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Retail Insolvencies in Canada Series, #1: Landlord Perspectives

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This article is the first 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 first article discusses retail insolvencies from the landlord perspective.

The North American consumer retail industry continues to experience significant financial stress. On June 22, 2017, Sears Canada, a major Canadian retailer established in 1952 that operates 225 stores across the country, filed for protection from its creditors under the CCAA. At the first day hearing, Sears Canada announced it will close 59 stores as part of its restructuring. The Sears Canada filing, and the dramatic increase over the last year in the number of insolvency filings involving distressed retailers in both the U.S. and Canada, may signify a tipping point that irrevocably changes the North American retail landscape. Most industry experts expect this trend to continue and forecast a sustained wave of retail insolvency filings.

OVERVIEW

In most CCAA proceedings involving a distressed retailer in prominent shopping malls, a relatively small group of shopping mall landlords will hold the vast majority of retail leases and comprise a significant portion of the creditor constituency. These landlords are typically the major players in the Canadian commercial real estate sector that own or control multiple locations. They are highly sophisticated and well organized, with significant experience in insolvency proceedings.

Landlords and their advisers can be very creative and are often prepared to bring the full weight of their economic clout to bear to advance their interests. For example, in 2015, a prominent Canadian landlord provided a C$10-million priming debtor-in-possession (DIP) facility to Laura's Shoppe (P.V.) Inc. (Laura). The DIP facility was approved over the objection of the existing senior lender. Laura was an important tenant for the landlord in multiple locations and the landlord found it in its interests to provide the financing necessary to facilitate the restructuring and preserve Laura as a going concern.

TREATMENT OF RETAIL LEASES

As a result of the standard CCAA stay, a landlord cannot terminate a lease or sue the tenant for accelerated rent by reason of the commencement of the CCAA proceeding or the insolvency of the retailer. The stay can also be extended to non-debtor entities. Tenants in the same mall as the CCAA debtor may be able to exercise remedies in accordance with the terms of their leases (including lease termination rights), if the CCAA debtor is the "anchor tenant" and plans to cease operations in the particular shopping mall. As happened in the Sears CCAA filing, these third-party rights can be stayed in order to maintain stability where the CCAA proceeding is pending.

Generally speaking, retail leases may be treated in one of three possible ways in a CCAA proceeding:

1. **Disclaimer**: Leases can be disclaimed (the equivalent of rejection under Chapter 11) by the retailer. The landlord is entitled to 30 days' notice of the retailer's decision to disclaim the lease with the approval of the court-appointed monitor. The landlord can dispute the disclaimer on certain limited grounds, primarily on the basis that the disclaimer does not enhance the restructuring goal. If the landlord objects or the monitor does not approve the proposed disclaimer, court approval of the disclaimer is required in advance. Any damages arising from the disclaimer of the lease are treated as unsecured claims, subject to compromise in the CCAA proceeding. Unlike under Chapter 11, the retailer does not have to elect to retain the lease within a prescribed period of time. The lease simply continues in effect until disclaimed or until it expires in accordance with its terms. The landlord is entitled to be paid rent until the effective date of the disclaimer.

2. **Assignment**: Leases can be assigned by a retailer over the objection of a landlord, with court approval, even if the lease has restrictions on assignment without landlord consent. The assignment can be either part of a larger going concern sale or can be made on a location-by-location basis, following a liquidation of inventory and cessation of business. As a condition to court approval, monetary defaults under the lease being assigned must be cured. Landlords can object to the assignment of a lease on certain grounds. For example, the CCAA requires that the assignee be able to fulfil its obligations under the assigned contract and that the assignee be an "appropriate person." Although there is little judicial guidance on the interpretation of "appropriate person," a landlord may be able to assert the assignee is not an appropriate person if the assignee intends to use the leased premises in a manner inconsistent with the lease terms.

