Court File No. CV-18-00611219-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

B E T W E E N:

FTI CONSULTING CANADA INC.,
in its capacity as Court-appointed monitor in proceedings
pursuant to the *Companies' Creditors Arrangement Act,* RSC 1985, c. c-36

Plaintiff

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ESL INVESTMENTS INC., ESL PARTNERS LP, SPE I PARTNERS, LP, SPE MASTER I, LP, ESL INSTITUTIONAL PARTNERS, LP, EDWARD S. LAMPERT, SEARS HOLDINGS CORPORATION, WILLIAM HARKER and WILLIAM CROWLEY

Defendants

AMENDED STATEMENT OF DEFENCE OF THE DEFENDANTS
WILLIAM HARKER and WILLIAM CROWLEY

1. The Defendants William Harker and William Crowley deny each and every allegation in the Amended Statement of Claim, except where hereinafter expressly admitted, and deny that the Plaintiff FTI Consulting Canada Inc. is entitled to any of the relief sought in the Amended Statement of Claim.

OVERVIEW

2. The Plaintiff seeks to recover the full amount of a dividend paid to all shareholders of Sears Canada Inc. ("Sears Canada" or the "Company") almost six years ago (the "2013 Dividend"). This dividend was unanimously approved by the Company's experienced board of directors (the "Board"), the majority of which was independent, following comprehensive and

careful consideration of the best interests of the Company. Sears Canada remained financially sound following the payment of the 2013 Dividend, and indeed for the duration of the tenure of the Defendants William Harker and William Crowley as directors.

3. In 2011, in a challenging retail and economic environment, Sears Canada began a three-year strategic plan to transform the Company into a strong mid-market retailer with a renewed focus on suburban and smaller/rural centres (the “Transformation Plan”). As part of that strategic evolution, management recommended and the Board approved the divestiture of certain non-core real estate assets. These divestitures were expected to result in improvements to long-term financial and operational performance. As a result of these divestitures, as well as the financial and operational improvements consequent to the implementation of the strategic plan, Sears Canada had significant cash on hand – expected to be more than $1 billion at the end of fiscal 2013.

4. Consistent with corporate governance best practices, the Board’s decision regarding the use of the significant excess cash involved careful consideration of the financial and operational position of Sears Canada in light of its strategic plan and capital requirements, market conditions, and the fact that the Company had virtually no debt. Among other things, the Board assessed the needs of the business based on the Transformation Plan and management’s priorities and operating plans, including strategies aimed at long-term growth. Management did not request any funding in excess of what would be available following payment of the 2013 Dividend to pursue the Transformation Plan or its other priorities, and more than sufficient cash remained on hand.

5. The 2013 Dividend was paid *pro rata* to Sears Canada’s shareholders, all of whom were treated equally and all of whose interests were aligned. After the 2013 Dividend was paid, Sears Canada’s largest shareholders continued to have the largest investments – and strongest interests – in the ongoing operational success of the Company. Sears Canada was not insolvent

or near insolvent when the 2013 Dividend was declared or paid, and it was not rendered insolvent by that payment. On the contrary, following payment of the 2013 Dividend, approximately $513.8 million in cash still remained on Sears Canada's balance sheet, with virtually no debt, and its operations and plans for implementing management's strategic objectives remained fully funded.

6. Indeed, between 2011 and 2015, Sears Canada had no significant debt, maintained a significant cash position ($398 million in 2011 and $315 million in 2015) and, with availability under its credit facility, had significant total liquidity ranging from $434 million to $887 million in this period. Sears Canada was financially sound when the Board approved the 2013 Dividend and remained so in 2015 when Harker and Crowley left the Board.

7. There was nothing improper whatsoever about the Board's approval of the 2013 Dividend. It was not undertaken to defraud, defeat, or delay any of Sears Canada's creditors and none were in fact defrauded, defeated, delayed, or otherwise harmed by the 2013 Dividend. In fact, for many years thereafter, Sears Canada continued to implement its Transformation Plan, run its operations, pay its creditors in the ordinary course, maintain significant cash on hand, and reduce its overall debt.

8. The claim that Harker and Crowley should now pay $509 million – the amount of the 2013 Dividend – to benefit the current creditors of Sears Canada is factually baseless and without legal merit. This action should be dismissed.

THE PARTIES

The Former Directors – Harker and Crowley

9. The Defendant William Harker was a director of Sears Canada from November 2008 to April 2015. Harker was at all material times a highly experienced corporate lawyer, corporate director, and senior manager with significant experience in the retail sector and in investment fund strategy and management.

10. Prior to, and concurrent with part of, his tenure on the Board, Harker held management roles with Sears Holdings Corporation ("Sears Holdings"), including as chief counsel from September 2005, then as general counsel from April 2006 to May 2010, and then as an officer until August 2012, and with ESL Investments Inc. as general counsel from February 2011 to August 2012. Harker also co-founded an investment fund in 2013. He previously practised as a corporate lawyer with the law firm of Wachtell Lipton Rosen & Katz LLP in New York City and has a law degree from the University of Pennsylvania.

11. The Defendant William Crowley (together with Harker, the "Former Directors") was a director of Sears Canada from March 2005 to April 2015, and chair of the Board from December 2006 to April 2015. Crowley was at all material times a highly experienced executive and corporate director with extensive experience in the management of retail organizations, investment fund strategy and management, and finance.

12. Prior to, and concurrent with part of, his tenure on the Board, Crowley held management roles with Sears Holdings, as executive vice-president, chief financial officer, and chief administrative officer at various times from March 2005 to January 2011, and with ESL Investments Inc., as president and chief operating officer from January 1999 to May 2012. Crowley previously worked as a financial analyst with Merrill Lynch and as a managing director of Goldman Sachs and co-founded an investment fund in 2013. Crowley has an undergraduate degree and a law degree from Yale University and a master's degree in philosophy, politics, and economics from the University of Oxford.

