

**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., STRUDEX FIBRES LIMITED,
and 538686 B.C. LTD.
Respondents

APPLICATION UNDER SECTION 43 and SECTION 243 OF THE *BANKRUPTCY AND
INSOLVENCY ACT*, R.S.C. 1985, c. B-3, as amended

**FACTUM OF THE APPLICANT
(APPLICATION FOR BANKRUPTCY ORDER
AND RECEIVERSHIP ORDER RETURNABLE JUNE 11, 2012)**

June 8, 2012

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Court File No. CV12-9731-00CL

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FACTUM OF THE APPLICANT

PART I - OVERVIEW

1. Upon the return of the application on June 11, 2012, the Applicant, Pinnacle Capital Resources Limited ("**Pinnacle**") in its capacity as general partner of Red Ash Capital Partners II Limited Partnership ("**Red Ash**") seeks the following relief:

- (a) the administrative consolidation of the bankruptcy application in respect of Kraus Canada Inc. ("**Kraus Canada**"), originally brought in the Manitoba Court of Queen's Bench in Winnipeg, Manitoba, with the already-consolidated bankruptcy applications of Kraus Inc. ("**Kraus**"), and Strudex Fibres Limited ("**Strudex**");

- (b) orders granting the bankruptcy applications (the “**Bankruptcy Orders**”) in respect of Kraus Canada, Strudex, and Kraus (collectively, the “**Operating Companies**”);
- (c) an order suspending the effective time of the Bankruptcy Orders until immediately prior to the Receivership Order Effective Time (defined below), if the Receivership Order (defined below) is granted;
- (d) an order appointing PricewaterhouseCoopers Inc. (“**PwC**”), which is currently the interim receiver of the Operating Companies, as receiver (the “**Receiver**”), without security, over the Respondents (the “**Receivership Order**”) pursuant to section 243 of the *Bankruptcy and Insolvency Act* (“**BIA**”); and
- (e) in the event that the Purchase Transaction (defined below) is not approved, an order approving the liquidation of the assets of the Kraus Group (defined below).

2. The Operating Companies (along with other entities defined below as the “**Kraus Group**”) are currently and have, for more than the past two years, been operating pursuant to a series of consecutive forbearance agreements with their major secured lenders.

3. The Kraus Group commenced an extensive sales process in October 2011, in an effort to find a strategic investor willing to assist with turning around its operations and financial performance of the Kraus Group. That sales process was run by

PricewaterhouseCoopers Corporate Finance Inc. (“**PwCCF**”), an affiliate of PwC and attracted wide interest and multiple proposals from potential purchasers. Hilco UK Limited (“**Hilco**”) made a bid during this sales process and in February 2012, PwCCF advised Hilco that its bid to invest in the Kraus Group was the superior bid.

4. Hilco and the secured creditors of the Kraus Group negotiated a number of potential investment/purchase structures over a period of approximately ten weeks. Based on the exhaustive sales process that PwCCF ran, there is no need for any further marketing of the Respondents’ assets and it is apparent that no better offer for such assets—or any offer which is likely to provide value to creditors subordinate to Red Ash—is likely to be obtained.

5. Around May 7, 2012, Hilco, through its nominee Red Ash, took an assignment of all outstanding debt of approximately \$126 million and security of the Kraus Group held by the Senior Lenders, BMOCC, and Nelson, which are the three main secured lenders (all of whom are defined below).

6. Red Ash has filed bankruptcy applications as against the Operating Companies.

7. On May 28, 2012, Mr. Justice Morawetz granted an order

- (a) appointing PwC as interim receiver, without security, in respect of the Operating Companies;
- (b) administratively consolidating the bankruptcy applications in respect of Kraus and Strudex;

8. If the Bankruptcy Orders are granted on June 11, 2012, Red Ash will immediately thereafter seek the appointment of PwC as receiver under section 243 of the BIA for the purpose of having PwC, in its capacity as receiver, seek approval of (“**Approval and Vesting Order**”), and complete, a sale of substantially all of the assets of the Respondents (including the shares of the non-Canadian Kraus entities within the Kraus Group (the “**Canadian Assets**”). The purchase price will be satisfied by the assumption of a substantial portion of the secured debt, the assumption of certain other specified liabilities and the payment or assumption of claims that rank in priority to the secured debt (the “**Purchase Transaction**”).)

9. The Purchase Transaction will benefit all major groups of stakeholders. The purchaser, Kraus Brands LP (“**Kraus Brands**” or the “**Purchaser**”), an affiliate of Hilco, intends to operate the business as a going concern and to retain the substantial majority of employees, including the unionized employees. Red Ash, the only creditor with an economic interest in the Purchase Transaction (given that the realizable value of the Kraus Group’s assets is materially less than the amount of the debt to Red Ash) supports the transaction.

10. The Kraus Group is currently out of cash and needs immediate financing if it is to survive. If the Purchase Transaction is not approved and completed, the Kraus Group will not be able to carry on business.

