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Cross-border DIP issues in *Re InterTAN Canada Ltd.*

Case Study Series - 6

Cross-border Dip Issues in *Re InterTAN Canada Ltd.*

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I. Introduction

On the eve of the Christmas shopping season in November 2008, InterTAN Canada Ltd. ("InterTAN") faced a liquidity crisis that threatened to imperil the future of the company. Its U.S. parent, Circuit City Stores, Inc. ("Circuit City") and a number of other U.S. affiliates (collectively the "U.S. Debtors") had filed for protection under Chapter 11 of the United States Code, triggering defaults in the secured credit facility that InterTAN shared with the U.S. debtors (the "Secured Facility"). The Secured Facility was terminated as a result of these defaults and InterTAN was faced with the prospect of not being able to purchase inventory for its most significant sales season. Without financing, InterTAN faced an impending liquidity crisis, the prospect of a liquidation of its assets and the loss of over 3000 jobs.

In an effort to save the business, InterTAN filed for protection under the *Companies' Creditors Arrangement Act* (the "CCAA") on November 10, 2008. Due to its immediate need for financing, a crucial component of the CCAA relief requested by InterTAN was the approval of a debtor-in-possession credit facility (the "DIP Facility"). Like the Secured Facility, the proposed DIP Facility would be part of a single financing package to be provided jointly to InterTAN and the U.S. Debtors.

However, the proposed DIP Facility contained a number of notable features that raised questions for Canadian creditors and ultimately tested the limits of DIP financing in a cross-border context. The InterTAN proceedings provide an excellent overview of numerous pitfalls, solutions and best practices relevant to cross-border DIP financing. The difficult issues raised by the DIP Facility in the early days of the InterTAN case provide guidance as to how Canadian courts will balance a company's dire need for interim financing with the imperative of protecting Canadian stakeholders in a cross-border insolvency.

II. Background

At the time of its filing under the CCAA, InterTAN was a leading retailer of consumer electronics in Canada, with over 3000 employees and more than 750 retail locations operating under *The Source by Circuit City* trade name. InterTAN was the Canadian operating subsidiary of Circuit City, a U.S.-based company that operated a nationwide chain of large electronics stores.

InterTAN, Circuit City and the other U.S. debtors were financed under a single credit facility, the Secured Facility, which was provided by a lending syndicate led by Bank of America. The Secured Facility consisted of a US$1.25 billion loan to the U.S. Debtors and a separate US$50 million loan to InterTAN. InterTAN was a borrower only under the Canadian loan and was not liable for the borrowings of the U.S. debtors under the U.S. loan. The borrowers' obligations were secured by their receivables, inventory, cash and intangibles; however the security did not extend to equipment or real estate.

Although InterTAN had been in compliance with its obligations under the Secured Facility, the Chapter 11 filings by the U.S. Debtors constituted an event of default affecting all of the borrowers and ultimately resulted in the termination of the Secured Facility by Bank of America. InterTAN was required to repay immediately all amounts outstanding under the Canadian portion of the loan, and it was unable to draw any further amounts.

[*] The views expressed in this article are the views of the author and not of INSOL International, London.
[*] Goodmans LLP acted for Alvarez & Marsal ULC, the court-appointed Monitor in the InterTAN restructuring proceedings.

Without any other financing available, InterTAN filed for protection under the CCAA in the Ontario Superior Court of Justice (the "Ontario Court"). It was clear at the time of the CCAA filing that a going concern restructuring or sale would be far preferable to a liquidation and wind-down of InterTAN, which would detrimentally affect suppliers, landlords, customers, employees and numerous other stakeholders. However, the prospects of a going concern solution depended on InterTAN operating through the crucial holiday sales season. InterTAN needed interim financing immediately.

