

Court File No. CV-19-00614629-00CL

**PAYLESS SHOESOURCE CANADA INC. and
PAYLESS SHOESOURCE CANADA GP INC.**

**SUPPLEMENT TO THE FIFTH REPORT OF FTI CONSULTING CANADA
INC., AS MONITOR**

September 17, 2019

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

**IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,
R.S.C. 1985, c. C-36, AS AMENDED**

**AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF
PAYLESS SHOESOURCE CANADA INC. AND PAYLESS SHOESOURCE CANADA
GP INC.**

**SUPPLEMENT TO THE FIFTH REPORT TO THE COURT
SUBMITTED BY FTI CONSULTING CANADA INC.,
IN ITS CAPACITY AS MONITOR**

A. INTRODUCTION

1. On September 12, 2019, the Monitor filed its Fifth Report to the Court (the "**Fifth Report**") in relation to the relief sought by the Payless Canada Entities at a hearing scheduled for September 17, 2019. The Fifth Report noted that the Monitor intended to file a supplemental report to summarize and comment on the proposed CCAA Plan. This is that supplemental report (the "**Supplemental Report**").

B. PURPOSE

2. The purpose of this Supplemental Report is to provide the Court with the Monitor's comments and/or recommendations regarding:
 - (a) an update in respect the Second Amended U.S. Plan (as defined below); and
 - (b) the Payless Canada Entities' Plan of Compromise and Arrangement (the "**CCAA Plan**") dated September 17, 2019.

C. TERMS OF REFERENCE

3. In preparing this Supplemental Report, the Monitor has relied upon audited and unaudited financial information provided by the Debtors, including their books and records, financial information, forecasts and analysis, in addition to discussions with various parties,

including senior management ("**Management**") of, and advisors to, the Payless Canada Entities, the other Debtors, and Ankura (collectively, the "**Information**").

4. Except as otherwise described in the Supplemental Report:
 - (a) the Monitor has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of the Information in a manner that would comply with Generally Accepted Assurance Standards pursuant to the Chartered Professional Accountants of Canada Handbook; and
 - (b) the Monitor has not examined or reviewed the financial forecasts or projections referred to in the Supplemental Report in a manner that would comply with the procedures described in the Chartered Professional Accountants of Canada Handbook.
5. Future-oriented financial information reported in or relied on in preparing the Supplemental Report is based on Management's and Ankura's assumptions regarding future events. Actual results will vary from these forecasts and such variations may be material.
6. The Monitor has prepared this Supplemental Report in connection with certain relief originally sought in connection with the September 17 Motion and now scheduled to be heard on September 19, 2019 at 9:15am. The Supplemental Report should not be relied on for any other purpose.
7. Unless otherwise stated, all monetary amounts contained herein are expressed in Canadian Dollars.
8. Capitalized terms not otherwise defined herein have the meanings ascribed to them in the Frankum Affidavit (as defined in the Fifth Report), the Marotta Affidavit (as defined below), the Meetings Order, the Pre-Filing Report, the First Report, the Second Report, the Third Report, the Fourth Report and/or the Fifth Report, as applicable.

D. UPDATE IN RESPECT OF THE SECOND AMENDED U.S. PLAN

9. As described in the Affidavit of Stephen Marotta sworn September 17, 2019 (the "**Marotta Affidavit**"), the Monitor understands that the U.S. Debtors have further amended the U.S. Plan and the U.S. Disclosure Statement (the "**Second Amended U.S. Plan**" and the "**Second Amended Disclosure Statement**", respectively). Copies of the Second Amended U.S. Plan and Second Amended U.S. Disclosure Statement are included as Exhibit "B" and Exhibit "C", respectively, to the Marotta Affidavit.
10. The Marotta Affidavit also attaches an information memorandum (the "**Information Memorandum**") which is intended to provide creditors of the Payless Canada Entities with a summary regarding the CCAA Proceedings and the Chapter 11 Proceedings and the impact of the Second Amended U.S. Plan on the CCAA Plan and creditors of the Payless Canada Entities. The Information Memorandum is included as Exhibit "D" to the Marotta Affidavit.
11. As described in more detail in the Marotta Affidavit, the Monitor understands that the Second Amended U.S. Plan provides for distributions to stakeholders as follows:
 - (a) Administrative Claims (post-filing claims entitled to priority under U.S. law), Other Priority Claims (claims entitled to priority) and Other Secured Claims (mostly, claims secured by cash deposits or letters of credit), will be paid in full in cash.
 - (b) Term Loan Lenders holding Tranche A-1 Term Loan Secured Claims will receive their *pro rata* share of US\$68,800,000 in cash (an increase of approximately US\$1.8 million from the prior version filed) and will waive any distributions in respect of related deficiency claims.
 - (c) Term Loan Lenders holding Tranche A-2 Term Loan Secured Claims can elect to receive their *pro rata* share of common ownership units in the reorganized Payless Holdings LLC, or cash in the amount of 10% of their allowed tranche A-2 claims, and in either case, will waive any distributions in respect of related deficiency claims.

