Distressed Debt and Claims Trading Advisory

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A New Target for Distressed Investors: What Claims Traders Need to Know About Target Canada and Canadian Insolvency Law

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On January 14, 2015, Target Corporation ("Target US") announced the exit of substantially all of its Canadian operations less than two years after opening its first Canadian stores in a strategic push to operate at least one store in every province of Canada. The following day, on January 15, the Ontario Superior Court of Justice (Commercial List) in Toronto (the "Court") granted Target Canada Co. and certain other wholly owned subsidiaries of Target US[1] (collectively, "Target Canada" or the "Debtor") protection under the *Companies' Creditors Arrangement Act* (Canada) R.S.C. 1985, c. C-36, as amended ("CCAA") to orderly wind down and liquidate its Canadian operations.

Target Canada is the Canadian wholly owned operating subsidiary of Target US, one of the largest retailers in the United States. In early 2011, Target US undertook an extensive investment to expand its retail presence in the Canadian market. Initial sales and operating results of Target Canada proved to be substantially worse than expected. Having faced significant losses in every fiscal quarter, Target US projects cumulative pre-tax losses of more than C$2.5 billion from its entry in the Canadian market to the end of the 2014 fiscal year. With little prospect of seeing profits in the near future, Target US concluded that that it was in the best interest of all its stakeholders to cease its Canadian operations.

Uniquely Advantageous Aspects of the Target Canada Proceedings

Although proceedings commenced only a month ago, Target Canada has piqued the interest of many savvy distressed investors for a number of reasons.

Firstly, more than half of Target Canada's liabilities will be subordinated to those of other general unsecured creditors. According to financial statements as of November 1, 2014, Target Canada had total assets of approximately C$5.408 billion and total liability of approximately C$5.118 billion. The biggest liability stems from a C$4 billion unsecured loan facility funded by its direct parent company, Nicollet Enterprise 1 S.à r.l. ("NE1"), a Luxembourg entity indirectly owned by Target US through several other entities. NE1 is the largest creditor listed on the consolidated list of creditors with a C$3.1 billion claim, representing the funded portion of the loans. Of critical interest to claims traders, NE1 agreed to postpone and subordinate to all creditors for all amounts owed by Target Canada under the loan facility.

Other affiliates such as Target Brands Inc. and Target US (the ultimate parent company) hold several hundreds of million dollars in claims. It is unclear whether these intercompany claims also will be subordinated, but thus far Target US has proved to be a benevolent corporate parent, particularly with respect to employee wages. Indeed, the strength of Target US greatly enhances the value of Target Canada's estate.

Secondly, with respect to its approximate 17,600 Canadian employees, Target US has agreed to fund an employee trust ("Employee Trust") to a maximum of C$70 million. Target US will <u>not</u> seek to recover from Target Canada's estate any amounts paid out of the Employee Trust. Moreover, all costs and expenses incurred in administering the Employee Trust will be borne by the Employee

[1] Additional applicants include: Target Canada Health Co., Target Canada Pharmacy (BC) Corp., Target Canada Pharmacy Corp., Target Canada Property LLC, Target Canada Mobile GP Co., Target Canada Pharmacy (Ontario) Corp., and Target Canada Pharmacy (SK) Corp. The applicants are also seeking protection for the following limited partnerships: Target Canada Pharmacy Franchising LP, Target Canada Property LP, and Target Canada Mobile LP.

Trust and not Target Canada's estate. Note also that Target Canada's employees are not represented by a union and there is no registered pension plan for such employees; the absence of each are sure to benefit the general claims pool.

Thirdly, Target US has agreed to provide post-filing financing during the CCAA proceeding up to US$175 million, secured by all of the real and personal property owned, leased or acquired by the Target Canada entities. Target US, as the sole lender, has agreed to financing terms advantageous to a debtor – no fees are payable under the loan facility and interest will be charged at only five percent. That financing on favorable terms is being extended by the parent company, and not a third-party activist investor, is but one additional factor benefiting the general claims pool.

Who Are the Creditors?

Although Target Canada has not yet established a claims procedure, they have released their consolidated list of creditors, which lists approximately 1800 creditors. Given the breadth and size of Target Canada's business and operations, the creditor pool is vast. The majority of creditors are trade vendors including many large, recognizable companies such as 20th Century Fox, Mattel, Nestle, PepsiCo, Procter & Gamble and Starbucks. Most of the vendors deliver to both Target US and Target Canada.