III. "No Other Alternatives"

The Cross-Guaranteed and Cross-Collateralized DIP Facility

InterTAN sought approval of the DIP Facility as part of the initial CCAA Order. Like the Secured Facility, the proposed DIP Facility would be governed by a single credit agreement and would be comprised of a US$1 billion U.S. component to be used by the U.S. Debtors and a US$50 million Canadian component to be used by InterTAN. However, the DIP Facility also introduced a number of new controversial features. In particular:

- unlike the Secured Facility, under which InterTAN was liable only for its own borrowings, the DIP Facility provided that InterTAN would also be liable for the amounts borrowed under the DIP Facility by the U.S. Debtors;

- unlike the security provided under the Secured Facility, which secured only InterTAN's borrowings, InterTAN would be required under the DIP Facility to pledge its assets and property as security for the U.S. Debtors' borrowings;

- unlike the Secured Facility, which provided the secured lenders with security over InterTAN's receivables, inventory, cash and intangibles, the DIP Facility was a court-ordered super-priority charge in favour of the DIP lenders (the "DIP Charge") that extended over all of the property and assets of InterTAN;

- even if InterTAN did not require all of the Canadian commitment under the DIP Facility, the Canadian commitment would remain fully drawn at all times and the unused amount would be advanced by InterTAN to the U.S. Debtors; and

- the DIP Facility would be a "roll-up" facility, meaning any new advances would be made under the DIP Facility but repayments would count towards the Secured Facility such that the pre-existing secured debt would be effectively rolled-up into the DIP Facility.

These features of the DIP Facility raised serious concerns for unsecured creditors of InterTAN. Without the changes introduced by the DIP Facility, InterTAN's unsecured creditors were in an in-the-money position – the estimated value of InterTAN's combined assets in an orderly liquidation of the business far exceeded InterTAN's borrowings under the Secured Facility – meaning it was likely that unsecured creditors' would receive a meaningful recovery on the estimated $27 - $32 million owed to them. However, the DIP Facility would render InterTAN liable, on a secured super-priority basis, for up to US$1 billion dollars of U.S. borrowings for which it had not previously been liable, and it would extend the lenders' security to include assets that were not previously secured. The DIP Facility therefore threatened to prejudice the Canadian unsecured creditors' in-the-money position.

To provide some measure of protection to the Canadian unsecured creditors, the DIP lenders ultimately agreed to the creation of a Canadian Creditors Charge of $25 million to secure payment of the claims of Canadian unsecured creditors. The DIP Charge would be split into two parts – the Primary DIP Charge would secure the borrowings of InterTAN under the DIP Facility, and the Subordinated DIP Charge would secure InterTAN's liability for any borrowings of the U.S. Debtors under the DIP Facility. The Canadian Creditors Charge would rank below the Primary DIP Charge but ahead of the Subordinated DIP Charge so that Canadian unsecured creditors were guaranteed

some recovery before InterTAN was permitted to apply its resources to the repayment of the U.S. Debtor's obligations. At the time of InterTAN's CCAA filing, both InterTAN and the Monitor recognized that this was an imperfect solution. However, with no other financing alternatives, InterTAN would either have to obtain approval of the DIP Facility on these terms or face certain liquidation.

Despite the issues with the DIP Facility, it was apparent that interim financing was essential to a going-concern restructuring of InterTAN. The DIP lenders were adamant that they were only willing to provide interim financing on the terms and conditions of the DIP Facility and subject to approval of the DIP Facility by both the U.S. court and the Ontario Court. In seeking court approval of the DIP Facility, InterTAN emphasized that the DIP Facility had been exhaustively negotiated and represented the best result that InterTAN could achieve in the circumstances. A going-concern solution would protect jobs and preserve value, and approval of the DIP Facility, despite its imperfections, was essential to a going-concern solution. InterTAN had no other alternative to avoid liquidation.