PART II - FACTS

The Parties

11. Pinnacle is incorporated pursuant to the *British Virgin Islands Business Companies Act, 2004*. Pinnacle is the general partner of Red Ash. Hilco, a company incorporated pursuant to the laws of the United Kingdom, is the sole shareholder of Pinnacle.

Affidavit of Christopher Emmott sworn May 25, 2012 ("Emmott Affidavit"),
Application Record, Tab 2 at paras. 1, 3 and 4.

12. The Kraus Group (the collective name for the entities listed below) carries on business as a manufacturer and distributor of flooring products, including carpeting. Its operations extend across Canada, the United States, and Australia, but management control is centred in Waterloo, Ontario, where main production occurs. The Kraus Group is made up of the following entities:

- (a) 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, Waterloo, Ontario (the "**Waterloo Premises**"). It sells substantially all of the fibre it produces to Kraus Inc. and to Northstate Carpet Mills Pty. Strudex has approximately 100 full-time employees, of which 80 are members of the United Food and Commercial Workers, Local 175 (the "**UFCW**");
- (b) 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 275 people, of which 175 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 entities within the Kraus Group;

- (c) 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, Winnipeg, Ontario, Alberta and Nova Scotia. Kraus Canada employs 144 people, including eight unionized employees who are represented by the Teamsters (as defined below);
- (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 business involvement with any Kraus Group entity;
- (e) *538626 B.C. Ltd.* ("**Kraus B.C.**") is a corporation incorporated pursuant to the laws of British Columbia, which has its registered office in Vancouver. Kraus B.C. is non-operating, has no employees, no material assets, and no material liabilities;
- (f) *Kraus USA Inc.* ("**Kraus U.S.**") is a corporation incorporated pursuant to the laws of Delaware. Kraus USA 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 D.C., and 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 35 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.* (“**Kraus Australia**”) is a corporation located in the Gold Coast region of Queensland, Australia. Kraus Australia is a manufacturer and distributor of carpet and flooring products in Australia. Kraus Australia purchases the majority of its yarn from Strudex and a majority of its carpet from Kraus. Kraus Australia employs approximately 40 employees, of none of whom are unionized.

Emmott Affidavit at para. 14

13. 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. It 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.

Emmott Affidavit at paras. 15 and 16

14. 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%.

Emmott Affidavit at para. 17

15. 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. The Kraus Group markets its carpet and flooring products to both the commercial and residential markets.

Emmott Affidavit at paras. 18 and 19

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

Emmott Affidavit at para. 20

17. The Kraus Group is party to three separate collective agreements (defined below, collectively, the "**Collective Agreements**") which cover a portion (but not all) of the workforce:

- (a) Strudex and the UFCW are parties to a collective agreement, dated March 20, 2008 (the "**Strudex Collective Agreement**") and in force until July 2013. Approximately 93 employees are subject to the Strudex Collective Agreement.

- (b) Kraus and the UFCW are parties to a collective agreement, dated July 1, 2009 (the **Kraus Collective Agreement**) and in force until June 30, 2012. Approximately 175 employees are subject to the Kraus Collective Agreement.
- (c) 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**). The Kraus Canada Collective Agreement expired on September 30, 2011, however, the Kraus Canada Collective 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.

Emmott Affidavit at paras. 21-23; Supplementary Affidavit of Christopher Emmott sworn June 6, 2012 (the "Supplementary Affidavit"), Supplementary Application Record, Tab 1 at paras. 11 and 12.

18. In anticipation of the potential Purchase Transaction, on May 7, 2012, the Purchaser and the UFCW concluded negotiations regarding memoranda of settlement to amend the Strudex Collective Agreement and the Kraus Collective Agreement.

Supplementary Affidavit at para. 10

19. At a vote held on May 31, 2012, the employees subject to the Strudex Collective Agreement ratified the corresponding memorandum of settlement such that there is now a binding settlement. Of the approximately 93 employees eligible to vote under the

Strudex Collective Agreement (of which 85 are actively employed and 8 are on layoff or long-term leave), 89 attended the vote. Seventy-two members, being 81% of those in attendance, voted in favour of the memorandum of settlement.

Supplementary Affidavit at para. 11

20. At a vote held on May 31, 2012, the employees subject to the Kraus Collective Agreement ratified the corresponding memorandum of settlement such that there is now a binding settlement. Of the approximately 175 employees eligible to vote under the Kraus Collective Agreement, 145 attended the vote. One hundred and twenty-three members, being 84% of those in attendance, voted in favour of the memorandum of settlement.

Supplementary Affidavit at para. 12

21. With respect to the Teamsters, if the Purchase Transaction is approved by the Court, the purchaser intends to assume the existing collective agreement.

Supplementary Affidavit at para. 13

22. 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'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;

Emmott Affidavit at para. 117.

