

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
COMMERCIAL LIST**

**B E T W E E N:**

PINNACLE CAPITAL RESOURCES LIMITED in its capacity as general  
partner of RED ASH CAPITAL PARTNERS II LIMITED PARTNERSHIP

Applicant

- and -

KRAUS INC., KRAUS CANADA INC., and STRUDEX FIBRES LIMITED,

Respondents

**APPLICATION UNDER SUBSECTION 46(1) and 243 OF THE *BANKRUPTCY AND  
INSOLVENCY ACT*, R.S.C. 1985, c. B-3, as amended**

**APPLICATION RECORD  
(APPLICATION FOR INTERIM RECEIVER RETURNABLE MAY 28, 2012)**

May 25, 2012

**CASSELS BROCK & BLACKWELL LLP**

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Lawyers for the Applicant

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1.  
Cv/2-9731-0001

Court File No.

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
COMMERCIAL LIST**

BETWEEN:

 PINNACLE CAPITAL RESOURCES LIMITED in its capacity as general partner of RED ASH CAPITAL PARTNERS II LIMITED PARTNERSHIP  
Applicant

- and -

KRAUS INC., KRAUS CANADA INC., STRUDEX FIBRES LIMITED  
and 538626 B.C. LTD.  
Respondents

**APPLICATION UNDER SUBSECTION 46(1) and SECTION 243 OF THE  
BANKRUPTCY AND INSOLVENCY ACT, R.S.C. 1985, c. B-3, as amended**

**NOTICE OF APPLICATION**

TO THE RESPONDENT(S)

A LEGAL PROCEEDING HAS BEEN COMMENCED by the Applicant. The claim made by the Applicant appears on the following page.

THIS APPLICATION will come on for a hearing on Monday, May 28, 2012, at 9:30 a.m., before a judge presiding over the Commercial List at 330 University Avenue, 8th Floor, Toronto, Ontario, M5G 1R7.

IF YOU WISH TO OPPOSE THIS APPLICATION, to receive notice of any step in the application or to be served with any documents in the application you or an Ontario lawyer acting for you must forthwith prepare a notice of appearance in Form 38A prescribed by the *Rules of Civil Procedure*, serve it on the Applicant's lawyer or, where the Applicant does not have a lawyer, serve it on the Applicant, and file it, with proof of service, in this court office, and you or your lawyer must appear at the hearing.


IF YOU WISH TO PRESENT AFFIDAVIT OR OTHER DOCUMENTARY EVIDENCE TO THE COURT OR TO EXAMINE OR CROSS-EXAMINE WITNESSES ON

THE APPLICATION, you or your lawyer must, in addition to serving your notice of appearance, serve a copy of the evidence on the Applicant's lawyer or, where the Applicant does not have a lawyer, serve it on the Applicant, and file it, with proof of service, in the court office where the application is to be heard as soon as possible, but at least four days before the hearing.

IF YOU FAIL TO APPEAR AT THE HEARING, JUDGMENT MAY BE GIVEN IN YOUR ABSENCE AND WITHOUT FURTHER NOTICE TO YOU. IF YOU WISH TO OPPOSE THIS APPLICATION BUT ARE UNABLE TO PAY LEGAL FEES, LEGAL AID MAY BE AVAILABLE TO YOU BY CONTACTING A LOCAL LEGAL AID OFFICE.

Date May 25, 2012

Issued by

  
Local Registrar

Address of

court office: 330 University Avenue, 7th Floor  
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AND TO: KRAUS INC.  
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AND TO: KRAUS CANADA INC.  
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AND TO: 538626 B.C. LTD.  
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AND TO: **MILLER THOMSON LLP**  
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**Attention: Debbie Lyon, Superintendent of Pensions**

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AND TO: IBM CANADA LIMITED – PPSA ADMINISTRATOR  
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AND TO: INTEGRATED DISTRIBUTION SYSTEMS LIMITED PARTNERSHIP  
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## APPLICATION

1. The Applicant makes application for:

- (a) preliminary relief upon the initial return of this Application on May 28, 2012, or as soon after that time as such preliminary relief can be heard, as follows:
  - (i) an Order that service of notice for the preliminary relief on any interested party is hereby dispensed with;
  - (ii) an order confirming that the within application is properly brought before the Commercial List;
  - (iii) an order pursuant to subsections 43(4) and 187(7) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (the "**BIA**") administratively consolidating the following applications for bankruptcy orders and confirming that the hearing of such applications shall be on the Commercial List at Toronto before a judge:
    - (A) bankruptcy application in respect of Kraus Inc. ("**Kraus**") brought in the Ontario Superior Court of Justice as court file no. 31-OR-207897-T (the "**Kraus Bankruptcy Application**"); and
    - (B) bankruptcy application in respect of Strudex Fibres Limited ("**Strudex**") brought in the Ontario Superior Court of Justice

as court file no. 31-OR-207896-T (the “**Strudex Bankruptcy Application**”);

- (iv) an order that the Kraus Bankruptcy Application and Strudex Bankruptcy Application shall be returnable in Toronto before a judge of the Commercial List at 9:30 a.m. on June 11, 2012;
- (v) an order directing that the application for an interim receiver in respect of Kraus Canada Inc. (“**Kraus Canada**”), which is the subject of a bankruptcy application in the Manitoba Court of Queen’s Bench at Winnipeg, Manitoba as court file no. BK 12-01-02706 and bearing Official Receiver file no. 21-081406 (the “**Kraus Canada Bankruptcy Application**”), be heard in Toronto on the Commercial List;
- (vi) an order pursuant to subsection 46(1) of the BIA appointing PricewaterhouseCoopers Inc. (“**PwC**”) as interim receiver (the “**Interim Receiver**”) in respect of the Respondents other than 538626 B.C. Ltd. (collectively, the “**Operating Companies**”) with the authority to monitor receipts and disbursements but expressly without authority to take possession of any property or operate or manage the businesses of the Operating Companies;
- (vii) an order authorizing and directing the Interim Receiver and proposed Receiver (as defined below) to bring a motion in these proceedings for approval of a transaction (the “**Transaction**”) for the

sale of the assets of the Operating Companies as a going concern to Kraus Brands LP (the “**Purchaser**”) along with certain assets of 538626 B.C. Ltd. (the “**Sale Approval Motion**”); and

- (viii) an order authorizing and directing the Interim Receiver to give notice of the Sale Approval Motion to the beneficiaries of the registered pension plans sponsored by Kraus and Kraus Canada at their last known addresses, such notice in substantially the form attached to the draft order sought on this Application;
- (b) upon the subsequent return of this Application, currently scheduled for June 11, 2012, or as soon after that time as the following subsequent relief can be heard,
  - (i) an order validating the manner of service of the Application Record in respect of such subsequent relief and declaring that the time for service be abridged so that the subsequent relief is returnable on June 11, 2012 and that further service thereof is dispensed with;
  - (ii) in the event that the Kraus Canada Bankruptcy Application is transferred to Toronto by order of the Manitoba Court of Queen’s Bench, an order administratively consolidating the Kraus Canada Bankruptcy Application with the Kraus Bankruptcy Application and Strudex Bankruptcy Application;

- (iii) an order directing that the Kraus Bankruptcy Application, Kraus Canada Bankruptcy Application, and Strudex Bankruptcy Applications (collectively, the “**Operating Companies’ Bankruptcy Applications**”) shall be heard together immediately prior to the hearing for relief sought in paragraph 1(b)(v) below (the “**Receivership Application**”);
- (iv) an order suspending the effective time of any bankruptcy orders granted pursuant to the Operating Companies’ Bankruptcy Applications, until immediately prior to the Receivership Order Effective Time (defined below), if the Receivership Application is granted;
- (v) an order pursuant to section 243 of the BIA appointing PwC as receiver (the “**Receiver**”), without security, of the Respondents and directing that the appointment of the Receiver shall become effective on the earlier of (a) immediately prior to the closing of the Transaction if the Sale Approval Motion is granted or (b) in the event that the Transaction is terminated in accordance with the terms thereof, immediately following such termination (the “**Receivership Order Effective Time**”); and
- (vi) in the event that the Transaction is terminated in accordance with the terms thereof, an order authorizing and directing PwC, as receiver, to liquidate the assets of the Respondents;

- (c) the costs of this proceeding, plus all applicable taxes; and
- (d) such further and other relief as this Honourable Court may deem just.

