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Retail Insolvencies in Canada Series, #2: Supplier Perspectives

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This is the second instalment in a series examining large retail insolvencies in Canada from the perspective of various stakeholders. The *Companies' Creditors Arrangement Act* (Canada) (CCAA) is the principal statute for the reorganization or sale of large corporate debtors in Canada and the functional equivalent to Chapter 11 of the *U.S. Bankruptcy Code* (Chapter 11) in the United States. Accordingly, our series focuses on CCAA proceedings, with references to alternate insolvency proceedings where applicable.

This article discusses retail insolvencies from the perspective of third-party inventory suppliers and service providers, and follows the CCAA filing of Toys "R" Us (Canada) Ltd. (Toys Canada), a leading toy and baby products retailer. The first article in this series, focusing on the landlord perspective on retail insolvencies, was published shortly after Sears Canada's June 22, 2017 CCAA filing.

On September 19, 2017, Toys Canada obtained Chapter 11 protection from the U.S. Bankruptcy Court for the Eastern District of Virginia, together with its U.S. parent (Toys US) and various affiliated entities. Later that same day, Toys Canada also filed for CCAA protection before the Ontario Superior Court of Justice (Commercial List).

Although Toys US was facing significant fiscal challenges, Toys Canada had strong financial metrics. Nonetheless, Toys Canada was facing a liquidity crisis due to the loss of access to its operating facility following the event of default that was triggered under its credit facilities by the Chapter 11 filing. In its court materials, Toys Canada acknowledged the need to modernize its stores and significantly improve its online sales platform in order to remain competitive in its market sector. Attempts by the Toys "R" Us corporate group to secure the necessary financing outside an insolvency process had failed. Lenders were only prepared to provide the needed funding in connection with a court-supervised process. The Toys Canada filing and the rationale behind it is further evidence that Canada's retail landscape will continue to reshape as traditional brick-and-mortar stores face increasing pressure in the ever-evolving digital marketplace.

OVERVIEW

In most CCAA proceedings involving a distressed retailer, the vast number of creditors will be composed of suppliers (exceptions include cases where the Canadian subsidiary is solely supplied by its U.S. parent, such as the recent insolvency proceedings of Payless Shoes Canada, Express Canada and American Apparel).

However, suppliers often exert less influence on the outcome of CCAA proceedings than lenders or landlord creditors because suppliers are generally more dispersed and less coordinated. A single large landlord, for example, may have distressed tenants in multiple locations and thus a significant economic stake in the outcome of the proceedings. Accordingly, the impact of an individual supplier in any particular insolvency will likely be more limited than the impact of a mobilized landlord creditor. Suppliers as a group, though, are critical stakeholders who can amplify their collective voice through informed decision-making and coordinated action.

CREDITOR COMMITTEES

In Canada, there have been instances of suppliers acting in unison through a committee; however, such committees have been formed on an *ad hoc* basis because they are not expressly provided for by statute as is the case under Chapter 11.

In the recent Target Canada CCAA proceeding, the court — with the support of Target Canada and the court-appointed monitor — appointed a consultative committee of senior insolvency practitioners (including Blakes lawyers), who represented a cross-section of various stakeholders, including inventory suppliers. The consultative committee acted as a "sounding board" and consulted with the monitor and the Target Canada entities on various aspects of the case, including the treatment of intercompany claims and the formulation of a plan for distribution of the proceeds of liquidation. The plan ultimately received unanimous support and the consultative committee played a key role in achieving that outcome. Notably, the consultative committee was funded by Target Canada. It was viewed by Target Canada and the monitor as an efficient means of achieving a consensual resolution of the outstanding issues in the case.

OBLIGATION TO SUPPLY

As a result of the standard CCAA stay granted in the Initial Order commencing CCAA proceedings, suppliers cannot discontinue, fail to honour, alter, interfere with, repudiate, terminate or cease to perform their obligations under existing contracts with the retail debtor. This is even the case if the supply agreement provides that the obligation to supply terminates upon an insolvency filing. As is the case in Chapter 11, these "*ipso facto*" termination clauses are unenforceable in the face of a stay.

As a matter of practice, following a CCAA filing, the debtor or the court-appointed monitor will send letters to suppliers notifying them of the commencement of the CCAA proceedings and highlighting the existence of the stay in the Initial Order.

These stay provisions serve to preserve the *status quo* as at the filing date and only operate in circumstances where a supplier is under an existing contractual obligation to supply. Where a contractual obligation to supply only arises upon the acceptance of a purchase order or statement of work that is submitted by the debtor, the supplier is generally free to cease accepting purchase orders and supplying the retail debtor. However, caution should be exercised before a supplier ceases to supply in the presence of a stay, even in the absence of a written agreement to supply. A debtor may take the position that notwithstanding the absence of a written agreement, a contract to supply has arisen orally or through a course of conduct. If a contract is established on this basis, it would be subject to the stay of termination rights. In addition, suppliers without a contractual obligation to supply may be compelled to do so if they are designated by the court as critical suppliers (discussed below).

