Court File No. CV-18-00611214-00CL

***ONTARIO***
**SUPERIOR COURT OF JUSTICE**
**COMMERCIAL LIST**

B E T W E E N:

SEARS CANADA INC., by its Court-appointed Litigation Trustee,
J. DOUGLAS CUNNINGHAM, Q.C.

Plaintiff

- and -

ESL INVESTMENTS INC., ESL PARTNERS LP, SPE I PARTNERS, LP, SPE MASTER I, LP, ESL INSTITUTIONAL PARTNERS, LP, EDWARD LAMPERT, EPHRAIM J. BIRD, DOUGLAS CAMPBELL, WILLIAM CROWLEY, WILLIAM HARKER, R. RAJA KHANNA, JAMES MCBURNEY, DEBORAH ROSATI, DONALD ROSS, and SEARS HOLDINGS CORP.

Defendants

# STATEMENT OF DEFENCE OF THE DEFENDANTS EPHRAIM J. BIRD, DOUGLAS CAMPBELL, WILLIAM CROWLEY, WILLIAM HARKER, JAMES MCBURNEY, and DONALD ROSS

1. The Defendants Ephraim J. Bird, Douglas Campbell, William Crowley, William Harker, James McBurney, and Donald Ross deny each and every allegation in the Amended Amended Statement of Claim, except where hereinafter expressly admitted, and deny that the Plaintiff Sears Canada Inc. is entitled to any of the relief sought in the Amended 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 Douglas Campbell, William Crowley, William Harker, James McBurney, Donald Ross, and Ephraim J. Bird (the “Former 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.

4. 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.

5. 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.

6. 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 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.

7. 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 during the Former Directors' respective terms on the Board.

8. The Former Directors complied with their duties and acted in the best interest of Sears Canada in approving the 2013 Dividend. The claim that the Former Directors should now pay $509 million—the amount of the 2013 Dividend—or any other amount to benefit the current creditors of Sears Canada, many of which were not even creditors when the 2013 Dividend was declared, is factually baseless and without legal merit. This action should be dismissed.

## THE PARTIES

### *The Former Directors*

9. The Defendant, Ephraim J. Bird, was a director of Sears Canada from May 2006 until November 18, 2013 and was the lead director of Sears Canada from May 2007 to March 2013. Bird resigned from the Board prior to the approval of the 2013 Dividend (for reasons related to overall Board composition). Bird was also the executive vice-president and chief financial officer of Sears Canada from March 2013 to June 2016. Bird was at all material times a highly

experienced director and officer with significant expertise in the management of retail organizations, investment fund strategy and management, and finance.

10. From 1991 to 2002, Bird was the chief financial officer of ESL Investments Inc. Bird is currently senior vice president and chief financial officer of Sears Hometown and Outlet Stores, Inc. Bird has a Master of Business Administration degree from the Stanford University Graduate School of Business, and he is licensed as a certified public accountant.

11. The Defendant, Douglas Campbell, was a director of Sears Canada from September 2013 to October 2014. In 2011, Campbell joined Sears Canada as an executive vice-president. In 2012, Campbell was promoted to the position of chief operating officer. In September 2013, Campbell succeeded Calvin McDonald as president and chief executive officer of Sears Canada, a position that he held until he resigned in the fall of 2014 for family reasons. Campbell was at all material times a highly experienced director and officer with significant expertise in the management of retail organizations and turnaround strategy.

12. Prior to joining Sears Canada, Campbell was a principal at Boston Consulting Group, where he focused on turnaround matters. Campbell is currently a partner with Harvest Partners, LP, a private equity firm focused on leveraged buyout and growth capital investments in mid-market companies. He has a Master of Business Administration degree in finance from The Wharton School at the University of Pennsylvania. Campbell has never held any position with the Defendant Sears Holdings Corporation ("Sears Holdings") or ESL Investments Inc.

13. The Defendant, William Crowley, 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.

14. 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.

15. 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.

16. Prior to, and concurrent with part of, his tenure on the Board, Harker held management roles with 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.

17. The Defendant, James McBurney, was a director of Sears Canada from April 2010 to April 2015. McBurney was at all material times a highly experienced executive and corporate director with extensive experience in mergers and acquisitions and corporate strategy.