In considering whether to approve the DIP Facility, Morawetz, J. of the Ontario Court framed the central issue as follows:

> It is clear that the DIP Facility results in a substantial change to the status quo. The use of the assets of InterTAN as a basis for obtaining finance for Circuit City raises a number of questions, especially when the approval of the DIP Facility could very well affect InterTAN's ability to honour its current obligations .... If there are no credit facilities, there is very little prospect of reorganizing or restructuring InterTAN.
>
> The issue is whether it is appropriate in the circumstances for InterTAN to provide support for its indirect parent, Circuit City.[1]

Morawetz, J. went on to emphasize that approval of the far-reaching elements of the DIP Facility would constitute extraordinary relief. It was therefore incumbent on parties requesting such relief to meet a high evidentiary standard commensurate with the extraordinary nature of the relief being sought.[2] Morawetz, J. ultimately held that the need for immediate approval of the DIP Facility had been substantiated and that the terms of the DIP Facility were warranted in the circumstances:

> In this case, however, I concluded, having considered and balanced the alternatives, that the DIP Facility should be approved. In my view, the potential upside of a going concern operation was preferable to a liquidation, notwithstanding the provisions of the DIP Facility which effectively transfers assets from InterTAN to another member of the enterprise group [i.e., the U.S. Debtors]. It was in my view, appropriate to approve the DIP Facility, taking into account the prospects of a continued going concern operation, the continued employment of over 3000 individuals and the benefits of a continued operation for other third party stakeholders. I also took into account that ... the creation of the [Canadian Creditors Charge] provides in theory, a degree of protection to this group of creditors who could otherwise be detrimentally affected by the DIP Facility.[3]

Critical to this decision was an analysis of the alternatives. In this case, the only alternative to a going concern restructuring was a value-destroying liquidation. The Ontario Court ultimately approved the DIP Facility, despite its far-reaching features, because DIP financing was proven to be essential to the going concern restructuring and the Ontario Court was satisfied that InterTAN truly had no other alternative than to accept the only deal on the table. InterTAN would have the interim financing it needed to carry it through the holiday sales season.

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[1] Reasons of Mr. Justice Morawetz, dated November 26, 2008 at para. 52 (See Appendix B).
[2] Reasons of Mr. Justice Morawetz, dated November 26, 2008 at paras. 58-59 (See Appendix B).
[3] Reasons of Mr. Justice Morawetz, dated November 26, 2008 at para. 69 (See Appendix B).

The parties to the InterTAN case would later learn that the Ontario Court was less than pleased when key aspects of "the only deal on the table" were changed in the Chapter 11 proceedings without the Ontario Court's approval.

IV. "The Strength Of The Argument Is Also Its Weakness"

The Status Quo Order

The DIP Facility was approved on an interim basis in the Chapter 11 proceedings concurrently with the approval of the DIP Facility in the CCAA proceedings. However, final approval of the DIP Facility in the Chapter 11 proceedings was not scheduled to occur until late December of 2008. In the intervening period, the U.S. Debtors found themselves at odds with an unsecured creditors' committee appointed in the Chapter 11 proceedings (the "UCC") with respect to several features of the DIP Facility, including the expansion of the lenders' security to cover assets that had not been secured under the Secured Facility.

The U.S. Debtors engaged in settlement discussions with the UCC as the date approached for final approval of the DIP Facility in the Chapter 11 proceedings. The parties to the Canadian proceedings had little visibility as to the status and development of these discussions since they were taking place within the framework of the Chapter 11 proceedings. The court-appointed Monitor of InterTAN, Alvarez & Marsal Canada ULC, expressed concern over this lack of visibility – it recognized that any changes to the DIP Facility mandated by the Chapter 11 proceedings could have an indirect impact on InterTAN given the cross-border nature of the DIP Facility.

The Monitor's concerns were ultimately substantiated. On December 21, 2008, the day prior to the motion for final approval of the DIP Facility, the Monitor received a copy of an amendment to the DIP Facility that had been agreed to by the U.S. Debtors and the UCC in settlement of the UCC's objections. The U.S. Debtors advised that they would be seeking final approval of the DIP Facility (as amended, the "Amended DIP Facility") from the U.S. court the following day. On December 23, 2008, the U.S. court granted an order approving the Amended DIP Facility.