PENSION PLANS

23. A number of entities in the Kraus Group have employee pension plans, which are summarized in the following chart:

Name of Plan	Covered Employees (No. active and inactive)	Nature of Employer Obligations
Kraus Canada Plan	Kraus Canada (202)	Defined Benefit (until December 31, 2009); Defined Contribution (from January 1, 2010 to present)
Strudex Plan	Kraus and Strudex (150)	Defined Benefit (until December 31, 2009); Defined Contribution (from January 1, 2010 to present)
Executive Plan	Kraus Executives (13)	Defined Benefit
Union Plan	Unionized Employees of Kraus (330)	Defined Benefit (until December 31, 1989)
Canadian Commercial Workers Industry Pension Plan	Unionized employees of Kraus and Strudex	Fixed per hour contributions pursuant to Collective Agreements (January 1, 1990 to present)

Emmott Affidavit at paras. 26-39.

24. If the Purchase Transaction is approved, the purchaser does not intend to assume the existing Kraus Group pension plans. Instead, the Purchaser's intention is to offer pension plan benefits to Assumed Employees that are substantially similar to benefits currently received by employees of the Respondents.

Supplementary Affidavit at para. 17

Kraus Group's Debt and Security Structure

25. Around May 7, 2012, Red Ash entered into the three following concurrent debt assignment transactions (hereafter collectively referred to as the "**Debt Assignment Transactions**");

- (a) The Senior Lenders agreed to irrevocably and unconditionally assign their respective interest to Red Ash (the "**Senior Debt Assignment Transaction**");
- (b) Red Ash 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 a master assignment agreement between Red Ash and BMOCC, dated May 8, 2012 (the "**BMOCC Debt Assignment Transaction**");
- (c) Red Ash also purchased the debt and security owned by Nelson Kraus Holdings Limited ("**NKHL**") as against the Kraus Group, by way of a master

assignment agreement between Red Ash and NKHL (the “**Nelson Kraus Debt Assignment Transaction**”).

Emmott Affidavit at paras. 51-53.

The Secured Debt

26. 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.

Emmott Affidavit at para. 54.

27. Kraus’s primary credit facilities are extended pursuant to a credit and guarantee agreement, dated as of June 28, 2007, pursuant to which Strudex, Kraus, and Kraus Canada are borrowers and guarantors.

Emmott Affidavit at para. 55.

28. This credit agreement was amended on five occasions from August 30, 2007 to March 7, 2011. (The credit agreement, including the amendments and all other relevant modifications, shall hereafter be referred to collectively as the “**Senior Credit Agreement**”). As of April 30, 2012, the total indebtedness outstanding under the Senior Credit Agreement was approximately \$71,115,000.

Emmott Affidavit at paras. 56 and 57.

29. 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 \$19,714,000.

Emmott Affidavit at para. 58.

30. 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.

Emmott Affidavit at para. 59.

31. Pursuant to the terms of the Nelson Kraus Debt Assignment Transaction, Red Ash purchased the Nelson Promissory Note from Nelson, together with the associated security provided in support thereof.

Emmott Affidavit at para. 60.

The Corresponding Security and Related Defaults

32. 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**")

Emmott Affidavit at para. 61.

33. The Kraus Group's debts, obligations and liabilities under the Junior Credit Facility are fully secured by a series of security documents (the "**Junior Security Documents**"). The Junior Security Documents establish a general charge against all of the Canadian Assets as well as a specific charge. Generally speaking, the Junior Security Documents rank second in priority, behind the Senior Security Documents.

Emmott Affidavit at paras. 62 and 63.

34. The Kraus Group's debts, obligations and liabilities pursuant to the Nelson Promissory Note are secured by various security documents (collectively the "**Nelson Security**"). 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. In particular, Strudex, Kraus and Kraus Canada all granted security over certain assets to NKHL (which is now held by Red Ash). Generally speaking, the Nelson Security ranks third in priority, behind the Senior Security Documents and the Junior Security Documents, respectively.

Emmott Affidavit at paras. 64 and 65.

35. 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.

Emmott Affidavit at para. 66.

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

- (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 are collectively referred to as the "**Defaults**").

Emmott Affidavit at para. 67.

37. 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.

Emmott Affidavit at para. 68.

Kraus's Declining Financial Performance

38. 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 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

Emmott Affidavit at para. 71.

39. 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)	\$34,751	\$29,068	\$7,222	\$8,900	\$8,305	\$4,814

Emmott Affidavit at para. 72.

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

Emmott Affidavit at para. 73.

41. 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.

Emmott Affidavit at para. 75.

42. The Canadian carpet market has also experienced a decline over the last several years. However, 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.

Emmott Affidavit at paras. 76 and 77.

43. Kraus Group was affected by the increase in 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.

Emmott Affidavit at para. 78.

44. At the same time that its 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.

Emmott Affidavit at para. 79.