18. Prior to joining the Board, McBurney was the chief executive officer of HCF International Advisers in London, where he focused on strategic advisory and mergers and acquisitions

matters. Prior to that position, he was employed by Goldman Sachs in New York, where he focused on mergers and acquisitions. McBurney is currently an executive in the technology industry. McBurney has a Master of Business Administration degree from the Harvard Business School. McBurney has never held any position with Sears Holdings or ESL Investments Inc.

19. The Defendant, Donald Ross, was a director of Sears Canada from May 2012 to April 2014. Ross was at all material times a highly experienced lawyer with extensive experience in corporate law and corporate governance. From 1988 to August 2013, Ross was a partner at Osler, Hoskin & Harcourt LLP, where he focused on domestic and cross-border mergers and acquisitions and corporate finance and advised senior management and boards of directors on corporate governance matters. Since September 2013, he has held a senior counsel position with the New York office of Covington & Burling LLP.

20. Ross has been recognized for his work by numerous legal publications and organizations including Chambers Global, the Best Lawyers in Canada, the Lexpert/American Lawyer Guide to the Leading 500 Lawyers in Canada, and the IFLR 1000. He has an undergraduate degree from the University of Toronto, a law degree from Osgoode Hall Law School, and a master’s degree from the London School of Economics. He is a member of Ontario and New York bars. Ross has never held any position at Sears Holdings or ESL Investments Inc.

***Rosati and Khanna***

21. To the best of the Former Directors’ knowledge, the Defendant, Deborah E. Rosati, was a director of Sears Canada from April 2007 to August 2018 and the Defendant, R. Raja Khanna, was a director of Sears Canada from October 2007 to August 2018.

***Sears Holdings Corporation***

22. 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 pursuant to Chapter 11 of the *United States Bankruptcy Code*.

***The ESL Defendants***

23. 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").

24. To the best of the Former Directors' knowledge, the Defendant, Edward 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.

25. 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***

26. Sears Canada is a corporation incorporated under the laws of Canada, with its headquarters in Toronto, Ontario. On June 22, 2017, Sears Canada obtained protection under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (the "CCAA").

27. 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**

28. 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.

29. 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.

30. Sears Canada maintained a strong financial position despite economic and retail market conditions and operational challenges. In particular, in 2010, it reduced its debt exposure through the repayment of $300 million of medium-term notes and arranged access to an $800 million credit facility on which it could draw, 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.

31. 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, increased e-commerce and cross-border

shopping, and shifting spending patterns in the baby boomer generation, a key target market for Sears Canada.

**THE TRANSFORMATION PLAN**

32. Beginning in 2011, under the guidance of its new chief executive officer, 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.

33. 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.

34. 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. Sears Holdings, Lampert, and ESL did not take a direct role in developing Sears Canada's business strategy.

35. 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.

36. 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.

37. 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 invested

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

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

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

38. 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 the initiative "Project Matrix".

39. 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

[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.

Holdings, ESL or Lampert as a “plan to extract cash” from Sears Canada. 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.

40. 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 Board. 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.

41. 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 for Sears Canada by increasing demand for space that did not fit within the Company’s business model.

42. 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.

43. 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.

44. 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**

45. 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. Lampert did not direct the negotiating strategy in connection with these transactions.

46. 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]

***The Oxford Transaction***

47. 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.

48. 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.

49. 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 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 exceeded management's estimate of real estate value by approximately $55 million.

***The Concord Transaction***

50. 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.

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

51. Management recommended partnering with Concord, in preference to 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***

52. 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.

53. 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.

54. Management had determined that the five stores that were the subject of the Cadillac Fairview transaction were among the seventeen stores whose real estate value most significantly exceeded trading value, and three of the stores were 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 more than 26.1 times the four-wall trading EBITDA and exceeded management's estimate of real estate value by approximately $158 million.

***The Montez Transaction***

55. 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.

56. 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 amended to show Sears Canada as a tenant and not a landlord.

57. 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***

58. The Board did not approve transactions proposed by management that were inconsistent with the Transformation Plan. 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.

59. 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 did not authorize management to pursue the proposed transaction.

***All Transactions Were Driven by the Transformation Plan***

60. 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 whose 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.

61. 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.

62. 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.

63. 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.

