CITATION: Payless Holdings LLC (Re), 2017 ONSC 2321
COURT FILE NO.: CV-17-11758-00CL
DATE: 2017-04-20

SUPERIOR COURT OF JUSTICE - ONTARIO

RE: IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF PAYLESS HOLDINGS INC LLC, PAYLESS SHOESOURCE CANADA INC., PAYLESS SHOESOURCE CANADA GP INC. AND THOSE OTHER ENTITES LISTED ON SCHEDULE "A" HERETO

APPLICATION OF PAYLESS HOLDINGS LLC UNDER SECTION 46 OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

BEFORE: Regional Senior Justice G.B. Morawetz

COUNSEL: *John MacDonald* and *Patrick Riesterer,* for the Applicant

Clifton Prophet and *Mark Crane* for Ivanhoe Cambridge Inc.

Ashley Taylor and *Lee Nicholson*, for Alvarez & Marsal Inc., Proposed Information Officer

David Bish, for the Cadillac Fairview Corporation Ltd.

Tony Reyes, for Wells Fargo, ABL DIP Lender (Agent)

Linda Galessiere, for 20 Vic; Morguard; SmartREIT, Oxford; RioCan; Triovest; Springwood; Crombie REIT; Blackwood; Southridge Mall

David Ullmann, for Bentall Kennedy (Canada) LP, Quadreal Group and First Capital Management ULC

HEARD: April 10, 2017
ENDORSED: April 12, 2017
RELEASED: April 20, 2017

ENDORSEMENT

[1] On April 7, 2017, an Initial Recognition Order was granted in these proceedings. The reasons are reported at 2017 ONSC 2242 and should be read in conjunction with these reasons.

[2] On April 12, 2017, the Record was endorsed as follows:

> "Supplemental Order granted, with exception of DIP Motion and anything related directly or indirectly to the DIP ABL Agreement, the DIP Order or DIP ABL Facilities. Reasons to follow.

[3] These are the reasons.

[4] The Applicant seeks an order recognizing and giving effect to certain interim or final orders ("collectively, the First Day Orders"), including the:

i. Foreign Representative Order;

ii. Joint Administration Order;

iii. Prepetition Wages and Benefits Order;

iv. Interim Insurance Order;

v. Interim Customer Partner Order;

vi. Interim Cash Management Order;

vii. Interim DIP Order;

viii. Interim Critical Vendors and Shippers Order;

ix. Prepetition Taxes and Fees Order; and

x. Surety Bond Order.

[5] The Applicant also seeks orders appointing Alvarez & Marsal Canada Inc., ("A&M") as Information Officer, and granting the DIP ABL Lenders' Charge, the Canadian Unsecured Creditors' Charge, and the Administration Charge.

[6] The requested relief is set out in the draft Supplemental Order.

[7] Having reviewed the record, I am satisfied, based on Mr. Schwindle's affidavit, that it is appropriate to grant the relief sought in the Supplemental Order, with the exception of the aspects of the Supplemental Order that relate in any way to the DIP ABL Agreement.

[8] The foregoing relief is granted in order to maintain the status quo and protect the assets of the Chapter 11 Debtors, while permitting the Payless Canada Group to continue operating its business as usual in Canada during the Chapter 11 proceedings.

[9] I decline to grant recognition to the Interim DIP ABL Order. I do not do so lightly and I do so for the following reasons.

[10] The Interim DIP Order authorized the Chapter 11 Debtors to borrow up to $245 million under the DIP ABL Credit Agreement pending the hearing on the Final DIP Order. The Interim DIP Order also granted the DIP ABL Lenders and DIP Term Loan Lenders security interests and liens on the collateral provided by the Chapter 11 Debtors under the DIP Agreements.

[11] The U.S. court has scheduled a final hearing to consider the Final DIP Order for May 9, 2017.

[12] The Applicant is of the view that the Chapter 11 Debtors need to move quickly to comply with the terms of the DIP ABL Agreement. I am aware that it is a condition of the DIP ABL Agreement that the Chapter 11 Debtors obtain recognition of the Interim DIP Order within five business days of the day that the Interim DIP Order was issued by the U.S. court. The deadline in this case was April 12, 2017 and for this reason I issued my endorsement on that date, with reasons to follow.

[13] During argument, counsel for the Applicant stressed the importance of the deadline. The Applicant takes the position that it requires all of the liquidity under the DIP ABL Facility forthwith, and the assets of the Payless Canada Group will not be included in the borrowing phase under the DIP ABL Facility until this court recognizes certain of the First Day Orders.