Sears Holdings Corporation

12A. To the best of the Former Directors' knowledge, the Defendant Sears Holdings is a corporation incorporated under the laws of Delaware. On October 15, 2018, Sears Holdings filed for protection from its creditors under Chapter 11 of the *United States Bankruptcy Code*.

The ESL Defendants

13. To the best of the Former Directors' knowledge, the Defendant ESL Investments Inc. is an investment fund incorporated under the laws of Delaware. The Defendants ESL Partners LP, SPE I Partners, LP, SPE Master I LP, and ESL Institutional Partners, LP were at all material times controlled directly or indirectly by ESL Investments Inc. (these limited partnerships, together with ESL Investments Inc., "ESL").

14. To the best of the Former Directors' knowledge, the Defendant Edward S. Lampert is an individual residing in Florida who at all material times was the principal of ESL. Lampert was also, at all material times, the chair and chief executive officer of ESL Investments Inc., the chair of Sears Holdings, and beginning in February 2013 the chief executive officer of Sears Holdings.

15. To the best of the Former Directors' knowledge, at all material times, Sears Holdings held a 51% interest in Sears Canada, ESL held a 17.4% interest in Sears Canada, and Lampert held a 10.2% interest in Sears Canada.

The Plaintiff

16. On June 22, 2017, Sears Canada obtained protection under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (the "CCAA"). The Plaintiff FTI Consulting Canada Inc. is the court-appointed monitor of Sears Canada and its debtor affiliates in the CCAA proceedings.

17. Prior to the CCAA proceedings, Sears Canada was a multi-format retailer focused on merchandising and sale of goods and services through its network of approximately 111 full-line department stores and 295 speciality stores, including Sears Home stores and Sears Hometown dealer stores, as well as its direct (catalogue/internet) channel.

BACKGROUND

18. The global economic recession in 2008 and 2009 negatively impacted Canadian retailers, including Sears Canada. Its business, like many retailers, was affected by various factors such as low consumer confidence (the lowest in almost 30 years), high unemployment, rising consumer debt, a strong Canadian dollar, and rising expenses, among others.

19. These factors, combined with the increasingly competitive retail marketplace, were major contributors to changes in Sears Canada's operational performance in 2010, including a 4% same store sales decline and a 41% decline in EBITDA as compared to 2009.

20. Sears Canada maintained a strong financial position despite economic and retail market conditions and operational challenges. In particular, in 2010, it reduced its debt profile with the repayment of $300 million of medium term notes and arranged access to an $800 million credit facility which it could draw on, if necessary, to fund working capital needs, capital expenditures, acquisitions, and for other general corporate purposes. Additionally, in 2010, Sears Canada declared total dividends of $753.4 million, or $7 per share, and repurchased approximately 2.2 million shares for approximately $43 million pursuant to a normal course issuer bid.

21. Nevertheless, given the changes in the retail landscape, and since Sears Canada's traditional customer base – older Canadians living in suburban and smaller/rural centres – was eroding, the Company initiated a process to redefine itself. This process was undertaken in the context of volatility in the retail industry, at a time when Sears Canada faced fierce competition from entry into the Canadian market by American retailers, the liquidation of other Canadian retailers, the advancement of consumer technologies and the increased use by Canadian consumers of e-commerce, increased cross border shopping, and shifting spending patterns in the baby boomer generation – a key target market for Sears Canada.

THE TRANSFORMATION PLAN

22. Beginning in 2011, under the guidance of its new CEO Calvin McDonald, Sears Canada undertook a full diagnostic review of all aspects of its business. The purpose of this review, which included an assessment of, among other things, merchandising and marketing, operations and logistics, direct sales (website and catalogue), and the nature and extent of the Company's "retail footprint", was (i) to focus the business on the Company's strengths and (ii) to determine how best to respond to changing market conditions.

23. This review culminated in a three-year strategic plan designed to transform the Company over time by renewing and improving its operational performance and re-focusing its retail business on its traditional core strengths. This Transformation Plan acknowledged that Sears Canada had strong performance in suburban and smaller centre/rural markets, had "lost its focus" by pursuing urban markets, and was "stuck" without a relevant value proposition for these three distinct markets: rural, suburban, and urban.

24. The Transformation Plan, which was carefully considered and approved by the Board, was a "compass" for the business transformation, with annual financial and operational plans functioning as "roadmaps" for the implementation of that transformation. The Transformation Plan and annual financial and operational plans included initiatives to improve Sears Canada's operational performance, enhance its core retail business, and unlock value, including through operational changes and capital investment to refresh a number of Sears Canada's stores and thereby improve the performance of the refreshed stores.

25. The Transformation Plan acknowledged the need for Sears Canada to focus on getting the basics of retail right before it could realize any benefit from investing significantly in its retail locations and provided for a disciplined approach to capital investment.

26. In connection with the store refreshes, management recommended a phased approach, with an initial limited phase of refreshes, and a demonstrated return on investment prior to any further or Company-wide implementation of store refreshes. The Board authorized the phased approach to capital investment to ensure adequate return for the benefit of the Company.

27. Sears Canada made significant investments in its business as part of the implementation of the Transformation Plan and operating plans in 2012 and 2013. Among other things, it:

(a) invested a total of $165 million in capital expenditures;

(b) invested approximately $40 million completing the refresh or reset of 58 full-line stores, with emphasis on merchandise presentation and standards; and

(c) invested $125 million in various other capital projects, including $8 million in its website, which drove e-commerce growth that exceeded the decline in catalogue.

