





Court No.31-OR-207897-T  
Estate No.35-124133

IN THE MATTER OF THE BANKRUPTCY OF  
1743122 Ontario Inc. (formerly known as Kraus Inc.)  
of the City of Waterloo, in the Province of Ontario

**TRUSTEE'S REPORT TO THE FIRST MEETING OF CREDITORS  
ON PRELIMINARY ADMINISTRATION**

**I BACKGROUND**

1743122 Ontario Inc. (formerly known as Kraus Inc.) ("**1743122**" or the "**Company**") was a privately held corporation incorporated under the *Ontario Business Corporations Act* that manufactured carpet for commercial and residential markets in Canada and the United States from a carpet mill in Waterloo, Ontario.

Anneleen Eckhardt Holdings Limited ("**Anneleen**"), a holding company, is the ultimate parent of the Company and certain other Canadian affiliates, such as 3851168 Canada Inc. ("**3851168**") (formerly Kraus Canada Inc.) and 798862 Ontario Limited ("**798862**") (formerly Strudex Fibres Limited), which are also subject to Canadian bankruptcy proceedings. Together 1743122, 3851168, and 798862 are known as the "**Companies**" in this report.

Anneleen's subsidiaries in the United States and Australia are not subject to insolvency proceedings in Canada or elsewhere. Anneleen and all of its subsidiaries (including the Companies) are collectively referred to as the "**Kraus Group**" in this report.

Prior to 2007, the Kraus Group had a history of strong and consistent financial performance. However, the downturn in the North American economy and collapse of the US housing market in 2008, led to a substantial decline in flooring demand, which resulted in significant losses for the Kraus Group, notwithstanding numerous cost cutting and improvement initiatives implemented by management.

As a result of these continued losses, the Kraus Group entered into numerous forbearance agreements with its secured lenders during the period from July 2008 to May 2012.

On or about May 7, 2012, Red Ash Capital Partners II Limited Partnership ("**Red Ash**") took an assignment of all the secured debt of the Kraus Group, having a face value of approximately



\$126.2 million and through its general partner Pinnacle Capital Resources Limited (“**Pinnacle**”), brought applications for bankruptcy orders against the Company, 798862 and 3851168.

On May 28, 2012, on application by Pinnacle, and pursuant to an order of the Ontario Superior Court of Justice (Commercial List) (the “**Court**”), PricewaterhouseCoopers Inc. (“**PwC**”) was appointed as interim receiver (the “**Interim Receiver**”) of the Company, 798862 and 3851168, pursuant to the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (the “**BIA**”).

During the interim receivership period, Kraus Brands LP (the “**Purchaser**”), an affiliate of Red Ash, made a binding offer, in the form of an asset purchase agreement (the “**APA**”), to PwC in its capacity as the proposed receiver for the purchase of substantially all of the Property (as defined below) of the Kraus Group, including substantially all of the assets of the Companies (the “**Transaction**”).

Also during the interim receivership proceedings, the Interim Receiver filed two reports with the Court (the “**Interim Receiver’s Reports**”), which among other things provided the Court with information relating to the interim receivership and the May 28, 2012 applications by Pinnacle to appoint PwC as receiver over the Companies (“**Receivership Applications**”), described the Interim Receiver’s activities and conduct, detailed the marketing and sale process undertaken by PricewaterhouseCoopers Corporate Finance Inc. (an affiliate of PwC) in the fall of 2011, provided information relating to the Kraus Group’s financial position and provided the Court with information regarding the proposed sale of all of the assets, undertakings and properties (the “**Property**”) of the Companies. Copies of these reports and the orders granted by the Court can be obtained from PwC’s website at [www.pwc.com/car-krauscarpets](http://www.pwc.com/car-krauscarpets).

On June 11, 2012, a bankruptcy order was made against the Company and PwC was named as trustee in bankruptcy (the “**Trustee**”), subject to affirmation by the creditors at the first meeting of creditors or substitution of another trustee by the creditors.