2. THE GROUNDS FOR THE APPLICATION ARE:

**BACKGROUND**

- (a) the Operating Companies carry on the business of the manufacture of carpeting and the sale of carpeting and other flooring products;
- (b) the primary credit facilities of the Operating Companies are extended pursuant to a credit and guarantee agreement dated as of June 28, 2007 (the "**Senior Credit Agreement**") among:
  - (i) the Respondents as Canadian borrowers and guarantors;
  - (ii) Barrett Carpet Mills, Inc. and Kraus USA, Inc. as U.S. borrowers and guarantors;
  - (iii) certain other Kraus Group corporations as guarantors;
  - (iv) National Bank of Canada as Canadian administrative agent;
  - (v) Bank of Montreal as U.S. administrative agent; and
  - (vi) a syndicate of financial institutions as lenders;
- (c) the indebtedness under the Senior Credit Agreement is secured by a first-ranking charge against all assets and undertaking of the Respondents;



- (d) on November 23, 2010, BMO Capital Corporation ("**BMOCC**") entered into a credit agreement with Kraus as principal debtor and Strudex as guarantor (the "**Junior Credit Agreement**") pursuant to which BMOCC agreed to provide a \$10 million credit facility to Kraus;
- (e) the indebtedness under the Junior Credit Agreement was secured by a second-ranking charge against specified assets and undertaking of the Respondents;
- (f) on November 23, 2010, Strudex issued an amended and restated promissory note in the amount of \$32,843,743.26 (the "**Note**") to Nelson Kraus Holdings Limited, which was later assigned to Nelson Kraus in his personal capacity;
- (g) the Note was secured by a third-ranking security interest on specified assets and undertaking of the Respondents, including a general security agreement given by the Respondents;

#### **PURCHASE OF DEBT AND SECURITY BY APPLICANT**

- (h) by agreements dated May 7, 2012 (the "**Debt Assignment Agreements**"), the Applicant purchased the debt and security associated with the Senior Credit Agreement, Junior Credit Agreement, and the Note (collectively, the "**Loan Agreements**");
- (i) as a result of the interests which it acquired through the Debt Assignment Agreements, the Applicant currently holds secured debt of the

Respondents in the total outstanding amount of approximately \$126 million (the “**Secured Debt Amount**”);

#### **LOAN DEFAULT AND PAYMENT DEMAND**

- (j) the Loan Agreements are in default and notice of the occurrence of these defaults has been given to the Respondents, but the defaults have not been cured. As a result, the Loan Agreements are currently in default such that the Secured Debt Amount is immediately due and payable;
- (k) the Applicant has issued a demand for repayment of the Secured Debt Amount to the Respondents and served a Notice of Intention to Enforce Security pursuant to section 244(1) of the BIA upon the same;
- (l) despite receiving the Demand, the Respondents have failed to repay the Secured Debt Amount;
- (m) on May 24, 2012, the Applicant issued the Operating Companies’ Bankruptcy Applications;
- (n) the Operating Companies’ Bankruptcy Applications were issued in Toronto, except for the Kraus Canada Bankruptcy Application, which was issued in Winnipeg;

#### **NEED FOR INTERIM RECEIVER**

- (o) the Operating Companies’ financial state is precarious in that
  - (i) they are sustaining and will continue to sustain substantial losses;

- (ii) cash flow from operations is not sufficient to meet ongoing expenses; and
- (iii) absent funding of cash flow, the Operating Companies will be required to cease operations in the near future and a liquidation of assets will have to be undertaken;
- (p) the Applicant is prepared to fund the immediate cash needs of the Operating Companies but only in the event that its interests are protected by the appointment of an Interim Receiver under section 46(1) of the BIA and a stay of proceedings;

#### **ANTICIPATED RECEIVERSHIP AND SALE APPROVAL**

- (q) after the initial return of this Application before the court on May 28, 2012, but prior to the second return date of the Application on June 11, 2012, the Applicant will bring a motion before the Manitoba Court of Queen's Bench seeking to transfer the Kraus Canada Bankruptcy Application to the Commercial List at Toronto;
- (r) pursuant to this Notice of Application, the Applicant seeks to bring back this Application before the Court on June 11, 2012 for the subsequent relief set out in paragraph 1(b) above, to be heard immediately following the hearing of the Operating Companies' Bankruptcy Applications. Immediately following the granting of bankruptcy orders of the Operating Companies, if such orders are granted, the Applicant will seek the appointment of the

Receiver with respect to the Respondents pursuant to section 243 of the BIA. Immediately thereafter, it is proposed that the Sale Approval Motion will be heard. In the event that the Sale Approval Motion is not granted, the Applicant seeks permission of the Court to have the Receiver terminate the operations of the Respondents and liquidate their assets;

- (s) it is just and convenient that a Receiver be appointed over the Respondents' assets and undertaking;
- (t) the realizable value of the Respondents' assets is substantially less than the approximately \$126 million which is owed to the Applicant;
- (u) the Applicant is the only party whose economic interest is engaged by the proposed receivership and sale of assets;
- (v) the Transaction would benefit the Applicant in its capacity as secured creditor and, given the Purchaser's intention to restructure and continue operation of the Respondents' business, will benefit other stakeholders such as approximately 530 employees who will continue to be employed by the Purchaser;
- (w) the Operating Companies have already attempted, over a period of several months, to sell their business and/or assets and it does not appear that a sale can be achieved on terms which are more favourable than those provided for in the Transaction;

- (x) the Applicant is only prepared to fund the operations of the Operating Companies for a short period and, if a sale to the Purchaser cannot be achieved, the Applicant intends to cease operational funding and, with court approval, seek to have the Receiver liquidate the Respondents' assets;

#### **NOTICE OF THESE PROCEEDINGS TO PENSIONERS**

- (y) the Purchaser does not intend, as part of the Transaction, to assume or continue any of the existing or past defined benefit or defined contribution pension plans of the Operating Companies (the "**Pension Plans**");
- (z) however, the Purchaser is actively negotiating new collective agreements which contemplate
  - (i) new defined contribution plans being put in place by the Purchaser on closing or as soon as possible thereafter (the "**New Plans**"); and
  - (ii) the Purchaser making employer contributions to the New Plans at substantially the same rate as that which is currently being made under the existing Pension Plans;
- (aa) with respect to those pension plan beneficiaries that currently participate in the Canadian Commercial Workers Industry Pension Plan ("**CCWIPP**"), the Purchaser will not assume Kraus's or Strudex's current participation agreements but anticipates entering into new participation agreements with CCWIPP that involve substantially the same contribution to CCWIPP;

- (bb) since the proposed proceedings are likely to affect the interest of beneficiaries of the Pension Plans to some extent, the Applicant seeks approval of a protocol to give notice to such beneficiaries; and
  - (cc) such further and other grounds as counsel may advise.
3. The following documentary evidence will be used at the hearing of the application:
- (a) the affidavit of Chris Emmott, sworn May 25, 2012;
  - (b) the draft First Report of the proposed Interim Receiver (to be filed);
  - (c) the consent of PricewaterhouseCoopers Inc. to act as Interim Receiver and Receiver; and
  - (d) the Kraus Bankruptcy Application, the Strudex Bankruptcy Application, and if transferred by Order of the Manitoba Court of Queen's Bench, the Kraus Canada Bankruptcy Application,

May 25, 2012

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PINNACLE CAPITAL RESOURCES  
LIMITED in its capacity as general partner  
of RED ASH CAPITAL PARTNERS II  
LIMITED PARTNERSHIP

Applicant

and KRAUS INC., KRAUS CANADA INC., STRUDEX FIBRES LIMITED and  
538626 B.C. LTD.

Respondents

Court File No.

*Ca 12-9731-00 CA*

ONTARIO  
SUPERIOR COURT OF JUSTICE  
(COMMERCIAL LIST)  
PROCEEDING COMMENCED AT  
TORONTO

NOTICE OF APPLICATION

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Lawyers for the Applicant

Court File No. CV-12- 9731 -00CL  
**ONTARIO**  
**SUPERIOR COURT OF JUSTICE**  
**COMMERCIAL LIST**

BETWEEN:

PINNACLE CAPITAL RESOURCES LIMITED in its capacity as general  
partner of RED ASH CAPITALPARTNERS II LIMITED PARTNERSHIP  
Applicant

- and -

KRAUS INC., KRAUS CANADA INC., STRUDEX FIBRES LIMITED, and  
538626 B.C. LTD.  
Respondents

**APPLICATION UNDER SUBSECTION 46(1) and SECTION 243 OF THE  
BANKRUPTCY AND INSOLVENCY ACT, R.S.C. 1985, c. B-3, as amended**

**AFFIDAVIT OF CHRISTOPHER EMMOTT**

**(Sworn May 25, 2012)**

I, Christopher Emmott, of the City of London in the United Kingdom, MAKE OATH  
AND SAY:

1. I am an Investment Director of Hilco UK Limited ("**Hilco**"), a company incorporated pursuant to the laws of the United Kingdom. As one of the key persons at Hilco responsible for this matter, I have knowledge of the matters discussed in this affidavit. Unless I indicate to the contrary, the following facts are within my personal knowledge. Where I have indicated that I have obtained the facts from other sources, I believe those facts to verily be true.



### Overview and Purpose of Affidavit – Summary of Affidavit

2. Defined terms not defined in this overview section shall have the meaning ascribed to them in the balance of this Affidavit.