28. As part of the Transformation Plan, management initiated a thorough assessment of the Company's real estate assets to identify unproductive stores and excess space that, in the context of the strategic review, had higher "real estate value" than "trading value", measured by a multiple of "four-wall" EBITDA.[1] Management called their initiative "Project Matrix".

29. Project Matrix was not initiated, as alleged, because Sears Holdings, ESL and Lampert "had an immediate need for cash" in early 2013. Nor was it devised, as alleged, by Sears Holdings, ESL or Lampert as a "plan to extract cash" from Sears Canada. In fact, the Former Directors were not aware of any cash liquidity issues or cash constraints for Sears Holdings, ESL or Lampert while they were directors of Sears Canada.

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[1] EBITDA refers to earnings before interest, tax, depreciation and amortization. It is a key measure of a company's operating performance and in particular indicates the cash operating profit of a business. It is used by management and investors to assess a company's operational performance by eliminating the effects of financing decisions, accounting decisions, or tax environments.

30. In fact, Project Matrix was initiated by Sears Canada's management in early 2012. It was led by a steering committee composed of senior management from the real estate, legal, and finance departments of Sears Canada, not by the Former Directors. The assessment undertaken in connection with Project Matrix confirmed that the Company was not optimally positioned with its "real estate footprint", that certain locations (particularly in large urban centres) were more valuable to the Company as real estate assets than as operating stores, and that the divestiture of those assets could "right size" and re-focus the business by reducing major urban locations.

31. In particular, given economic conditions and the increasingly competitive retail landscape in Canada, management recognized that the sale of store leases for stores that did not generate meaningful operational returns would allow the Company to focus on its core retail business. At the same time, aggressive entry into the Canadian market by American retailers presented a unique and time-limited opportunity to Sears Canada by increasing demand for space that did not fit within the Company's business model.

32. The initiative became a key aspect of the ongoing implementation of the Transformation Plan to refocus operations on Sears Canada's core customer base in suburban, mid-market, and smaller/rural locations, and generate long-term value. Management provided detailed reports to the Board on the results of Project Matrix, including an assessment of each store, with rankings according to their respective real estate values and trading values, measured by a detailed "four-wall" EBITDA assessment, and the proposal to divest unproductive real estate assets to transition the Company to a mid-market retailer without major urban locations.

33. Management identified the top ten stores for which the real estate value far exceeded the trading value. Management presented various scenarios and proposed that Sears Canada pursue the sale of six to eight of these full-line stores, located in urban markets, and right-size an additional seven or eight full-line stores by subletting excess space in the near term.

34. The Board approved annual financial and operational plans presented by management relating to implementation of the Transformation Plan, which were designed to address changes in retail market conditions and the impact of the various initiatives on the Company's business. In addition to quarterly meetings, the Board met with management every month to review financial and operational performance and each fall, the Board attended a two-day strategic session prior to the review and approval of the annual financial and operational plan.

REAL ESTATE DIVESTITURES

35. Project Matrix culminated in Sears Canada entering into four transactions in 2013 for the sale or redevelopment of certain store locations. Management led the negotiations for each transaction with assistance from external advisors and input from various Board members. The Board was specifically aware of the assistance provided by the Former Directors and Jeffrey Stollenwerck, an executive with Sears Holdings, who had relevant expertise and relationships with Sears Canada's and other retail landlords. Sears Holdings, ESL, and Lampert did not direct the negotiating strategy in connection with these transactions.

36. Management recommended each transaction to the Board following comprehensive review and consideration and provided detailed presentations to the Board with its recommendations, which included an assessment of the transaction, an evaluation of store performance versus real estate value, accounting implications of a sale, and the impact of the proposed sale on operational and financial performance, EBITDA, and the balance sheet. Each of the four transactions was carefully reviewed and unanimously approved by the Board as being in the best interests of Sears Canada.[2]

[2] In light of a potential conflict in respect of outside business activities not related to Sears Canada, the Former Directors recused themselves from the review and approval of the Concord transaction, described below.

The Oxford Transaction

37. Sears Canada entered into a transaction with Oxford Properties Group ("Oxford") for the sale of leases for Yorkdale and Square One for total consideration of $191 million and a $1 million payment by Oxford in exchange for an option to purchase the Scarborough Town Centre lease for $53 million.

38. The transaction was not initiated by the Company. Rather, it was initiated by a proposal from Oxford and negotiations were led by Sears Canada's management with input as necessary from external advisors and various Board members.

39. Management had ranked the three stores in the Oxford transaction in the top ten stores with real estate value exceeding trading value, and the divestiture of these assets was consistent with the Company's plan to right-size and re-focus its business. The consideration of $191 million represented a value of more than 21 times the four-wall trading EBITDA for Yorkdale and the Square One locations, 10.6 times the four-wall trading EBITDA for Scarborough Town Centre, and greatly exceeded management's estimate of real estate value by approximately $55 million.

The Concord Transaction

40. Sears Canada entered into a transaction with Concord Kingsway Project Limited Partnership ("Concord") for the sale of a 50% beneficial interest in its property in Burnaby, British Columbia – except for the new Sears Canada store site – and the creation of a co-ownership joint venture for the redevelopment of a mixed-use residential office and retail shopping centre. The total consideration proposed was approximately $140 million.

41. Management recommended partnering with Concord over two other candidates that had been considered on the basis that Concord proposed the most favourable structure, was one of Canada's largest mixed-use developers, and offered the highest net present value.

The Cadillac Fairview Transaction

42. Sears Canada entered into a transaction with Cadillac Fairview Corporation Limited ("Cadillac Fairview") for the sale of leases for five stores: the Toronto Eaton Centre, Sherway Gardens, Markville Shopping Centre, Masonville Place, and Richmond Centre. The total consideration proposed was $400 million.

