

**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 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**

**MOTION RECORD
(DISCHARGE OF RECEIVER)
(Returnable October 16, 2012)**

October 9, 2012

BLAKE, CASSELS & GRAYDON LLP
199 Bay Street
Suite 4000, Commerce Court West
Toronto ON M5L 1A9

Pamela Huff - LSUC No.: 27344V
Tel: 416-863-2958
Email: pamela.huff@blakes.com

Linc Rogers - LSUC No.: 43562N
Tel: 416-863-4168
Email: linc.rogers@blakes.com

Jenna Willis - LSUC No.: 58498U
Tel: 416-863-33
Fax: 416-863-2653
Email: jenna.willis@blakes.com

Lawyers for PricewaterhouseCoopers Inc. in its
capacity as the Court-appointed Receiver

TO: TO THE SERVICE LIST ATTACHED TO THE NOTICE OF MOTION HEREIN

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

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**MOTION RECORD
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TAB 1

Court File No. CV-12-9731-00CL

**ONTARIO
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PINNACLE CAPITAL RESOURCES LIMITED in its capacity as general
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Applicant

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KRAUS INC., KRAUS CANADA INC., STRUDEX FIBRES LIMITED
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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 MOTION
(DISCHARGE OF RECEIVER)
(Returnable October 16, 2012)**

PRICEWATERHOUSECOOPERS INC. ("PwC"), in its capacity as Court-appointed receiver (the "**Receiver**") of the properties, assets and undertakings of 1743122 Ontario Inc. (formerly Kraus Inc.) ("**Kraus**"), 3581168 Canada Inc. (formerly Kraus Canada Inc.) ("**Kraus Canada**"), 798862 Ontario Limited (formerly Strudex Fibres Limited) ("**Strudex**") and 538626 B.C. Ltd. (collectively, the "**Debtor**"), will make a motion to the Court, on October 16, 2012, at 10:00 a.m. or as soon after that time as the motion can be heard, at 330 University Avenue, Toronto, Ontario.

PROPOSED METHOD OF HEARING: The motion is to be heard orally.

THE MOTION IS FOR AN ORDER:

- a) abridging the time for service and validating the service of this Notice of Motion and the Motion Record, including the Fourth Report of the Receiver dated October 9, 2012 (the "**Fourth Report**"), so that this Motion is properly returnable today and dispensing with further service thereof;

- b) approving the Third Report of the Receiver dated June 14, 2012 (the “**Third Report**”) and the Fourth Report and the activities of the Receiver as described therein;
- c) deeming any and all cash held by the Receiver in the Priority Charge Reserve (as defined below) to be held by PwC in its capacity as trustee in bankruptcy of Kraus, Kraus Canada and Strudex (in such capacities, the “**Trustee**”), to be used by the Trustee to satisfy any claims that may be subject to the BIA Charges (as defined below) and authorizing the Trustee, upon its discharge, to distribute any remaining cash in the Priority Charge Reserve to the Purchaser (as defined below);
- d) deeming any and all cash held by the Receiver in the s.81.1 Claims Reserve (as defined below) to be held by the Trustee, in trust, in place and stead of the applicable s.81.1 Asset (as defined below), until such time as the claim to the applicable s.81.1 Asset is determined by agreement among the applicable parties or further order of the Court;
- e) authorizing the distribution of any residual funds remaining in the receivership, after payment of all expenses and obligations incurred by the Receiver, to Red Ash Capital Partners II Limited Partnership (“**Red Ash**”), as lender under the Funding Term Sheet (as defined below);
- f) discharging PwC as Receiver of the undertaking, property and assets of the Debtor upon the filing of the Receiver’s Discharge Certificate (as defined below);
- g) releasing PwC from any and all liability in any way arising out of the acts or omissions of PwC while acting in its capacity as Receiver, save and except for any gross negligence or wilful misconduct on the Receiver’s part; and
- h) such further and other relief as the Receiver may request and this Court shall deem just.

THE GROUNDS FOR THE MOTION ARE:

- a) pursuant to the Order of the Ontario Superior Court of Justice (the “**Court**”) dated June 11, 2012, PwC was appointed as Receiver of the Debtor (the “**Receivership Order**”);
- b) on June 11, 2012 the Court issued an Order (the “**Sale Approval and Vesting Order**”) approving the sale transaction (the “**Purchase Transaction**”) contemplated by an asset purchase agreement (the “**Sale Agreement**”) between the Receiver and Kraus Brands LP (the “**Purchaser**”) dated as of June 11, 2012, and vesting in the Purchaser the Receiver’s right, title and interest, if any, and the Debtor’s right, title and interest in and to the Purchased Assets (as defined therein);
- c) the Purchase Transaction closed on June 11, 2012;

Statutory Duties

- d) the Receiver has complied with and completed substantially all of its statutory duties and will complete the remaining statutory duties, including preparing and filing its final report pursuant to subsection 246(3) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c.B-3, as amended (the “**BIA**”) prior to filing its Discharge Certificate;

Pension Plans

- e) the Receiver has been advised that the registered pension plans of the Debtor have been or will be terminated and wound up by entities that have been appointed by the applicable provincial pension authority to administer such pension plans;