3. I swear this affidavit in support of this application by the Applicant, Pinnacle Capital Resources Limited ("**Pinnacle**") in its capacity as general partner of Red Ash Capital Partners II Limited Partnership (collectively, "**Red Ash**"), for

- (a) on the initial hearing of this application, on or around May 28, 2012, the appointment of PricewaterhouseCoopers Inc. ("**PWCI**") as interim receiver over Kraus Inc., Kraus Canada Inc., and Strudex Fibres Limited (collectively, the "**Operating Companies**") pending the hearing of the subsequent relief sought on this application described below;
- (b) the consolidation of certain bankruptcy proceedings of the Operating Companies in Toronto on the Commercial List for administrative purposes;; and
- (c) upon the subsequent hearing of this application on or around June 11, 2012, following the granting of bankruptcy orders in the bankruptcy proceedings of the Operating Companies, the appointment of PWCI as receiver of all of the Respondents, pursuant to section 243 of the *Bankruptcy and Insolvency Act* ("**BIA**").

4. Pinnacle is incorporated pursuant to the *British Virgin Islands Business Companies Act, 2004*. Hilco is the sole shareholder of Pinnacle. Attached to my Affidavit as **Exhibit "A"** is a copy of Pinnacle's certificate of incorporation.

5. The Kraus Group is currently insolvent and has, for the past two years, been operating pursuant to a series of consecutive forbearance agreements with their secured lenders. The Kraus Group commenced an extensive sales and investor solicitation process in October 2011, in an effort to find a buyer or strategic investor willing to assist with turning around its operations and financial performance. Hilco made a bid during this sales process and in February 2012, the Kraus Group advised Hilco that its bid to invest in the Kraus Group was the superior bid.

6. Hilco and the secured lenders of the Kraus Group negotiated a number of potential investment/purchase structures over a period of approximately ten weeks.

7. As of May 7, 2012, Hilco, through its nominee Red Ash, took an assignment of all outstanding debt and security (the "**Senior Secured Debt**") of the Kraus Group held by the Senior Lenders, BMOCC, and Nelson, which are the three main secured lenders.

8. Red Ash has filed bankruptcy applications as against the Operating Companies. In this application, Red Ash seeks the appointment of PWCI as interim receiver under section 46(1) of the BIA to monitor the receipts and disbursements of the Operating Companies with a stay of proceedings in place, pending the hearing of the bankruptcy applications.

9. Assuming that the Operating Companies are subsequently adjudged bankrupt, Red Ash seeks on the second hearing date of this application (currently scheduled for June 11, 2012), the appointment of PWCI as receiver for the purpose of having PWCI, in its capacity as receiver, complete a sale of substantially all of the assets owned by the Respondents (including the shares of the non-Canadian Kraus entities within the Kraus Group (the “**Canadian Assets**”) to Kraus Brands LP (“**Kraus Brands**”). As the purchase price, Kraus Brands will assume a substantial portion of the debt under the Senior Credit Agreement and Junior Credit Agreement in exchange for all of the Canadian Assets. (Hereafter, the above-noted sale transaction shall be referred to as the “**Purchase Transaction**”).

10. Kraus Brands is related to Red Ash and Hilco.

11. The Kraus Group will be out of cash within a matter of weeks and needs financial support if it is to survive. Red Ash has developed a business strategy that, if successful, has the potential of saving the Kraus Group from what is otherwise certain liquidation. If court approval of the Purchase Transaction is granted, Red Ash is willing to make a significant investment in the Kraus Group's operations and immediately implement its business strategy.

12. If the Court does not approve the Purchase Transaction, Red Ash intends to immediately commence an orderly liquidation of the Kraus Group's Canadian operations.

13. This Affidavit will provide this court with an overview of

- (a) the Kraus Group's business operations;
- (b) the Kraus Group's corporate structure;

- (c) the Kraus Group's employees and the pension and benefits currently available to the employees;
- (d) the Kraus Group's current secured and unsecured obligations;
- (e) the security granted by the Respondents to Red Ash; and
- (f) the sales process for the Kraus Group wherein Hilco's bid was the superior bid.

#### **The Kraus Group of Companies – Overview of Operations**

14. The operations of the Kraus Group (as defined below) extend across Canada, the United States, and Australia. However, control of operations is centred in Waterloo, Ontario, where main production occurs and from where management of the Kraus Group takes place. The Kraus Group is made up of the following entities:

- (a) *Strudex Fibres Limited* ("**Strudex**") is a corporation incorporated pursuant to the laws of Ontario and has its registered office in Waterloo. Strudex operates the carpet fibre manufacturing facility located at 65 Northfield Drive West, Waterloo, Ontario (the "**Waterloo Premises**"). Strudex is considered the ultimate parent company of all of the Kraus Group operating companies. It sells substantially all of the fibre it produces to Kraus Inc. and to Northstate Carpet Mills Pty Ltd. Strudex has approximately 110 full time employees, of which approximately 85 are members of the United Food and Commercial Workers, Local 175 (the "**UFCW**");
- (b) *Kraus Inc.* ("**Kraus**") is a corporation incorporated pursuant to the laws of Ontario and has its registered office in Waterloo. Kraus operates the main carpet manufacturing unit from the Waterloo Premises. Kraus employs approximately 265 people, of which approximately 165 are members of the UFCW. However, these unionized employees are subject to a collective agreement that is separate and distinct from the collective agreement which covers Strudex employees. The majority of Kraus's sales are to other entities within the Kraus Group;

- (c) *Kraus Canada Inc.* ("**Kraus Canada**") is a corporation incorporated pursuant to the laws of Canada and has its registered office in Winnipeg, Manitoba. Kraus Canada operates the Canadian carpet and flooring distribution network for the Kraus Group. Kraus Canada's registered office is located in Winnipeg, Manitoba. However, the top-level management of Kraus Canada is conducted from the headquarters of the Kraus Group in Waterloo. More than 50% of Kraus Canada's purchases are from Kraus. Kraus Canada markets and distributes this product across Canada through its five distribution centres, which are located in British Columbia, Manitoba, Ontario, Alberta and Nova Scotia. Kraus Canada employs 144 people, including 8 unionized employees who are represented by the Teamsters (as defined below). There are 54 people working in sales positions, 54 people working in administration positions, and 28 people working in various warehousing positions;
- (d) *Anneleen Eckhardt Holdings Ltd.* ("**Anneleen**") is a corporation incorporated pursuant to the laws of Ontario, and has its registered office in Waterloo. It is a privately-owned holding company which has a direct or indirect majority shareholding interest in each of the other Kraus Group entities. Anneleen does not have direct operational involvement with any Kraus Group entity;
- (e) *538626 B.C. Ltd.* ("**Kraus BC**") is a corporation incorporated pursuant to the laws of British Columbia, which has its registered office in Vancouver. Kraus BC is non-operating and has no employees. It does, however, have one main asset, a receivable from S.L. Marcella Carpets Ltd., which is why Red Ash intends to bring Kraus BC within the receivership under section 243 of the BIA. However, Kraus BC will not be subject to bankruptcy or interim receivership proceedings;
- (f) *Kraus USA, Inc.* ("**Kraus U.S.**") is a corporation incorporated pursuant to the laws of Delaware. Kraus U.S. operates the United States carpet and flooring distribution network for the Kraus Group. Kraus U.S.'s head office is

in Clarion, Pennsylvania. Kraus U.S. purchases 40% of its inventory from Kraus with the remaining 60% coming from a variety of third-party flooring manufacturers. Kraus U.S. sells products to flooring retailers, big box stores and renovators. Kraus U.S. employs 100 people, none of whom are unionized. Kraus U.S. maintains distribution centres in Seattle, Washington and Clarion, Pennsylvania;

- (g) *Barrett Carpet Mills, Inc.* ("**Barrett**") is a corporation incorporated pursuant to the laws of Georgia. Barrett's offices are located in Dalton, Georgia. Barrett purchases and distributes carpet to flooring and carpet retailers in the US. Barrett also provides other functions for the Kraus Group, including credit, contract manufacturing and research and development. Barrett employs approximately 30 employees, none of which are unionized;
- (h) Royal Scot Floorcovering Distribution LLC ("**Royal**") is a corporation incorporated pursuant to the laws of Illinois. Royal is non-operating, has no employees, no material assets and no material liabilities;
- (i) Kraus Floors LLC was party to a joint venture that is non-operating, has no employees, no material assets and no material liabilities;
- (j) Northstate Carpet Mills Pty Ltd. ("**Kraus Australia**") is a corporation organized under the laws of Queensland, Australia, which is located in the Gold Coast region of that state. Kraus Australia is a manufacturer and distributor of carpet products in Australia. Kraus Australia purchases its yarn from Strudex and a majority of its carpet from Kraus. Kraus Australia employs approximately 40 employees, none of whom are unionized.

Hereafter, these entities referred to in subparagraphs (a) through (j) above are referred to collectively as the "**Kraus Group**". A corporate organization chart for the Kraus Group is attached to my Affidavit as **Exhibit "B"**.

15. The Kraus Group is a vertically-integrated manufacturer of premium carpet for the commercial and residential market. It is also a distributor in North America of flooring products produced by other manufacturers.

16. The Kraus Group was established in 1959 as a carpet manufacturer. Since then, it has significantly expanded its operations. It now operates two carpet-manufacturing mills:

- (a) the 850,000 square foot flagship mill at the Waterloo Premises, which is owned and operated by Kraus, and
- (b) a smaller mill in Queensland, Australia, which is operated by Kraus Australia.