43. The transaction was not initiated by the Company. Rather, it was initiated by a proposal from Cadillac Fairview and negotiations were led by Sears Canada's management with input as necessary from external advisors and various Board members.

44. Management had ranked the five stores in the Cadillac Fairview transaction in the top seventeen stores with real estate value exceeding trading value, with three being in the top ten. The divestiture of these assets was consistent with the Company's plan to right-size and re-focus its business. The consideration of $400 million represented a value of more than 26.1 times the four-wall trading EBITDA and greatly exceeded management's estimate of real estate value by approximately $158 million.

The Montez Transaction

45. Sears Canada entered into a transaction with Montez Income Properties ("Montez") for the sale of Sears Canada's 50% joint venture interest with Westcliff Group of Companies in eight shopping centres in Quebec for consideration of approximately $315 million.

46. Management advised the Board that this amount represented fair market value for these non-core real estate assets. The transaction allowed the Company to refocus is business by exiting the joint venture arrangement while continuing to operate full-line stores in the eight shopping centres, with the leases being revised to account for Sears Canada being a tenant and not a landlord.

47. When announcing the transaction with Montez, the Company explained that “unlocking the value of assets is a lever we use as a way to help create total value. The joint venture assets we are selling to Montez impact neither our store operations nor our ability to serve customers. As such, our primary focus in creating long-term value remains on the basics of the business and continuing to become more relevant with Canadians coast to coast.”

The Board Rejected Transactions Inconsistent with the Transformation Plan

48. Transactions proposed by management that were inconsistent with the Transformation Plan were not authorized by the Board. In particular, in late 2013 management proposed a transaction with Ivanhoe Cambridge to sell five store leases and its 15% joint venture interest in a shopping centre in Quebec. As with all potential real estate divestitures presented by management, the Board conducted a thorough review and consideration of this transaction to determine whether it was consistent with Sears Canada’s strategy and long-term interests.

49. After careful consideration, the Board decided that the proposed transaction was not consistent with the objectives of the Transformation Plan, including the right-sizing of the retail footprint since most of these locations were too valuable as operating stores to be divested. Accordingly, the Board declined to authorize management to pursue the proposed transaction.

All Transactions Were Driven by the Transformation Plan

50. These transactions did not represent a sale of the Company’s “crown jewels”, as alleged. In fact, the opposite is true. All of these transactions related to store locations where value as real estate assets far exceeded their trading value as operating stores. The sale of these assets was consistent with the Transformation Plan – the strategy approved by the Board to right-size the Company’s full-line store network and refocus Sears Canada’s retail operations on its core customer base in suburban and smaller/rural locations while growing that business.

51. The Former Directors deny that any of these transactions was entered into for an improper purpose and deny that the divestment of these real estate assets in 2013 had any negative short term or long-term impact on the Company, or in the alternative, could be foreseen to have a long-term negative impact.

52. In fact, these transactions were expected to generate positive results. In September 2013, management presented the 2014 financial and operating plan, with a focus on improving earnings through further cost savings, right-sizing, and targeted capital expenditures. The plan outlined various financial and operational improvements from the implementation of the Transformation Plan in the first half of 2013, including improvements in EBITDA of approximately $19 million (on a comparable basis) and in gross margin rate of approximately 66 basis points year over year.

53. The plan outlined a path, in light of retail market conditions, to achieve EBITDA ranging from 3.9% to 5% of total revenue with more moderate sales growth and projected cost savings initiatives totalling approximately $200 million in various areas of the business, including logistics and cost of goods sold over the next three years. It also incorporated the impact of the divestiture of full-line locations as part of the Company's continued right-sizing. Through the continued implementation of these initiatives, Sears Canada's EBITDA was projected to be $196 million by 2016 rather than the projected negative $105 million without such initiatives.

54. In late September 2013, McDonald resigned as CEO of Sears Canada to take a senior leadership position with a global retailer. He was replaced by Douglas Campbell, the Company's COO, who had particular expertise in retail turnaround and other turnaround projects, including in the manufacturing, consumer packaged goods, chemicals, and pharmaceuticals industries. Sears Canada continued to implement the Transformation Plan and the Project Matrix strategies developed under McDonald's leadership, with necessary adjustments as recommended by Campbell – particularly those focused on cost savings.

APPROVAL OF THE 2013 DIVIDEND

55. The four real estate transactions resulted in total cash consideration of $906 million, and management anticipated that Sears Canada would have cash on hand of approximately $1 billion at the end of fiscal year 2013. As a result, the Board determined in early November 2013 to consider the use of the proceeds, which would include consideration of the financial and operational position of the Company, as well as future needs of the business, as Sears Canada implemented its strategic plan, at the Board meeting scheduled for November 18 and 19, 2013.

56. The process undertaken by the Board leading up to the approval of the 2013 Dividend was robust and consistent with good corporate governance practices. The approval of the 2013 Dividend by the Board was an exercise of informed business judgment.

The Board Was Aware of the Requirements for Declaring Extraordinary Dividends

57. Approximately one year earlier, on December 12, 2012, in the midst of implementing the Transformation Plan, Sears Canada declared an extraordinary dividend of $102 million (the "2012 Dividend"). Prior to the declaration of the 2012 Dividend, Sears Canada had anticipated cash and cash equivalents of approximately $400 million. As of year-end 2012, after paying the 2012 Dividend, Sears Canada had approximately $240 million in cash and cash equivalents.

58. Prior to approving the 2012 Dividend, the Board received a presentation which included an analysis of the impact of a dividend on the Company's financial position, including its liquidity position, cash, EBITDA and total debt, the anticipated cash requirements for operations, and a sensitivity assessment. This presentation reviewed the Board's governance considerations, and summarized the statutory solvency and process requirements, under the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (the "CBCA").

