

Peaks and valleys: MEC's struggle to survive in a hostile retail market

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On Oct. 28, 2020, the Supreme Court of British Columbia (the Court) released its written reasons for previously allowing the board of directors (the Board) of Mountain Equipment Co-operative (MEC) to proceed with a sale of the co-operative despite pushback from some stakeholders (the MEC Decision).¹ Notwithstanding the transaction's completion, a community group of members of MEC, with the support of several public interest groups, has sought leave to navigate uncharted terrain at the Court of Appeal for British Columbia.

Governance structure of cooperatives

MEC is an association incorporated under the *Cooperative Association Act* (British Columbia) (the Co-op Act).² Unlike legislation that governs corporations and other business associations, the Co-op Act provides for the registration, incorporation, and inspection of enterprises whose primary purpose is to provide services to members on a cooperative basis.³ A co-operative operates on a co-operative basis if it is substantially organized, operated, and administered on the principals and methods listed in section 8(2) of the Co-op Act. Examples of such principals and methods include:

- Membership in the association is open in a non-discriminatory manner;
- Surplus funds are used for the purpose of: (i) Developing the association; (ii) Providing or improving services to members; and (iii) Community welfare or the proration of cooperative enterprise; and
- Education is provided on the principles and techniques of the cooperative enterprise.⁴

In this regard, a co-operative may, depending on the nature of its purpose(s), overlap with certain features of British Columbia's new "benefit corporations".

MEC is Canada's largest supplier of outdoor equipment and known for its commitment to environmental protection. As described in its *Memorandum of Association* (the MEC Memorandum), MEC's purpose is:

- Designing, manufacturing, purchasing, selling and renting products for self-propelled wilderness oriented recreational activities;

- Marketing goods and services produced or supplied by members; and
- Any business which may conveniently be carried on in connection with those businesses.

As a co-operative, the governance structure of MEC is unique to most large retailers who typically structure themselves as corporations.⁵ In principle, co-operatives such as MEC are democratic organizations controlled by their members. These members may actively participate in policy development and decision-making processes of the co-operative.⁶ As of Oct. 28, 2020, MEC had approximately 5.8 million members, each having paid a \$5 lifetime membership fee, and in return, receiving one membership share. The membership share attaches the right to shop at MEC and participate in its governance as a co-operative member, including the right to vote at general meetings and special resolutions (e.g. a sale of the business/undertaking). In addition, a member of MEC may receive patronage shares in proportion to the amount spent by him/her in purchasing goods or services from MEC so that a member's overall share balance may grow. Similar to the issuance of dividends, MEC has issued 16 share redemptions and returned \$35 million to its members during the period of 1971 to 2017. Since 2017, however, due to financial hardship and liquidity issues, MEC has not issued any share redemptions.

MEC's financial troubles and attempts to resolve them

In 2015, MEC initiated a significant growth plan by expanding the number of its retail stores and product offerings. This growth strategy was successful from the standpoint of market penetration and expansion; however, the commitments to new retail stores resulted in a higher fixed-cost structure and increased debt levels. To illustrate, net operating losses of MEC are \$80 million for the period since 2017.

The issues arising from increased costs, debt load, and liquidity strains continued into 2020, as evident in the fiscal year ending Feb. 23, 2020 – MEC experienced a net loss of approximately \$22.7 million. Between February and March 2020, MEC took steps to address its financial difficulties by appointing a new management team to focus on cost reduction and a return to profitability. MEC engaged Alvarez and Marsal Canada Securities (ULC) and created a special committee, comprised of three members of the Board (the Special Committee) to make recommendations on strategic alternatives.

Lockdowns due to the COVID-19 pandemic were at their peak while the Special Committee was brainstorming solutions. The BC Registries and Online Services, granted business associations, including co-operatives, a six-month extension to hold their annual general meetings.⁷ MEC, as many organizations did, decided to postpone its annual general meeting, originally scheduled in June 2020, to Dec. 10, 2020. The result of this decision to delay the annual general meeting meant that the Board did not inform stakeholders, particularly its members, of the Special Committee's formation and its recent activities.

Negotiations with MEC's Lenders (as defined below) occurred and the Special Committee considered other creative solutions such as seeking support from its members. On June 10, 2020, initiatives to address the financial difficulties led to the implementation of a sale and investment solicitation process (the SISP). The Special Committee established guiding principles in the design of the SISP to:

- Provide maximum value to the broad stakeholder group;
- Preserve the maximum number of store locations and jobs; and
- Ensure that, if possible, the buyer preserve MEC's purpose, values and outreach programs.

After 100 days of submissions, discussions, negotiations and analysis, including interest from over 150 parties, the Special Committee settled on four final bids.