45. An additional factor in Kraus's decline has been the impact of the buyout of the Kraus Group's former shareholder, NKHL in 2007 (the "**Share Purchase**"). In 2007, the Kraus Group purchased NKHL's 50% ownership interest. 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.

Emmott Affidavit at para. 80.

46. Although the Kraus Group has taken steps to cut costs since 2008, in its manufacturing process and by closing distribution facilities, the Kraus Group still has not been able to improve its financial performance nor to minimize its mounting debt obligations.

Emmott Affidavit at para. 81.

47. Cash flow projections which Red Ash has prepared show that the Kraus Group will require substantial additional funding over the coming weeks. Notwithstanding the demands for payment, Red Ash has allowed the Operating Companies to continue to use accounts receivable to pay operating expenses.

Emmott Affidavit at para. 82.

48. 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.

Emmott Affidavit at para. 96.

Bankruptcy Proceedings

49. Red Ash has demanded payment under the Senior Credit Agreement, Junior Credit Agreement, and Nelson Promissory Note and is not prepared to make any further advances other than in the context proposed in these proceedings.

Emmott Affidavit at para. 83 and Exhibit K.

50. 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 (the "**Manitoba Court**"). Such application bears court file no. BK 12-01-02706 and Official Receiver file no. 21-081406 (the "**Kraus Canada Bankruptcy Application**"). On June 5, 2012, Registrar Berthaudin of the Manitoba Court made an order transferring the Kraus Canada Bankruptcy Application to the Ontario Superior Court of Justice (Commercial List) and Bankruptcy Division 31 (i.e., Toronto).

Emmott Affidavit at paras. 84 and 85; Supplementary Affidavit at para. 19.

51. On May 24, 2012, Red Ash also commenced bankruptcy applications on the Commercial List at Toronto in respect of Strudex and Kraus, bearing respectively court file no. 31-OR-207896-T (the "**Strudex Bankruptcy Application**") and court file no. 31-OR-207897-T (the "**Kraus Bankruptcy Application**").

Emmott Affidavit at paras. 84 and 85.

52. The Kraus Bankruptcy Application and the Strudex Bankruptcy Application were brought in Toronto, rather than London, pursuant to leave granted by Justice Morawetz on May 17, 2012.

Emmott Affidavit at para. 87.

53. On May 28, 2012, this Court granted an order

- (a) appointing PwC, a licensed trustee, as interim receiver, without security, in respect of the Operating Companies; and
- (b) administratively consolidating and transferring to the Commercial List the Strudex Bankruptcy Application and the Kraus Bankruptcy Application.

54. Since the Kraus Bankruptcy Application and the Strudex Bankruptcy Application were brought in Toronto, Red Ash also brought its application for an interim receiver of all three Respondents in Toronto.

55. PwC, a licensed bankruptcy trustee, has agreed to act as interim receiver and as Receiver if so appointed by the court. PwC is also the bankruptcy trustee which Red Ash wishes to have appointed in respect of the Operating Companies and PwC has consented to act in this capacity, as well.

Emmott Affidavit at para. 91.

56. PwC, in its capacity as Receiver (if so appointed), will be seeking this Court's approval to enter into an asset purchase agreement with the Purchaser (the "**APA**") immediately following its appointment as Receiver. The Purchaser has executed and agreed to be bound by the terms of the APA if approved by this Court on June 11, 2012.

Emmott Affidavit at para. 98.

57. Save and except for the granting of the requested Bankruptcy Orders, the granting of the requested Receivership Order and the approval of the APA by this Court, all conditions precedent to the Purchase Transaction have either been fulfilled or were waived by the Purchaser.

Supplementary Affidavit at para. 15.

PART III - ISSUES

58. The Applicant seeks the following relief:

- (a) an order validating the manner of service of the Application Record in respect of the relief sought herein and declaring that the time for service be abridged so that the relief sought herein is returnable on June 11, 2012 and that further service thereof is dispensed with;
- (b) an order administratively consolidating the Kraus Canada Bankruptcy Application with the already-consolidated Kraus Bankruptcy Application and Strudex Bankruptcy Application;
- (c) orders granting the Bankruptcy Orders but suspending the effective time of such orders until immediately prior to the Receivership Order Effective Time (defined below), if the Receivership Order is granted;
- (d) an order pursuant to section 243 of the BIA appointing PwC as the Receiver and directing that the appointment of the Receiver shall become effective on the earlier of (a) immediately prior to the closing of the Purchase Transaction if the Sale Approval Motion is granted or (b) in the event that

the Purchase Transaction is terminated in accordance with the terms thereof, immediately following such termination (the “**Receivership Order Effective Time**”); and

- (e) in the event that the Transaction is not approved or is terminated in accordance with the terms thereof, an order authorizing and directing PwC, as the Receiver, to liquidate the assets of the Respondents.