17. The Kraus Group also manufactures fibre for use in carpet manufacturing, and supplies both the Waterloo and Australian mills. The Waterloo mill accounts for approximately 90% of the Kraus Group's manufacturing revenue, while Kraus Australia is responsible for the remaining 10%.

18. Approximately 60% of the Kraus Group's revenues are generated through the sale of carpet. The remaining revenues are generated through the sale of private label and branded laminate, hardwood, cork and other flooring products sourced from third parties.

19. The Kraus Group markets its carpet and flooring products to both the commercial and residential markets. In respect of retail customers, the Kraus Group's products are sold to both independent stores and big box retailers. The Kraus Group's Canadian sales account for approximately 52% of total sales, with American sales accounting for

approximately 42% of total sales, and the remaining 6% occurring in Oceania (Australia and New Zealand) and elsewhere.

20. As of May 2012, the Kraus Group employed approximately 750 people in Canada, the United States and Australia.

21. The Operating Companies are party to three separate collective agreements. Strudex and the UFCW are parties to a collective agreement dated March 20, 2008 (the "**Strudex Collective Agreement**"). The Strudex Collective Agreement is in force until July 2013. Approximately 85 employees are subject to the Strudex Collective Agreement.

22. Kraus and the UFCW are parties to a collective agreement, dated July 1, 2009 (the "**Kraus Collective Agreement**"). The Kraus Collective Agreement is in force until June 30, 2012. Approximately 165 employees are subject to the Kraus Collective Agreement.

23. Kraus Canada and Teamsters Local Union No. 213 (affiliated with the International Brotherhood of Teamsters, of the City of Vancouver, Province of British Columbia) (the "**Teamsters**") are parties to a collective agreement dated October 1, 2010 (the "**Kraus Canada Collective Agreement**"). Although the Kraus Canada Collective Agreement expired on September 30, 2011, such agreement continues to be in force on a year to year basis, subject to rights of renewal, negotiation and termination. Approximately five employees are subject to the Kraus Canada Collective Agreement.

24. Hereafter, the Strudex Collective Agreement, the Kraus Collective Agreement and the Kraus Canada Collective Agreement will be referred to collectively as the "**Collective Agreements**".



## PENSION PLANS

25. The Operating Companies maintain certain employee pension plans described below.

### **Registered Pension Plan for Employees of Kraus Canada Inc.**

26. The registered pension plan for employees of Kraus Canada is a pension plan registered, for pension standards purposes, in the Province of Manitoba and, for tax purposes, under the *Income Tax Act* (Canada). It bears registration number 0279992 (the "**Kraus Canada Plan**").

27. The Kraus Canada Plan consists of a defined benefit provision and a defined contribution (i.e., money purchase) provision. The defined benefit provision was established in 1963 under the name "W.G. McMahon Canada Ltd. Retirement Plan". The name of the defined benefit provision was changed effective October 1, 2009. Effective January 1, 2010, pensionable service ceased to accrue under the defined benefit provision and, instead, the plan continued as a defined contribution plan. While service accruals for the defined benefit provision ceased as of that date, benefits for accrued service are based on the final average earnings of members.

28. The funding medium for the defined benefit provision of the Kraus Canada Plan is an insurance policy number 99900236 issued by The Manufacturers Life Insurance Company. The detailed financial report issued by Kraus Canada indicates that, as of December 31, 2011, the policy held assets with a book value of \$20,975,397.56 and a market value of \$22,674,088.60. The actuarial valuation report prepared for the defined

benefit provision by Aon Hewitt shows, as of December 31, 2010, a going concern surplus of \$956,000 and a solvency deficit of \$2,072,000. As of that date, the report shows that 202 individuals participated in the plan, of which 119 were active or disabled members, 33 were deferred vested members and 50 were pensioners or beneficiaries.

29. The defined contribution provision of the Kraus Canada Plan is known as "The Registered Pension Plan for Employees of Kraus Canada" and refers to Group Annuity Policy Number 10001236. The funding medium for the money purchase provision is also an insurance policy. The defined contribution provision has members in all ten provinces, other than Prince Edward Island. Since this part of the plan does not guarantee any particular level of benefits to plan members, there can be neither a deficit nor a surplus and an actuarial valuation is not required.

#### **Pension Plan for Employees of Kraus Inc. and Strudex Fibres Limited**

30. The Registered Pension Plan for Employees of Kraus and Strudex is a pension plan registered, for pension standards purposes, in the Province of Ontario and, for tax purposes, under the *Income Tax Act* (Canada). It bears registration number 0330621 (the "**Strudex Plan**").

31. The Strudex Plan consists of a defined benefit provision and a defined contribution (i.e., money purchase) provision. The defined benefit provision was established in 1973 under the name Pension Plan for the Employees of Kraus Carpet Mills Limited, the change to the current name being made by amendment effective December 31, 2009. The defined benefit provision provides benefits on a career average basis, meaning that

benefits accrued for a year are a function of the earnings in that year. Effective January 1, 2010, pensionable service ceased to accrue under the defined benefit provision.

32. The funding medium for the defined benefit provision of the Strudex Plan is an insurance policy issued by The Manufacturers Life Insurance Company, bearing number 99900053. The actuarial valuation report prepared for the defined benefit provision by Morneau Shepell Ltd. ("**Morneau**") shows, as of January 1, 2011, a going concern deficit of \$316,836 and a solvency deficit of \$1,776,693, with a market value of assets as of that date of \$8,872,970. As of January 1, 2011, the report shows participation of 150 individuals, of which 81 were active members, 28 were deferred vested or variable vested members and 41 were pensioners or beneficiaries.

33. The defined contribution provision of the Strudex Plan is entitled "The Registered Pension Plan for Employees of Kraus Inc. and Strudex Fibres Limited" and is funded through an insurance policy. This defined contribution plan began on January 1, 2010 as a successor to the defined benefit plan. Plan membership appears to be restricted to Ontario employees only. Since this is a defined contribution policy, where pension benefits are not guaranteed, there can be neither a deficit nor a surplus in this part of the plan and an actuarial valuation is not required.

#### **Pension Plan for Executive Employees of Kraus Inc.**

34. The pension plan for executive employees of Kraus is a pension plan registered, for pension standards purposes, in the Province of Ontario and, for tax purposes, under the *Income Tax Act* (Canada). It bears registration number 0551580 (the "**Executive Plan**").

35. The Executive Plan consists of a defined benefit provision and, since January 1, 2007, provides benefits based on a final average earnings formula. The defined benefit provision was established in 1968 under the name "Pension Plan for the Executive Employees of Kraus Carpet Mills Limited".

36. The funding medium for the Executive Plan is an insurance policy issued by The Manufacturers Life Insurance Company, bearing number 99900052. The actuarial valuation report prepared for the Plan by Morneau shows, as of April 30, 2011, a going concern deficit of \$2,373,591 and a solvency deficit of \$3,700,000, with a market value of assets as of that date of \$4,886,159. As of that date, the report shows participation of 13 individuals, of which 7 were active members and 6 who were retirees or beneficiaries.

#### **Pension Plan for the Union Employees of Kraus Inc.**

37. The Pension Plan for Union Employees of Kraus Inc. is a pension plan registered, for pension standards purposes, in the Province of Ontario and, for tax purposes, under the *Income Tax Act* (Canada) (the "**Union Plan**").

38. The Union Plan consists of a defined benefit provision and provides benefits based on a career average formula. The Plan became effective January 1, 1986, under the name Pension Plan for the Union Employees of Kraus Carpet Mills Limited, but was closed to new entrants effective December 31, 1989. The Union Plan's name was changed effective December 31, 2009. Unionized employees of Strudex also participated in the Union Plan.

39. The funding medium for the Union Plan is an insurance policy issued by The Manufacturers Life Insurance Company, bearing number 99900054. The actuarial valuation report prepared for the Plan by Morneau shows, as of December 31, 2010 a solvency deficit of \$216,494, with a market value of assets as of that date of \$1,972,287. As of that date, the report shows participation of 330 individuals, of which 180 were active members, 43 were deferred vested members and 107 were retirees or beneficiaries.

40. Effective December 31, 1989, unionized employees of Kraus and Strudex, including those participating in the Union Plan, commenced participation in the multi-employer pension plan known as the Canadian Commercial Workers Industry Pension Plan ("**CCWIPP**"). Pursuant to the Collective Agreements, Kraus and Strudex are required to make fixed per hour contributions to the CCWIPP on behalf of Kraus and Strudex employees (the "**CCWIPP Contributions**").

41. Hereafter, the Kraus Canada Plan, the Strudex Plan, the Executive Plan, the Union Plan, and CCWIPP are referred to collectively as the "**Pension Plans**".

### **Original Marketing Process**

42. In the fall of 2011, Hilco first became aware of the Kraus Group's need to identify and source equity capital and Hilco first considered the possibility of acquiring the Kraus Group.