59. The Board also received confirmation from the chief financial officer, following consultation with the Company's auditor, Deloitte, that statutory solvency requirements were met,

and was provided with an officer's certificate certifying that, among other things, there were no reasonable grounds for believing that Sears Canada was, or would be after the payment of the 2012 Dividend, unable to pay its liabilities as they became due.

60. In light of the Board's ongoing dialogue and consideration of the Company's business and operations throughout 2012, including at numerous Board meetings and otherwise, much of the information contained within this presentation was already known to the Board when the presentation was provided.

61. The process undertaken by management and the Board leading up to the declaration of the 2012 Dividend was robust and consistent with corporate best practices. The decision to declare the 2012 Dividend was an exercise of informed business judgment by the Board acting in the best interests of Sears Canada.

The Board Was Fully Informed and Engaged

62. The Board was provided with the information necessary for the consideration of a dividend in 2013, and the decision by the Board to approve the 2013 Dividend was informed by the analyses, presentations, and discussions that occurred during the November 18, 2013 meetings and the informal and formal meetings of the Board and the audit committee of the Board (the "Audit Committee"), which took place leading up to those meetings, and in the course of extensive dialogue among members of the Board.

63. In particular, in advance of the declaration of the 2013 Dividend, the Audit Committee, composed entirely of independent directors, met on February 26, March 14, May 21, August 20, and November 18, 2013. Additionally, in advance of the declaration of the 2013 Dividend, the Board met on January 30, March 14, April 24, April 25, April 29, May 21, June 13, July 16, September 4, September 5, September 23, October 11, October 28, and November 18, 2013.

64. Aside from formal meetings, members of the Board were in frequent contact not only around the scheduled meetings but also on an as-needed basis, and at least once per month. The Board was also informed by the analyses and discussions that occurred at such meetings in advance of the Company declaring the 2013 Dividend and their experience and knowledge regarding practices and processes relating to a decision to declare a dividend.

65. In 2013, the Former Directors received, among other things:

(a) annual operating plans which included detailed cash flow analyses, operating cash requirements, and capital expenditures relating to the ongoing business and the implementation of the Transformation Plan;

(b) regular updates on the financial and operational position of the Company, the status of the implementation of the Transformation Plan – including capital needs required to drive long-term growth in a manner consistent with this strategy, cash flow analyses and cash requirements, debt, and the status of pension funding, including at quarterly Board meetings and on monthly financial update calls; and

(c) regular updates on the implementation of Project Matrix, the divestiture of real estate assets, including at quarterly board meetings, at special purpose board meetings, by e-mail, and at informal Board meetings.

66. In light of the significant amount of information provided to the Board by management, in the summer of 2013 the Board was aware of the cash needs and operational requirements of the Company. In particular, from ongoing monthly and, at times, weekly discussions with management, the Board was aware that all transformation and operating plan projects were adequately funded and that no additional capital could be usefully deployed to enhance these projects and drive long-term growth for the Company.

67. In September, October, and early November 2013, over multiple meetings of the Board, management provided analyses and other details relating to the business and operations of the Company, cash flows, and pending real estate transactions, all of which were discussed and considered by the Board. The financial performance updates in respect of the implementation of the Transformation Plan and annual operating plan provided by management to the Board in that period advised that the Company's EBITDA was improving as compared to the prior year as follows:

(a) regarding the September 2013 financial results, that EBITDA had improved by $2 million compared to September 2012;

(b) regarding the October 2013 financial results, that EBITDA had improved by $5.6 million compared to October 2012; and

(c) regarding the third quarter 2013 financial results, that EBITDA had improved $11.7 million compared to October 2012 on a year-to-date basis and by $19.6 million on a comparable year-to-date basis.

68. As part of the preparation for the Board meeting scheduled for November 18 and 19, 2013, management prepared *pro forma* balance sheet, income statement, and cash flow analyses for the remainder of 2013 and 2014, and analyzed the impact of potential dividend scenarios. Based on these analyses, management determined that the difference between Sears Canada's cash on hand and cash needs to implement its strategic plan resulted in significant excess cash and would allow for a dividend of between $7 and $8 per share, assuming no debt.

69. Crowley did not at that time, or ever, direct management to "move forward" with a dividend. To the contrary, Crowley confirmed that the determination regarding the use of the proceeds would be made by the Board once it had an opportunity to consider and discuss

alternatives for the use of the proceeds at the November Board meeting. Indeed, the Board had previously agreed to consider the appropriate use of excess cash at its meeting in November.

70. In advance of that Board meeting, the Board received and reviewed voluminous materials. In particular, the materials provided to the Board in advance of the Audit Committee meeting, which was attended by the entire Board, included:

(a) the draft third quarter results, MD&A and draft press release, as well as an analysis prepared by management relating to the Company's financial performance, factors relating to the retail sector, and accounting implications of divestiture of real estate assets;

(b) an analysis prepared by Deloitte relating to third quarter 2013 results; and

(c) an analysis regarding pending litigation.

71. In addition, the materials provided to the Board in advance of the Board meeting included:

(a) an analysis outlining management's immediate priorities, including:

(i) building a long term growth strategy by focusing on sustainable growth on a smaller asset base; and

(ii) generating cash from investing activities to create value and fund growth by selling assets deemed to be non-core;

(b) an analysis of asset valuation, which confirmed that there was a substantial core business remaining after the real estate divestitures;

(c) an analysis of operating efficiency, which included a plan to drive excess cost out of the business, allowing Sears Canada to meet 70% of its $200 million savings

target in 2014 and an update on a “90 Day Program”, advising that top opportunities were being pursued that would yield $106 million in annual savings;

(d) an analysis of merchandising value, which included a category performance review, strategies to address gaps in operational performance and strategies to re-build Sears Canada’s value proposition with the goal of clearly and consistently standing for something in the minds of Canadian consumers; and

(e) a financial analysis prepared by the CFO together with the Company’s 2014 Financial Plan, which provided management’s view of the Company’s financial position and cash needs for 2014.