64. In late September 2013, McDonald resigned as chief executive officer of Sears Canada to take a senior leadership position with a global retailer. He was replaced by Douglas Campbell, the Company's chief operating officer, 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

65. 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.

66. In early November 2013, the Board decided that, at its November 18 and 19, 2013 meeting, it would evaluate possible uses of the proceeds while taking into account the financial and operational position of the Company and the future needs of the business, as Sears Canada implemented its strategic plan. Bird, Crowley, Harker and the other Former Directors never treated approval of the 2013 Dividend as a "foregone conclusion".

67. The Board's process 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*

68. 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 expected to have on hand cash and cash equivalents of approximately $400 million. At the end of 2012, after paying the 2012 Dividend, Sears Canada had approximately $240 million in cash and cash equivalents.

69. Prior to approving the 2012 Dividend, the Board received a presentation which included both (i) an analysis of the impact of a dividend on the Company's financial position, including its liquidity position, cash, EBITDA, total debt, and the anticipated cash requirements for operations and (ii) a sensitivity analysis. 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").

70. 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.

71. 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.

72. 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***

73. 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.

74. 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.

75. Aside from formal meetings, members of the Board were in frequent contact not only around the time of 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.

76. In 2013, the Board received, among other things, the following:

(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 at quarterly, special-purpose, and informal Board meetings and by e-mail about the implementation of Project Matrix and the divestiture of real estate assets.

77. 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 sometime 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.

78. In September, October, and early November 2013, during 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 that management provided to the Board about the implementation of the Transformation Plan and annual operating plan demonstrated that the Company's EBITDA was improving as compared to the prior year:

(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.

79. 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 Sears Canada's cash-on-hand substantially exceeded the cash needed to implement its strategic plan, and thus there was sufficient excess cash to permit a dividend of between $7 and $8 per share, assuming no debt.

80. 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 the entire Board attended, included the following:

(a) the draft third quarter results, management discussion and analysis, 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 of pending litigation.

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

(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 so that Sears Canada could achieve 70% of its $200 million savings target in 2014 and an update on a "90 Day Program" stating 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 chief financial officer together with the Company's 2014 Financial Plan, which provided management's view of the Company's financial position and cash needs for 2014.

82. 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 that

(a) 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, and that during the third quarter Plan assets had increased on a net basis by $10.2 million; and

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

***Declaration of 2013 Dividend: Exercise of Business Judgment***

83. 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.

84. 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, on November 18, 2013 before the Board meeting, 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.

85. 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 draws 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.

86. 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.

87. During the Board meeting, with the benefit of information that had been provided to them in advance and at the Audit Committee meeting, management and the Board discussed the real estate divestiture transactions, cash position, capital requirements, funding for turnaround projects, long-term growth, and possibility and amount of a potential dividend.

88. At this meeting, the Board also

(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 and considered a dividend sensitivity analysis 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, 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 chief financial officer 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 chief financial officer prior to approving the 2013 Dividend.

89. 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 input and advice of both the general counsel and the assistant general counsel, who attended the Audit Committee and Board meetings.

90. 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 interests 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.

91. None of the Former Directors had 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 when they voted to approve the 2013 Dividend.[3] Any historic relationships between some of the Former Directors and Sears Holdings, ESL, or Lampert did not in any way affect their decisions as directors of Sears Canada.

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

92. 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.

93. Contrary to the allegations in the Amended Amended Statement of Claim, the 2013 Dividend was not approved by the Board with "undue haste", in an ill-considered manner, or in concert with Sears Holdings, Lampert or ESL. Nor was the timing or quantum of the 2013 Dividend driven or dictated by Sears Holdings, Lampert, or ESL, or their need for funds.

94. 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 was 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 in such a plan.

95. 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.

96. On December 6, 2013, the 2013 Dividend was paid *pro rata* to Sears Canada's shareholders. Sears Canada was not insolvent or nearly 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***

97. 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, respectively, at $1.50 and $2.50 per share.

98. 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.

99. 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.

100. Ultimately, the Board decided not to declare a dividend because of Sears Canada's unexpected poor performance in the fourth quarter of 2013 and its resulting cash position, which was lower than expected. 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.

**DEFENCES TO CLAIMS**

***No Breach of Duty***

101. At all material times, and in particular, in approving the 2013 Dividend, the Former Directors acted honestly and in good faith with a view to the best interests of Sears Canada. They also exercised the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances in approving the 2013 Dividend.