[14] The Applicant also takes the position that the Payless Canada Group stands to see a substantial benefit from the DIP ABL Facility, given that the viability of the Payless Canada Group depends on the viability of Payless as a whole.

[15] The Proposed Information Officer, Alvarez & Marsal Canada Inc. ("A&M") comments on this issue in its report dated April 7, 2017.

[16] The Interim DIP Order authorizes the Chapter 11 Debtors to enter into and perform their obligations under the DIP ABL Credit Agreement, DIP Term Loan Agreement and their respective related credit and loan documents subject to the terms of the Interim DIP Order.

[17] In addition to seeking recognition of the Interim DIP Order, the Applicant seeks an order granting a DIP ABL Lenders' Charge on the property of Payless Canada Group that ranks in priority to all unsecured claims, but is subordinate to the Administration Charge, a charge in the amount of $1.4 million (the "Canadian Unsecured Creditors' Charge"), which will be set aside for the pre-filing unsecured creditors, aside from Kuehne & Nagel Ltd. ("K&N") (which would be paid pursuant to the Critical Vendors Order), and validly perfected secured claims.

[18] The issue to consider in assessing whether the Interim DIP Order should be recognized is that the DIP ABL Credit Agreement requires Payless Canada Group Entities to be guarantors and to employ their assets as collateral for the indebtedness under the DIP ABL Facility, even though the Payless Canada Group Entities are not borrowers under the current credit facility or the DIP ABL Facility, and will not receive any advances under the DIP ABL Facility and the Payless Canada Group assets are currently unencumbered (other than certain limited security interests granted to equipment lessors and certain landlords).

[19] The Applicant submits that it is reasonable and appropriate to recognize the Interim DIP Order and to grant the DIP ABL Lenders' Charge. They rely on the broad remedial purposes of and the flexibility inherent in the CCAA which allows the court to consider the interest of the broader stakeholder body in making orders under the CCAA.

[20] The Applicant submits that the following facts support the granting of the DIP ABL Lenders' Charge:

(a) The order is in the interests of the entire Payless organization and its many stakeholders, particularly the Chapter 11 Debtors, suppliers and employees.

(b) Without immediate access to the DIP Facilities, the Chapter 11 Debtors will be unable to finance their operations, and their ability to preserve and maximize the value of their assets and operations would be irreparably harmed. That would have disastrous effects on the Payless Canada Group, which cannot survive as a going concern enterprise without their U.S. counterparts. Among other problems, the Payless Canada Group would lose access to:

i. the high quality, low cost merchandise from Payless's manufacturing partners that are vital to its business strategy;

ii. Payless's licencing agreements, design partnerships and company owned brands, and other trademarks and IP; and

iii. Essential head office services that are vital to its continued operation and to the continued employment of its employees.

[21] The Applicant also points out that the DIP ABL Lenders' Charge would be subordinate to the proposed Canadian Unsecured Creditors' Charge and to validly perfected security interests of secured creditors.

[22] Further, during its restructuring, it is anticipated that the majority of the Payless Canada Group's creditors (including employees) will be unaffected creditors and will continue to be paid in the ordinary course. Also, at this time, the Applicant is of the view that it is not anticipated that any Canadian stores will be closed.

[23] The Applicant also points out that, in the alternative, so-called "roll-up provisions" are permitted in appropriate circumstances in a recognition proceeding, and roll-ups have been approved in circumstances similar to the present application. They reference *Hartford Computer Hardware Inc. (Re)*, 2012 ONSC 964.

[24] The Applicant also references *InterTAN Canada Ltd., Re*, 2008 CarswellOnt 8040 (S.C.J.) [Commercial List], where the court allowed the assets of the Canadian subsidiary to be employed as collateral for $1 billion of DIP financing made available to its U.S. parent.

[25] The Proposed Information Officer states at section 9.10 of its Report that the entities in the Payless Canada Group are not borrowers under the DIP ABL Credit Agreement but are obligated to guarantee the DIP ABL Credit Facility.

[26] The Proposed Information Officer also states that the Payless Canada Group was previously not liable for any obligations under the ABL Credit Facility and their assets did not comprise part of the collateral provided as security in connection with the ABL Credit Facility.

[27] However, following recognition of the Interim DIP Order, the Payless Canada Group would effectively become jointly liable with the U.S. Chapter 11 Debtors for obligations incurred by the U.S. Chapter 11 Debtors under the ABL Credit Facility prior to the filing date. The Payless Canada Group would also become liable for new obligations of the U.S. Chapter 11 Debtors incurred in connection with the DIP ABL Credit Facility.

[28] Based on discussions with the Chapter 11 Debtors and their Canadian counsel, the Proposed Information Officer understands that the DIP ABL Lenders would not agree to provide additional financing if the Payless Canada Group did not guarantee the DIP ABL Facility and provide collateral to secure such guarantee.

