

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

B E T W E E N:

1291079 ONTARIO LIMITED

Plaintiff

- and -

SEARS CANADA INC., SEARS HOLDINGS CORPORATION, ESL
INVESTMENTS INC., WILLIAM C. CROWLEY, WILLIAM R. HARKER,
DONALD CAMPBELL ROSS, EPHRAIM J. BIRD, DEBORAH E. ROSATI, R.
RAJA KHANNA, JAMES MCBURNEY and DOUGLAS CAMPBELL

Defendants

Proceeding under the *Class Proceedings Act, 1992*

STATEMENT OF DEFENCE

1. The defendants R. Raja Khanna (“**Khanna**”) and Deborah E. Rosati (“**Rosati**”) deny the allegations contained in the plaintiff’s fresh as amended statement of claim (“**Statement of Claim**”), unless expressly admitted herein.

Relationship with Sears Canada

2. Sears Canada Inc. (“**Sears Canada**”) is a *Canada Business Corporations Act* (“**CBCA**”) corporation with its head office located in Toronto, Ontario. Sears Canada operated primarily as a department store chain from approximately 1952 until June 22, 2017, when it filed for and obtained protection under the *Companies’ Creditors Arrangement Act* (“**CCAA**”).

3. The defendant Rosati is a resident of Ontario and served as an independent director of Sears Canada from April 26, 2007 until her resignation effective August 14, 2018. She was not a nominee of any of the ESL parties, nor of Sears Holdings Corporation, nor of any other Sears Canada shareholder. She is a Fellow Chartered Professional Accountant and has over 30 years of experience serving in financial, operational, and strategic management and as a director of numerous public and private corporations.

4. The defendant Khanna is a resident of Ontario and served as an independent director of Sears Canada from October 25, 2007 until his resignation effective August 14, 2018. He was not a nominee of any of the ESL parties, nor of Sears Holdings Corporation, nor of any other Sears Canada shareholder. He holds a Bachelor of Laws degree from Osgoode Hall Law School and has over 25 years of experience serving as a director and officer of numerous public and private corporations.

5. In their capacities as directors, Rosati and Khanna received regular updates and projections from Sears Canada's management regarding Sears Canada's business operations and financial situation.

The Hometown Dealer Class Action and Subsequent Oppression Action

6. The plaintiff, 1291079 Ontario Limited, is the representative plaintiff in a class proceeding that it commenced in July 2013 against Sears Canada and Sears, Roebuck and Co.

7. In the 2013 class action, the plaintiff seeks up to \$100 million in damages for breach of contract, negligent misrepresentation, and breaches of various provincial franchise legislation.

8. The action was certified as a class proceeding in September 2014. The class is defined as “all corporations, partnerships, and individuals carrying on business as a Sears Hometown Store under a Dealer Agreement with Sears [Canada] at any time from July 5, 2011 to the date of sending of the notice of certification”.

9. Sears Canada defended the action on the basis that the claims asserted had no merit.

10. Sears Canada never disclosed any contingencies arising from the class action in its public disclosures.

The 2010 to 2013 Dividends

11. From 2010 to 2013, the Board of Directors of Sears Canada (the “**Board**”) unanimously approved the following dividends, which were paid by Sears Canada:

- (a) a dividend of approximately \$376.7 million approved on May 18, 2010 and paid on June 4, 2010;
- (b) a dividend of approximately \$376.7 million approved on September 9, 2010 and paid on September 24, 2010;
- (c) a dividend of approximately \$102 million approved on December 12, 2012 and paid on December 31, 2012; and
- (d) a dividend of approximately \$509 million approved on November 18 and/or 19, 2013 and paid on December 6, 2013.

12. Prior to issuing each of the 2010 to 2013 dividends:

- (a) the Board considered the interests of Sears Canada's various stakeholders, including shareholders, creditors, and debenture holders;
- (b) the Board was informed by Sears Canada's management that Sears Canada had sufficient cash on hand to pay the dividends;
- (c) the Board received a certificate from Sears Canada's management confirming that the declaration and payment of each of the dividends was in compliance with section 42 of the *CBCA*, and in particular, certifying that:
 - (i) there were no reasonable grounds for believing that Sears Canada was, or after the payment of each of the dividends would be, unable to pay its liabilities as they became due;
 - (ii) it is unlikely that Sears Canada would be required to make payment in respect of any contingent liability within a reasonably foreseeable period; and
 - (iii) there were no reasonable grounds for believing that the realizable value of Sears Canada's assets, after giving effect to the payment of the dividend, would be less than the aggregate of Sears Canada's liabilities and the stated capital of all classes;
- (d) the Board reviewed ongoing and detailed disclosure and analysis of the financial position and results of Sears Canada; and

(e) the Board determined that issuing each of the dividends was in the best interests of Sears Canada.