Other creditors of Target Canada will include landlords. As of the filing date, Target Canada operated 133 stores, all but three of which are leased. Target Canada also leases a variety of warehouse and office spaces. Although these leases will be part of the sale of the Debtor's real estate portfolio, it is unclear whether any third party will purchase these leases for value or whether Target Canada can successfully develop and implement a plan that their stakeholders and landlords will accept. In fact, landlords have already begun objecting to the lease sale process. To the extent that any lease is not sold (and approved by the Court) prior to June 30, 2015, a landlord may request a release from the applicable stay (which we anticipate will be extended) of proceedings and can apply to the Court for damages. According to analysts, potential lease damages are estimated to be approximately C$1.8-2 billion.

It is also worth noting that many of the Debtor's leases are subject to a parent guarantee or indemnity provided by Target US to the benefit of particular landlords. Thus, in the event that landlord-related damages are not paid in full from the Target Canada estate, such claim may be guaranteed by the solvent parent company. Target Canada's landlords include Cadillac Fairview Corporation Limited, RioCan Real Estate Investment Trust (holding the greatest number of leases, 26), and First Capital Realty Inc., among others.

In addition to the Debtor's direct lease obligations, landlords may also have an additional potential claim in connection with their leases with third-party tenants sharing retail spaces in the same center as Target Canada, where Target Canada served as the "anchor tenant." Typically, leases of non-anchor tenants provide for some tenant recourse in the event the anchor tenant becomes insolvent or ceases operations. To the extent that such non-anchor tenants seek damages from the landlord, the landlord may have additional claims against Target Canada. Given that Target Canada leased 130 stores, landlord claims will be a significant factor in creditor recoveries. Landlords will continue to play a significant role in the course of the Target Canada proceedings and their actions should be monitored closely.

When purchasing and diligencing lease claims against Target Canada, claim traders should keep these potential additional sources of recovery in mind. To the extent that lease claims (particularly with related parent guarantees) are acquired, claim purchasers must ensure that the guarantee is enforceable by third parties, and that the right to assert claims for contingent and ancillary recoveries are explicitly included in the bundle of "transferred rights" described in the assignment agreement.

Key Differences Between Canadian and US Insolvency Law

The *Companies' Creditors Arrangement Act* (CCAA) is Canadian federal law which allows insolvent corporations with debts in excess of $5 million to restructure their business and financial affairs. The main purpose of the CCAA is to enable financially distressed companies to avoid bankruptcy, foreclosure or seizure of assets while maximizing returns for creditors and preserving jobs and a company's value as a functioning business. CCAA proceedings are carried out under the supervision of a presiding court, with the involvement of a monitor whose role is to oversee the debtor's business and financial affairs to ensure compliance with the law, court orders and terms of a restructuring plan.

The majority of cross-border restructurings in Canada are administered under the CCAA, which is generally used for more complex, longer restructurings as compared to those under the BIA. Proceedings under the CCAA are very similar to those under Chapter 11 of Title 11 of the United States Code (the "US Bankruptcy Code"), but differ in several noteworthy respects.

When contrasting the CCAA to the US Bankruptcy Code, note that the CCAA has no analogous rules addressing: (i) adequate protection; (ii) administrative expense claims under 503(b)(9) of the US Bankruptcy Code for vendors delivering goods within a window of insolvency[2]; (iii) restrictions on the use by a debtor of cash collateral or property subject to an existing security interest; (iv) authority to create unsecured creditor committees, or impose disclosure requirements similar to Rule 2019 of the Federal Rules of Bankruptcy Procedure; or (v) an absolute priorities rule. Nonetheless, enough similarities do remain.

Below is an overview of certain key restructuring principles under the CCAA as compared to those under the US Bankruptcy Code which may be of concern to investors seeking to invest in claims against Target Canada.

Issue	U.S. Chapter 11 Reorganization	Companies' Creditors Arrangement Act
Automatic Stay	Commences as of the petition date; effective for the duration of the bankruptcy proceedings, except to the extent creditors may be granted relief for cause or with respect to their collateral.	The stay is not automatic but courts usually issue an initial stay of 30 days (the debtor must move to extend the stay) at the commencement of the case. The the scope of the stay is in the discretion of the court but will generally stay all claims and proceedings against the debtor and its property.
General Priority Rules	1. Secured creditors are entitled to be paid first from proceeds of their collateral, subject to competing liens; 2. Administrative expense claims, including the debtor's post-petition operating expenses and professional fees, and claims for goods shipped within 20 days prior to the petition date; 3. Priority claims, including claims for certain wages and benefits, tax claims, and other claims under Section 507 of the Code (not generally a significant component of total claims); 4. General unsecured claims (including all non-priority claims), such as trade claims, unsecured bonds, deficiency claims, etc.; and 5. Equity interests.	With certain exceptions, there are no express priority rules under the CCAA, but plan priorities generally reflect the following scheme: 1. Post-filing priority charges (generally includes professional costs, director and officer indemnification for certain post-filing, tax and employee liabilities, and can include DIP financing and critical supplier obligations) 2. Priority claims for certain tax, pension and employee obligations; 3. Secured Claims; 4. Unsecured claims; and 5. Equityholders (these are subordinated). Note, the CCAA does not provide for reclamation rights for vendors.
Executory Contracts	In order to maximize the value of the estate, the debtor has the option to: 1. Assume; 2. Reject; or 3. Assume and assign the contract to a third party.	A debtor must continue to fulfill its post-filing contractual obligations unless the debtor disclaims (rejects) the agreement. A debtor may also seek to assign a contract (even if the contract does not permit such assignment) so long as, among other criteria, any pre-filing monetary defaults are cured.