In the circumstances, the Monitor had insufficient time and facts to assess the impact of the Amended DIP Facility before the final approval motion in the Chapter 11 proceedings. However, based upon the Monitor's initial review, the Monitor concluded that two key features of the Amended DIP Facility could have an adverse impact on the stakeholders of InterTAN. Specifically:

- to address the UCC's concerns that the DIP Facility expanded the scope of the lenders' security, the Amended DIP Facility provided that certain property of the U.S. Debtors would no longer be secured under the Amended DIP Facility and that the U.S. Debtors' estate would have full access to the proceeds of that property; and

- the Amended DIP Facility provided that the DIP lenders would distribute 50% of any proceeds recovered from the Subordinated DIP Charge in the CCAA proceedings to the U.S. Debtors for the benefit of the U.S. Debtors' unsecured creditors.

The Monitor was of the view that these amendments could have an unfair and inequitable impact on the unsecured creditors of InterTAN. Firstly, the fact that the Amended DIP Facility provided unsecured creditors of the U.S. Debtors with access to the value of certain previously secured property would potentially reduce the recoveries of the DIP lenders in the Chapter 11 proceedings and thus *increase* the likelihood that the DIP lenders would need to have recourse to the Subordinated DIP Charge. This would negatively affect the recoveries to Canadian unsecured creditors if the Canadian Creditors Charge turned out to be insufficient to repay all of their claims.

Secondly, by enabling the DIP lenders to share half of the Subordinated DIP Charge with the unsecured creditors of the U.S. Debtors, the Amended DIP Facility would make property of InterTAN

available to unsecured creditors of the U.S. Debtors without any assurances that the unsecured creditors of InterTAN would be paid in full. Rather than protecting the DIP Lenders' ability to be repaid from InterTAN's assets for U.S. lending, the Subordinated DIP Charge could potentially be used to repay unsecured creditors of the U.S. Debtors *ahead* of unsecured creditors of InterTAN, thereby inverting the structural priority held by the Canadian unsecured creditors.

These concessions by the DIP lenders in the Chapter 11 proceedings contradicted the evidence adduced at the initial CCAA hearing that the DIP Facility, in its original form, was "the only deal on the table". From the Monitor's perspective, it appeared that the security provided by the Subordinated DIP Charge, which had apparently been a non-negotiable condition precedent to the provision of DIP financing, had been bartered away by the U.S. Debtors and the DIP Lenders to unsecured creditors of the U.S. Debtors to settle the UCC's objections to the DIP Facility.

The Monitor raised these concerns before the Ontario Court in an emergency hearing on December 24, 2008. In response, Morawetz, J. granted an Order that, among other things, prohibited any intercompany advances from InterTAN to the U.S. Debtors and any distribution of proceeds from InterTAN's property (the "Status Quo Order") pending a comprehensive hearing to address the impact of the Amended DIP Facility on InterTAN. In effect, the Ontario Court granted a temporary injunction that prevented any of InterTAN's funds from leaving Canada.

The Monitor subsequently brought a motion before the Ontario Court for an Order, *inter alia*, (i) extending the Status Quo Order until the Canadian creditors' recovery was better particularized and there was clarity as to the DIP lenders' need to access the Subordinated DIP Charge to cover any shortfall in their recoveries from the U.S. Debtors; and (ii) reducing the Subordinated DIP Charge by the amount of any recoveries U.S. unsecured creditors received from property of the U.S. Debtors that was originally secured under the DIP Facility but whose value was allocated to the U.S. unsecured creditors under the Amended DIP Facility. The Monitor's position was supported by several unsecured creditors of InterTAN.

Not surprisingly, the Monitor's motion was opposed by the DIP Lenders. The DIP lenders argued that they should be able to use the Subordinated DIP Charge in any manner they choose, whether to recover on their advances or to use as currency for the settlement of the UCC's objections in the Chapter 11 proceedings. They had already relied on unrestricted access to the Subordinated DIP Charge in making advances through the holiday season and now, after the fact, the Monitor was asking that their access to the Subordinated DIP Charge be restricted only to circumstances in which they had exhausted all possible recoveries from the U.S. Debtors. The DIP lenders argued that such a result would set the inauspicious precedent that DIP priority charges would be subject to retroactive adjustment if the DIP lenders' business decisions subsequently displeased the court. InterTAN also objected to the Monitor's requested Order on the basis that compliance with such an Order could put InterTAN in default of its obligations under the Amended DIP Facility.