Leases will have value in a liquidation to the extent that the rent payable thereunder is less than current market rates. In the Target Canada CCAA proceeding, which saw the liquidation of Target Canada's inventory and an end of its operations in Canada, the assignment of leases generated aggregate proceeds of approximately C$110-million. Although landlords continue to receive rent during the lease marketing process, they often express concern about the timeframe for the sale of the leases, the uncertainty that can surround a lengthy sale process and whether the sale process will result in a suitable tenant for the future.

3. **Repurchase of Lease**: If rent payable under a lease is under market or if the leased premises can be reconfigured in a way that is economically advantageous (e.g., a single store can be split into two smaller stores with greater aggregate rent than the previous tenant), the landlord itself may wish to buy back the lease from the retailer, in which case the landlord would pay the retailer to surrender the leased property to it. The landlord essentially controls the marketing of the leased premises and gains the ability to get more rent for the premises. In the Target Canada CCAA proceedings, landlords paid approximately C$170-million to repurchase their own leases through a series of court-approved transactions.

SALE GUIDELINES

With few exceptions, once a decision is made by a retailer to discontinue operations at some or all of its store locations, retailers typically retain third-party liquidators to liquidate their inventory (the Blockbuster Canada receivership was a rare example where no third-party liquidator was engaged). A practice has developed whereby the retailer seeks court approval of an agency agreement or liquidation services agreement between the retailer and the liquidator as well as sale guidelines, which govern the conduct of the liquidation sale on the leased premises. The sale guidelines will set out what "going out of business" or "store closing" signs can be used in connection with the sale, the process for the removal of tenant fixtures, whether inventory being liquidated can be augmented with inventory from other stores, and a host of other ancillary and related matters. The current versions of these sale guidelines have been heavily negotiated and reflect extensive input from landlords over a number of retail insolvency filings.

Generally, landlords will be interested in ensuring that a liquidation is carried out in a manner that preserves the value of their branding at a particular retail centre. In this regard, they will often insist upon the ability to monitor certain aspects of the liquidation with a pre-set mechanism to deal with any objections that they may have throughout the sale process.

DIP FINANCING

In April 2017, U.S.-based Payless Shoes (Payless U.S.) and its Canadian subsidiary (Payless Canada), filed for Chapter 11 protection before the U.S. Bankruptcy Court for the District of Delaware. Payless U.S. then sought to have the Chapter 11 proceeding recognized in Canada, including the DIP financing approved by the U.S. Bankruptcy Court. The CCAA contains provisions that provide for the recognition of foreign insolvency proceedings, akin to Chapter 15 of the *U.S. Bankruptcy Code*.

The DIP facility was a "roll-up" DIP. The substantive effect of a roll-up DIP is that the pre-filing credit facility is paid out by the DIP facility and/or by cash receipts collected after the insolvency filing (resulting in the debtor having to borrow additional funds under the DIP facility to meet its working capital needs). The end result is that the pre-filing facility is effectively rolled up into the DIP facility. Payless Canada was not a borrower or a guarantor under the pre-filing secured facility but was required to provide a guarantee of Payless U.S.'s obligations under the roll-up DIP facility.

The Canadian landlords successfully objected to the recognition of the DIP facility before the Canadian court on the basis that the landlords' collateral position would be prejudiced. Before the insolvency filing, the landlords were "in the money" in a liquidation. If the guarantee of the roll-up DIP was approved, they would be behind hundreds of millions of secured debt, even though Payless Canada was not a borrower under the DIP facility or obligated under the pre-filing facility. The Canadian court concluded the DIP financing arrangements approved in the U.S. did not sufficiently safeguard the rights of Canadian landlords.

QUANTIFICATION OF CLAIMS

As noted previously, if a landlord's lease is disclaimed, it will have a claim for unsecured damages in the CCAA proceeding. In a proposal proceeding under the *Bankruptcy and Insolvency Act* (Canada) (BIA) — restructuring proceedings typically used for smaller and less complicated businesses — there is a specific formula that is set out to quantify landlord claims. The BIA proposal formula permits a landlord to file a claim for the lesser of (i) the aggregate of the rent for the first year following the date on which the disclaimer became effective and 15 per cent of the rent for the remainder of the term of the lease after that year; and (ii) three years' rent.