Section 81.1 Claims and the Third Report

- f) certain of the Purchased Assets were subject to claims asserted pursuant to s.81.1 of the BIA (such claims, the “**s.81.1 Claims**” and such assets, the “**s.81.1 Assets**”);

- g) the Sale Approval and Vesting Order required the Receiver to file a report advising as to the s.81.1 Assets in the possession of the Debtor as at June 11, 2012 and, to the extent ascertainable, as at May 28, 2012;
- h) the Receiver prepared and filed its Third Report to report on same and subsequently assessed each s.81.1 Claim using the criteria set out in s.81.1 of the BIA;
- i) the Receiver understands that each s.81.1 Claim has been settled by the Purchaser and the applicable claimant except the s.81.1 Claim of Equistar Chemicals LP ("**Equistar**");
- j) in accordance with the provisions of the Sale Approval and Vesting Order, the Purchaser or the Debtor used or consumed the assets subject to Equistar's s.81.1 Claim that were in the possession of the Debtor on June 11, 2012 and paid the Receiver the invoice amount for such assets (such amounts, the "**s.81.1 Claims Reserve**");
- k) in accordance with the provisions of the Sale Approval and Vesting Order, the Receiver continues to hold the s.81.1 Claims Reserve in trust, in place and stead of the applicable s.81.1 Assets pending agreement among the applicable parties or further order of the Court;
- l) the Receiver wishes to proceed with its discharge, and to facilitate this process, proposes to transfer the s.81.1 Claims Reserve to the Trustee, to be held by the Trustee on the same terms as the Receiver has held same;

BIA Priority Charges

- m) pursuant to the Sale Agreement, the Purchaser paid \$24,500 (the "**Priority Charge Reserve**") to the Receiver as a reserve to satisfy any potential liability in respect of the charges created by sections 81.3, 81.4, 81.5 and 81.6 of the BIA (collectively, the "**BIA Charges**");
- n) the Receiver has received nine proofs of claim from former employees of the Debtor and has reviewed and responded to such claims;

- o) the Receiver has assessed that the total value of the valid claims received to date that are subject to the BIA Charges to be \$918.75 (the “**Allowed Claims**”);
- p) the Receiver has received some, and may receive additional, subrogation notices from Service Canada indicating that Service Canada has paid certain claims made by former employees of the Debtor pursuant to the *Wage Earner Protection Program Act*;
- q) to avoid duplicate payment to former employees of the Allowed Claims (once by Service Canada and once by the Receiver), the Receiver has not yet paid the Allowed Claims;
- r) the Allowed Claims will be paid from the Priority Charge Reserve in due course, either to the applicable claimant or to Service Canada pursuant to a subrogation notice in respect of such claim;
- s) the Receiver wishes to proceed with its discharge, and to facilitate this process, proposes to transfer the Priority Charge Reserve to the Trustee, to be used by the Trustee to satisfy the Allowed Claims and any additional claims that may be subject to the BIA Charges, and for any remaining cash in the Priority Charge Reserve to be distributed by the Trustee to the Purchaser upon the Trustee’s discharge;

Receiver’s Fees and Expenses

- t) the Receivership Order provides that the Receiver and its legal counsel shall only be required to pass their accounts if Red Ash makes a written request to the Receiver for such passing of accounts;
- u) Red Ash has been provided with a copy of all accounts of the Receiver and its legal counsel and has not requested a passing of such accounts;

Distribution of Residual Funds

- v) pursuant to the term sheet dated as at June 8, 2012 between the Receiver and Red Ash (the “**Funding Term Sheet**”), Red Ash agreed to fund the

Receiver for certain costs and expenses incurred by the Receiver in connection with the receivership proceedings;

- w) the Funding Term Sheet provides that at the end of its appointment, the Receiver shall, after paying all obligations incurred, reimburse Red Ash any residual funds in the receivership;

Remaining Duties of the Receiver

- x) the Receiver has substantially completed its duties and obligations in these proceedings, other than the outstanding matters described herein, and wishes to be discharged upon the filing of a certificate certifying all obligations incurred by the Receiver have been paid (the “**Discharge Certificate**”);

Other Grounds

- y) the Receiver also relies on:
 - i) such further and other grounds as are set out in the Third Report, filed;
 - ii) such further and other grounds as are set out in the Fourth Report, to be filed;
 - iii) the provision of the BIA;
 - iv) Rules 2.03, 3.02, 16 and 37 of the Ontario *Rules of Civil Procedure*, R.R.O. 1990, Reg. 194, as amended; and
 - v) such further and other grounds as counsel may advise and this Court may permit.

THE FOLLOWING DOCUMENTARY EVIDENCE will be used at the hearing of the motion:

- a) The Third Report of the Receiver, filed;
- b) The Fourth Report of the Receiver, to be filed;
- c) The pleadings and proceedings herein; and

- d) Such further and other materials as counsel may advise and this Court may permit.