NO OBLIGATION TO EXTEND CREDIT

While the stay limits a supplier's ability to terminate a supply contract, the CCAA does grant suppliers certain protections in these circumstances. The CCAA provides that no party is required to continue to supply goods or services on credit, or otherwise advance credit to the debtor company (note that debtors often require confirmation from suppliers that any payments made to them post-filing will not be applied to, or set-off against, pre-filing obligations owed to such suppliers). The one exception to this rule is when a supplier is designated as a critical supplier.

Generally, there are five options available to a supplier that must continue to supply a retail debtor during a CCAA proceeding:

1. **No Change:** A supplier may choose to supply without insisting on any changes to the existing supply relationship and continue to extend trade credit. Unlike administrative expense claims under Chapter 11 for post-filing supply, the supplier is not automatically afforded any special protections under the CCAA. The supplier bears the risk that in the event of an unforeseen cessation of operations and bankruptcy (equivalent of Chapter 7) of the retail debtor, it does not receive payment in full for goods or services provided on credit on a post-filing basis. Some suppliers, however, are satisfied with the level of funding available to the retailer in the CCAA proceeding and wish to accommodate the retailer in order to secure future business.

2. **Expedited Payment Terms:** A supplier and debtor can agree to shorten existing payment terms (e.g., going from net 60 days to net 15 days) so as to reduce the supplier's exposure. While this option reduces the risk that a supplier is not paid in full for goods or services provided following a filing, it does not eliminate such risk entirely. The supplier may pursue this option to reduce its risk profile while accommodating a retailer with whom it wishes to continue doing business.

3. **Cash-on-Delivery:** A supplier may pursue cash-on-delivery to insulate itself from further exposure to the insolvent retailer. While this option fully protects suppliers for the post-filing supply of goods, the volume of shipments and/or back-office capabilities of either the debtor or supplier may prove cash-on-delivery challenging to implement.

4. **Advance Payment:** When supplying on advance payment terms, the supplier receives payment in full for a particular post-filing order before shipping goods or providing services to the debtor pursuant to that order. Typically, these arrangements provide that when a purchase order or statement of work is received and accepted by the supplier, it is processed and the debtor is provided with an invoice or order acknowledgment, setting out the amount to be paid in advance before such goods or services are provided to the debtor. These arrangements are generally easier to implement than cash-on-delivery.

5. **Payment Assurance:** A debtor may also provide a supplier with other forms of payment assurance (e.g., a cash deposit or letter of credit) to protect the supplier in the event of non-payment. Suppliers need to ensure that the deposit is sufficient to cover their exposure at any given point, for such payment assurance to mitigate exposure effectively.

The CCAA proceedings of specialty fashion retailer Comark Inc. (Comark) provides an interesting variation to this approach. Comark obtained an order allowing it to enter into an Inventory Purchase Guarantee

Facility because it needed inventory for the holiday season and its suppliers were uneasy about providing the inventory without advance payment or deposits. Comark did not view it as prudent to make advance payments to suppliers (including offshore suppliers) to which it already owed pre-filing payments and opted to obtain payment guarantees from a lender to backstop its post-filing purchase of inventory.

CRITICAL SUPPLIERS

Paying Pre-filing Claims

In certain CCAA cases, including the recent Sears Canada, Toys Canada and Express Canada proceedings, the courts allowed the distressed retailer to make payments of pre-filing debts to certain suppliers, in order to ensure the uninterrupted supply of goods to the retailer. For example, it may be difficult to enforce the Initial Order against offshore suppliers and the only practical means to ensure continued supply is to pay pre-filing arrears. Further, if certain logistics providers, custom brokers or sales agents fail to honour their supply or service commitments (notwithstanding the stay), there could be a material impact on the retailer's ability to obtain delivery of goods in a timely manner.

In these circumstances, it may be necessary to make pre-filing payments to a subset of suppliers to ensure continued supply. In the Toys Canada proceedings, the court noted that such payments would normally constitute a form of preference (discussed below), but ultimately provided the requested relief, while emphasizing that payment of pre-filing claims should be infrequent and carefully scrutinized by the monitor to ensure such payments are only made to preserve critical, uninterrupted supply of goods and services.

Critical Supplier Charge

In addition to the discretion that is sometimes afforded to retailers to pay pre-filing claims of suppliers, under the CCAA, a debtor company may bring a motion asking the court to declare a person as a critical supplier, whether or not there is an ongoing supply contract. The court must be satisfied that the person is a supplier of goods or services to the debtor company and such goods or services are critical to the company's continued operation.

If a supplier is declared by the court to be a critical supplier under the CCAA, the court may then require supply goods or services to the debtor company on any terms and conditions that are consistent with the pre-filing supply relationship or that the court considers appropriate. The court's ability to impose economic (i.e., pricing) terms that are different than those set out in a contract is a matter of significant debate in Canada and to date, no court has amended such terms in a supply agreement. Where a court deems a party a critical supplier, it must also declare that all or part of the property of the debtor is subject to a security or charge in favour of the critical supplier, in an amount equal to the value of the goods or services supplied under the terms of the court's order.