- (d) General Unsecured Creditor recovery has been revised to reflect the global settlement with the Official Committee of Unsecured Creditors including:
 - i. General Unsecured Creditors of Payless ShoeSource Worldwide, Inc. and Collective Brands Logistics Limited (Class 5A) ("**Class 5A General Unsecured Creditors**") will receive their *pro rata* share of US\$8.4 million, plus certain unused amounts currently designated for professional fees; and
 - ii. General Unsecured Creditors of all other U.S. Debtors (Class 5B) ("**Class 5B General Unsecured Creditors**"), will receive their *pro rata* share of US\$5.1 million, plus certain unused amounts currently designated for professional fees (less the Canadian GUC Amount of US\$900,000);
 - (e) Intercompany claims will be reinstated or cancelled as determined by the U.S. Debtors and the Requisite Plan Support Parties, and with respect to the Payless Canada Entities, with the consent of the Payless Canada Entities;
 - (f) Intercompany equity interests will be reinstated or cancelled as determined by the U.S. Debtors and the Requisite Plan Support Parties; and
 - (g) Equity interests in Payless Holdings LLC will be cancelled for no consideration.
12. The fixed amount for distribution to the general unsecured creditors of the Payless Canada Entities is US\$900,000 (being referred to as the "**Canadian GUC Amount**"), which the Monitor understands will be converted to Canadian dollars in the amount of \$1,183,500.00 (using the exchange rate of 1.315).
13. The Payless Canada Entities, as guarantors, are indebted to the Term Loan Lenders in the aggregate amount of US\$277.2 million as of the Filing Date under and in respect of the Terms Loan Credit Facility. The Monitor has received an opinion from its independent counsel that, subject to the typical assumptions and qualifications, the security in respect of the Terms Loan Credit Facility is valid and enforceable. Since all, or substantially all, of the Payless Canada Entities' assets are subject to liens of the Terms Loan Lenders (who will not be paid in full), the Canadian GUC Amount is a "gift", which the Terms Loan Lenders advise would not be available in a bankruptcy.

14. The Class 5A General Unsecured Creditors will receive a distribution larger than the Class 5B General Unsecured Creditors because Payless ShoeSource Worldwide, Inc. and Collective Brands Logistics Limited have certain additional unencumbered assets to support a higher distribution to unsecured creditors of those entities.
15. The Monitor is of the view that the unsecured creditors of the Payless Canada Entities are similarly situated to the Class 5B General Unsecured Creditors, and as such should be treated equitably with the Class 5B General Unsecured Creditors.
16. As described in the Marotta Affidavit, the U.S. Debtors and the Payless Canada Entities, with the assistance of the Monitor, compared the total amount of claims asserted in the Chapter 11 Claims Process and in the CCAA Proceedings pursuant to the Claims Procedure Order. Although a formal claims reconciliation process has not yet been undertaken in either jurisdiction, solely for purposes of this analysis:
 - (a) all suspected duplicate claims, including claims filed against the Payless Canada Entities which were properly considered to be filed against the U.S. Debtors, were eliminated;
 - (b) all unliquidated claims were estimated at zero;
 - (c) all intercompany claims were disregarded;
 - (d) the restructuring period claim in respect of each Canadian Lease was calculated under the landlord formula provided for in the United States Bankruptcy Code, which limits landlord claims to the greater of one lease year or 15 percent, not to exceed three years, of the remaining lease term plus any pre-filing amounts owed; and
 - (e) all other claims were assumed allowed in full in the amounts set out in the U.S. schedules, the U.S. proofs of claim, the Claim Statements, the Amended Claim Statements or the Proofs of Claim.
17. Based on this analysis, the U.S. Debtors and the Payless Canada Entities, with the assistance of the Monitor, estimated that the recovery to unsecured creditors of the

applicable U.S. Debtors and the recovery (on a *pro rata* basis) to unsecured creditors of the Payless Canada Entities would be approximately 3.2%, subject to further reconciliation and finalization of Claims.