October 9, 2012

BLAKE, CASSELS & GRAYDON LLP

199 Bay Street
Suite 4000, Commerce Court West
Toronto ON M5L 1A9

Pamela Huff - LSUC No.: 27344V

Tel: 416-863-2958

Email: pamela.huff@blakes.com

Linc Rogers - LSUC No.: 43562N

Tel: 416-863-4168

Email: linc.rogers@blakes.com

Jenna Willis - LSUC No.: 58498U

Tel: 416-863-33

Fax: 416-863-2653

Email: jenna.willis@blakes.com

Lawyers for PricewaterhouseCoopers Inc. in its
capacity as the Court-appointed Receiver of the
Respondents

TO: THE ATTACHED SERVICE LIST

SERVICE LIST

MILLER THOMSON LLP Accelerator Building 295 Hagley Boulevard, Suite 300 Waterloo, ON N2L 6R5 Lawyers for Strudex Fibres Limited, Kraus Inc., Kraus Canada Inc. and 538626 B.C. Ltd.	Dwayne Kuiper Tel: (519) 593-3243 Fax: (519) 743-2540 E-mail: dkuiper@millerthomson.com
STRUDEX FIBRES LIMITED 65 Northfield Drive Waterloo, ON N2J 4J4	
KRAUS INC. 65 Northfield Drive Waterloo, ON N2J 4J4	
KRAUS CANADA INC. 1551 Church Avenue Winnipeg, MB R2X 1G7	
538626 B.C. LTD. Robson Court 1000-840 Howe Street Vancouver, BC V6Z 2M1	
PRICEWATERHOUSECOOPERS INC. 18 York Street, Suite 2600 Toronto, ON M5J 0B2 Receiver	John McKenna Tel: (416) 941-8314 Fax: (416) 941-8378 E-mail: john.p.mckenna@ca.pwc.com Michelle Pickett Tel: (416) 815-5002 Fax: (416) 941-8393 E-mail: michelle.pickett@ca.pwc.com Tracey Weaver Tel: (416) 814-5735 Fax: (416) 814-3210 E-mail: tracey.weaver@ca.pwc.com
BLAKE, CASSELS & GRAYDON LLP 199 Bay Street Suite 4000, Commerce Court West Toronto, ON M5L 1A9 Lawyers for the Receiver	Pamela Huff Tel: (416) 863-2958 Fax: (416) 863-2653 E-mail: pamela.huff@blakes.com Linc Rogers Tel: (416) 863-4168 Fax: (416) 863-2653 E-mail: linc.rogers@blakes.com Jenna Willis Tel: (416) 863-3348 Fax: (416) 863-2653 E-mail: jenna.willis@blakes.com

<p>CASSELS BROCK & BLACKWELL 2100 Scotia Plaza 40 King Street West Toronto, ON M5H 3C2</p> <p>Lawyers to Pinnacle Capital Resources Limited</p>	<p>John Birch Tel: (416) 860-5225 Fax: (416) 640-3057 E-mail: jbirch@casselsbrock.com</p> <p>Larry Ellis Tel: (416) 869-5406 Fax: (416) 350-6918 E-mail: lellis@casselsbrock.com</p> <p>Joe Bellissimo Tel: (416) 860-6572 Fax: (416) 642-7150 E-mail: jbellissimo@casselsbrock.com</p>
<p>NORTON ROSE CANADA LLP Suite 3800, Royal Bank Plaza, South tower 200 Bay Street, P.O. Box 84 Toronto, ON M5J 2Z4</p> <p>Lawyers to Crystal Financial LLC</p>	<p>Alan Merskey Tel: (416) 216-4805 Fax: (416) 216-3930 E-mail: alan.merskey@nortonrose.com</p> <p>David Amato Tel: (416) 216-1861 Fax: (416) 216-3930 E-mail: david.amato@nortonrose.com</p> <p>Adrienne Glen Tel: (416) 216-4082 Fax: (416) 216-3930 E-mail: adrienne.glen@nortonrose.com</p>
<p>MINDEN GROSS LLP 145 King Street West, Suite 2200 Toronto, ON M5H 4G2</p> <p>Lawyers to Nylene Canada Inc.</p>	<p>David Ullmann Tel: (416) 369-4148 Fax: (416) 864-9223 E-mail: DUllmann@mindengross.com</p>
<p>BENNETT JONES LLP 3400 One First Canadian Place P.O. Box 130 Toronto, ON M5X 1A4</p> <p>Lawyers for Total Petrochemicals & Refining USA, Inc.</p>	<p>Sean Zweig Tel: (416) 777-6254 Fax: (416) 863-1716 E-mail: zweigS@bennettjones.com</p>
<p>SACK GOLDBLATT MITCHELL LLP 20 Dundas Street West, Suite 1100 Toronto, ON M5G 2G8</p> <p>Lawyers for Teamsters Local Union No. 213</p>	<p>James K. McDonald Tel: (416) 979-6425 Fax: (416) 591-7333 E-mail: jmcdonald@sgmlaw.com</p>
<p>THORNTON GROUT FINNIGAN LLP Suite 3200, Canadian Pacific Tower 100 Wellington Street West, P.O. Box 329 Toronto, ON M5K 1K4</p> <p>Lawyers for Propex Operating Company, LLC</p>	<p>Kyla E.M. Mahar Tel: (416) 304-0594 Fax: (416) 304-1313 E-mail: kmahar@tgf.ca</p>