59. PwC, as interim receiver and as proposed Receiver, brings a motion, concurrently with this Application, seeking court approval of the Purchase Transaction and the granting of a vesting order. In support of that motion, PwC is separately filing a report and a factum.

PART IV - LAW AND ARGUMENT

A. The Operating Companies’ Bankruptcy Applications Should Be Consolidated

60. The Court has authority to administratively consolidate the Kraus Canada Bankruptcy Application with the already consolidated Kraus Bankruptcy Application and the Strudex Bankruptcy Application, pursuant to subsection 43(4) of the *Bankruptcy and Insolvency Act*, which states as follows:

43 (4) If two or more applications are filed against the same debtor or against joint debtors, the court may consolidate the proceedings or any of them on any terms that the court thinks fit.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 43(4)

61. To come within the ambit of the above provision, a party seeking an administrative consolidation must show that the applications it seeks to consolidate have been filed against the same debtor or joint debtors.

62. Kraus Canada is a joint debtor along with Kraus and Strudex. All three entities are borrowers and guarantors under the Senior Credit Agreement. Further, Kraus Canada has granted security over certain of its assets in connection with the Junior Credit Agreement under which Kraus and Strudex are borrower and guarantor respectively. Finally, all three Operating Companies granted security in connection with the Nelson Promissory Note.

63. The Operating Companies are highly integrated and operate as part of the interdependent Kraus Group. Since the Kraus Bankruptcy Application and Strudex Bankruptcy Application have already been consolidated, there is all the more reasons to consolidate the Kraus Canada Bankruptcy Application with those proceedings.

64. Administrative consolidation will not prejudice any of the Kraus Group's creditors. Red Ash, the only secured creditor of Kraus Canada with an economic interest in the Purchase Transaction, fully supports the consolidation. Further, there is no scenario available that will permit any recovery by unsecured creditors.

B. The Operating Companies Should Be Adjudged Bankrupt

65. In support of its application for the Bankruptcy Orders, Red Ash relies on section 43(1) of the BIA, which provides as follows:

Bankruptcy Application

43. (1) Subject to this section, one or more creditors may file in court an application for a bankruptcy order against a debtor if it is alleged in the application that

(a) the debt or debts owing to the applicant creditor or creditors amount to one thousand dollars; and

(b) the debtor has committed an act of bankruptcy within the six months preceding the filing of the application

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 43(1)

66. Further, subsection 42(1)(j) of the BIA provides that a debtor commits an act of bankruptcy, where the debtor ceases to meet its liabilities generally as they become due.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 42(1)(j)

67. The two part test in section 43 has been met. The Operating Companies are liable for more than \$126 million. On April 30, 2012 the Operating Companies owed approximately \$71,115,000 under the Senior Credit Agreement, \$19,714,000 under the Junior Credit Agreement, and \$35,407,000 under the Nelson Promissory Note. Since the security given by the Operating Companies has a realizable value which is substantially less than the \$126 million which is owing, Red Ash has an unsecured claim of at least \$10 million.

68. The Operating Companies have ceased to meet their liabilities generally as they become due. The Kraus Group has committed a number of defaults under the various credit agreements and has been operating pursuant to a series of forbearance agreements since October 2010. The Kraus Group ceased to meet its obligations to the Senior Lenders, BMOCC, and Nelson. On May 18, 2012, after acquiring most of the Kraus Group's debt, Red Ash demanded repayment and issued notices of intention to enforce security. The Operating Companies have failed to meet their obligation to repay the debt.

69. The current failure to pay Red Ash is a continuation of existing defaults occurring in the last six months, including the previous failure to pay the Senior Lenders, BMOCC, and Nelson.

70. There is no legitimate basis on which a bankruptcy order should be refused. The refusal to grant a bankruptcy order based on “other sufficient cause” in section 43(7) of the BIA occurs only in limited circumstances where the applicant has an ulterior motive or where granting a bankruptcy order would serve no meaningful purpose.

Re Ivaco Inc., 2006 CarswellOnt 6292 at para. 37 (C.A.)

Re Lambert, 2002 CarswellOnt 2659 at para. 40 (C.A.)

71. Further, the fact that a bankruptcy may alter creditor rights and priorities is not sufficient reason to deny a bankruptcy order.

Re Ivaco, *supra*, at para. 76.

Bank of Montreal v. Scott Road Enterprises Ltd., 1989 CarswellBC 337 at paras. 35-37 (C.A.)

72. The regime of the BIA (and the *Companies’ Creditors Arrangement Act*) reflect a single proceeding model where a collective proceeding supersedes the usual civil process available to creditors. Creditors’ remedies are collectivized to prevent the free-for-all that would result from individual creditor action.

Century Services v. Canada (Attorney General), [2010] 3 S.C.R. 379 (S.C.C.) at para. 22.

73. In this case, Red Ash has met the standard statutory test for a bankruptcy order. Since there is no ulterior motive (such as in *Re Lambert*, cited above) and no party has shown that the bankruptcy would not serve a meaningful purpose, a bankruptcy order should issue in respect of the Operating Companies.