43. On or about October 20, 2011, Hilco received a letter from PricewaterhouseCoopers Corporate Finance Inc. ("**PWCCF**"), an affiliate of PWCI, advertising the sale of the assets of a leading manufacturer and distributor of carpet and

flooring products with operations across North America and in Oceania (the "**Teaser**"). A copy of the Teaser is attached to my Affidavit as **Exhibit "C"**. I am advised by Eric Castonguay, a senior managing director at PWCCF, and believe, that during this period the Kraus Group retained PWCCF as its financial advisor.

44. The Teaser stated that additional information would be made available to those parties that executed a confidentiality agreement. The Teaser further advised that non-binding expressions of interest were due to PWCCF by December 7, 2011.

45. In mid-November 2011, representatives of Hilco travelled to Canada, executed a confidentiality agreement and immediately commenced due diligence. Hilco was given access to a data room that was populated with information about the assets and liabilities of the Kraus Group that were for sale.

46. On or about December 11, 2011, Hilco completed the first stage of its due diligence review of the Kraus Group assets, which included a review of the Kraus Group's corporate structure, its sales and distribution network, its management and employees, its assets and liabilities and a summary of other financial information. On December 13, 2011, Hilco submitted a non-binding expression of interest for consideration by PWCCF (the "**Hilco EOI**").

47. Hilco learned during the initial phase of the due diligence that the Kraus Group's senior secured creditor was a syndicate of banks, including National Bank of Canada, National Bank of Canada (New York Branch), Bank of Montreal, Bank of Montreal (Chicago Branch), Comerica Bank (Canada Branch), Comerica Bank, The Royal Bank of Scotland N.V. (Canada) (formerly known as ABN Amro Bank N.V. Canada), the Royal

Bank of Scotland N.V. (formerly known as ABN Amro Bank N.V.), the Toronto-Dominion Bank and the Toronto-Dominion Bank (Texas) LLC (collectively the "**Senior Lenders**").

48. Hilco is in the business of acquiring financially challenged companies and developing a more efficient business plan with a view to returning them to profitability. The most common method Hilco uses to acquire a business, or its assets, is to purchase the debt and security of the target company's secured creditor. Once the debt and security is acquired, Hilco will use an appropriate insolvency proceeding to acquire the assets into a Hilco-related corporate structure. In light of this strategy, the Hilco EOI and subsequent bids described below contemplated a purchase of the debt and security of the Senior Lenders.

49. In or around the middle of December 2011, PWCCF confirmed to Hilco that the Hilco EOI was one of the superior proposals received and invited Hilco to conduct further due diligence, which included a review of the Waterloo Premises. Around January 24, 2012, Hilco submitted an offer to PWCCF (the "**Hilco Offer**"). The Hilco Offer increased the consideration to the Senior Lenders and required that the Senior Lenders sell a larger percentage interest of their debt and security to Hilco.

50. From this point in time, the Senior Lenders, together with PWCCF and the Kraus Group, negotiated with Hilco over a period of approximately six weeks and on March 5, 2012, agreed to terms of a letter of intent whereby Hilco agreed to purchase all of the Senior Lenders' first-ranking debt and security position.

51. Around May 7, 2012, Hilco and the Senior Lenders finalized terms of a master assignment agreement, wherein each of the Senior Lenders agreed to irrevocably and

unconditionally assign its respective interest to Red Ash (the "**Senior Debt Assignment Transaction**"). A redacted copy of the assignment agreement evidencing the Senior Debt Assignment Transaction is attached to my Affidavit as **Exhibit "D"**.

52. Concurrent with its consummation of the Senior Debt Assignment Transaction, Hilco also consummated a second transaction whereby it purchased the debt and security owned by Bank of Montreal in its capacity as assignee of the subordinate secured position of BMO Capital Corporation ("**BMOCC**") as against the Kraus Group, by way of master assignment agreement between Red Ash and BMOCC, dated May 7, 2012 (the "**BMOCC Debt Assignment Transaction**"). A redacted copy of the assignment agreement evidencing the BMOCC Debt Assignment Transaction is attached to my Affidavit as **Exhibit "E"**.

53. Concurrent with the consummation of the Senior Debt Assignment Transaction and the BMOCC Debt Assignment Transaction, Hilco also consummated a transaction (the "**Nelson Kraus Debt Assignment Transaction**") whereby it purchased the debt and security owned by Nelson Kraus Holdings Limited ("**NKHL**") as against the Kraus Group, by way of master assignment agreement between Red Ash and NKHL. A redacted copy of the assignment agreement evidencing the Nelson Kraus Debt Assignment Transaction is attached to my Affidavit as **Exhibit "F"**. Hereafter, the Senior Debt Assignment Transaction, the BMOCC Debt Assignment Transaction and the Nelson Kraus Debt Assignment Transaction are referred to collectively as "**Debt Assignment Transactions**".



## KRAUS GROUP'S DEBT AND SECURITY STRUCTURE

### The Secured Debt

54. Pursuant to the Debt Assignment Transactions, Red Ash took an absolute, irrevocable and unconditional assignment of each of the loan and security documents referenced in the following sections.

55. Kraus's primary credit facilities are extended pursuant to a credit and guarantee agreement dated as of June 28, 2007, among

- (a) Strudex, Kraus, and Kraus Canada as Canadian borrowers and guarantors;
- (b) Barrett Carpet Mills, Inc. and Kraus USA, Inc. as U.S. borrowers and guarantors;
- (c) certain other Kraus Group corporations as guarantors;
- (d) National Bank of Canada, as Canadian Administrative Agent,
- (e) Bank of Montreal, as U.S. Administrative Agent, and
- (f) a syndicate of financial institutions as lenders.

56. This credit agreement was amended pursuant to credit and guarantee amendment agreements dated August 30, 2007, January 26, 2009, May 21, 2009, November 23, 2010, and March 7, 2011. (Hereafter, this credit agreement, including the amendments and all other modifications made in relation thereto shall be referred to collectively as the "**Senior Credit Agreement**").

57. As of April 30, 2012, the total indebtedness outstanding under the Senior Credit Agreement was approximately \$71,115,000. The Senior Credit Agreement is attached to my Affidavit as **Exhibit "G"**. Since that time, Red Ash has permitted ordinary course borrowings by the Kraus Group pursuant to the terms of the Senior Credit Agreement.

58. The second ranking secured creditor of the Kraus Group was BMOCC. Kraus as borrower and Strudex as guarantor entered into an amended and restated credit agreement with BMOCC dated as of November 23, 2010 which has subsequently been amended on several occasions (collectively the "**Junior Credit Agreement**"). The Junior Credit Agreement was a successor to an earlier agreement dated July 24, 2007 whereby BMOCC agreed to lend \$10 million. At the time that the parties entered into the Junior Credit Agreement in 2010, the indebtedness owing to BMOCC exceeded \$15 million because interest on the existing facility had not been paid but was capitalized. BMOCC subsequently assigned all of its rights, entitlements and interest under the Junior Credit Agreement to Bank of Montreal. As of April 30, 2012, the amount outstanding under the Junior Credit Agreement was approximately \$19,714,000. The Junior Credit Agreement, excluding schedules, is attached to my Affidavit as **Exhibit "H"**.

59. The third ranking secured creditor of the Kraus Group was NKHL, a corporation controlled by Nelson Kraus ("**Nelson**"), a member of the family that founded the Kraus Group. On November 23, 2010, Strudex executed and delivered to NKHL a promissory note in favour of NKHL (the "**Nelson Promissory Note**"). NKHL subsequently assigned the Nelson Promissory Note to Nelson. As of April 30, 2012, the amount outstanding on the Nelson Promissory Note was \$35,407,000. The Nelson Promissory Note is attached to my Affidavit as **Exhibit "I"**.

60. Pursuant to the terms of that certain Master Assignment Agreement entered into by Red Ash with Nelson dated May 7, 2012, Red Ash purchased the Nelson Promissory Note from Nelson, together with the associated security provided in support thereof.

### **The Corresponding Security**

61. The Kraus Group's debt obligations and liabilities pursuant to the Senior Credit Agreement are fully secured by a series of security agreements over all present and after acquired real and personal property (collectively, "**Senior Security Documents**") including without limitation:

- (a) a \$165,000,000 first mortgage over the Waterloo Premises;
- (b) security and an assignment of rents over the property of Barrett Carpet Mills, Inc. in Dalton, Georgia;
- (c) first-ranking personal property security over all the assets of the Kraus Group in Canada, the U.S., and Australia; and
- (d) a guarantee dated January 26, 2009 executed by Anneleen.