BORDEN LADNER GERVAIS LLP Scotia Plaza, 40 King Street West Toronto, ON M5H 3Y4 Lawyers for Equistar Chemicals, LP	Craig J. Hill Tel: (416) 367-6156 Fax: (416) 361-7301 E-mail: chill@blg.com
SHUH CLINE & GROSSMAN 17 Webber Street West Kitchener, ON N2H 3Y9 Lawyers for Millers Electric Limited	Mark S. Grossman Tel: (519) 578-9010 ex. 231 Fax: (416) 578-1590 E-mail: mgrossman@shuhclinegrossman.com
MCDONALD SAGER MANIS LLP Suite 800, 150 York Street Toronto, ON M5H 3S5 Lawyers for Tri-Tex Co.	Howard Manis Tel: (416) 364-5289 Fax: (416) 364-1453 E-mail: hmanis@msmlaw.ca
BORDEN LADNER GERVAIS LLP Scotia Plaza, 40 King Street West Toronto, ON M5H 3Y4 Lawyers for Carpets & Rugs Backings and Supplies, Inc.	Sam Rappos Tel: (416) 367-6033 Fax: (416) 361-7306 E-mail: srappos@blg.com
BENNETT JONES LLP 4500 Bankers Hall East 855 – 2 nd Street SW Calgary, AB T2P 4K7	Kelsey Drozdowski Tel: (403) 298-3323 Fax: (403) 265-7219 E-mail: drozdowskik@bennettjones.com
BENNETT JONES LLP 3200 Telus House, South Tower 10020 – 100 Street Edmonton, AB T5J 0N3 Lawyers for WAM Development Management Corp.	William Hembroff Tel: (780) 917-5241 Fax: (780) 421-7951 E-mail: hembroffw@bennettjones.com
UNITED FOOD AND COMMERCIAL WORKERS LOCAL 175 2200 Argentia Road Mississauga, ON L5N 2K7	Luc Lacelle, Director, Central West Tel: (905) 545-8345 Fax: (416) 545-8355 E-mail: luc.lacelle@ufcw175.com
TEAMSTERS LOCAL UNION NO. 213 490 East Broadway Vancouver, BC V5T 1X3	Anita Dawson, Business Representative Tel: (604) 876-5213 Fax: (604) 872-8604 E-mail: anita@teamsters213.org
HUNTSMAN CORPORATION OF CANADA INC. 10003 Woodloch Forest Drive The Woodlands, TX 77380 USA	Julia Scott E-mail: julia_scott@huntsman.com
AMERICAN BERBER 100 Thomas Street Calhoun, GA 30703-0430	James Frazee E-mail: frazeejames@att.net
ATLANTIC PACKAGING PRODUCTS, LTD. 111 Progress Ave Scarborough, ON M1P 2Y9	Jane MacKenzie E-mail: jane_mackenzie@atlantic.ca

BEAULIEU GROUP 201 Princeton Boulevard Adairsville, GA USA 30103	Phyllis Garrett E-mail: phyllis.garrett@beaulieugroup.com
WHITE LAMB FINLAY INC. 107 Woodbine Downs Blvd., Unit 10 Toronto, ON M9W 6Y1 As agent for Don & Low Ltd.	Daniel Gamper E-mail: dgamper@whitelambfinlay.com
DON & LOW LTD. Newfordpark House, Glamis Road Forfar, Angus DD8 1FR, Scotland	Colin Johnson , Finance Director E-mail: colin.johnson@donlow.co.uk
I.G. INVESTMENT MANAGEMENT LTD. AS TRUSTEE FOR INVESTORS REAL PROPERTY FUND c/o WAM Development Group 10213 - 11 Street Edmonton, AB T5K 2V6	Bill Bird Email: bbird@wamdevelopment.com) William Hembroff HembroffW@bennettjones.com
PEEL PROPERTIES INC. 125 Bessborough Drive Toronto, ON M4G 3J7	Ed Bissinger Email: ebissinger@sympatico.ca
LONGO DEVELOPMENT CORPORATION c/o Ideal Welders Ltd. 660 Caldew Street Delta, BC V3M 5S2	Jim Longo Email: jim@idealwelders.com
WCB REALTY LIMITED c/o Towers Realty Group Ltd. 100-1420 Taylor Ave. Winnipeg, MB R3N 1Y6	John Kasian Email: JKasian@towersrealty.ca
ADDITIONAL SERVICE LIST	
DEPARTMENT OF JUSTICE CANADA PO Box 36, Exchange Tower 130 King St. West, Suite 3400 Toronto, ON M5X 1K6	Diane Winters , General Counsel Tel: (416) 973-3172 Fax: (416) 973-0810 E-mail: diane.winters@justice.gc.ca
FINANCIAL SERVICES COMMISSION OF ONTARIO 5160 Yonge Street P.O. Box 85 Toronto, ON M2N 6L9	Mark Bailey E-mail: Mark.Bailey@fsco.gov.on.ca Deborah McPhail E-mail: Deborah.McPhail@fsco.gov.on.ca Stephen Scharbach E-mail: Stephen.Scharbach@fsco.gov.on.ca
HER MAJESTY THE QUEEN IN RIGHT OF THE PROVINCE OF ONTARIO AS REPRESENTED BY THE MINISTER OF FINANCE Legal Services Branch 33 King Street West, 6 th Floor P.O. Box 620 Oshawa, ON L1H 8E9	Kevin J. O'Hara E-mail: kevin.ohara@ontario.ca