72. Sears Canada’s investment committee also received presentations prepared by Towers Watson and management relating to the registered pension plan (the “Plan”) in advance of the Board meeting, which were relayed to the Board at the meeting, and confirmed:

(a) that the year-to-date return for the Plan was 8.3% and for the third quarter was 2.54%, both of which were above the benchmark for the Plan, while during the third quarter Plan assets had increased on a net basis by $10.2 million; and

(b) that on a going concern basis, the Plan was forecasted to achieve a surplus of $77 million, and that the Plan’s solvency was forecasted to improve by more than 50%.

Declaration of 2013 Dividend: Exercise of Business Judgment

73. On November 18 and 19, 2013, the Board met to review and consider a number of items, including the possible declaration of a dividend. This meeting was held in New York, consistent with the Board’s practice to have periodic meetings in both Toronto and New York.

74. The Board did not decide to authorize the 2013 Dividend at a "short pre-dinner discussion on November 18, 2013", or without receiving any financial analyses or information from management, as alleged. In fact, in advance of the Board meeting, on November 18, 2013, the Audit Committee met to consider a number of matters. All of the members of the Audit Committee were independent directors. Consistent with past practice, all of the Board members attended the Audit Committee meeting. The Company's auditor, Deloitte, also participated in the meeting and an *in-camera* session with the committee members.

75. The presentation provided by management at this meeting indicated that the Company's balance sheet and liquidity position remained strong, with significant cash on hand and no draw downs on the credit facility. The presentation also indicated that Sears Canada had approximately $1.66 billion in current assets, and provided information on real estate transactions completed, including the Oxford, Concord, Montez, and Cadillac Fairview transactions.

76. Additionally, Deloitte delivered a report on November 18, 2013 which noted that it had discussed a number of matters with management, including pending litigation, changes to pension discount rates and the required reserve, and the recent real estate transactions completed by the Company.

77. The real estate divestiture transactions, cash position, capital requirements and funding for turnaround projects, long-term growth, and possibility of declaring a dividend, including the potential amount of the dividend, were discussed by management and the Board during the Audit Committee meeting, with the benefit of the information provided to the Board in advance of and at the Audit Committee meeting.

78. The Board then discussed the potential dividend during the Board meeting held on November 18, 2013, following the Audit Committee meeting. At the Board meeting, the Board, among other things:

(a) received and considered a detailed presentation on management's priorities and asset valuation, including strategies aimed at long-term growth for the Company – all of which were fully funded;

(b) received a sensitivity analysis with respect to the payment of a potential dividend, and discussed and considered the timing and quantum of a dividend in light of the Company's operational and cash position, and the cash that would remain following payment, including in the event that:

(i) the Montez transaction entered into by Sears Canada, which was expected to close in January 2014, did not close; or

(ii) projected revenues and earnings were not achieved;

(c) received and considered a detailed presentation from the CFO regarding the financial and operational position of the Company, future cash requirements, cash flow and liquidity, and the impact of the payment of a dividend of $5 per share on the Company's financial and liquidity position in 2013 and 2014;

(d) received and considered a presentation from the chair of the Board's investment committee regarding the Plan; and

(e) received confirmation from management, following consultation with Deloitte, that the statutory solvency requirements were met and received a certificate of solvency from the CFO prior to approving the 2013 Dividend.

79. All but two of the directors, Campbell and Ron Weissman, were members of the Board when Sears Canada had declared an extraordinary dividend less than one year earlier, after receiving legal advice about their duties in relation to declaring dividends. The Board, which was

composed of highly skilled and experienced corporate directors with expertise in retail, finance, accounting, and law, had significant and specific experience relating to these duties. In addition, the Board had the benefit of the participation of both the general counsel and the assistant general counsel at the Audit Committee and Board meetings.

80. The two directors who were not members of the Board when it approved the 2012 Dividend were, like the other directors, satisfied that the 2013 Dividend was in the best interest of Sears Canada on the basis of the information provided to them in advance of and at the Audit Committee and Board meetings, their discussions with other members of the Board, and the information presented to the Board by management on November 18, 2013.

81. The Former Directors did not have a material relationship with Sears Holdings, ESL, or Lampert which could reasonably have been expected to interfere with their independent judgment in supporting the 2013 Dividend. At all material times, and in particular on November 18, 2013, the Former Directors were not conflicted and exercised their independent judgment with a view to the best interests of Sears Canada in voting to approve the 2013 Dividend.[3] Their historic relationships with Sears Holdings, ESL, and Lampert did not motivate any decisions whatsoever in which they participated as directors of Sears Canada.

82. Additionally, and in any event, the interests of all shareholders with respect to the Company's declaration of the 2013 Dividend were aligned, all shareholders were treated the same, and Sears Holdings, ESL and Lampert had the strongest interest in (and investment in) the ongoing financial and operational success of Sears Canada.

83. The 2013 Dividend was not approved by the Board with undue haste, in an ill-considered manner, or "in concert" with <u>Sears Holdings,</u> Lampert or ESL. Nor was the timing or quantum of

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[3] Although the Former Directors were not considered to be independent under National Instrument 52-110, which relates to independence for the purpose of audit committee membership only, the Former Directors were not members of the Audit Committee.

the 2013 Dividend driven or dictated by Sears Holdings, Lampert or ESL, or their need for funds. The circumstances surrounding the approval of the 2013 Dividend did not raise “red flags”.