On the same day, pursuant to the Receivership Applications, an order was granted by the Court, appointing PwC as receiver (the “**Receiver**”) of the Property, pursuant to section 243 (1) of the BIA.

Also, on June 11, 2012, the Court issued an order (the “**Sale Order**”) approving the APA and vesting the assets, on closing, in and to the Purchaser free and clear of liens and encumbrances other than certain Permitted Encumbrances (as defined in the APA). The sale also closed on June 11, 2012. The gross consideration of the Transaction, which has not yet been allocated by



the Purchaser amongst the individual Companies or agreed to by the Receiver, is estimated to be in excess of \$83 million (the “**Unallocated Purchase Price**”), consists of:

- (i) the assumption of certain portions of the Companies’ secured debt owed to Red Ash, in the amount of approximately \$80.2 million (the “**Assumed Secured Debt**”);
- (ii) payment on closing of certain potential claims ranking in priority to the Assumed Secured Debt, pursuant to sections 81.3, 81.4, 81.5 and 81.6 of the BIA, estimated not to exceed \$24,500; and
- (iii) the assumption of certain Assumed Liabilities, as defined in the APA, estimated to be approximately \$2.8 million, which include certain trade credit advanced by suppliers in respect of goods and services ordered and delivered after May 28, 2012 (unless reduced for goods returned or offered for return to the applicable supplier), and assumed outstanding wages and vacation pay of certain transferred employees.

Following the closing of the Transaction, the only assets not transferred to the Purchaser, were certain excluded assets, (which included equipment lease and service contracts between the Companies and various suppliers, and real property leases) and certain inventory subject to claims for repossession under s. 81.1 of the BIA.

On June 13, 2012, Kraus Inc. changed its legal name to 1743122, in accordance with the terms of the APA.

On June 18, 2012, notice of the first meeting of creditors, a list of creditors, a proof of claim form and a proxy were sent to all known creditors of 1743122. Also on June 18, 2012, notice of the bankruptcy and the first meeting of creditors was published in the Globe and Mail (National Edition).

The activities of the Trustee since its appointment have primarily consisted of statutory work in accordance with the provisions of the BIA.

## **II CAUSES OF BANKRUPTCY AND FINANCIAL POSITION**

The Kraus Group’s internal consolidated financial statements showed that since 2008, the Kraus Group has incurred losses totalling approximately \$67.0 million.

By May 2012 the Kraus Group’s significant losses had consumed a significant amount of the Company’s working capital, and it was no longer able to operate efficiently or pay its obligations as they became due.



The Trustee understands that the principal causes of the losses, which resulted in the bankruptcy, include:

- (i) a significant decline in carpet sales over an extended period of time;
- (ii) the increased strength of the Canadian dollar; and
- (iii) higher input prices, for oil, resin and other raw materials.

### **III FINANCIAL POSITION/ASSETS**

As detailed in the Statement of Affairs, the assets of 1743122 as at the date of bankruptcy included cash, accounts receivables, inventory and personal property, which as shown in Schedule H of the Statement of Affairs were subject to Red Ash's security and were sold pursuant to the APA. As such, 1743122's only remaining asset is its share of the Unallocated Purchase Price, which has not yet been allocated by the Purchaser amongst each of the Companies or agreed to by the Receiver. Notwithstanding, Red Ash, the principal secured creditor, has security over these proceeds and is owed in excess of \$128 million as at the date of bankruptcy. As a result, Red Ash will suffer a significant shortfall on its secured debt and, accordingly, it is anticipated that there will be no funds available for distribution to the unsecured creditors of the Company.

### **IV SECURED CREDITORS**

As at the date of bankruptcy, the Companies' only registered secured creditor was Red Ash, who was owed in excess of \$128 million (other than holders of purchase money security interests).

The Receiver has obtained independent legal opinions on the validity and enforceability of the security held by Red Ash as against the Company and its related entities from (i) its independent Ontario, Quebec, Alberta and British Columbia counsel, Blake, Cassels & Graydon LLP ("**Blakes**"); (ii) its independent Nova Scotia counsel, Cox & Palmer LLP ("**C&P**"); and (iii) its independent Manitoba counsel, Pitblado LLP ("**Pitblado**"). As detailed in the Interim Receiver's Reports, based on its review, and subject to the customary assumptions, qualifications and limitations contained therein, Blakes, C&P and Pitblado are of the opinion that the security held by Red Ash is affective and constituted legal, valid and enforceable security.