E. THE CCAA PLAN

18. The Monitor had input into the development of the CCAA Plan, has reviewed it, and is of the view that it is appropriate and reasonable for the Payless Canada Entities to seek the approval of the CCAA Plan by affected creditors at this time. A copy of the CCAA Plan is included as Exhibit "A" to the Marotta Affidavit.

Classification of, and Distributions to, Affected Creditors

19. As described in the Fifth Report and the Marotta Affidavit, the CCAA Plan provides for two (2) classes of voting under the CCAA Plan: (i) the General Unsecured Creditor class and (ii) the Landlord class.
20. It is proposed that each General Unsecured Creditor with a Proven Claim will receive a distribution in an amount equal to its *pro rata share* of the General Unsecured Pool. It is estimated that each General Unsecured Creditor will receive a recovery of approximately 3.2% of its Proven Claim subject to further reconciliation and finalization of Claims. With respect to Landlords, the CCAA Plan provides that each Landlord will receive the lesser of:
- (a) \$3,840.00 per Lease (provided that if there are multiple Landlords per Lease, only one payment of \$3,840.00 shall be made); or
 - (b) the amount asserted in the Landlord's Notice of Dispute of Claim Statement or Proof of Claim, or if no Notice of Dispute of Claim Statement or Proof of Claim was filed, then the amount in the Landlord's Claim Statement.
21. A summary of the Claims filed pursuant to the Claims Procedure Order was provided in the Fifth Report. The Landlords are cumulatively the largest unsecured creditor group of the Payless Canada Entities. To date, the Monitor has received 254 Notices of Dispute of Claim Statement from the Landlords. As described in the Marotta Affidavit, because of the

relatively modest pool of funds available for unsecured creditors in Canada and the difficulty in reconciling Landlord Claims, the CCAA Plan proposes a fixed recovery per Landlord Claim. If the Payless Canada Entities and/or the Monitor were required to reconcile each Landlord Claim, including reviewing the specific terms of each relevant lease and the Landlord's efforts to mitigate damages, the Monitor believes that most (if not all) funds that would otherwise be available for distribution to unsecured creditors would be spent on professional fees. Fixing the recovery in respect of Landlord Claims allows the Payless Canada Entities and the Monitor to undertake a much more limited review of such Claims, which in turn, reduces professional costs and returns more value to unsecured creditors. The Monitor believes that this approach is appropriate and reasonable in the unique circumstances of this case, particularly the fixed Canadian GUC Amount available and relatively modest estimated recovery.

22. The Monitor is of the view that the fact that the Claims of Landlords and General Unsecured Creditors are being treated differently (although equitably) under the CCAA Plan justifies two separate voting classes.
23. The Payless Canada Entities and the Monitor arrived at the estimated distribution of \$3,840.00 per Lease by examining the estimated percentage recovery to General Unsecured Creditors and Landlords under various scenarios.
24. The Monitor is of the view that the quantum of the proposed fixed distribution to Landlords is appropriate in the circumstances because:
 - (a) it is subject to reduction if the amount asserted in the Landlord's Notice of Dispute of Claim Statement, or, in the Landlord's Claim Statement if no Notice of Dispute of Claim Statement was filed, is less than \$3,840.00;
 - (b) based on current estimates, it will result in an estimated recovery to General Unsecured Creditors of approximately 3.2% subject to further review and finalization of Claims, which is consistent with the current estimated recovery for Class 5B General Unsecured Creditors under the Second Amended U.S. Plan; and