MINISTRY OF REVENUE Revenue Collections Branch Insolvency Unit 33 King St. West, P.O. Box 627 Oshawa, ON L1H 8H5	L. Parent – Insolvency Officer Tel: 1-866-668-8297 ext: 18562 Fax: (905) 436-4524 E-mail: larry.parent@fin.gov.on.ca
WORKPLACE SAFETY AND INSURANCE BOARD, HEAD OFFICE (ONTARIO) 200 Front Street West Toronto, ON M5V 3J1	Fax: (416) 344-4684 E-mail: wsibcomm@wsib.on.ca
MINISTÈRE DU REVENU QUÉBEC CENTRE DE PERCEPTION FISCALE 1600 boulevard Rene-Levesque Ouest, 3 ^e étage Montreal, QC H3H 2V2	
MONSIEUR LE MINISTRE MINISTÈRE DU REVENUE QUÉBEC (QST, INCOME TAX, GST) Centre de perception fiscale 3800, rue de Marly Quebec City, QC G1X 4A5	Claude Provencher Fax: (514) 215-3672
COMMISSION DE LA SANTÉ ET DE LA SÉCURITÉ DU TRAVAIL DU QUÉBEC (CSST) – MONTREAL 1. complexe Desjardins Tour Sud, 31 ^e étage Case postale 3 Succursale Place-Desjardins Montréal, QC H5B 1H1	Tel: (866) 302-2778 Fax: (514) 906-3133
OFFICE OF THE SUPERINTENDENT MANITOBA PENSION COMMISSION 401 York Avenue, Suite 1004 Winnipeg, MB R3C 0P8	Debbie Lyon , Superintendent of Pensions E-mail: pensions@gov.mb.ca
MANITOBA FINANCE – TAXATION DIVISION 401 York Avenue, Suite 101 Winnipeg, MB R3C 0P8	E-mail: mbtax@gov.mb.ca
WORKERS COMPENSATION BOARD OF MANITOBA 333 Broadway Winnipeg, MB R3C 4W3	Tel: (204) 954-4321 Fax: (204) 954-4999 E-mail: wcb@wcb.mb.ca
MANITOBA EMPLOYMENT STANDARDS 401 York Avenue, Suite 104 Winnipeg, MB R3C 0P8	Tel: (204) 945-3352 Fax: (204) 948-3046 E-mail: Employmentstandards@gov.mb.ca
HER MAJESTY THE QUEEN IN RIGHT OF THE PROVINCE OF ALBERTA AS REPRESENTED BY THE MINISTER OF FINANCE (INCOME TAX) The Tax and Revenue Administration 9811 – 109 Street Edmonton, AB T5K 2L5	John Chiarella Tel: (780) 644-4122 Fax: (780) 422-3770 E-mail: john.chiarella@gov.ab.ca

WORKERS' COMPENSATION BOARD OF ALBERTA 9912 – 107 Street Edmonton, AB T5J 1G5	Manoj Gupta Tel : (780) 498 8666 Fax : (780) 498 7876 E-mail: manoj.gupta@wcb.ab.ca
MINISTRY OF FINANCE FINANCIAL SERVICES BRANCH 2350 Alberta Street, 5 th Floor Regina, SK S4P 4A6	Fabian Cascante Fax: (306) 787-6576 E-mail: fabian.cascante@gov.sk.ca
MINISTRY OF FINANCE REVENUE DIVISION – PROVINCIAL SALES TAX (PST) BRANCH TAX INFORMATION SERVICES 2350 Alberta Street, 5 th Floor Regina, SK S4P 4A6	Fax: (306) 798-3045
BRITISH COLUMBIA MINISTRY OF FINANCE Income Taxation Branch 1802 Douglas Street, Main Floor Victoria, BC V8T 4K6	
HER MAJESTY THE QUEEN IN RIGHT OF THE PROVINCE OF BRITISH COLUMBIA AS REPRESENTED BY THE MINISTRY OF THE ATTORNEY GENERAL Ministry of the Attorney General Legal Services Branch 1001 Douglas Street Victoria, BC V8W 9J7	
THE COMMISSIONER Consumer Taxation Branch Suite 800, 360 West Georgia Street Vancouver, BC V6B 6B2	
WORKERS' COMPENSATION BOARD OF BRITISH COLUMBIA Main Building 6951 Westminster Highway Richmond, BC V7C 1C6	Fax: (888) 922-8807
NOVA SCOTIA DEPARTMENT OF FINANCE P.O. Box 187 1723 Hollis St. Halifax, NS B3J 2N3	Joseph Pettigrew E-mail: pettigjw@gov.ns.ca John Traves, Q.C. E-mail: travesjw@gov.ns.ca
DEPARTMENT OF FINANCE P.O. Box 8700 3rd Floor, East Block Confederation Building St. John's, NL A1B 4J6	Fax: (709) 729-2856 E-mail: taxadmin@mail.gov.nl.ca
WEPP PROCESSING CENTRE PO Box 5900 Cornwall ON K6H 6J6	