84. Indeed, none of the decisions regarding Project Matrix, the divestiture of real estate assets, any other aspect of the Company’s financial and operational plans, or the 2013 Dividend were in any way directed by or related to the financial needs of Sears Holdings, ESL or Lampert. There was no “plan to extract cash from Sears Canada” through the sale of real estate assets devised by Sears Holdings, ESL or Lampert, or at all. Even if there were such a plan, which is denied, the Former Directors were not generally or specifically aware of it, and they were certainly not participants.

85. Rather, the process undertaken by management and the Board leading up to the declaration of the 2013 Dividend was robust and consistent with corporate best practices. Moreover, the decision was an exercise of informed business judgment by the Board acting in the best interests of Sears Canada.

86. On December 6, 2013, the 2013 Dividend was paid *pro rata* to Sears Canada’s shareholders. Sears Canada was not insolvent or near insolvent when the 2013 Dividend was declared or paid and was not rendered insolvent by that payment. On the contrary, following that payment, approximately $513.8 million in cash still remained on Sears Canada’s balance sheet, with virtually no debt, and its operations and plans for the future remained fully funded.

No Dividend in 2014: Exercise of Business Judgment

87. In March 2014, the Board considered the Company’s cash position following the completion of the Montez transaction and the possibility of a further dividend. In particular, the Board reviewed two further dividend scenarios presented by management, valued at $1.50 per share and $2.50 per share, respectively.

88. At that time, the Board received a detailed presentation from management regarding the financial and operating results for the fourth quarter of 2013, the drivers for such results, and various initiatives being undertaken by management to improve performance.

89. Consistent with its approach to the consideration of the 2012 Dividend and the 2013 Dividend, the Board undertook a comprehensive review and consideration of the financial position and the potential impact of various dividend scenarios.

90. Ultimately, the Board decided not to declare a dividend. This decision was not the result of concerns about Sears Canada's long-term viability. Rather, the Board decided not to declare a dividend in early 2014 in light of Sears Canada's unexpected poor performance in the fourth quarter of 2013 and its resulting cash position, which was lower than expected.

91. As with the decision to declare the 2013 Dividend, the decision not to declare a dividend in 2014 was an exercise of informed business judgment by the Board acting in the best interests of Sears Canada.

NO TRANSFER AT UNDERVALUE

92. The 2013 Dividend was not a transfer at undervalue within the meaning of section 96 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (the "BIA"). In any event, neither Sears Canada nor the Former Directors intended to defraud, defeat, or delay any of Sears Canada's creditors, and none were in fact defrauded, defeated, or delayed in connection with the approval or payment of the 2013 Dividend.

Section 96 Does Not Apply

93. Dividends are a return on the investment made by shareholders. Dividends are not by their nature "reviewable transactions" under section 96 of the BIA because the definition of "transfer at undervalue" contemplates a *transaction* where there is no consideration, or where the

consideration received by the debtor is "conspicuously" less than the fair market value of the consideration given by the debtor.

94. Dividends are not transactions of that kind because they are not, and not intended to be by design, an exchange for value at all. Since a corporation never receives consideration (*i.e.* "value") from a shareholder for payment of a dividend, the payment of a dividend cannot take place at "undervalue".

95. Additionally, the concept of "fair market value" required for the application of section 96 of the BIA cannot apply to the declaration and payment of a dividend. The decision as to the amount of a dividend is within the discretion of a corporation's board of directors. There is no "market" for dividends and, therefore, they have no "market value", whether fair or otherwise.

96. Instead, dividends are reviewable pursuant to section 101 of the BIA – titled "Inquiries into Dividends" – which provides that a trustee in bankruptcy (or a monitor in CCAA proceedings) may review and inquire into such dividends where the corporation was insolvent or rendered insolvent by the payment of a dividend within one year of the date of the initial bankruptcy event.

97. Section 101 is the only provision of the BIA that would permit the Plaintiff (as monitor of Sears Canada) to seek to review a dividend declared by the Board in light of Sears Canada seeking protection under the CCAA. However, Sears Canada was not insolvent or rendered insolvent by the payment of the 2013 Dividend and, in any event, such a claim is now statute-barred because the 2013 Dividend was declared more than three and a half years prior to the date of the initial bankruptcy event.

Requirements of Section 96 Not Met

98. Even if dividends could be considered "transfers at undervalue", which is unprecedented and denied, the requirements of paragraph 96(1)(b) are not met.

99. Paragraph 96(1)(b) requires that the “party was not dealing at arm’s length with the debtor”. The 2013 Dividend was declared pursuant to the discretion of the Board acting in the best interests of Sears Canada, without negotiation or other dealings with shareholders, and each of Sears Canada’s shareholders received the same per share dividend. Shareholders were not “dealing” with Sears Canada at all, let alone in a manner that was non-arm’s length.

100. Moreover, even if the concept of “dealing at arm’s length” has applicability to the declaration of a dividend, which is denied, then Sears Canada and the Board dealt at arm’s length with the Company’s shareholders, including Lampert, ESL, and Sears Holdings, in connection with the approval and payment of the 2013 Dividend.

101. Paragraph 96(1)(b) also requires that the debtor – Sears Canada – intend to defraud, defeat, or delay a creditor. In declaring the 2013 Dividend, Sears Canada did not intend to defraud, defeat, or delay its creditors, and did not in fact do so.

102. Although it was not the Former Directors who caused Sears Canada to declare the 2013 Dividend – but instead the Board acting unanimously – the Former Directors did not in any event intend to defraud, defeat, or delay Sears Canada’s creditors in connection with the approval of the 2013 Dividend or otherwise. In fact, in approving the 2013 Dividend, it was the Former Directors’ intention to act in the best interests of Sears Canada, and they did so.

103. Neither the Former Directors, nor the Board generally, had reason to believe in November 2013 that payment of the 2013 Dividend could negatively impact Sears Canada’s creditors. The Company’s creditors continued to be paid for many years thereafter.