C. PwC Should Be Appointed Receiver in respect of the Operating Companies

74. The Court has authority to appoint a receiver pursuant to section 243 of the *Bankruptcy and Insolvency Act*, which states as follows:

Court may appoint receiver

243. (1) Subject to subsection (1.1), on application by a secured creditor, a court may appoint a receiver to do any or all of the following if it considers it to be just or convenient to do so:

(a) take possession of all or substantially all of the inventory, accounts receivable or other property of an insolvent person or bankrupt that was acquired for or used in relation to a business carried on by the insolvent person or bankrupt;

(b) exercise any control that the court considers advisable over that property and over the insolvent person's or bankrupt's business; or

(c) take any other action that the court considers advisable.

Restriction on appointment of receiver

(1.1) In the case of an insolvent person in respect of whose property a notice is to be sent under subsection 244(1), the court may not appoint a receiver under subsection (1) before the expiry of 10 days after the day on which the secured creditor sends the notice unless

(a) the insolvent person consents to an earlier enforcement under subsection 244(2); or

(b) the court considers it appropriate to appoint a receiver before then.

Definition of "receiver"

(2) Subject to subsections (3) and (4), in this Part, "receiver" means a person who

(a) is appointed under subsection (1); or

(b) is appointed to take or takes possession or control — of all or substantially all of the inventory, accounts receivable or other property of an insolvent person or bankrupt that was acquired for or used in relation to a business carried on by the insolvent person or bankrupt — under

(i) an agreement under which property becomes subject to a security (in this Part referred to as a "security agreement"), or

(ii) a court order made under another Act of Parliament, or an Act of a legislature of a province, that provides for or authorizes the appointment of a receiver or receiver-manager.

Definition of "receiver" — subsection 248(2)

(3) For the purposes of subsection 248(2), the definition "receiver" in subsection (2) is to be read without reference to paragraph (a) or subparagraph (b)(ii).

Trustee to be appointed

(4) Only a trustee may be appointed under subsection (1) or under an agreement or order referred to in paragraph (2)(b).

Place of filing

(5) The application is to be filed in a court having jurisdiction in the judicial district of the locality of the debtor.

Orders respecting fees and disbursements

(6) If a receiver is appointed under subsection (1), the court may make any order respecting the payment of fees and disbursements of the receiver that it considers proper, including one that gives the receiver a charge, ranking ahead of any or all of the secured

creditors, over all or part of the property of the insolvent person or bankrupt in respect of the receiver's claim for fees or disbursements, but the court may not make the order unless it is satisfied that the secured creditors who would be materially affected by the order were given reasonable notice and an opportunity to make representations.

Meaning of "disbursements"

(7) In subsection (6), "disbursements" does not include payments made in the operation of a business of the insolvent person or bankrupt.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 243

75. The appointment of a receiver is a matter of discretion. Where a secured party has a right under its security to appoint a receiver, the question the court must answer is whether an appointment by the Court is more in the interests of all concerned than not.

Canadian Tire Corp. v. Healy, [2011] O.J. No. 3498 (S.C.J.) at para. 18

Bank of Montreal v. Carnival National Leasing Limited and Carnival Automobiles Limited, 2011 ONSC 1007 (S.C.J.)(C.L.) at paras. 26-29

76. In so deciding, the Court must have regard to all of the circumstances. This includes: the potential costs, the relationship between the debtor and the creditors, the likelihood of maximizing the return on and preserving the subject property, and the best-way of facilitating the work and duties of the receiver-manager.

Bank of Nova Scotia v. Freure Village on Clair Creek, [1996] O.J. No. 5088 (O.C.J. Gen. Div.) at para. 12

77. Where demand for payment has been made, the reasonable time allowed for debtors to raise the necessary funds for repayment is very finite and a matter of days, not weeks.

Canadian Tire Corp. v. Healy, [2011] O.J. No. 3498 (S.C.J.) at para. 21.

78. In this case, payment demand was made on May 18, 2012. Although more than three weeks have elapsed since the demand, the Respondents have not paid the debt owing.

79. The appointment of PwC as Receiver, without security, over the Respondents is in the interests of all concerned. The appointment will allow the receiver to effect the proposed Purchase Transaction so that the Operating Companies can continue operations and preserve jobs. The appointment of the Receiver is integral to the overall transaction with the Purchaser and is a condition of the APA. If the Purchase Agreement is not approved by the court (in accordance with the motion being brought concurrently by PwC as proposed Receiver) or is not completed, Red Ash will seek a liquidation of the Respondents' assets, which is a far less favourable outcome for stakeholders—especially employees—than the Purchase Transaction.