PPSA CREDITORS	
FINANCIALINX CORPORATION 2001 Sheppard Ave. E., 6 th Floor Toronto, ON M2J 4Z8	
BMW CANADA INC. 50 Ultimate Drive Richmond Hill, ON L4S 0C8	
CBSC CAPITAL INC. 100-1235 North Service Road Oakville, ON L6M 2W2	
FASKEN MARTINEAU DuMOULIN LLP 333 Bay Street, Suite 2400 Bay Adelaide Centre Toronto, ON M5H 2T6 Lawyers for Nelson Kraus Holdings Limited and Nelson Kraus	Edmond Lamek Tel: (416) 865-4506 Fax: (416) 364 7813 E-mail: elamek@fasken.com
NELSON KRAUS HOLDINGS LIMITED and NELSON KRAUS 263 Anita Court Waterloo, ON N2K 2R4	
BMO CAPITAL CORPORATION 100 King Street West, 11 th Floor Toronto, ON M5X 1A1	
IBM CANADA LIMITED – PPSA ADMINISTRATOR 3600 Steeles Ave. East, F4 Markham, ON L3R 9Z7	
INTEGRATED DISTRIBUTION SYSTEMS LIMITED PARTNERSHIP and WAJAX GP HOLDCO INC. 3280 Wharton Way Mississauga, ON L4X 2C5	
BLUE CHIP LEASING CORPORATION 156 Duncan Mills Road, Unit 16 Toronto, ON M3B 3N2	
REAL PROPERTY ENCUMBRANCES	
PINNACLE CAPITAL RESOURCES LIMITED c/o Nerine Chambers Quastisky Building 3 rd Floor, P.O. Box 905 Road Toror, Tortola VG 1110 British Virgin Islands	Fax: 1 (284) 494-8791 Phone: 1 (284) 494-8790 or 1 (284) 494-2972

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

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(COMMERCIAL LIST)**

Proceeding commenced at Toronto

**NOTICE OF MOTION
(DISCHARGE OF RECEIVER)
(RETURNABLE OCTOBER 16, 2012)**

BLAKE, CASSELS & GRAYDON LLP
Suite 4000, Commerce Court West
199 Bay Street, Suite 4000
Toronto, Ontario M5L 1A9

Pamela Huff - LSUC No.: 27344V
Tel: (416) 863-2958

Linc Rogers - LSUC No.: 43562N
Tel: (416) 863-4168

Jenna Willis - LSUC No.: 58498U
Tel: (416) 863-3348
Fax: (416) 863-2653

Lawyers for PricewaterhouseCoopers Inc. in its
capacity as the Court-appointed Receiver of the
Respondents

TAB 2

Court File No. CV12-9731-00CL

**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

**FOURTH REPORT OF PRICEWATERHOUSECOOPERS INC.
AS RECEIVER**

October 9, 2012

A. INTRODUCTION

1. On May 28, 2012, the Ontario Superior Court of Justice (Commercial List) (the “**Court**”) granted an order appointing PricewaterhouseCoopers Inc. (“**PwC**”) as interim receiver (“**Interim Receiver**”) in respect of Kraus Inc. (“**KI**”), Kraus Canada Inc. (“**KCI**”), and Strudex Fibres Limited (“**Strudex**”).
2. On June 11, 2012 (“**Date of Bankruptcy**”), the Court granted an order appointing PwC as trustee in bankruptcy (“**Trustee**”) of KI, KCI and Strudex pursuant to bankruptcy applications brought by Pinnacle Capital Resources Limited, in its capacity as general partner of Red Ash Capital Partners II Limited Partnership (collectively “**Red Ash**”).
3. The bankruptcy application in respect of KCI was initially brought before the Manitoba Court of Queen’s Bench (the “**Manitoba Court**”) in Winnipeg, Manitoba and was transferred to the Court in Toronto on June 5, 2012, pursuant to an Order of the Manitoba Court.
4. On June 11, 2012 (“**Date of Appointment**”), the Court issued an order (the “**Receivership Order**”) appointing PwC as Receiver (“**Receiver**”) in respect of KI, KCI, Strudex and 538626 B.C. Ltd. (collectively the “**Companies**” or “**Debtor**”) pursuant to a receivership application brought before the Court by Red Ash in these proceedings. Pursuant to the terms of the Receivership Order, PwC was discharged as Interim Receiver when the Receivership Order became effective in accordance with its terms.
5. Also on June 11, 2012, the Court issued an order (the “**Sale Approval and Vesting Order**”) approving the sale transaction (“**Purchase Transaction**”) contemplated by an asset purchase agreement between the Receiver and Kraus Brands LP (the “**Purchaser**”) dated as of June 11, 2012 (the “**Sale Agreement**”), vesting in the Purchaser the Receiver’s right, title and interest, if any, and the Debtor’s right, title and interest in and to the Purchased Assets (as defined in the Sale Agreement). A copy of the Sale Approval and Vesting Order is attached as Appendix “A”.
6. PwC, in its capacity as Interim Receiver and proposed Receiver, filed its first report in respect of its motion for approval of the Sale Agreement on May 29, 2012 (“**First Report**”). A copy of its First Report, without appendices, is attached as Appendix “B”.
7. PwC, in its capacity as Interim Receiver and proposed Receiver, filed its second report dated June 10, 2012 (“**Second Report**”) to update the Court with respect to the Purchase Transaction including minor amendments in the Sale Agreement, the status of Priority Claims, BIA Charges, Source

Deduction Claims and Assumed Liabilities (all as defined in the Sale Agreement) as well as to update the Court on the status of the Debtor's business operations since the appointment of the Interim Receiver, and to report on the Interim Receiver's activities since its appointment. A copy of the Second Report, without appendices is attached as Appendix "C".