PREFERENCE PAYMENTS

The CCAA and BIA contain provisions for, among other things, the review and challenge of pre-filing payments by the debtor company on the basis that they amounted to a preference. Generally, unsecured creditor claims are to be treated rateably and an insolvent company should not pay one unsecured creditor while leaving others unpaid without a justifiable reason. To the extent this occurs, the payment may be subject to challenge. In the case of a supplier dealing at arm's length with the debtor, it must be established that the applicable payment took place within three months prior to the initial insolvency event (i.e., the CCAA filing) with a view to giving that creditor a preference over another creditor and that the debtor was insolvent at the time of the transaction.

Under Chapter 11, suppliers that have received a payment from a debtor within a period of 90 days of the insolvency filing will, as a matter of course, receive a letter from the debtor company or a claims administrator demanding the return of such payments. Canadian proceedings are much less litigious and the technical requirements to void such transactions are more onerous. Suppliers can take comfort that payments received by them in the normal course from a debtor prior to the commencement of CCAA proceedings are not likely to be challenged.

CLAIMS PROCESS

Unlike Chapter 11, in a CCAA case, there is no statutory requirement to file a proof of claim within a defined time period, following the commencement of the case.

Generally, the claims of suppliers in CCAA proceedings will be treated as unsecured claims that must be proven in a court-approved claims process (to the extent one is sought). If any distributions are made, payment of these unsecured claims is made on a *pro-rata* basis. However, in circumstances where there is a liquidation or sale of a business (rather than a restructuring) and the proceeds of such sale or liquidation are insufficient for there to be any distributions to unsecured creditors, a debtor may not seek the approval of a claims process to identify and quantify unsecured claims. For example, in the recent Golf Town CCAA proceedings, the business was sold as a going concern but the proceeds of sale were insufficient to pay out all secured creditors. No claims process was initiated and no distributions were made to unsecured creditors.

NO 30-DAY GOODS CLAIMS

In bankruptcy or receivership proceedings, suppliers have a limited right to recover inventory supplied to a debtor within a period of 30 days before the date of the bankruptcy or receivership. Such goods must be identifiable, in the same state as on delivery, in the possession of the trustee or receiver and not subject to a subsequent arm's-length sale. This repossession right does not exist under the CCAA and the CCAA contains no analogous provisions in respect of reclamation claims provided for under Chapter 11.

In the Target Canada CCAA proceedings, counsel to certain suppliers indicated an intention to bring a motion for priority to be afforded to claims relating to goods supplied to Target Canada in the 30 days leading up to the CCAA filing date. The operating theory was that from the outset, the Target Canada CCAA proceeding was a liquidating CCAA proceeding with no intention or prospect of a going concern solution and was thus akin to bankruptcy. Therefore, the argument was that the court should exercise its equitable jurisdiction to import the bankruptcy concept of 30-day goods claims into the CCAA case. Ultimately, the motion was not brought but had this motion proceeded, any remedy provided by the court would have been novel.

TITLE RETENTION CLAUSES AND INVENTORY SECURITY

Supply agreements will typically contain a standard title retention clause that provides that title to the goods supplied to the retailer remains the property of the supplier unless (and until) such property is paid for in full. Under personal property security legislation in all common law provinces of Canada (i.e., all provinces other than Quebec), the supplier's retention of title simply provides it with a security interest in the inventory supplied, in order to secure payment of the purchase price of such inventory. The supplied inventory itself is considered property of the retailer, notwithstanding the title retention clause. Unless the supplier has perfected its security interest by way of registration, it will have only an unsecured claim for the unpaid purchase price of the inventory and no property claim to the inventory itself.

If a security interest is registered, the supplier will not have priority over prior registered security interests unless the supplier satisfied the requirements that afford priority to holders of a purchase money security interest (PMSI) under applicable personal property security legislation. To achieve this priority, the inventory supplier must have registered its security interest in the applicable provincial personal property security registry, and provided notice in the prescribed form to all other secured parties with an interest in the retailer's inventory, prior to delivery of the inventory to the retailer. Even if the supplier has acquired PMSI priority in the inventory supplied, once the inventory has been sold, the supplier will not be able to assert any priority to such proceeds unless the proceeds of sale are traceable and identifiable as proceeds of sale of the relevant inventory. Although Quebec civil law does not use PMSI terminology, it has specific registration requirements for parties asserting a priority right to goods based on title retention provisions in a contract.

TAKEAWAY

Inventory suppliers are important stakeholders in any CCAA restructuring. Indeed, the driving purpose of a restructuring in this sector is to enable the distressed retailer to continue to deliver inventory to consumers in a more cost-efficient and consumer-friendly manner. The key for suppliers is to educate themselves on the insolvency process and harmonize their approach so that they can more effectively leverage their collective economic interests and act as a counterbalance to other significant commercial actors.

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

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