On Sept. 11, 2020, MEC entered into an asset purchase and sale agreement (the APA) to sell substantially all of MEC's assets to 1266524 B.C. Ltd., a Canadian subsidiary owned by Kingswood Capital Management LP⁸ through various funds, for a base purchase price of \$120 million (subject to purchase price adjustments therein).

At this time, MEC owed:

- Approximately \$4.6 million in rent deferrals or arrears in respect of its leases;
- Significant past due amounts to merchandise suppliers and other vendors; and
- Approximately \$74 million under its credit facility (the Credit Agreement) with a syndicate led by Royal Bank of Canada (RBC), as agent on behalf of the lenders thereto (the Lenders).⁹

The Credit Agreement was set to mature on Sept. 30, 2020. MEC had insufficient cash-on-hand to pay upon the maturity date and RBC formally notified MEC of defaults under the Credit Agreement. The APA, supported by the Lenders, was the chosen solution to resolve MEC's liquidity issues. Pursuant to the terms and conditions of the APA, Kingwood agreed to:

- Continue to operate the business as a going concern under a similar name to MEC and maintain the goodwill of the retail business;
- Retain at least 75 per cent of the active employees of MEC;
- Acquire, or assume, the leases for at least 17 of MEC's retail locations;
- Assume liabilities including with respect to warranties, existing gift cards (estimated \$13.2 million) and employees who accept offers of employment (estimated \$2 million);
- Assume liability for payments to certain inventory and other key vendors and suppliers (estimated \$25 million) and seek assignment of certain contracts; and
- Payout of all of MEC's debt obligations under the Credit Agreement.

Three days later, on Sept. 14, 2020, MEC sought and obtained an initial order for relief pursuant to the *Companies' Creditors Arrangement Act* (the CCAA, the related proceedings thereto, the CCAA Proceedings). On Sept. 22, 2020, MEC submitted a notice of application (MEC Application) for, among other things, a sale approval and vesting order (the AVO) from the Supreme Court of British Columbia to approve the APA. Surprised by the recent developments, a group of MEC's members (SaveMEC), with support from two public interest groups, BC Co-op Association and Cooperatives and Mutuals Canada, sought a minimum two-week adjournment (the SaveMEC Application) of the MEC Application on the basis that, among other claims, MEC did not consult its members at any point during the restructuring process and was required to do so. SaveMEC did not submit however, although another party did, that the SISF was not extensive or properly administered.

Dispute with SaveMEC

The SaveMEC Application contains, among others, two principle complaints that the Board did not adequately consider the viable option of raising funds from the members of MEC, and the restructuring process was conducted in an oppressive manner against the members of MEC. SaveMEC submitted that the Board did not inform its members of the intent to sell substantially all of the assets of MEC until after the APA was signed and the CCAA Proceedings were commenced. SaveMEC's position was, and continues to be, that members were barred from exercising any voting rights in connection with the APA and risk losing, and now have lost, their financial interest in MEC.

In deciding whether to grant the AVO, the MEC Decision grapples with two inter-related issues:

- Did the SISF, as a “pre-packaged proceeding” or “pre-pack”, meet the principles of section 36 of the CCAA (*i.e.* was the SISF itself abusive to the CCAA); and
- Did the Board have a duty to consult voting members of a co-operative subject to an informal restructuring process, particularly in the context of a sale of substantially all of a debtor's assets?

The pre-packaged proceedings

Fitzpatrick J. aptly notes that (i) there is nothing inherently wrong with pre-packs, and (ii) the CCAA does not preclude pre-packs so long as the pre-filing sale and investment process is consistent with section 36 of the CCAA.¹⁰ The primary concern of pre-packs is that, given the non-court supervised nature, the process may insufficiently consider the position of vulnerable stakeholders (*i.e.* members of MEC who hold a residual interest in the co-operative). Fitzpatrick J. followed the Court of Queen's Bench of Alberta in *Sanjel Corp. (Re)*, which notes, “pre-packaged proceedings ought to be subject to a high level of scrutiny”.¹¹ In this particular scenario, the Court found that MEC had legitimate business reasons for engaging in the SISF before filing for CCAA protection:¹²

- MEC was operating in a fragile economic state and actively pursued alternatives for refinancing the Credit Agreement, which was approaching maturity;
- MEC decided to avoid a distressed-assets situation sale and thereby maintain MEC's relationships with vendors, customers, and service providers in order to preserve going concern value;
- The SISF was a competitive process, conducted in a fair and reasonable manner, and adequately canvassed the market for refinancing options; and
- The Lenders and their professional advisors reviewed the process without objection.

SaveMEC suggested that MEC could have instead raised funding from its members. However, this position failed to raise any doubts about the legitimacy of the pre-packaged proceedings. Fitzpatrick J. agreed with the Special Committee that a public plea for funding was impractical. The Court might have found SaveMEC's position more plausible where members of MEC had a formal representative group prior to the CCAA Proceedings. Ostensibly, MEC's growth over the past few decades has diluted its co-operative spirit and its members' ability to answer any call for help.