The Ontario Court ultimately granted the Monitor's motion. The DIP lenders' rights under the initial CCAA Order, including the approval of the DIP Facility and the Subordinated DIP Charge, were a finely balanced "package" that was carefully calibrated to InterTAN's circumstances at the time of the CCAA filing. The DIP lenders could not then unilaterally make changes to the DIP Facility in the United States in a way that was detrimental to InterTAN's creditors. To do so would undermine the basis on which the Ontario Court had originally granted the DIP lenders their package of rights. The Ontario Court stated:

> I have no doubt that the DIP Lenders have relied on the approvals granted in the [initial CCAA Order]. I accept the submissions put forward by counsel to this effect. I also accept the submission that the DIP Lenders should be able to rely on what has been approved by this court. However, the strength of the ... argument is also its weakness. ...

> I do not agree that the DIP Lenders have the unilateral ability to discharge portions of the collateral package to the detriment of Canadian creditors without receiving court authorization to do so. The DIP Lenders' Charge incorporates a charge on the Property of [InterTAN]. In considering whether it is appropriate to approve such a facility, the court takes into account a number of factors which include the benefits that the [debtor company] will receive from the DIP Facility and the collateral that is charged under the DIP Lenders' Charge. In my view, it is not appropriate to provide court approval to the entire package and then tacitly approve the unilateral activities of the DIP Lenders in discharging portions of the collateral to the potential detriment of certain stakeholders in the CCAA proceedings...
>
> The DIP Lenders had an option in this case. They chose to obtain approval of the [Amended DIP Facility] in the Chapter 11 Proceedings and not to obtain such approval in this court. Having elected to proceed in this manner, the DIP lenders now take the position that they are entitled to rely on court approval. I agree, but in the context of these proceedings, court approval has not been obtained to incorporate into the DIP Facility the amendments which are contained in the [Amended DIP Facility] and approved in the Chapter 11 Proceedings. ...
>
> In my view, to the extent that the DIP Lenders made advances and relied upon the Final Second Amendment having effect in these CCAA proceedings, they did so at their peril.[4]

The Ontario Court went on to address InterTAN's submission that compliance with the Status Quo Order would result in an event of default under the Amended DIP Facility:

> If this, indeed, is the outcome of the Monitor's motion, it is one that defies logic. The crisis has been created by an arrangement as between the DIP Lenders and the UCC and agreed to by the U.S. Debtors. On this issue, it would appear that these parties have, for all practical purposes, ignored the CCAA proceedings. Having ignored the CCAA proceedings, the DIP Lenders take the position that steps taken by the Monitor to monitor compliance with existing court orders creates an event of default. This should not and cannot be the effect of this endorsement.[5]

On this basis, Morawetz, J. extended the Status Quo Order pending a final assessment of the DIP lenders' recoveries in the United States. In addition, the Subordinated DIP Charge was reduced by the amount of any recoveries U.S. unsecured creditors received from collateral of the U.S. Debtors that was originally secured under the DIP Facility but whose value was allocated to U.S. unsecured creditors under the Amended DIP Facility.

While the cross-border DIP issues were by no means the only complex and controversial matters in the InterTAN restructuring, they were perhaps the most ground-breaking in terms of the legal principles they established.

V. Developments Since InterTAN

There have been two key developments affecting the law of cross-border interim financing since the InterTAN case.

Firstly, the issue of cross-border guarantees was once again put before Morawetz, J. in the CCAA proceedings of Indalex Limited and certain of its affiliates (collectively, "Indalex Canada"). As part of a motion for approval of DIP financing, Indalex Canada sought approval of a secured guarantee granted by Indalex Canada in favour of the DIP lenders in respect of Indalex Canada's U.S.-based affiliates (collectively, "Indalex U.S."). Building on the principles considered in the InterTAN case,

[4] Reasons of Mr. Justice Morawetz, dated January 23, 2009 at paras. 49-57 (See Appendix C).
[5] Reasons of Mr. Justice Morawetz, dated January 23, 2009 at para. 58 (See Appendix C).

