

**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 E. ROSATI, DONALD ROSS and SEARS HOLDING CORP.

Defendants

STATEMENT OF DEFENCE

1. The defendants R. Raja Khanna (“**Khanna**”) and Deborah E. Rosati (“**Rosati**”) deny the allegations contained in the plaintiff’s amended statement of claim (the “**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 2010 to 2013 Dividends

6. 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.
7. 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; and

- (ii) 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.
8. Contrary to what is alleged in the Statement of Claim, Rosati and Khanna did not "rubber-stamp" the 2013 dividend without scrutiny or evaluation. At the time, Sears Canada had over \$1 billion in cash, and limited debt. Its pension plan had a 95% solvency ratio.

Project Matrix

9. 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.
10. 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.

11. 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.

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

13. 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

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

15. 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.

16. 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.

17. 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

18. Rosati and Khanna exercised their business judgment when authorizing the 2013 dividend.

19. The decision to authorize the 2013 dividend was reasonable and appropriate at the time it was 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.

20. The decision to authorize the 2013 dividend is entitled to deference under the business judgment rule.

No Breach of Fiduciary Duty

21. Rosati and Khanna did not breach their fiduciary duties owed to Sears Canada by authorizing the 2013 dividend. Their authorization of the 2013 Dividend was in the best interests of Sears Canada. No such duty was owed to creditors, and in any event no duty was breached.

22. Contrary to what is alleged in the Statement of Claim, Rosati and Khanna did not authorize the 2013 dividend to favour the interests of the “Significant Shareholders” (as defined in the Statement of Claim) or any other particular stakeholder of Sears Canada over the best interests of Sears Canada.

No Breach of the Standard of Care

23. Rosati and Khanna did not breach the standard of care in authorizing the 2013 dividend. They acted honestly and in good faith, and exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances when authorizing the 2013 dividend.

No Oppression

24. The oppression provisions of the *CBCA* do not permit Sears Canada to be the oppressed person. Pursuant to section 241(2) of the *CBCA*, the oppressive conduct must be directed to a “security holder, creditor, director or officer” – not the company itself. Accordingly, the plaintiff’s claim for oppressive conduct towards Sears Canada must fail.

25. Contrary to what is alleged in the Statement of Claim:

- (a) the plaintiff is not a proper “complainant” under section 238 of the *CBCA*;
- (b) Rosati and Khanna did not disregard any reasonable expectation of Sears Canada or other stakeholders, and did not use their powers for the benefit of third parties rather than for the benefit of the company; and

- (c) the authorization of the 2013 dividend by Rosati and Khanna was not oppressive, nor unfairly prejudicial to and did not disregard their interests of Sears Canada and its creditors.

26. Trade and other creditors who extended credit or performed services after November 2013 did so with full knowledge that the 2013 dividend was paid, and of Sears Canada's publicly disclosed financial position.

27. The plaintiff is not entitled to oppression relief under the *CBCA* 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. The plaintiff fails to sufficiently identify the reasonable expectations of particular classes of creditors on which it relies.

No Conspiracy

28. Rosati and Khanna deny that there was any conspiracy surrounding the 2013 dividend as alleged in the Statement of Claim.

29. As set out above, Rosati and Khanna did not breach their fiduciary duties or the standard of care and did not engage in oppressive conduct. Accordingly, contrary to what is alleged in the Statement of Claim, they engaged in no unlawful means to carry out any alleged conspiracy.

30. Rosati and Khanna were not involved in any agreement in late 2012 and early 2013, or at any other time, amongst Lampert, Crowley, Harker, and Bird, to sell Sears Canada's assets and distribute the bulk of the proceeds to Sears Holdings and ESL. They are not aware of any such agreement.

31. Rosati and Khanna did not agree with Lampert in fall 2013, or at any other time, to authorize the payment of the 2013 dividend by Sears Canada for the benefit of Sears Holdings, ESL, and Lampert.

The Claim is Limitations Barred

32. On January 20, 2014 – less than two months after the 2013 dividend was paid – counsel to beneficiaries of Sears Canada’s pension plan sent a letter to Sears Canada’s counsel and to each of the Board members at the time, including Rosati and Khanna, alleging that the payment of the 2013 dividend was unlawful and setting out the material facts that form the basis for the claim now asserted by the plaintiff.

33. On October 21, 2015, a putative class action was commenced by a Sears Hometown retailer against Sears Canada, Rosati, Khanna, and other defendants (including the Board at the time of the 2013 dividend and ESL Investments Inc., who are all defendants in this action) alleging that it and the putative class members were oppressed by the payment of the 2013 dividend. The material facts alleged in the Statement of Claim in that action are substantially the same as the material facts alleged by the plaintiff in this action.

34. The plaintiff commenced this action in December 2018 – five years after the payment of the 2013 dividend, almost five years after the January 2014 letter referred to above, and about three years after the October 2015 class action was commenced.

35. The plaintiff commenced this proceeding more than two years after the day on which the person(s) with the claim discovered the claim or on which a reasonable person with the abilities and in the circumstances of the person(s) with the claim first ought to have discovered the claim.

36. The plaintiff's claim is statute-barred by the two-year limitation period set out in section 4 of the *Limitations Act, 2002* (Ontario).

No Losses or Damage

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

- (a) They are not responsible at law for any such losses or damages;
- (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 has failed to take reasonable or any measures to reasonably mitigate its damages.

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

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

July 29, 2019

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J. DOUGLAS CUNNINGHAM, Q.C.
Plaintiff

ESL INVESTMENTS INC. et al.

Defendants

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

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PROCEEDING COMMENCED AT
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