- (c) subject to any reduction referred to in (a) above, based on current estimates, it will result in a recovery to Landlords of approximately 3.2% based on how their claims would be calculated under the United States Bankruptcy Code, which is consistent with the current estimated recovery for landlords who are Class 5B General Unsecured Creditors.
25. The Monitor recognizes and acknowledges that under the CCAA, Landlord Claims are not to be calculated based on the formula set out in the United States Bankruptcy Code. However, given the unique circumstances of this case, as discussed above, the Monitor believes it is fair and appropriate to consider what Landlords would have received under the United States Bankruptcy Code in determining the appropriate distribution for the Landlords.
26. The Monitor has been very focused on ensuring that unsecured creditors of the Payless Canada Entities are treated equitably with similarly situated unsecured creditors of the U.S. Debtors, and the Monitor believes that has been achieved in the CCAA Plan. The Monitor notes that the Payless Canada Entities are U.S. Debtors and as such, any Canadian GUC Amount contemplated under the CCAA Plan ought to be equivalent to what they would have otherwise received under the U.S. Plan.
27. Pursuant to the terms of the CCAA Plan, no distributions will be made to Landlords or General Unsecured Creditors until documentation in form and content satisfactory to the Payless Canada Entities, the Supporting Term Loan Lenders and the Monitor (the "**Comfort Letter**") is received from the applicable Governmental Entity authorizing the Monitor to make the distributions, disbursements, or payments without any liability to any of the Payless Canada Entities, the Monitor, or each of their respective Directors, Officers, employees or agents in respect of the ITA, *Excise Tax Act*, and any other legislation pertaining to Taxes is received. The CCAA Plan provides that in the event the Comfort Letter is not received by December 31, 2019, the Payless Canada Entities may seek further directions from the Court.
28. The Monitor is of the view that receipt of the Comfort Letter prior to making distributions is necessary in order to eliminate the risk of any potential tax-related liability that could

arise in connection with the distributions to be made to the General Unsecured Creditors and the Landlords.

29. The CCAA Plan provides that further information regarding the treatment of Intercompany Claims will be provided in the Plan Supplement (which is described below).

Reserves

30. The CCAA Plan contemplates the creation of certain reserves (collectively, the "**Reserves**") in respect of Priority Claims and Claims that are required to be paid by Court order. In particular, the CCAA Plan provides for:
 - (a) an Administrative Reserve, which will hold the estimated costs of administering the CCAA Plan;
 - (b) a Directors' Claim Reserve, which will hold amounts secured by the Directors' Charge until applicable Claims have been resolved or paid;
 - (c) Priority Claim Reserve, which will hold amounts necessary to pay any Crown Priority Claims or Employee Priority Claims that remain unpaid; and
 - (d) a Post-Filing Claim Reserve, which will include an amount to pay for any unpaid Post-Filing Claims as estimated by the Monitor prior to implementation.
31. The Reserves will be subject to the security of the Term Loan Agent.
32. The CCAA Plan provides that the amount of the Reserves will be set out in the Plan Supplement, which must be acceptable to the Payless Canada Entities, the Monitor and the Supporting Term Loan Lenders.
33. To the extent that a Claim may be payable from more than one Reserve, the Monitor understands that the Payless Canada Entities will only reserve for such Claim once. To the extent that the Payless Canada Entities or the Monitor determine (with the consent of the other party) that there are funds in any Reserve sufficiently in excess of the amount required to fund payments that may be required to be made from such Reserve, the Payless Canada

Entities, with the consent of the Monitor and in consultation with the Term Loan Lenders, may transfer such excess funds to another Reserve.

34. To the extent that the Payless Canada Entities or the Monitor determine, with the consent of the other party, that there are insufficient funds in any Reserve to fund payments that may be required to be made from such Reserve, no excess amounts from any other Reserves will be distributed to the Payless Canada Entities without ensuring that sufficient funds are added to the applicable Reserve.
35. In the event that a dispute arises in respect of the Reserves, the parties to such dispute may seek a further order of the Court.
36. The Monitor intends to report on the Reserves in a further report to Court once they are determined.

Releases

37. The CCAA Plan contains broad releases of the Payless Canada Entities, the Term Loan Agent, the Term Loan Lenders and the Monitor, and each of their respective directors, officers, agents, professionals and certain other parties. The Monitor notes that the releases specifically do not release:
 - (a) the Payless Canada Entities and their respective assets, undertaking and properties from any Unaffected Claim that has not been paid in full under the CCAA Plan or the Plan Supplement to the extent of such non-payment;
 - (b) a Released Party (as defined below) from its obligations under the CCAA Plan or the Plan Supplement;
 - (c) subject to provisions in the CCAA Plan pertaining to insurance, a Released Party found by a court of competent jurisdiction by final determination on the merits to have committed fraud or willful misconduct in relation to a Released Claim for which it is responsible at law; or
 - (d) subject to provisions in the CCAA Plan pertaining to insurance, the Directors from any Claims which have been preserved in accordance with the Claims Procedure

Order that cannot be compromised due to the provisions of Section 5.1(2) of the CCAA. To the extent not released, the proposed Sanction Order will limit recovery for such claims against the Directors to available insurance.