62. The Kraus Group's debts, obligations and liabilities under the Junior Credit Agreement are fully secured by a series of security documents (the "**Junior Security Documents**") including, without limitation, the following:

- (a) Deed of Hypothec dated July 23, 2007 between BMOCC and W.G. McMahon Canada Ltd. (now Kraus Canada);
- (b) First Canadian Title Insurance Policy dated July 23, 2007 issued and underwritten by First American Title Insurance Company with BMOCC as the named insured;

- (c) Pledge and Security Agreement dated July 24, 2007, granted to BMOCC by Strudex Fibres Limited, Kraus Carpet Mills Limited and 1029011 Ontario Inc. (collectively, now Kraus Inc.), W.G. McMahon Canada Ltd. (now Kraus Canada Inc.) and McMahon Holdings Inc. (now Kraus USA, Inc.);
- (d) Guarantee dated July 24, 2007, between BMOCC and Strudex, W.G. McMahon Canada Ltd. and 1029011 Ontario Inc. as guarantors;
- (e) Debenture dated July 24, 2007, granted to BMOCC by Strudex;
- (f) Debenture Delivery Agreement dated July 24, 2007, between BMOCC and Strudex;
- (g) Security Pledge Agreement dated July 24, 2007, granted to BMOCC by Anneleen;
- (h) Guarantee dated July 24, 2007, granted to BMOCC by Anneleen as guarantor;
- (i) Joinder Agreement to the Pledge and Security Agreement dated January 22, 2008, by Kraus B.C.;
- (j) Guarantee dated January 22, 2008, granted to BMOCC by Kraus B.C. Ltd. as guarantor;
- (k) Amended and Restated Warrant Agreement dated November 23, 2010, between Strudex and BMOCC; and
- (l) Debt Pledge Agreement dated November 23, 2010, granted to BMOCC by Anneleen.

63. The Junior Security Documents establish a general charge against all of the Canadian Assets as well as a second mortgage in favour of BMOCC, in the principal sum of \$12,500,000, as against the Waterloo Premises. Generally speaking, the Junior Security Documents rank second in priority, behind the Senior Security Documents.

64. The Kraus Group's debts, obligations and liabilities pursuant to the Nelson Promissory Note are secured by various security documents (collectively the "**Nelson Security**"), including, without limitation, the following:

- (a) Security Agreement dated June 28, 2007, granted to NKHL by Strudex, Kraus Carpet Mills Limited and 1029011 Ontario Inc. (collectively now known as Kraus Inc.) and W.G. McMahon Canada Ltd. (now Kraus Canada Inc.);
- (b) Pledge Agreement dated June 28, 2007, granted to NKHL by Anneleen;
- (c) Limited Recourse Guarantee dated June 28, 2007 granted to NKHL by Anneleen Eckhardt and Harold Eckhardt as guarantors;
- (d) Security Agreement dated June 28, 2007, granted to NKHL by Barrett, Kraus Orders Inc., and other non Kraus Group entities.

65. The Nelson Security is a general charge against all of the Canadian Assets as well as a general charge against the assets located in the United States. Generally speaking, the Nelson Security ranks third in priority, behind the Senior Security Documents and the Junior Security Documents, respectively.

66. The Kraus Group has been operating pursuant to terms of numerous consecutive forbearance agreements since October 2010. These forbearance agreements note the Kraus Group's numerous defaults pursuant to the Senior Credit Agreement. Attached to my Affidavit as **Exhibit "J"** is a copy of the forbearance agreement pursuant to which the Kraus Group currently operates.

67. The key Kraus Group defaults pursuant to the Senior Credit Agreement include, but are not limited to the following:

- (a) the Kraus Group was not in compliance with its covenant obligation to maintain the required first lien debt to EBITDA ratio;
- (b) the Kraus Group was not in compliance with its covenant obligation to make certain requisite debt payments in accordance with its debt service coverage ratio;
- (c) the Kraus Group was not in compliance with its covenant obligation to maintain a minimum net worth of the Kraus Group's operations; and
- (d) the Kraus Group's forecast calculations demonstrate that the Kraus Group is not in compliance with its financial performance forecast requirements.

(Hereafter, these defaults will be collectively referred to as the "**Defaults**").

68. On May 18, 2012, Red Ash demanded repayment from each Canadian entity within the Kraus Group. Additionally, Red Ash issued its notices of intention to enforce its security, pursuant to section 244 of the BIA.

69. Attached to my Affidavit as Exhibit "**K**" are complete copies of the demand letters and notices of intention to enforce security.

70. Attached hereto and marked as Exhibits are the following items:

- (a) **Exhibit "L"**: copy of the Ontario *Personal Property Security Act* search results in respect of Kraus, dated April 29, 2012;
- (b) **Exhibit "M"**: copy of the Ontario *Personal Property Security Act* search results in respect of Strudex, dated April 29, 2012; and

- (c) **Exhibit "N"**: copy of the Manitoba *Personal Property Security Act* search results in respect of Kraus Canada, dated April 30, 2012.

### Kraus's Declining Financial Performance

71. The Kraus Group's financial performance has declined dramatically over the past several years. Since 2006, its gross revenues have dropped precipitously. In fact, the annual revenue for 2011 is only 60.5% of the 2006 amount. Consolidated annual revenues for the Kraus Group (from continuing operations) for the years ended December 2006 to December 2011 are as follows:

Year	2006	2007	2008	2009	2010	2011*
Revenue from continuing operations (\$000s)	\$324,639	\$260,510	\$242,309	\$223,076	\$202,767	\$195,089

72. This dramatic revenue decline has had a significant negative effect on the Kraus Group's EBITDA, which has declined from approximately \$34 million in 2006 to under \$5 million in 2011.

Year	2006	2007	2008	2009	2010	2011*
EBITDA from continuing operations (\$000s)	\$27,575	\$22,552	\$7,352	\$8,843	\$8,306	\$4,814

73. For each of the last four fiscal years, the Kraus Group has suffered net losses. In 2011, net losses totalled \$14,612,000.

74. Attached hereto and marked as **Exhibit "O"** is a copy of the audited consolidated financial statements for the Kraus Group for the year ended December 31, 2010. Attached hereto and marked as **Exhibit "P"** is a copy of the internally-prepared consolidated financial statements for the Kraus Group for the year ended December 31, 2011.

75. There are several reasons for the financial decline. First, the Kraus Group's performance was badly damaged by the downturn in the U.S. housing market and the subsequent recession in North America, which severely affected the residential and commercial flooring sectors. For example, by 2009 and 2010, North American carpet and flooring sales volumes had declined by 40% from their peak levels in 2005 and 2006, largely as a result of weaknesses in the U.S. housing market and the general effects of the recession. This sales decline was particularly pronounced in the Southeastern and Midwestern United States – historically strong markets for the Kraus Group.

76. The Canadian carpet market has also experienced a decline over the last several years.

77. Apart from a general decline in the market, the specific circumstances faced by the Kraus Group contributed to the decline in its fortunes. First, as a vertically-integrated producer and distributor, the Kraus Group faced significant fixed costs, including those associated with maintaining and operating the Waterloo Premises and a North America-wide distribution network. Those fixed costs could not be reduced or downsized to correspond with an overall decline in market demand.



78. Kraus Group was affected by the increase in the Canadian dollar over the past several years. A significant portion of its costs are incurred in Canadian dollars but a large proportion of revenues are generated in U.S. dollars. As such, while Canadian dollar expenses remained relatively static or rose, revenues from U.S. sales declined in relative Canadian dollar terms. As such, margins were negatively affected.

79. At the same time as the Kraus Group's revenues were being squeezed by the appreciating Canadian dollar, many expenses rose. For example, the cost of resin, a key component in carpet manufacturing, has increased substantially, thereby further reducing margins.

80. An additional factor in the Kraus Group's decline has been the impact of the buyout of its former shareholder, NKHL, in 2007 (the "**Share Purchase**"). In 2007, the Kraus Group purchased NKHL's 50% ownership interest in the Kraus Group. The purchase price paid by the Kraus Group consisted of a cash component, together with the Nelson Promissory Note. The Kraus Group financed the cash component of the Share Purchase using its existing cash and through an increased reliance on third party borrowings.

81. Although the Kraus Group has taken steps since 2008 to cut costs in its manufacturing process and by closing distribution facilities, the Kraus Group still has not been able to improve its financial performance or to minimize its mounting debt obligations.

82. Cash flow projections which Red Ash has prepared show that the Kraus Group will require substantial additional funding over the coming weeks. Red Ash is prepared to

make additional advances during this period pending the hearing for the application for the appointment of a Receiver.

### **RELIEF SOUGHT**

83. Red Ash has demanded payment under the Senior Credit Agreement and Junior Credit Agreement and is not prepared to make any further advances other than in the context proposed in these proceedings. Red Ash wishes to restructure the operations of the Kraus Group in these proceedings as follows.

84. First, on May 24, 2012, Red Ash commenced an application for a bankruptcy order in respect of Kraus Canada in the Court of Queen's Bench in Winnipeg, Manitoba. Such application is currently returnable before the Registrar in Winnipeg on June 5, 2012.

85. On May 24, 2012, Red Ash also commenced bankruptcy applications on the Commercial List at Toronto in respect of Strudex and Kraus. Such applications have been made returnable before a judge of the Commercial List on June 11, 2012.

86. Attached hereto and marked as

- (a) **Exhibit "Q"** is a copy of the bankruptcy application in respect of Kraus Canada;
- (b) **Exhibit "R"** is a copy of the bankruptcy application in respect of Kraus; and
- (c) **Exhibit "S"** is a copy of the bankruptcy application in respect of Strudex.