102. The Former Directors complied with their statutory fiduciary duties and their duty of care set out in paragraphs 122(1)(a) and (b) of the CBCA, as well as any common law duties they owed.

103. The Former Directors (and the Board as a whole) were entitled to determine that it was in the best interests of Sears Canada to distribute to shareholders, by declaring a dividend, some or all of the net proceeds of previous divestitures of unneeded real estate assets.

104. The Former Directors (and the Board as a whole) properly discharged their statutory duties in relation to the 2013 Dividend, including by ensuring that the solvency test set out section 42 of the CBCA was met. In particular, in addition to considering the solvency test, the Former Directors (and the Board as a whole)

(a) received and considered extensive information about the performance of Sears Canada and its progress in achieving the goals set out in Project Matrix;

(b) knew that as a result of the divestitures of real estate assets Sears Canada had cash on hand that exceeded its contemplated requirements and, as a result, that the business of Sears Canada would not be impaired by the payment of a dividend; and

(c) specifically obtained a solvency certificate from management confirming the solvency of Sears Canada both before and after the payment of the 2013 Dividend.

105. The Board's decision to approve the 2013 Dividend, based on the information that was available at that time, was an informed exercise of business judgment by the Board, including the Former Directors.

106. Bird was not a director of Sears Canada at the time the 2013 Dividend was approved and did not propose or approve the 2013 Dividend. Bird provided sufficient and adequate information to the Board before it considered and approved the 2013 Dividend.

***No Oppression***

107. The Former Directors did not act in a manner that was oppressive toward Sears Canada or its creditors, or at all. In any event, the Former Directors deny that there is any basis in fact or in law for Sears Canada to claim oppression based upon its own interests and expectations or on behalf of any of its creditors whatsoever.

108. The Former Directors did not owe any duties to existing or future creditors of Sears Canada in the circumstances of the 2013 Dividend, including because the solvency test set out in section 42 of the CBCA was met.

109. In any event, the Former Directors deny that the creditors of Sears Canada had any reasonable expectations that the Board would not declare a dividend in the circumstances. Sears Canada's creditors could not reasonably have expected the Company to hold onto hundreds of millions of dollars in 2013 to hedge against the risk that it might fail three-and-a-half years and be unable to pay creditors. Such expectations, which are denied, are not supported by any legal duty.

110. The Former Directors further deny that they disregarded any reasonable expectations of Sears Canada or its creditors or that they exercised their powers to propose, plan for, prepare, recommend, or authorize the 2013 Dividend in a manner that was unfairly prejudicial, or which disregarded, the interests of Sears Canada and its creditors, which unfairness, prejudice, and disregard is denied.

111. In addition, the Former Directors deny that there is any basis in fact or in law for Sears Canada to claim oppression on behalf of creditors who were not creditors at the time of the 2013 Dividend or who were repaid after the 2013 Dividend was paid. These creditors do not themselves have a claim under section 241(2) of the CBCA. In particular,

(a) creditors who became creditors after the 2013 Dividend have no claim since they were not creditors at the time of the allegedly oppressive conduct and therefore

(i) cannot have had a reasonable expectation in relation to a past event, namely the declaration of the 2013 Dividend;

(ii) extended credit on the basis of Sears Canada's then-existing financial state, which accounted for the 2013 Dividend; and

(iii) cannot have suffered a loss caused by the 2013 Dividend.

(b) creditors who were creditors at the time of the 2013 Dividend but were thereafter repaid suffered no loss and therefore have no claim, even if they extended further credit thereafter since

(i) such further credit was extended taking into account the circumstances of Sears Canada after the 2013 Dividend was paid; and

(ii) any losses resulting from the extension of such further credit could not have been caused by the 2013 Dividend.

112. In any event, the Former Directors determined, in good faith and on reasonable grounds, that the payment of the 2013 Dividend would not impair Sears Canada's business. The decision was an informed exercise of business judgment and, as such, could not have unfairly disregarded the interests of creditors.

***No Conspiracy***

113. The Former Directors did not participate in any conspiracy with the other defendants or any other person to commit an unlawful act that would harm Sears Canada or in connection with the matters raised in the Amended Amended Statement of Claim.