80. Further, as the first, second, and third ranking secured creditor holding debt in the amount of approximately \$126 million, Red Ash has the only economic interest engaged by the insolvency proceedings. The net realizable value of the Respondents' assets is substantially less than the amount of Red Ash's secured indebtedness. Concluding a sale of the Respondents' assets to the Purchaser on a going concern basis will realize the maximum return on the assets.

D. Sequence and Effective Time of Orders

81. Should the Court grant the Bankruptcy Orders and the Receivership Order, the Applicants seek a suspension of the time that they become effective until shortly before the Purchase Transaction closes.

82. Red Ash seeks an order such that, only when the Purchase Transaction is ready to close will the three main types of relief sought on June 11 will become effective. In particular, Red Ash seeks an order providing that, immediately before closing,

- (a) the Bankruptcy Orders will become effective,
- (b) then the Receivership Order will become effective, and
- (c) then the Approval and Vesting order shall become effective,

all within a matter of seconds (or milliseconds).

83. Red Ash is owed in excess of \$126 million, holds comprehensive security over the Respondents and is entitled to available remedies under insolvency legislation. Red Ash asks for Bankruptcy Orders so that it may avail itself of the certainty of distribution under the BIA. It asks for the Receivership Order for the purpose of the Receiver conveying the Purchased Assets to the Purchaser. The proposed Receiver asks for the Approval and Vesting Order in order to effect an immediate sale where it is the conduit for the conveyance, but does not otherwise take possession of the assets or operate the businesses. In the event that the Approval and Vesting Order is not granted, Red Ash still seeks Bankruptcy Orders. The employees will be terminated and the businesses shut down as a result of the Bankruptcy Orders. Red Ash would still seek the appointment of the Receiver, but not to operate the businesses or complete a going concern sale, but rather to liquidate the assets. Both Red Ash and the proposed Receiver are of the view that the Purchase Transaction is not only of greater benefit to Red Ash than liquidation, but also to the customers, suppliers and employees, who will benefit from the continuation of the businesses.

84. If a Receiver is appointed and the Purchase Transaction is approved and closes, deferring the effective time of the Bankruptcy Orders (until shortly before the Receivership

Order Effective Time and the closing) will allow a smooth transition of the Operating Companies' affairs and the employment of their workers to the Purchaser's control, without any material "gap period" during which, for example, employees would be without jobs.

E. Liquidation as an Option

85. In the event that the Purchase Transaction is not approved by the court or is not completed for any reason, Red Ash seeks to have the Receiver commence liquidation of the assets owned by the Respondents on June 12, 2012.

86. The reasons Red Ash would wish to pursue a prompt liquidation are numerous.

87. 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.

88. 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.

89. The Kraus Group does not have the ability to continue to sustain operations without an immediate solution and 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.

90. In order to effect the liquidation of the Kraus Group, Red Ash requests that this Court authorize PwC, in its capacity as Receiver (if so appointed), 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 PwC or, in the alternative, a liquidator selected by the court.

PART V - ORDER REQUESTED

91. The Applicant requests the relief previously set out at paragraph 58.

ALL OF WHICH IS REPECTFULLY SUBMITTED this 8th day of June, 2012.



John Birch

June 8th, 2012

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SCHEDULE “A”

1. *Re Ivaco Inc.*, 2006 CarswellOnt 6292 (C.A.)
2. *Re Lambert*, 2002 CarswellOnt 2659 (C.A.)
3. *Bank of Montreal v. Scott Road Enterprises Ltd.*, 1989 CarswellBC 337 (C.A.)
4. *Century Services v. Canada (Attorney General)*, [2010] 3 S.C.R. 379 (S.C.C.)
5. *Canadian Tire Corp. v. Healy*, [2011] O.J. No. 3498 (S.C.J.)
6. *Bank of Montreal v. Carnival National Leasing Limited and Carnival Automobiles Limited*, 2011 ONSC 1007 (S.C.J.)(C.L.)
7. *Bank of Nova Scotia v. Freure Village on Clair Creek*, [1996] O.J. No. 5088 (O.C.J. Gen. Div.)

SCHEDULE "B"

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 42(1)

Acts of Bankruptcy

42. (1) A debtor commits an act of bankruptcy in each of the following cases:

(a) if in Canada or elsewhere he makes an assignment of his property to a trustee for the benefit of his creditors generally, whether it is an assignment authorized by this Act or not;

(b) if in Canada or elsewhere the debtor makes a fraudulent gift, delivery or transfer of the debtor's property or of any part of it;

(c) if in Canada or elsewhere the debtor makes any transfer of the debtor's property or any part of it, or creates any charge on it, that would under this Act be void or, in the Province of Quebec, null as a fraudulent preference;

(d) if, with intent to defeat or delay his creditors, he departs out of Canada, or, being out of Canada, remains out of Canada, or departs from his dwelling-house or otherwise absents himself;