8. The Receiver filed its third report to the Court dated June 14, 2012 ("**Third Report**") to report on the status of the s. 81.1 Assets (as defined herein) in the possession of the Companies as at June 11, 2012, as discussed in greater detail below. A copy of the Third Report, without appendices, is attached as Appendix "D".
9. This is the Receiver's fourth report to the Court ("**Fourth Report**"), the purpose of which is to:
 - a) provide the Court with information in respect of:
 - (i) the Receiver's activities since the Date of Appointment;
 - (ii) the Closing (as defined herein) of the Purchase Transaction;
 - (iii) the status of the s. 81.1 Claims (as defined herein) and the Priority Claims (as defined in the Sale Agreement);
 - (iv) the status of the Companies' Contracts (as defined in the Sale Agreement) and Real Property Leases (as defined herein); and
 - (v) the Receiver's R&D (as defined herein); and
 - b) seek an order ("**Order**") of the Court:
 - (i) approving the Third Report and the actions and activities of the Receiver as set out therein;
 - (ii) approving this Fourth Report and the actions and activities of the Receiver as set out herein;
 - (iii) authorizing the Receiver to transfer the residual balance of the Priority Claims Reserve (as defined herein) in the amount of \$24,500 to the Trustee in trust and authorizing the Trustee to administer the Priority Claims Reserve in respect of any

valid claims related to the BIA Charges, and upon the Trustee's discharge to distribute any remaining balance of the Priority Claims Reserve to the Purchaser;

- (iv) authorizing the Receiver to transfer to the Trustee in trust the residual balance of the s. 81.1 Trust Fund (as defined herein) to be held by the Trustee pending an agreement by the applicable parties or further order of the Court with respect to the s. 81.1 Claim filed by Equistar Chemicals LP ("**Equistar**");
 - (v) authorizing the Receiver, pursuant to the funding term sheet dated as at June 8, 2012 between the Receiver and Red Ash (the "**Term Sheet**"), to distribute to Red Ash any residual funds remaining in the receivership upon the Receiver's discharge; and
 - (vi) declaring that upon the Receiver filing a discharge certificate (the "**Discharge Certificate**"), PwC has duly and properly discharged its duties, responsibilities and obligations as the Receiver of the Companies and discharging and releasing the Receiver from any and all further obligations as Receiver of the Companies and any and all liability that PwC now has or may hereafter have by reason of, or in any way arising out of, the acts or omissions of PwC while acting as Receiver, save and except for any gross negligence or wilful misconduct on the Receiver's part.
10. In preparing this Fourth Report, the Receiver has relied upon information provided by the Companies and the Purchaser. The Receiver has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of the information provided and expresses no opinion, or other form of assurance, in respect of the information contained in this Fourth Report. The Receiver reserves the right to refine or amend its comments and findings as further information is obtained or brought to its attention subsequent to the date of this Fourth Report.
 11. Unless otherwise stated, all monetary amounts contained herein are expressed in Canadian dollars.

B. RECEIVER'S ACTIVITIES SINCE ITS APPOINTMENT

CLOSING OF PURCHASE TRANSACTION

12. Pursuant to the Receivership Order, the appointment of the Receiver became effective immediately prior to the Closing of the Purchase Transaction. The Receiver did not take

possession or control of the Purchased Assets at any time.

13. Pursuant to the Sale Approval and Vesting Order, on June 11, 2012, the Receiver took such steps and executed such documents as was necessary to complete the Purchase Transaction and convey the Purchased Assets to the Purchaser. The Purchase Transaction was completed and the sale closed on June 11, 2012 (the “**Closing**”).
14. On June 12, 2012, the Receiver filed its Receiver’s Certificate with the Court certifying that the Purchase Transaction had been completed on June 11, 2012, to the satisfaction of the Receiver.
15. The purchase price for the Purchased Assets was satisfied primarily through the assumption of secured debt by the Purchaser, a party related to the secured creditor, Red Ash. As further discussed below, certain funds were paid to the Receiver to satisfy claims that may rank in priority to Red Ash’s security. The Sale Agreement also provided a mechanism for secured creditors successfully asserting a priority to Red Ash to have such claims assumed and satisfied by the Purchaser.

CHANGING OF CORPORATE NAMES

16. On June 13, 2012, pursuant to the Sale Agreement and as authorized in the Sale Approval and Vesting Order, the corporate names of KI, KCI and Strudex were changed to 1743122 Ontario Inc., 3851168 Canada Inc. and 798862 Ontario Limited, respectively.