Rights belonging to the members

SaveMEC contended and continues to submit, that MEC conducted the restructuring process in an oppressive manner. SaveMEC based its oppression argument on the notion that members have a reasonable expectation (arguably heightened in the context of a co-operative) of participation in the sale of substantially all of the co-operative's assets. Section 71(2) of the Co-op Act and section 8.05 of the MEC Memorandum¹³ both state that a sale of substantially the whole of a co-operative's undertaking requires that MEC pass a special resolution. Nevertheless, Fitzpatrick J. dismissed the argument, stating: "I hardly think MEC members could conceivably realistically consider that they, and they alone, would dictate whether a sale would occur, when the co-operative is insolvent and their memberships presently have *no value*"¹⁴ (emphasis added). As a general premise, the value of membership/share interest is often "out-of-the-money" in a CCAA proceeding due to its residual priority. Yet, the cumulative value of memberships was approximately \$192 million prior to the initial order and during the majority of the restructuring process is not devoid of merit. Ultimately, Fitzpatrick J. considered the impracticality of member participation (particularly during the COVID-19 pandemic) and the impact of further delay to justify dismissing the SaveMEC Application.

Notably, and with the benefit of hindsight, the actual net operating income of MEC during Sept. 15, 2020 and Oct. 11, 2020 was \$2,014,000, a difference of \$10,793,000 compared to a projected net loss of \$8,779,000 over the same period. Furthermore, the purchaser was expressly prohibited from repudiating the APA based on any material adverse effect caused by (i) any pandemic, including the COVID-19 pandemic, or (ii) any action approved by, or motion made before CCAA Proceedings. Nonetheless, mergers and acquisitions, especially during a pandemic, are fickle, and it is understandable that the Court did not want to delay the inevitable.

The reasons of Fitzpatrick J. suggests that, in practice, members of a cooperative have few rights during a restructuring process, and even those rights fundamental to the co-operative's internal governance may be subordinated by impracticality. Understandably, in the wake of a pandemic, a competitive retail market and liquidity issues set to mature, time is of the essence.

The Board conducted a sophisticated auction process and found a solution to MEC's liquidity issue, which was the APA. The Court weighed the rights of the members against the need for an expedient sale of MEC in advance of Black Friday and the holiday season. Given the economic uncertainty of the COVID-19 pandemic, the Court felt that the latter would more appropriately further the goals of the CCAA.

Next step in the MEC saga

On Oct. 23, 2020, SaveMEC sought leave to appeal the MEC Decision for a second opportunity to persuade a court in British Columbia that the members of MEC, as members of a cooperative and not shareholders of a corporation, deserve, at minimum, the right to be consulted in a restructuring process of their beloved co-operative. For now, the MEC Decision suggests that, during periods of extreme uncertainty and illiquidity, a court will not question the business judgment of a special committee to

neglect members of a co-operative during a SISP, despite statutory obligations that require a special resolution.

¹ *Mountain Equipment Co-Operative (Re)*, 2020 BCSC 1586.

² *Cooperative Associations Act* (British Columbia), SBC 1999, C. 28.

³ *Ibid*, s. 8(1).

⁴ *Supra* note 2, s. 8(2).

⁵ MEC's *Memorandum of Association* states that the co-operative is authorized to issue an unlimited number of membership shares, but is not permitted to issue investment shares. See: [Mountain Equipment Co-operative Memorandum of Association](#).

⁶ In Canada, co-op principles are based on the International Cooperative Alliance Statement of the cooperative identity. "Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions on the principle of one member one vote. Men and women serving as elected representatives are accountable to the membership". More information can be found at: [Co-op Business Model](#) ; [Cooperative Identity](#).

⁷ Government of British Columbia, BC Registrar and Online Services, [available here](#).

⁸ Kingswood Capital Management LP is a private investment company based in Los Angeles.

⁹ In August 2017, MEC entered into a credit agreement with RBC, as agent, and RBC, as lender, Canadian Imperial Bank of Commerce and the Toronto-Dominion Bank for an asset-backed revolving credit facility, allowing MEC to borrow up to an aggregate amount of \$130 million, which was reduced to \$100 million by an amending agreement. The agreement granted the Lenders first priority security over all of MEC's assets.

¹⁰ *Supra* note 1, para 100.

¹¹ *Supra* note 1, para 103.

¹² *Supra* note 1, paras 107 – 112.

¹³ Section 8.05 states that "The Co-operative must not dispose of the whole or substantially the whole of its undertaking unless a) the disposition is authorized by a special resolution; and b) all members have the opportunity to vote on the special resolution by mail or electronic ballot. [Available here](#).

¹⁴ *Supra* note 1 at para 136.

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