87. The bankruptcy applications in respect of Kraus and Strudex are being brought in Toronto, rather than London, pursuant to leave granted by Mr. Justice Morawetz on May

17, 2012 following his consultation with the Regional Senior Justice for the Superior Court of Justice, Southwest Region.

88. Since the Kraus and Strudex bankruptcy applications are being brought in Toronto, Red Ash is also bringing its application for an interim receiver of all Operating Companies in Toronto. Although the Kraus Canada bankruptcy application was commenced in Winnipeg, in the event that this court grants an order administratively consolidating the interim receivership application of all Operating Companies in Toronto along with the Kraus and Strudex bankruptcy applications, Red Ash will bring a motion before the Court of Queen's Bench in Winnipeg to transfer the Kraus Canada bankruptcy application to Toronto. Such motion is anticipated to be heard between May 28 and June 8, 2012.

89. The application for an interim receiver is to allow the financial affairs of the Operating Companies to be monitored on an interim basis while the bankruptcy applications are pending and until a full receiver over all Respondents can be appointed. The primary reasons to appoint an interim receiver include the following:

- (a) Bankruptcy applications have been commenced in respect of the Operating Companies and Red Ash has demanded payment of the indebtedness. The Kraus Group has no right to obtain further credit under the Senior Credit Agreement or Junior Credit Agreement;
- (b) The Kraus Group's cash position will be tight in the near future. Disruptions to the cash position resulting from unexpected events could result in the Kraus Group not being able to make critical payments. It is important that

during the short period between May 28, 2012 (the first hearing date) and June 11, 2012 (the proposed approval date) (the "**Interim Sale Period**") that the Kraus Group operate in the ordinary course of business. In that regard, Red Ash has agreed to provide additional advances to the Kraus Group during the Interim Sale Period, conditional upon the appointment of an Interim Receiver and the granting of a stay of proceedings;

- (c) In order to protect and preserve the value of the Kraus Group and its assets, management of the Kraus Group must be permitted to focus on maintaining operations during the Interim Sale Period. A stay of proceedings together with the assistance of having an interim receiver to monitor receipt and disbursements is the best method for achieving stability and allowing management to focus on ordinary course operations; and
- (d) It is a condition of Red Ash that it will only allow continued funding under the Senior Credit Agreement and the Junior Credit Agreement, if a stay of proceeding is obtained during the Interim Sale Period.

90. As is set out in the Notice of Application, Red Ash also seeks the appointment of a receiver over the assets and undertaking of the Respondents (the "**Receiver**"). The receivership application will be heard on a subsequent date, currently scheduled on June 11, 2012, in order to allow sufficient time for all interested parties to be provided with notice.

91. PWCI, a licensed bankruptcy trustee, has agreed to act as interim receiver and as Receiver if so appointed by the court. PWCI is also the bankruptcy trustee which Red Ash

wishes to have appointed in respect of the Operating Companies and PWCI has consented to act in this capacity, as well.

### **Subsequent Hearing on June 11, 2012**

92. Red Ash seeks to have the bankruptcy applications of the Operating Companies made returnable before a judge of the Commercial List on June 11, 2012. Red Ash does not expect that the Operating Companies will oppose such applications.

93. In the event that bankruptcy orders are issued against the Operating Companies on June 11, 2012, immediately after the bankruptcy orders are issued, Red Ash will ask this court to appoint the Receiver. Red Ash asks that PWCI in its capacity as Interim Receiver, if so appointed, and in its capacity as proposed Receiver, be authorized and directed to bring a motion in these proceedings for an order approving the Purchase Transaction if and when appointed as Receiver under section 243 of the BIA in order to complete the Purchase Transaction with Kraus Brands (the "**Purchaser**"). As is discussed in more detail below, in the event that the sale of assets to the Purchaser is not approved, Red Ash seeks to empower the Receiver to immediately commence liquidation of the Respondents' assets.

94. Since the Respondents are insolvent and, by the time that the receivership application is heard, the Operating Companies will likely be bankrupt, I believe that there is good reason to appoint the Receiver.

### **Sale of Respondents' Assets**

95. In the event that PWCI is appointed as Interim Receiver, it will (both in that capacity and as proposed Receiver) bring a motion to the court returnable on June 11, 2012 seeking approval for the sale of substantially all of the Respondents' assets to the Purchaser.

96. As the first, second, and third ranking secured creditor holding debt totalling approximately \$126 million, the only economic interests which are engaged by these insolvency proceedings are those of Red Ash. Based on Red Ash's own analysis, which it expects will be confirmed by the report to be filed by PWCI, the net realizable value of the Respondents' assets—whether as a going concern or on a liquidation basis—is substantially less than the amount of Red Ash's secured indebtedness.

97. Red Ash wishes to maximize its returns by having the Receiver conclude a sale of the Respondents' assets to the Purchaser on a going concern basis as quickly possible.

98. PWCI, in its capacity as Receiver (if so appointed), will be entering into an asset purchase agreement with the Purchaser (the "**APA**") immediately following its appointment as Receiver. Prior to PWCI's appointment as Interim Receiver, the Purchaser will execute and agree to be bound by the terms of the APA if approved by this Court on June 11, 2012.

99. Pursuant to the APA, the Purchaser will acquire substantially all of the assets and property of the Respondents, including their shareholdings in the Respondents' foreign subsidiaries, with a view to continuing the Respondents' business as a going concern.

100. As consideration for the purchase, the Purchaser will assume a substantial portion of the senior secured debt owed to Red Ash by the Respondents pursuant to the Senior Credit Agreement and Junior Credit Agreement and will assume other "Assumed Liabilities" as are defined in the APA. The APA also requires that the Purchaser pay or assume identified priority claims on closing that rank in priority to the debt owing under the Senior Credit Agreement and Junior Credit Agreement ("**Priority Claims**"). Those Priority Claims which are to be paid or assumed on closing are set out in detail at Schedule I to the APA.

101. The Purchaser will not assume the debts, obligations and liabilities associated with the Nelson Promissory Note. The other debts and obligations which the Purchaser will not assume are as set out in detail at section 2.4 of the APA.

102. Other significant aspects of the APA and the related acquisition transaction are as follows:

- (a) the Purchaser will offer employment to substantially all of the non-unionized employees which are employed by the Kraus Group as of June 10, 2012, on terms to be determined by the Purchaser;
- (b) in addition to typical conditions with respect to authorizations and consents and the condition noted above, the APA is conditional upon
  - (i) certain *Competition Act* approvals;
  - (ii) the granting by this Court of the Bankruptcy Order, Receivership Order, and the Approval and Vesting Order (as such terms are defined therein) ;
  - (iii) entering into new collective agreements with the unions representing unionized Kraus Group employees and having such agreements ratified by members (the "**New Collective Agreements**");

- (iv) the Priority Claims not exceeding a specified maximum amount and there having been no judicial determination that the Priority Claims include claims related to any employee plans (including the Pension Plan) or that the Purchaser is otherwise liable or responsible for any claims under employee plans (other than as has been agreed to by the Purchaser);
- (c) assuming all of the conditions precedent to the APA are met or waived and the sale approval and vesting order is issued, the Purchase Transaction will close on June 11, 2012 (the “**Closing Date**”);
- (d) the APA will give the Purchaser the option as to whether or not to continue occupation of certain leased premises. In the event that the Purchaser does not wish to continue using the premises or cannot reach an appropriate agreement with the landlord, PWCI (as proposed bankruptcy trustee, receiver, and vendor) will likely disclaim the leases and surrender the premises; and
- (e) other than as noted above, there are no significant conditions to closing in favour of the Purchaser or PWCI in its capacity as vendor under the APA.

#### **Purchaser's Intentions with respect to Pension Plans**

103. Pursuant to the terms of the APA, the Purchaser is not assuming the Pension Plans. The current service obligations together with the outstanding Pension Plan deficiencies are a primary cause of the Kraus Group's declining financial performance. The Purchaser has concluded that in order to make the Kraus Group financially viable on a go forward basis, the Kraus Group must be relieved of the negative financial impact caused by servicing the Pension Plans.

104. The Purchaser's intention is to offer pension plan benefits to assumed employees that are substantially the same as benefits currently received by Kraus Group employees



in defined contribution plans. In order to accomplish this objective, the Purchaser is working on establishing a new defined contribution pension plan for the benefit of those assumed employees that are members under the existing defined contribution pension plan. The new pension plans will be in place on the Closing Date, or shortly thereafter, with the contributions to be applied retroactive to the Closing Date, thereby providing an uninterrupted benefit to those employees that are assumed.

105. In respect of those employees that are participants in CCWIPP, the Purchaser does not intend to assume Strudex's and Kraus's existing obligations to make contributions to the CCWIPP pursuant to an existing participation agreement. However, the Purchaser does intend to enter into a new participation agreement with the UFCW confirming that the Purchaser will, from and after the Closing Date, make contributions to CCWIPP which are substantially similar to those contributions currently being made by Strudex and Kraus.