38. The breadth and scope of the releases were developed by the Payless Canada Entities with input from the Monitor. The Monitor notes that all of the parties benefiting from the proposed releases under the CCAA Plan (each a "**Released Party**" and collectively, the "**Released Parties**") have played a significant role in the Payless Canada Entities' CCAA Proceedings. The Monitor also understands that the releases being sought by the Payless Canada Entities are critical to the Released Parties' support of the CCAA Plan.

Conditions to Implementation of CCAA Plan

39. The Monitor notes that there are a number of conditions to the implementation of the CCAA Plan that must be satisfied or waived, each of which is set out below:
- (a) the CCAA Plan must be approved by the Required Majorities;
 - (b) the Court must grant the Sanction Order, the operation and effect of which must not be stayed, reversed or amended, and in the event of an appeal or application for leave to appeal, final determination must be made by the appellate court;
 - (c) the Reserves and the Affected Creditor Distribution Account must be funded by the Payless Canada Entities;
 - (d) the U.S. Proceedings with respect to the Payless Canada Entities must be dismissed;
 - (e) the U.S. Plan must be effective;
 - (f) the Monitor must receive written confirmation from the Term Loan Agent/Supporting Term Loan Lenders that the Supporting Term Loan Lenders are satisfied with:
 - i. the treatment of the Post-Filing Intercompany Loans,
 - ii. the form and substance of the Plan Supplement; and

- iii. all variations and modifications of, and amendments and supplements to the Plan, the Plan Supplement and the Sanction Order, to and including the Implementation Date; and
 - (g) the Implementation Date must occur no later than the Outside Date.
40. The condition in (e) above may not be waived without the consent of the Supporting Term Loan Lenders, and the condition in (f) above may only be waived by the Supporting Term Loan Lenders.

Plan Supplement

41. The Payless Canada Entities, the Monitor and the Supporting Term Loan Lenders are continuing to consider the technical steps required to implement the CCAA Plan and the most efficient way to distribute funds in respect of the Term Loan Claims outside of the CCAA Plan. The Monitor expects that the determination of such steps will not impact Affected Creditors' recoveries, but will be necessary to quantify the Reserves. Additionally, given that the Term Loan Claims are Unaffected Claims under the CCAA Plan, the determination of such steps will also be necessary to quantify and determine the mechanics in respect of the distributions to be made to the Term Loan Claims outside of the CCAA Plan.
42. The proposed Meetings Order contemplates that the Payless Canada Entities file a Plan Supplement no later than five (5) Business Days prior to the Creditors' Meetings (or such other date as may be agreed to by the Monitor) providing such additional information in respect of the CCAA Plan. The Plan Supplement will be served on the Service List and posted on the Monitor's Website.
43. The Plan Supplement will be in form and substance acceptable to the Payless Canada Entities, the Monitor and the Supporting Term Loan Lenders.

F. CONCLUSION

44. The Monitor believes that the CCAA Plan should be accepted for filing and should be put out for a vote at the Creditors' Meetings as:

- (a) The CCAA Plan was negotiated at arm's length, in good faith between the Payless Canada Entities and its stakeholders, with significant input and oversight from the Monitor;
 - (b) It is reasonable for the CCAA Plan to be subject to approval by two classes of creditors, being:
 - i. the General Unsecured Creditor class; and
 - ii. the Landlord class;
 - (c) In the Circumstances, the CCAA Plan represents the best possible recovery for Affected Creditors; and
 - (d) The recoveries for General Unsecured Creditors and Landlords are expected to be commensurate with similarly situated creditors of the U.S. Debtors;
45. For the reasons stated in the Fifth Report and this Supplemental Report, the Monitor supports the relief sought by the Payless Canada Entities in connection with the September 17 Motion.

The Monitor respectfully submits to the Court this, its Supplemental Report.

Dated this 17th day of September, 2019.

FTI Consulting Canada Inc.,
solely in its capacity as Monitor of Payless ShoeSource Canada Inc.,
Payless ShoeSource Canada GP Inc. and Payless ShoeSource Canada LP,
and not in its personal capacity



Greg Watson
Senior Managing Director



Paul Bishop
Senior Managing Director