[29] The Proposed Information Officer states that due to the dependence of the Payless Canada Group's operations on the U.S. Chapter 11 Debtors, the Payless Canada Group believed that providing the guarantee and required security was in the best interests of their stakeholders.

[30] The Proposed Information Officer also reports that, to minimize the impact of the Guarantee and DIP ABL Lenders' Charge on existing unsecured creditors of Payless Canada Group, the proposed Supplemental Order creates a Canadian Unsecured Creditors' Charge to protect the Canadian unsecured trade creditors whose pre-Filing Date claims will not otherwise be paid through the provisions of the First Day Orders. The Canadian Unsecured Creditors' Charge creates a charge on the property of the Payless Canada Group that rank ahead of the DIP ABL Lenders' Charge up to a maximum amount of $1.4 million for claims of arms'-length unsecured trade creditors of the Payless Canada Group.

[31] The Proposed Information Officer prepared a preliminary illustrative liquidation analysis in order to provide the court, the landlords, and other creditors of the Payless Canada Group with information regarding the estimated potential recovery to creditors of the Payless Canada Group in an immediate bankruptcy and liquidation scenario in Canada. Based on the assumptions included in that analysis, net realizations from a liquidation and closure of Payless Canada Group's stores over a three month liquidation closure period could be up to approximately $13 million (the "NRV Amount"). During the liquidation/closure period, it is estimated that landlords would receive three months' occupation rent of approximately $6.9 million (approximately $2.3 million per month). The NRV Amount would then be available for distribution to creditors based on filed and proven claims.

[32] The Information Officer reports that taking into account:

(a) that the Payless Canada Group is wholly-dependent on other Chapter 11 Debtors for all corporate and managerial functions;

(b) that the Restructuring Support Agreement ("RSA") sets out the framework of a reorganization plan;

(c) the RSA, DIP ABL Credit Agreement and the DIP Term Loan Agreement includes a series of milestones in the Chapter 11 proceedings designed to ensure that the Chapter 11 Debtors move expeditiously towards conformation of a plan;

(d) the proposed Canadian Unsecured Creditors' Charge; and

(e) there are currently no plans to liquidate and close any Canadian stores.

the Proposed Information Officer reports that the creditors of the Payless Canada Group do not appear to be materially prejudiced by the terms in the DIP ABL Credit Agreement and the DIP ABL Lenders' Charge.

[33] The Report goes on to note that unsecured trade creditors pre-filing claims will be secured by a court-ordered super priority charge and will continue to be paid in the ordinary course for future supply. In addition, employees will be paid all of their pre and post-filing wages in the ordinary course and will continue to be employed. The Report states that the Payless Canada Group's landlords will continue to be paid rent during the restructuring period and if there is a liquidation, the landlords will still be entitled to the same occupation rent they would realize during an immediate liquidation. If particular stores are closed, that landlord will have received a number of months' rent in the meantime and will be entitled to file a claim for any damages.

[34] The Report concludes that though the guarantee and security provided by the Canada Payless Group is not optimal from a Canadian creditor's perspective, the DIP ABL Credit Facility appears to be the best alternative in the circumstances to maintain the operations of Payless Canada Group as a going concern to the benefit of all Canadian stakeholders and is a necessary precondition to advance towards a successful restructuring as contemplated by the RSA and the milestones included in the DIP ABL Credit Agreement.

[35] The position of the Applicant was opposed by a group of landlords having multiple locations (the "Landlord Groups"). The Landlord Groups take the position that the guarantee and security to be provided by the Payless Canada Group is detrimental to the position of the landlords and that the DIP ABL Order should not be recognized.

[36] Mr. Bish, on behalf of Cadillac Fairview, took the position that prior to the filing, the Payless Canada Group was not insolvent on either a balance sheet test or a cash-flow test. However, the guarantee and security provided by the Payless Canada Group under the proposed DIP Facility would render the Payless Canada Group insolvent. He submitted that this would be unfair to the position of the landlords. He reasoned that arrangements were being made to pay

K&N as a critical vendor, security would be provided to cover the obligations owed to the unsecured trade creditors, and employees would be paid on an ongoing basis. The group that will not be protected are the landlords. Although the Applicant takes the position that landlords will be paid in the ordinary course, the landlords will still be unsecured and the good intentions of the Applicant in continuing operations and making promises to pay the landlords could change depending on economic conditions.

[37] It was also pointed out that the projected cash flow statement of Payless, Inc., set out in the Report of the Proposed Information Officer, does not project a cash flow crisis during the initial 13 week stay period.