#### **Purchaser's Intentions with respect to Collective Agreements**

106. Pursuant to the Terms of the APA, the Purchaser requires that the New Collective Agreements be entered into on terms satisfactory to the Purchaser, the UFCW and the Teamsters.

107. The Purchaser has met with the UFCW's bargaining committees for Strudex and Kraus (the "**Bargaining Committees**"). The Purchaser and the Bargaining Committees negotiated over a two week period culminating in memoranda of settlement. Both the Bargaining Committee for Strudex and the Bargaining Committee for Kraus will organize ratification votes with respect to the memoranda of settlement during the Interim Sale

Period. The members of the Bargaining Committees unanimously support the memoranda of settlement and will recommend to the general membership of their respective unions that the memoranda of settlement be ratified.

108. It is the Purchaser's intention to commence negotiations with the Teamsters during the Interim Sale Period.

### **Moving Forward with the Purchase Transaction**

109. Importantly, the Purchase Transaction will allow Kraus to continue as a going concern and to preserve as many jobs as possible. The current estimate is that substantially all of the non-unionized employees and substantially all of the unionized employees, as are employed by the Operating Companies on June 10, 2012, will be offered positions if the APA is approved and the sale completed. The large manufacturing and warehousing facilities in Waterloo, Ontario will continue to operate, as will the Kraus Group's distribution facilities throughout Canada (if satisfactory arrangements are made with the respective landlords), the United States and Australia and Kraus Australia's manufacturing operation.

110. The Purchase Transaction will allow the Purchaser to carry on the carpet and flooring business of the Kraus Group, which would be a successful outcome for customers, suppliers, employees and other stakeholders.

111. Crucially, as a result of the Kraus Group's dire financial position, it continues to burn through cash at a significant rate and has no other options. If the Purchase Transaction is not approved, Red Ash will have no option but to liquidate.

**Dealing with Suppliers/Customers**

112. Once the Interim Receiver is appointed and a stay is in place, the Purchaser intends to contact suppliers and customers for the purpose of providing them with information related to the Purchaser's long term strategies and goals for reviving the Kraus Group's business operations. In this regard, the terms of the APA allow the Purchaser to assume, with the necessary consents, those contracts that the Purchaser deems as important to continuing the Kraus Group business operations.

**Liquidation as an Option**

113. In the event that the Purchase Transaction is not approved or is not concluded for any reason, Red Ash seeks to have the Receiver commence liquidation of the assets owned by the Respondents on June 12, 2012. The reasons Red Ash wishes to pursue a prompt liquidation are as follows:

- (a) PWCCF recently completed an extended and thorough sales process for the purpose of locating a going concern buyer or investor for the Kraus Group. Within this sales process, PWCCF determined that Hilco's bid was the superior bid. It is highly unlikely that another sales process would generate net proceeds in excess of the more than \$126 million of secured debt held by Red Ash;
- (b) It is also highly unlikely that a new purchaser would come forward and submit a bid that would be supported by the Kraus Group's secured creditor, being Red Ash;

- (c) The recent historical Kraus Group financial statements together with the future financial forecasts for the Kraus Group establish that it is in dire need of a thorough restructuring in order to have an opportunity to become sustainable and have satisfactory EBITDA. There is no viable commercial reason to further invest in the Kraus Group under its current business model; and
- (d) Red Ash is not prepared to extend further financing to the Kraus Group to cover cash flow deficiencies under any alternative to the Purchase Transaction.

114. In order to effect the liquidation of the Kraus Group, Red Ash will request that this Court authorize PWCI, in its capacity as Receiver, to retain a liquidator for the purpose of liquidating the assets of the Operating Companies. Red Ash seeks to have appointed a liquidator approved by both Red Ash and PWCI or, in the alternative, a liquidator selected by the court.

115. The Kraus Group owes Red Ash approximately \$126 million. Through the security documents, the Kraus Group has provided first ranking security to Red Ash over all of the Kraus Group's assets. We are advised by PWCI that its counsel has reviewed the Canadian security documents relating to the Senior Credit Agreement, Junior Credit Agreement, and Nelson Promissory Note, and provided a legal opinion confirming validity and enforceability. Red Ash's liquidation analysis establishes that the range of recovery for the Kraus Group assets is materially less than the amount of the Respondents' indebtedness to Red Ash. Red Ash's liquidation analysis is supported by an independent

liquidation analysis prepared by PWCI as proposed Interim Receiver and Receiver, which demonstrates that there will be no recovery for creditors other than Red Ash and certain statutory claims which still rank in priority following the bankruptcy of the Operating Companies. The conclusion is that Red Ash is the sole remaining economic stakeholder in the Kraus Group assets.

### **Consolidation of Bankruptcies**

116. As detailed above, Red Ash is bringing bankruptcy applications for Strudex, Kraus and Kraus Canada. Kraus Canada's registered head office is in Winnipeg, Manitoba. Strudex and Kraus's head office is located in Waterloo, Ontario. It is Hilco's position that these bankruptcy applications ought to be consolidated into one application that is overseen by this Court.

117. The companies within the Kraus Group are highly integrated and they operate as a coordinated unit. Examples of integration include the following:

- (a) the vast majority of the Kraus Group's senior management works from the offices located in Waterloo, Ontario;
- (b) the administration of the Kraus Group, including marketing and human resources, operates primarily from Waterloo, Ontario;
- (c) there is considerable commonality of the people that sit on the board of directors for Strudex, Kraus and Kraus Canada. The vast majority of these board members reside in Ontario;

- (d) Kraus Canada does maintain its own local bank accounts across Canada; however, it does have bank accounts as well as a large distribution centre in Ontario;
- (e) Kraus Canada's business operations are dependent on the business operations of Strudex and Kraus. As stated above, Kraus Canada receives the majority of its supply from Strudex and Kraus and would not be able to continue business operations without this supply. Further Kraus Canada's senior management is based in Waterloo;
- (f) legal counsel for the Kraus Group is located in Toronto, Ontario, together with legal counsel for PWCI, legal counsel for Red Ash, and legal counsel for the Purchaser; and
- (g) the senior personnel of PWCI with carriage of these proceedings are located in Toronto, Ontario.

118. For these reasons a consolidation of the bankruptcy proceedings in Toronto would be significantly more efficient and cost effective than either having separate proceedings or having consolidated proceedings in a different province.

119. Importantly, Kraus Group's creditors will not be prejudiced by an administrative consolidation of the bankruptcy applications. Red Ash, the only secured creditor of the Respondents with an economic interest in the Purchase Transaction, fully supports the consolidation. There is no scenario available that will generate any recovery by

unsecured creditors. As such, there is no prejudice to unsecured creditors if the applications are administratively consolidated.

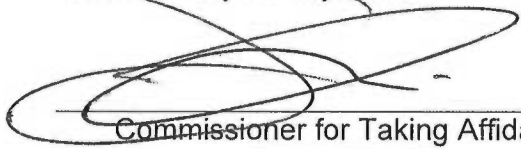
### **The Service Protocol**

120. As the Applicant in these proceedings, Red Ash, working with PWCI in its capacity as proposed interim receiver, has developed a protocol to provide notice of the relief requested herein to individual beneficiaries of the Pension Plans (the "**Members**"). The protocol is as follows:

- (a) PWCI will work with the Kraus Group to obtain current mailing information for all of the Members. PWCI will at all times keep this personal information confidential;
- (b) once appointed as Interim Receiver, and once the mailing information has been obtained, PWCI will complete a mailing to all Members notifying them of the current proceedings and directing them to their website to locate the relevant court materials. A toll-free telephone number will also be provided so that Members can request that a copy of the court materials be couriered to them. The proposed form of notice to be used pursuant to this mailing is attached as Schedule A to the draft Interim Receiver appointment order ;  
and
- (c) PWCI will not respond to substantive questions or provide any advice, but will suggest that Members that contact PWCI obtain independent financial and or legal advice.

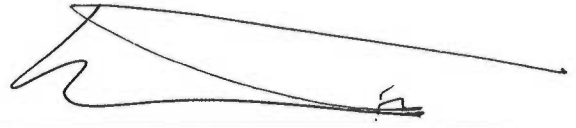
121. Notice is being given to members of the Pension Plans because, if the Purchase Transaction is approved, Red Ash does not intend to assume the Pension Plans.

SWORN BEFORE ME at the City of  
Waterloo, in the Province of Ontario, on  
the 25th day of May, 2012.

A large, stylized signature in black ink, consisting of several overlapping loops and a long horizontal stroke.

Commissioner for Taking Affidavits  
(or as may be)

*Sarah Emily Lodi*

A signature in black ink, featuring a large, sweeping loop followed by a horizontal line and a small flourish.

CHRISTOPHER EMMOTT



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PINNACLE CAPITAL RESOURCES LIMITED  
Applicant and

KRAUS INC. et al

Respondents

Court File No.

ONTARIO  
SUPERIOR COURT OF JUSTICE  
(COMMERCIAL LIST)  
  
PROCEEDING COMMENCED AT  
TORONTO

AFFIDAVIT OF CHRISTOPHER EMMOTT  
(SWORN MAY 25, 2012)

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