In a bankruptcy proceeding under the BIA (akin to a Chapter 7 proceeding under the *U.S. Bankruptcy Code*), landlord claims are capped at three months of rental arrears and three months of accelerated rent. These claims are treated as preferred claims in a bankruptcy, ranking in priority to other unsecured claims but subordinate to secured claims. The Linens 'n Things Canada insolvency proceedings in 2013 was an example of a retail insolvency that converted from a BIA proposal proceeding into a bankruptcy, materially effecting the aggregate landlord claims that could be asserted in the case.

Landlords have resisted importing the BIA proposal formula, or variations thereof, into CCAA proceedings in which there is no statutory formula. This has led to some controversy as to how to quantify landlord claims in a CCAA proceeding. Issues have also arisen relating to the obligation to mitigate damages and whether claims relating to the cost of renovating or repairing the leased premises and other administrative and legal costs incurred by the landlord arising from the disclaimer of the lease properly form part of the landlord's unsecured claim. As discussed previously, in certain cases where the retailer is the anchor tenant in a mall that is now ceasing to carry on business, other tenants in the mall may be entitled to rent relief or other remedies under their respective leases, including a right of termination. Landlords have even sought to include loss of rent from third parties as a result of termination of leases in their damage claims.

Notably, however, landlords have recognized the litigation risk in asserting contentious claims and have agreed, in various CCAA cases, to a pre-determined formula to quantify their claims. However, as previously noted, landlords tend to oppose any formula being imposed on them and may even contest the court's authority to prescribe a formula to which the landlords themselves do not consent.

LEASE GUARANTEES

When an established foreign retailer begins a new venture in Canada, landlords will often require a guarantee from the foreign parent of the Canadian retailer's lease obligations. In the Target Canada CCAA proceedings, a number of Target Canada's landlords secured lease guarantees from Target Canada's U.S. parent (Target U.S.). At the outset of the proceeding, several landlords that were concerned about guarantee claims being compromised in a CCAA proceeding took issue with Target Canada using the CCAA to effect a liquidation of its inventory, suggesting that a bankruptcy proceeding under the BIA was a more appropriate vehicle for a liquidation where no going concern, restructured business was contemplated. Their objections were eventually withdrawn when the initial CCAA order granting relief to Target Canada was amended to provide that Target Canada would not seek to compromise the guarantee claims that landlords had against Target U.S.

Following the liquidation of inventory and the monetization of a significant portion of Target Canada's lease portfolio, a CCAA plan was filed by Target Canada for the distribution of proceeds of liquidation that also sought to release these parent guarantees and compromise landlord claims on plan implementation.

Target Canada argued that:

- Circumstances had changed since the issuance of the amended initial order, as Target U.S. was now prepared to subordinate almost C$1.5-billion of intercompany claims (in addition to the approximately C$3-billion of intercompany debt it had agreed to subordinate at the outset of the case) to increase the distributable proceeds available for other creditors, including landlords; and
- The objection of the landlords should be dealt with at the plan sanction hearing (the equivalent of the confirmation hearing under Chapter 11) once creditors had been given an opportunity to vote on the plan.

The landlords successfully objected to the plan even being submitted to a creditor vote. The court commented in its reasons that an agreement reached with the landlords after the filing date and memorialized by court order was sacrosanct and that the plan was not in a form the court could ever approve (and therefore, there was no point in allowing it to go to a vote of creditors).

Target Canada ultimately submitted a revised plan that received the unanimous support of creditors, including landlords. Landlord guarantee claims were unaffected by the revised plan and settled by way of contractual arrangements between the individual landlords and Target U.S.

TAKEAWAY

Landlords form an important stakeholder group in retail insolvency cases. Landlords will usually take a long-term strategic view in assessing which position they will assert in a CCAA proceeding. They are particularly attuned and attentive to the implications that a particular judicial finding in one case might have in subsequent cases. Taking into account and proactively addressing their concerns will greatly increase the likelihood of a successful (and perhaps less contentious) insolvency proceeding.

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

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