent motions in the CCAA proceedings, the Canadian court granted orders that preserved the *status quo* (by restricting the flow of funds from Canadian collateral to the U.S.). Ultimately, the court ordered that the Subordinated Guarantee Charge was to be reduced by the amount of any proceeds of realization of the Removed Collateral.

Payless Canada

Similarly, in the 2017 Payless Canada CCAA proceedings, the court refused to approve a DIP on the basis that doing so would prejudice certain existing creditors of Payless Shoes. In that case, the court was being asked to approve a roll-up DIP where the pre-filing facility of Payless U.S. was rolled up into the DIP facility and Payless Canada (which was neither a borrower nor guarantor under the pre-filing facility) was required to guarantee the obligations of Payless U.S. under the roll-up DIP. The result of this was that if the DIP was approved, Canadian landlords would, in effect, rank behind hundreds of millions of dollars of the U.S. corporate parent's pre-filing secured debt.

Toys "R" Us Canada

By way of contrast, in the Toys "R" Us Canada CCAA proceedings, the Canadian court was asked to approve a take-out DIP facility, whereby funds advanced under the DIP were to be used to repay Toys "R" Us Canada's indebtedness under its secured pre-filing facility from a lender other than the DIP lender. In approving the DIP, the court reviewed the restriction contained in the CCAA against securing pre-filing obligations with a DIP charge and noted that the funds contemplated to be advanced and covered by the DIP charge were fresh advances. The court further noted that the monitor had obtained an independent legal opinion that the pre-filing security being "taken out" was valid and ranked in priority to all claims that would be effectively replaced by the DIP charge. Therefore, the DIP charge was not filling any gaps in security coverage or prejudicing the position of Toys "R" Us Canada's existing creditors.

LIQUIDATIONS

Bias Towards Liquidation

In both Canadian and U.S. insolvency proceedings involving a retailer, the outcome tends to be liquidation (as was the case in the Canadian insolvency proceedings of Sears Canada, Target Canada, HMV, Express Canada, Nine West, American Apparel and Sterling Shoes and the recent U.S. insolvency proceedings of Bon-Ton and Toys "R" Us U.S.).

As lenders typically lend against a percentage of NOLV, in a liquidation, a lender can be reasonably comfortable that there should be sufficient proceeds to cover its exposure (provided the NOLV is calculated accurately). In a going concern sale process the retailer seeks to capture value in excess of NOLV. There is a possibility, however, that the costs of such process (i.e., restructuring costs and operational expenses) could erode the lender's collateral and in effect, result in the secured lender bearing the costs of a process that seeks to benefit other constituencies. Lenders, understandably, seek to place reasonable time limits and appropriate budgets on such going concern sale processes.

Another potential explanation for the bias towards liquidation is that the manner in which lenders assess the advancement of capital to retailers makes it challenging for a prospective going concern purchaser to secure financing sufficient to fund both the acquisition and the purchaser *pro forma* working capital needs.

Unless a purchaser has an equity cushion or other source of funds (i.e., immediately available funds as was the case in the going concern sale of Golf Town and Toys "R" Us Canada), it will need sufficient financing to satisfy the acquisition purchase price and post-closing working capital needs. In other words, the purchase price will, at a minimum, have to be equal to the NOLV (otherwise, the going concern transaction would lack economic justification relative to a liquidation). However, acquisition lenders asked to provide financing will be looking at, and lending against, this same NOLV, subject to certain reserves. This results in a shortfall in the amount of borrowed cash that the prospective purchaser requires to fund the purchase price and fund the going concern enterprise.

This may explain the trend observable in the Canadian going concern sales of Golf Town, Toys "R" Us Canada and Athletes World, and the U.S. going concern sales of Payless U.S., Gymboree and the Walking Company, whereby a portion (or entirety) of the acquisition was not funded solely through borrowed funds (notably, Toys "R" Us Canada also had valuable owned real estate which could be used to support commercial borrowings).

Forms of Liquidation

Although the end result of a liquidation (cessation of operations at a retail store) may be the same, not all liquidations are created equal. The structure of the liquidation engagement letter and compensation mechanism provided for therein may vary in each case.

Liquidators are often chosen following a solicitation process carried out by the insolvent retailer, with the assistance of its sale adviser (if one has been retained), court-appointed officer (i.e., monitor) and in consultation with (pre-filing and DIP) lenders.

Generally, liquidation proposals contain one of two types of compensation schemes (or a combination of hereof): a "net-minimum guarantee" structure or more traditional "fee" structure.

1. **Net-Minimum Guarantee Structure:** In this arrangement, the liquidator guarantees the minimum net proceeds to be realized from the liquidation (i.e., net of applicable taxes, expenses and costs) based on a percentage of the book value of inventory to be liquidated. The liquidator is then entitled to any recoveries (or more typically a portion thereof) in excess of that guaranteed amount. This type of arrangement provides a degree of certainty in the net proceeds that will be available to the estate following liquidation.

   However, it necessitates more comprehensive due diligence by bidding liquidators (which can be a challenge if market or operational factors require the liquidation to commence rapidly), as they are responsible for a base level of recovery, irrespective of the outcome of the

liquidation. Further, these arrangements are often based on certain assumptions (i.e., the book value of inventory or expenses), which cannot be quantified with precision until after the liquidation is complete. To the extent these assumptions do not hold true, there may be adjustments to the guaranteed amount.

2. **Fee Structure:** In this form of arrangement, the liquidator is to receive a fee equal to an agreed upon percentage of the net proceeds to be realized from the liquidation (i.e., net of applicable taxes, expenses and costs). This type of fee structure typically necessitates less diligence by the liquidator, but also does not provide the level of predictability for a retailer and its lender that accompanies a net-minimum guarantee arrangement.

Tensions may exist between the lender and other creditors where the analysis undertaken by a liquidator results in a guaranteed amount that matches or exceeds the NOLV. Although a fee structure may provide additional upside for other creditors (to the extent the results of liquidation exceed expectations, as was the case in the Express Canada CCAA proceedings), the rational lender will be understandably content with the net-minimum guarantee structure, which largely eliminates any risk to it and provides for an expeditious payout. It is worth noting, however, that even where net-minimum guarantee liquidations provide for an initial distribution to lenders, lenders will likely be asked to enter into a reimbursement agreement and covenant to pay back any amounts paid to them that are ultimately clawed back through post-liquidation adjustments to the guaranteed amount.

SERIES TAKEAWAY

A great deal has been written and said about the changing Canadian retail landscape and the challenges and opportunities facing market participants. This series has sought to participate in that conversation in a constructive way by examining insolvencies in the industry through the lens of various retail stakeholders. The discourse will continue and we are hopeful that our small contribution will make that dialogue a more informed and productive conversation.

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