13. Contrary to what is alleged in the Statement of Claim, Rosati and Khanna did not authorize the 2013 dividend without sufficient scrutiny. At the time, Sears Canada had over \$1 billion in cash, and limited debt. Its pension plan had a 95% solvency ratio.

Project Matrix

14. Contrary to what is alleged in the Statement of Claim, Sears Canada did not sell off certain leases as part of a nefarious conspiracy to generate cash to pay a dividend to benefit certain shareholders.

15. Sears Canada sold the leases identified in the Statement of Claim as part of a plan known within the company as “Project Matrix”. The plan involved focusing on smaller suburban markets, where Sears Canada anticipated greater success, and reducing operations in major urban locations, where Sears Canada was struggling.

16. The purported “crown jewel” leases identified in the Statement of Claim were leases for stores that were located in urban centres and were inconsistent with the Project Matrix plan and/or were prime urban locations that were more valuable to Sears Canada as real estate assets than as operating stores.

17. Rosati and Khanna carefully considered each of the lease transactions before approving them based on detailed information from management.

18. Rosati and Khanna exercised their business judgment and acted in the best interests of Sears Canada in approving the lease transactions.

Sears Canada's Performance and CCAA Filing

19. Sears Canada's performance declined in the period following the 2013 dividend, with net losses beginning in 2014.

20. In March 2014, the Board considered and discussed the declaration of another dividend. However, the Board determined not to declare a dividend at that time.

21. Factors contributing to Sears Canada's decline in financial performance in the subsequent period included:

- (a) a general weakening of the traditional Canadian retail industry;
- (b) increased competition in the retail industry from new entrants, the growth of luxury retailers, and the expansion of online sales;
- (c) fixed costs from an overly broad footprint;
- (d) the decline of the Sears Canada catalogue business;
- (e) lower than expected conversion of catalogue customers to online customers;
- (f) the inability to secure an agreement with a financial institution for the management of Sears Canada's credit and financial services operations; and
- (g) the weakening of the Canadian dollar.

22. After a period of declining financial performance due to the factors set out above, Sears Canada became insolvent and filed for and obtained CCAA protection in June 2017.

Business Judgment Rule

23. Rosati and Khanna exercised their business judgment when authorizing the lease transactions and the 2013 dividend. They acted in the best interests of Sears Canada when making those decisions and did not make those decisions to prefer any particular stakeholder over another.

24. The decisions to authorize the lease transactions and the 2013 dividend were reasonable and appropriate at the time those decisions were made. Upon payment of the 2013 dividend, Sears Canada remained readily solvent and had significant cash on hand, with little debt. The market continued to view Sears Canada as a valuable public company.

25. The decisions to authorize the lease transactions and the 2013 dividend are entitled to deference under the business judgment rule.

No Oppression

26. The plaintiff and the class members are not proper “complainants” under section 238 of the *CBCA*.

27. The oppression provisions of the *CBCA* do not permit the plaintiff or class members to be the oppressed persons. Pursuant to section 241(2) of the *CBCA*, the oppressive conduct must be directed to a “security holder, creditor, director or officer” – not a plaintiff with an unproven claim. Accordingly, the claim for oppressive conduct must fail.

28. At the time the 2013 dividend was authorized, the 2013 class action had not even been certified, let alone adjudicated on the merits. Accordingly, contrary to what is alleged in the Statement of Claim, the plaintiff and class members were not creditors of Sears Canada; rather, they were contingent creditors with unliquidated, weak claims that were unlikely to succeed on the merits.

29. The plaintiff and class members did not hold the reasonable expectations alleged in the Statement of Claim. To the extent they held those expectations, it was not reasonable for them to do so in the circumstances.

30. Rosati's and Khanna's actions in authorizing the lease transactions and the 2013 dividend were not oppressive or unfairly prejudicial to and did not unfairly disregard the interests of the plaintiff or the class members.

31. The plaintiff and class members are not entitled to oppression relief as no case for oppression is made out. No reasonable expectations of any valid stakeholder were thwarted, and there is no basis for statutory liability.

No Losses or Damage

32. Rosati and Khanna deny that the plaintiff or class members have incurred losses or damages as alleged in the Statement of Claim, or at all. Alternatively, if the plaintiff or class members did incur any losses or damage (which is expressly denied):

- (a) they are not responsible at law for any such losses or damage;

- (b) any such losses or damages claimed are excessive, exaggerated and/or too remote to be recoverable at law;
- (c) any such losses or damage were not caused by any negligence, act, omission, breach of duty, breach of contract or breach of any other legal obligation on the part of the defendants in fact or in law; and
- (d) the plaintiff and class members have failed to take reasonable or any measures to reasonably mitigate their damages.

33. The defendants Rosati and Khanna claim all rights of legal and equitable set-off that may be available to them.

34. The defendants Rosati and Khanna ask that this action be dismissed, with costs on an appropriate scale.

July 29, 2019

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Plaintiff

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Court File No. CV-19-617792-00CL

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PROCEEDING COMMENCED AT
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