(e) if the debtor permits any execution or other process issued against the debtor under which any of the debtor's property is seized, levied on or taken in execution to remain unsatisfied until within five days after the time fixed by the executing officer for the sale of the property or for fifteen days after the seizure, levy or taking in execution, or if any of the debtor's property has been sold by the executing officer, or if the execution or other process has been held by the executing officer for a period of fifteen days after written demand for payment without seizure, levy or taking in execution or satisfaction by payment, or if it is returned endorsed to the effect that the executing officer can find no property on which to levy or to seize or take, but if interpleader or opposition proceedings have been instituted with respect to the property seized, the time elapsing between the date at which the proceedings were instituted and the date at which the proceedings are finally disposed of, settled or abandoned shall not be taken into account in calculating the period of fifteen days;

(f) if he exhibits to any meeting of his creditors any statement of his assets and liabilities that shows that he is insolvent, or presents or causes to be presented to any such meeting a written admission of his inability to pay his debts;

(g) if he assigns, removes, secretes or disposes of or attempts or is about to assign, remove, secrete or dispose of any of his property with intent to defraud, defeat or delay his creditors or any of them;

(h) if he gives notice to any of his creditors that he has suspended or that he is about to suspend payment of his debts;

(i) if he defaults in any proposal made under this Act; and

(j) if he ceases to meet his liabilities generally as they become due.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 43(1)

Bankruptcy Application

43. (1) Subject to this section, one or more creditors may file in court an application for a bankruptcy order against a debtor if it is alleged in the application that

(a) the debt or debts owing to the applicant creditor or creditors amount to one thousand dollars; and

(b) the debtor has committed an act of bankruptcy within the six months preceding the filing of the application

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 43(4)

Consolidation of applications

43. (4) If two or more applications are filed against the same debtor or against joint debtors, the court may consolidate the proceedings or any of them on any terms that the court thinks fit.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 43(7)

Dismissal of application

43. (7) If the court is not satisfied with the proof of the facts alleged in the application or of the service of the application, or is satisfied by the debtor that the debtor is able to pay their debts, or that for other sufficient cause no order ought to be made, it shall dismiss the application.

Bankruptcy and Insolvency Act, RSC 1985, c B-3, s. 243

243. (1) Subject to subsection (1.1), on application by a secured creditor, a court may appoint a receiver to do any or all of the following if it considers it to be just or convenient to do so:

(a) take possession of all or substantially all of the inventory, accounts receivable or other property of an insolvent person or bankrupt that was acquired for or used in relation to a business carried on by the insolvent person or bankrupt;

(b) exercise any control that the court considers advisable over that property and over the insolvent person's or bankrupt's business; or

(c) take any other action that the court considers advisable

Restriction on appointment of receiver

(1.1) In the case of an insolvent person in respect of whose property a notice is to be sent under subsection 244(1), the court may not appoint a receiver under subsection (1) before the expiry of 10 days after the day on which the secured creditor sends the notice unless

(a) the insolvent person consents to an earlier enforcement under subsection 244(2); or

(b) the court considers it appropriate to appoint a receiver before then.

Definition of "receiver"

(2) Subject to subsections (3) and (4), in this Part, "receiver" means a person who

(a) is appointed under subsection (1); or

(b) is appointed to take or takes possession or control — of all or substantially all of the inventory, accounts receivable or other property of an insolvent person or bankrupt that was acquired for or used in relation to a business carried on by the insolvent person or bankrupt — under

(i) an agreement under which property becomes subject to a security (in this Part referred to as a "security agreement"), or

(ii) a court order made under another Act of Parliament, or an Act of a legislature of a province, that provides for or authorizes the appointment of a receiver or receiver-manager.

Definition of “receiver” — subsection 248(2)

(3) For the purposes of subsection 248(2), the definition “receiver” in subsection (2) is to be read without reference to paragraph (a) or subparagraph (b)(ii).

Trustee to be appointed

(4) Only a trustee may be appointed under subsection (1) or under an agreement or order referred to in paragraph (2)(b).

Place of filing

(5) The application is to be filed in a court having jurisdiction in the judicial district of the locality of the debtor.

Orders respecting fees and disbursements

(6) If a receiver is appointed under subsection (1), the court may make any order respecting the payment of fees and disbursements of the receiver that it considers proper, including one that gives the receiver a charge, ranking ahead of any or all of the secured creditors, over all or part of the property of the insolvent person or bankrupt in respect of the receiver’s claim for fees or disbursements, but the court may not make the order unless it is satisfied that the secured creditors who would be materially affected by the order were given reasonable notice and an opportunity to make representations.

Meaning of “disbursements”

(7) In subsection (6), “disbursements” does not include payments made in the operation of a business of the insolvent person or bankrupt.

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

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

Applicant

Court File No. CV12-9731-00CL

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

PROCEEDING COMMENCED AT
TORONTO

**FACTUM OF THE APPLICANT
(APPLICATION FOR BANKRUPTCY ORDER AND
RECEIVERSHIP ORDER RETURNABLE JUNE 11,
2012)**

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