### **V S.81.1 CLAIMS**

At the time of closing of the Transaction, certain of the Company's inventory was subject to claims asserted pursuant to section 81.1 of the BIA (the "**s.81.1 Claims**"). Pursuant to the



provisions of the Sale Order, the Receiver has been reviewing and evaluating inventory that was subject to s.81.1 Claims as all such inventory was excluded from the Transaction. Pursuant to the Sale Order, the s.81.1 Claims are to be resolved by agreement between the claimants and the Purchaser or by judicial determination.

## **VI SECURITY FOR UNPAID WAGES – S.81.3 CLAIMS**

Almost all of the Company's former employees were retained by the Purchaser following the closing of the Transaction and according to the Company's books and records, any employees who were terminated have been paid all of their outstanding wages and vacation pay. As a result, in accordance with the Company's payroll records, no amounts are shown as being owed to the Company's former employees for wages and vacation pay pursuant to section 81.3 of the BIA.

The Trustee, where applicable, will comply with the provisions of the *Wage Earner Protection Program Act* and related regulations.

## **VII PREFERRED CREDITORS**

1743122's Statement of Affairs indicates that there were no known preferred creditors as at the date of bankruptcy.

## **VIII UNSECURED CREDITORS**

1743122's Statement of Affairs indicates that there are 244 unsecured creditors with claims totalling approximately \$9.6 million, excluding the unsecured amounts owed to the Company's terminated employees (which were not calculated at the time of preparing the Statement of Affairs) and the amount owing to Red Ash in respect of the deficiency on its secured claim (approximately \$45.0 million in the aggregate, which is to be allocated among the Companies).



## IX PROVABLE CLAIMS

As at the date of this report, the Trustee has recorded Proof of Claims filed, as follows:

		<b>Number</b>	<b>(\$)</b>	<b>Proxy in favour of the Trustee</b>
Trade Secured	-	1	40,000,000	1
S.81 Employee Secured		1	67,918	0
Employee Preferred		1	34,821	0
Employee Unsecured		2	45,944	0
Trade Unsecured	-	20	1,014,458	5
<b>TOTAL</b>		<b>25</b>	<b>41,163,141</b>	<b>6</b>

## X PREFERENCE PAYMENTS AND TRANSFERS AT UNDER VALUE

The Trustee has not performed a review of 1743122's books and records, with respect to potential fraudulent preferences, settlements or transfers at undervalue, as defined in the BIA. It is the intention of the Trustee to discuss the scope of its review with the Inspectors to be appointed at the first meeting of creditors. However, as discussed earlier in this report and detailed in the Statement of Affairs, the principal secured creditor, Red Ash, is expected to suffer a shortfall on its secured debt in the amount of approximately \$45.0 million. Hence, any recoveries the Trustee may achieve from fraudulent preferences, settlements or transfers at undervalue will be exclusively or primarily for the benefit of the Red Ash.



## **XI TRUSTEE'S FEES**

In consideration for consenting to act in these proceedings, Hilco UK Limited, the parent of Red Ash, has agreed to guarantee payment of the Trustee's fees and disbursements, including the fees of the Trustee's legal counsel.

Further information relating to the bankruptcy proceeding may be obtained from PwC's website at [www.pwc.com/car-krausbankruptcy](http://www.pwc.com/car-krausbankruptcy).

Dated at Toronto, Ontario, this 26<sup>th</sup> day of June, 2012.

**PRICEWATERHOUSECOOPERS INC.,**  
in its capacity as Trustee of the estate of  
1743122 Ontario Inc. (formerly Kraus Inc.)  
and not in its personal capacity

A handwritten signature in cursive script, appearing to read "Michelle M. Pickett".

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Michelle Pickett  
Vice-President