[38] It is important to note that K&N is being protected by the Critical Vendors' Charge. Unsecured trade creditors are being protected by the Unsecured Creditors' Charge. Employees will be paid in the ordinary course and are being protected by the Prepetition Wages and Benefits Order. The landlords have no comparable protection from the impact of the Guarantee and the DIP ABL Lenders' Charge. They have an unsecured promise from Payless.

[39] It is noteworthy that not only was no charge granted in favour of the landlords but a provision was included in the DIP Agreement (para. 45) to specifically provide that the DIP Agents, DIP Lenders, Pre-Petition Revolver Parties, and Pre-Petition Term Loan Parties shall not be subject to the equitable doctrine of "marshalling" or any other similar doctrine with respect of any of the DIP collateral or the pre-petition collateral. This Charge clearly benefits the DIP Agent, DIP Lenders, Pre-Petition Revolver Parties and Pre-Petition Loan Parties to the detriment of the Canadian landlords.

[40] Counsel to the Landlord Groups submitted that this provision was unfair and uncalled for. Counsel submitted that a more equitable way of approaching the issue would be to permit marshalling or repayment of the DIP Facility whereby the DIP Lender would look first to U.S. assets before looking to the Canadian assets. I accept this submission.

[41] The fact remains that prior to the Chapter 11 filing, the Payless Canada Group was not a borrower. By providing the guarantee and the security, combined with the absence of a charge or other mechanism to protect the position of the landlords, the position of the landlords could be detrimentally affected.

[42] It seems to me that, at the very least, if the DIP ABL Credit Facility was to be approved, there would have to be adequate protection to ensure that all Canadian creditor groups would not be adversely affected by the grant of the security. That is not what is currently proposed. Three of the four groups (K&N, unsecured trade creditors and employees) have received security protection. The landlords have not received protection in the form of a court order from the U.S. Court or by way of a court-authorized charge.

[43] In my view, the grant of the DIP ABL Charge in exchange for benefits flowing to the parent company alters the status quo. This would only be acceptable in a CCAA proceeding if arrangements were made to ensure that all affected creditor groups of the Payless Canada Group were protected to the extent that they could be no worse off if the Recognition Order is granted.

[44] The Applicants rely on *Hartford* and *InterTAN, supra*. However, it should be noted that orders of the type requested in this motion are discretionary in nature and are very much driven by the facts of each case.

[45] In *Hartford*, the application was not opposed and the Information Officer reported that there would be no material prejudice to Canadian creditors. There was also no indication that certain Canadian creditor groups were receiving more favorable treatment than others. In this case, certain Canadian creditor groups, but not all groups, are receiving more favorable treatment.

[46] In *InterTAN*, the Court commented on the liquidity crisis that engulfed the economy in the fall of 2008. *InterTAN* also had a liquidity crisis. In addition, the application was essentially brought *ex parte*. In this case, the projected cash flow statement does not project an immediate crisis, and unlike the situation in *InterTAN*, the requested relief was not opposed.

[47] I recognize that the reorganization proposal contemplates the continued operation of all stores in Canada, but there can be no assurances that this proposal will come to fruition. In the event that circumstances change, it should not be the landlords who are put at risk. The landlords may be contingent unsecured creditors at this time but it is only fair and reasonable that they be provided with adequate protection to contemplate all going forward scenarios. Other unsecured creditor groups have received identifiable and quantifiable forms of protection and it is up to the Applicant to provide this type of comfort to the Landlord Group.

[48] Accordingly, I have not been persuaded that it is not appropriate to recognize the Interim DIP Order. I have not been satisfied that recognition of the Interim DIP Order and the granting of the DIP ABL Lenders' Charge is necessary for the protection of the property of the Payless Canada Group or the interest of the landlords of the Payless Canada Group.

[49] I am aware that the parties have been discussing the various alternatives to resolve the impasse that gave rise to this endorsement. However, it is not up to the court to fashion an alternative proposal to resolve this issue. This is a matter of contractual negotiation between the Applicant, the DIP Lenders and the Landlord Groups. The court was given the alternative of either recognizing the Interim DIP Order or not recognizing same, and to grant the ABL DIP Lenders' Charge or refuse same. It is in not the role of the court to put forth an alternative solution that has not been contemplated or negotiated by the parties.

[50] In the result, the Supplemental Order is granted, with the exception of the recognition of the Interim DIP Order and the granting of the DIP ABL Lenders' Charge.

[51] In the event that the parties wish to pursue an alternative resolution, they are, of course, at liberty to come back to court to have same reviewed.

Regional Senior Justice G.B. Morawetz

Date: April 20, 2017