104. Additionally, Sears Canada was not insolvent at the time at which the 2013 Dividend was declared or paid, nor was it rendered insolvent by the 2013 Dividend. Rather, the solvency of Sears Canada was specifically confirmed when the 2013 Dividend was declared and it had no

significant debt at that time. In fact, Sears Canada ended fiscal 2013 (the year ending February 1, 2014) in a strong financial position, with:

(a) approximately $514 million in cash and only $35.9 million in debt;

(b) over $1 billion in shareholder equity;

(c) net earnings of $446.5 million (an improvement of approximately $300 million compared to fiscal 2012);

(d) working capital of $567 million ($150 million more than in fiscal 2012), and the generation of $73.3 million in cash through better use of working capital;

(e) $76.8 million less in year-end inventory as compared to the end of fiscal 2012;

(f) $98 million lower operating expenses than in fiscal 2012 (after removing "transformation expenses" which relate primarily to severance); and

(g) $129.7 million lower retirement benefit plan obligations.

105. Indeed, according to Sears Canada's 2013 Annual Report:

> Our financial position as we ended 2013 was strong. We had $513.8 million of cash with no significant debt. In addition, we were undrawn on our credit facility at year-end. Based on our borrowing base and net of outstanding letters of credit of $24.0 million, we had availability under our senior secured revolving credit facility of approximately $374.0 [million] bringing our total liquidity to $887.8 million.

106. It was neither foreseeable nor a "foregone conclusion" on November 18, 2013, as alleged, that Sears Canada would become insolvent nearly four years later. When the Board authorized the 2013 Dividend on November 18, 2013, it was specifically looking to the future of the Company as a going concern by directing the ongoing implementation of the Transformation Plan.

107. At that time, Sears Canada intended to focus on increasing revenue in four priority categories (major appliances, women's apparel, children's wear, and footwear), and to continue to make progress toward its target of cutting $200 million in costs. The materials before the Board in November 2013 indicated that Sears Canada anticipated EBITDA of $135 million in 2014, an increase of $29 million from 2013.

SUBSEQUENT EVENTS

108. Following the approval and payment of the 2013 Dividend, Sears Canada continued to obtain and rely on financial, strategic, and other advice from third party professionals and continued to carry on business in the normal course for three and a half years – until at least June 21, 2017. During that time, management and other employees of Sears Canada operated stores, sold goods, undertook marketing efforts, implemented new initiatives, and made strategic, business, financial, operational, and other decisions.

109. However, after the Former Directors left Sears Canada, the Canadian retail market faced increasingly significant and unpredictable changes and stresses which posed new challenges for the continued successful operation of retailers, including Sears Canada. These events affected all segments of the retail market in Canada, including apparel, house wares, kitchen wares, office supplies, electronics, furnishings, toys, department stores, and jewellery. Numerous prominent retailers operating in Canada became insolvent, ceased operations, restructured, or reduced their footprint in the period immediately preceding Sears Canada's application for CCAA protection.

110. After payment of the 2013 Dividend, while the Former Directors remained on the Board, Sears Canada's Board and management worked to implement strategies in the best interests of Sears Canada and the Company's share price and financial position remained strong. In 2014, the Company's shares traded as high as $17.12 per share and not lower than $8.56 per share.

111. However, after the Former Directors ceased to hold positions on the Board, new management ushered in and oversaw significant shifts in the Company's strategic direction, including with a plan known as "Sears 2.0". In 2016, the Company's shares never traded higher than $7 per share (lower than the low in 2014) and the average trading price was only $3.68 per share. By early 2017, Sears Canada was in a difficult financial position.

112. As late as January 28, 2017, Sears Canada operated 95 full-line department stores, 830 catalogue and on-line merchandise pick-up locations, and 14 outlet stores. At that time, it had current assets of over $1 billion, of which $235.8 million was cash, with shareholder equity in the amount of $222.2 million. However, Sears Canada suffered a sudden, significant, and unexpected decline in early and mid-2017. In that period, cash on hand had fallen to $125.3 million and inventory on hand had increased to $648.1 million from $598.5 million. In addition, as of April 2017, the Company had incurred debt of $125 million under a term loan. By June 5, 2017 it had incurred additional debt of $33 million under a revolving credit facility.

113. Upon filing for CCAA protection, Sears Canada confirmed that the decline in financial performance was the result of market factors causing the decline of other retailers, as well as, among other things:

(a) unsustainable fixed costs from an overly broad retail footprint;

(b) the decline of the catalogue business and lower than expected conversion of catalogue customers to online customers; and

(c) the inability to secure an agreement for the management of credit and financial services operations.

THE ACTION SHOULD BE DISMISSED

114. Sears Canada continued to pay its creditors in the ordinary course, while reducing its overall debt, for many years after the 2013 Dividend was approved. It was not intended to defraud, defeat, or delay Sears Canada's creditors, and it did not do so.

115. The insolvency of Sears Canada, or any harm to its creditors as a result of the insolvency, which harm is denied, did not result from the decisions, actions, or omissions of the Former Directors in 2013. There is no basis in fact or in law for the Plaintiff's claim against the Former Directors, nor any basis for the relief sought against them.

116. The Former Directors claim the right, at law and in equity, to set off against the Plaintiff's claim the full amount of each of their unsecured claims against the estate of Sears Canada filed in the Company's CCAA proceeding.

117. The Former Directors plead and rely on the CBCA, the BIA, the CCAA, and the *Courts of Justice Act*, R.S.O. 1990, c. C.43, and request that this action be dismissed with costs on a substantial indemnity basis.

May 10, 2019

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FTI CONSULTING CANADA INC. Plaintiff -and- ESL INVESTMENTS INC. *et al.* Defendants

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