Morawetz, J. set out the following list of factors relevant to a court's consideration of a guarantee of U.S. borrowings by a Canadian debtor company in connection with a cross-border DIP facility:

a) the need for additional financing by the Canadian debtor to support a going-concern restructuring;

b) the benefit to the breathing space afforded by the DIP Financing to permit the Canadian debtors to identify a going concern solution;

c) the availability (or lack thereof) of any financing alternatives;

d) the practicality of establishing a stand-alone solution for the Canadian debtors given the integrated nature of Indalex Canada and Indalex U.S.;

e) the contingent nature of the liability of the proposed guarantee and the likelihood that it will be called on;

f) any potential prejudice to unsecured creditors that may arise as a result of approving a super-priority secured financing, including whether unsecured creditors are put in any worse position by the provision of a cross-guarantee of a foreign affiliate than as existed prior to the filing, other than the impact of the super-priority status of new advances to the debtor under the DIP financing;

g) the benefits that may result for the stakeholders if the request is approved and the prejudice to those stakeholders if the request is denied; and

h) a balancing of the prejudice to creditors against any benefits accruing to stakeholders generally.[6]

While the Ontario Court did not expressly apply these factors in the InterTAN case, it is apparent that many of these considerations were relevant in Morawetz, J.'s decision to approve the DIP Facility.

Secondly, the Canadian Parliament has enacted certain amendments to the CCAA that affect the parameters of DIP financing in Canada. Amendments to the CCAA effective September 18, 2009 codified much of the previously existing jurisprudence regarding the granting of interim financing in the CCAA context. Section 11.2 of the CCAA now provides a court with the authority to make an order declaring that all or part of the property of the debtor is subject to a security or charge in favour of a person who agrees to provide financing to the debtor. Thus, the section provides for the court to have broad discretion to make an order that it considers appropriate. However, section 11.2(1) now prohibits the application of a court-ordered DIP lenders' charge to any obligation that existed before the DIP financing order is granted. This would arguably preclude the kind of "roll-up" feature present in InterTAN's DIP Facility.

VI. Impact of the InterTAN Case

The cross-border DIP decisions in the InterTAN case are significant in several ways. The creation of a bifurcated DIP lenders' charge and the interposition of the Canadian Creditor Charge in the InterTAN case demonstrate that Canadian courts will go to great lengths and entertain highly flexible approaches to cross-border DIP financing to achieve the best possible balance of stakeholder interests.

However, it is equally clear that such a fine balance does not come without continued judicial scrutiny. Actions that upset the balance of interests, even if they occur south of the border and affect Canadian stakeholders only indirectly, will not be protected unless they have been disclosed and authorized by the CCAA court. Parties engaged in a cross-border restructuring should be mindful that seemingly

[6] *Indalex Ltd., Re*, (2009) 52 C.B.R. (5th) 61 (Ont. S.C.J.) ("*Re Indalex*").

remote steps taken in the foreign proceedings may very well require the approval of the CCAA court if they could have an impact on the Canadian restructuring.

The InterTAN cross-border DIP cases are also significant in terms of the active role played by the Monitor in voicing the interests of Canadian stakeholders. InterTAN did not have a functioning board of directors by the time of its CCAA filing and was being directed by certain of the U.S. Debtors pursuant to a unanimous shareholders agreement. In these circumstances, the Monitor took an interventionist approach in support of Canadian stakeholders' interests. Despite concerns expressed by other parties about the Monitor's more active role in this regard, the Court was of the view that it was entirely appropriate for the Monitor to bring a motion where it was necessary to voice its concerns to the court.[7]

While the cross-border DIP issues were only one of many interesting issues to emerge from the InterTAN restructuring, they leave behind an important legal legacy that will be considered and cited in many cross-border restructuring cases to come.

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[7] Reasons of Mr. Justice Morawetz, dated January 23, 2009 at paras. 8-10 (See Appendix C).