114. In particular, in late 2012 or early 2013, the Former Directors specifically did not agree to effect a "scheme" whereby Sears Canada would sell certain of its important assets and then declare a dividend to distribute the proceeds from the sale to shareholders, and none of the Former Directors participated in such a plan.

115. Nor did the Former Directors breach their statutory duties to Sears Canada, or act in a manner that was oppressive or unfairly prejudicial towards, or that unfairly disregarded, the interests of Sears Canada or its creditors, or commit any unlawful act, in declaring the 2013 Dividend, as alleged or at all.

116. Moreover, the Former Directors did not intend to act to the detriment of Sears Canada, nor did they have any reason to believe that the 2013 Dividend would have a detrimental effect on Sears Canada. Rather, the Former Directors (and the Board as a whole) concluded, in the exercise of their business judgment, that the payment of the 2013 Dividend was in the best interests of Sears Canada.

**NO CAUSATION OF DAMAGES**

117. For three-and-a-half years after the 2013 Dividend, market events and corporate decisions made by management of Sears Canada intervened to shape the ultimate fate of Sears Canada.

118. Following the approval and payment of the 2013 Dividend and until at least June 21, 2017, Sears Canada continued to obtain and rely on financial, strategic, and other advice from new

management and third party professionals and continued to carry on business in the normal course. 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.

119. However, after the Former Directors left the Board, the Canadian retail market faced increasingly significant and unpredictable changes and stresses that 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.

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

121. However, after the Former Directors left the Board, new management ushered in and oversaw significant shifts in the Company's strategic direction, including a plan known as "Sears 2.0". In 2016, the Company's shares never traded higher than $7 per share (*i.e.,* the high in 2016 was 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.

122. 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 fell to $125.3 million and inventory on hand 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.

123. 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.

124. The approval and payment of the 2013 Dividend did not cause Sears Canada's insolvency three and a half years later, or otherwise cause harm to Sears Canada or its stakeholders.

125. In the alternative, even if the 2013 Dividend contributed to the ultimate insolvency of Sears Canada many years later, which is denied, that result was not foreseen, nor reasonably foreseeable, by the Former Directors when the 2013 Dividend was approved by the Board.

**FAILURE TO MITIGATE**

126. Even if Sears Canada or its creditors suffered harm for which the Former Directors are liable, which is denied, Sears Canada has failed to mitigate such damages, including by failing to

deal with its creditors in a manner that would eliminate or lessen such damages and by taking on new debt.

**THE ACTION IS TIME-BARRED**

127. This action is time-barred. The declaration of the 2013 Dividend occurred on November 18, 2013. This action was commenced five years later, more than three years after the expiration of the two-year limitation period under section 4 of the *Limitations Act, 2002*, S.O. 2002, c. 24, Sch. B. (the “Limitations Act”). Contrary to the allegations in the Amended Amended Statement of Claim, the Plaintiff’s claim was discovered or discoverable more than two years before this action was commenced.

**THE ACTION SHOULD BE DISMISSED**

128. 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 (i) to warrant a declaration that the Former Directors breached any of their duties, (ii) to set aside the 2013 Dividend or impose a constructive trust over the funds paid, or (iii) to require the Former Directors to pay the amount of the 2013 Dividend, or some portion of it, to Sears Canada or to anyone else.

129. 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. Even if the 2013 Dividend impacted Sears Canada’s creditors in June 2017, which is denied, only creditors who had advanced credit before the 2013 Dividend could have been impacted. Creditors who advanced credit after the 2013 Dividend did so on the basis of Sears Canada’s financial and operational position and creditworthiness after payment of the 2013 Dividend.

130. 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.

131. There is no basis for any award of damages whatsoever, let alone the punitive damages sought by the Plaintiff.

132. The Former Directors plead and rely on the CBCA, the BIA, the CCAA, the Limitations Act, 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.

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Court File No.: CV-18-00611214-00CL

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

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**COMMERCIAL LIST**

PROCEEDING COMMENCED AT TORONTO

**STATEMENT OF DEFENCE OF THE DEFENDANTS EPHRAIM J. BIRD, DOUGLAS CAMPBELL, WILLIAM CROWLEY, WILLIAM HARKER, JAMES MCBURNEY, and DONALD ROSS**

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