[2] Note that many of Target Canada's trade vendors are arguing that the CCAA proceedings should be converted to a bankruptcy proceeding under the BIA. Under Section 81.1(1) of the BIA, similarly to Section 503(b)(9) of the US Bankruptcy Code, vendors have the right to access and repossess goods delivered to the debtor within the 30-day period prior to the filing date.

Issue	U.S. Chapter 11 Reorganization	Companies' Creditors Arrangement Act
Voidable Transfers	Preferences: Payments not in the ordinary course of business on account of an antecedent debt to insiders made within one year before filing petition and in the case of non-insiders, made within 90 days before filing petition; Fraudulent Transfers: Payments made within two to six years of filing (depending on state law): 1. made with intent to defraud creditors, or 2. made for less than reasonably equivalent value while debtor was insolvent or rendered insolvent by the transfer (e.g., dividends made while debtor was insolvent).	Preferences: 1. If the transfer is made by the debtor to an arm's length creditor, the transfer must (a) occur within three months prior to the commencement of the proceeding and (b) made with a view to giving such creditor a preference. 2. If the transfer is made by the debtor to a non-arm's length creditor, the transfer must (a) occur within 12 months prior to the commencement of the proceeding and (b) such transfer had the effect of preferring one creditor over another. (Note there is a presumption of intent to prefer if the transfer had the effect of giving the creditor a preference.) Transfers at Undervalue: 1. If the transfer is made by the debtor to an arm's length creditor, it must be proven that (a) the transfer occurred within one year of the day on which the proceeding commenced, (b) the debtor was insolvent at the time or was rendered insolvent by the transfer, and (c) the debtor intended to defraud, defeat or delay a creditor. 2. If the transfer is made by the debtor to a non-arm's length creditor, it must be proven that the transfer (i) occurred within one year of the day on which the proceeding commenced or (ii) occurred within five years of the day on which the proceeding commenced, and the debtor (a) was insolvent at the time or was rendered insolvent by the transfer, or (b) intended to defraud, defeat or delay a creditor.
Plan of Reorganization: Key Parties	Creditors can file competing plans of reorganization after exclusivity period expires. This incentivizes the debtor to timely file its plan and to submit a plan that is "fair and equitable" to creditors.	There is no exclusivity period and the debtor or a creditor may file a plan, although the court will generally defer to the debtor in the first instance.
Voting: Required Classes	All impaired classes of claims are entitled to vote on the plan.	Each class of creditors to which the plan is proposed is entitled to vote.
Voting: Rules of Acceptance	Plan must be approved by each impaired class of claims or equity interests, subject to the debtor or other plan proponent's right to cram down non-accepting classes, provided that there must be at least one impaired accepting class to confirm plan. An impaired class is deemed to accept if: (a) More than 50 percent in number of allowed claims voting, vote to accept; and (b) More than two-thirds in dollar amount of the allowed claims voting, vote to accept.	Plan approval requires acceptance by all classes. A class is deemed to accept if: (a) approved by at least two-thirds in value of voting claims; and (b) approved by a majority in number of voting creditors. Under the CCAA, there is no "cram down."

Issue	U.S. Chapter 11 Reorganization	Companies' Creditors Arrangement Act
DIP Financing	Entitles DIP lender to increasingly extraordinary protections depending on circumstances, up to and including superpriority administrative claims and priming liens.	The CCAA provides for a post-filing lender to obtain a priority charge for post-filing loans to a debtor over some or all of the debtor's property that primes existing lenders' claims.
Cross-Border Provisions	Chapter 15 recognizes main and non-main proceedings administered in foreign courts. Comity recognizes foreign proceedings even when substantive laws differ from the United States, provided foreign laws are not offensive to US public policy.	The CCAA provides for the recognition of a foreign main proceeding as well as a foreign non-main proceeding (based on UNCITRAL model).

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