STATUTORY DUTIES

17. On June 20, 2012, pursuant to section 245(1) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (“**BIA**”), the Receiver sent notice of its appointment, in the prescribed form, as well as a copy of its first report pursuant to section 246(1) of the BIA to all known creditors of the Companies, the Office of the Superintendent of Bankruptcy and to the Companies.
18. The Receiver has complied with its obligations under the *Wage Earner Protection Program Act*, S.C. 2005, c. 47, s. 1 (“**WEPPA**”), and will continue to do so, as required, including providing information to Service Canada and the Companies’ former employees for the purpose of filing claims under the WEPPA program with Service Canada.
19. In addition, subsequent to its appointment, the Receiver responded to various calls and emails

from suppliers, lessors and members of the Companies' pension plans in respect of these proceedings.

20. Prior to filing its Discharge Certificate, which is described in further detail later in this Fourth Report, the Receiver will complete its statutory duties including preparing and filing its final report pursuant to s. 246(3) of the BIA.

STATUS OF PENSION PLANS

21. The Receiver has been advised that, on June 19, 2012, pursuant to subsection 71(1) of the *Pension Benefits Act*, R.S.O. 1990, c. P.8, the Financial Services Commission of Ontario appointed Mercer (Canada) Limited ("**Mercer**") as administrator of the following pension plans:
 - a) Pension Plan for the Executive Employees of Kraus Inc. ("**Executive Plan**");
 - b) Pension Plan for Union Employees of Kraus Inc. ("**KI Plan**"); and
 - c) Pension Plan for Employees of Kraus Inc. and Strudex Fibres Limited ("**Strudex Plan**").
22. The Receiver understands that Mercer will take steps to terminate and wind up the Executive Plan, the KI Plan and the Strudex Plan.
23. The Receiver has also been advised that, on August 7, 2012, pursuant to clause 8(3)(c) of *The Pension Benefits Act*, C.C.S.M. c. P32, the Office of the Superintendent – Pension Commissions of Manitoba appointed Morneau Shepell Ltd. as administrator of the Registered Pension Plan for Employees of Kraus Canada Inc. ("**KCI Plan**") to administer, terminate and wind up the KCI Plan.

C. STATUS OF PRIORITY CLAIMS

S. 81.1 CLAIMS

24. As reported in the Third Report, at the time the Sale Approval and Vesting Order became effective, certain of the Purchased Assets were subject to claims asserted pursuant to s. 81.1 of the BIA (the "**s. 81.1 Claim(s)**"). A list of the s. 81.1 Claims is attached as Appendix "E".
25. Pursuant to a direction contained in the Sale Approval and Vesting Order, in its Third Report, the Receiver reported on the assets in the possession of the Companies as of June 11, 2012 that

were subject to s. 81.1 Claims (individually a “**s. 81.1 Asset**” and collectively, the “**s. 81.1 Assets**”) and to the extent ascertainable, the s. 81.1 Assets in the possession of the Companies as at May 28, 2012, the date of the Interim Receiver’s appointment.

26. Subsequent to the Receiver filing its Third Report with this Court and pursuant to the Sale Approval and Vesting Order, the Receiver assessed the s. 81.1 Claims using the criteria set out in s. 81.1 of the BIA (the “**Assessment(s)**”).
27. The Receiver discussed its Assessment in respect of each s. 81.1 Claim with the Purchaser, who concurred with the Receiver’s Assessments.
28. On June 19, 2012, the Receiver delivered its Assessments in respect of each of the s. 81.1 Claims to the applicable claimants and/or their legal counsel. The delivery of these Assessments led to subsequent correspondence and inquiries by certain claimants, to which the Receiver or its counsel responded.
29. The Sale Approval and Vesting Order provided that the s. 81.1 Assets remained the property of KI, KCI and Strudex, respectively, and did not vest in the Purchaser until such time as the applicable s. 81.1 Claim was determined by agreement of the parties or by further order of the Court. The Sale Approval and Vesting Order also provided that, notwithstanding the foregoing, the Purchaser was entitled to use and consume any s. 81.1 Asset, provided the Purchaser paid to the Receiver in trust the invoice amount for any s. 81.1 Asset used and consumed by the Companies or the Purchaser.
30. The Receiver understands that settlements have been reached between the Purchaser and each claimant in respect of all s. 81.1 Claims except the s. 81.1 Claim filed by Equistar. Equistar has advised the Receiver and the Purchaser that it is not in agreement with the Receiver’s Assessment of its s. 81.1 Claim.
31. In the period since June 11, 2012, the Purchaser has used or consumed the s. 81.1 Assets subject to Equistar’s s. 81.1 Claim that were in the Companies’ possession on June 11, 2012.
32. Pursuant to the Sale Approval and Vesting Order, the Purchaser has paid to the Receiver in trust (“**s. 81.1 Trust Fund**”) the invoice amount of certain s. 81.1 Assets used or consumed by the Purchaser or the Companies since June 11, 2012, including the s. 81.1 Assets subject to Equistar’s s. 81.1 Claim.

33. As all s. 81.1 Claims, with the exception of Equistar's, have been settled by the Purchaser, the amount of approximately \$35,425 remaining in the s. 81.1 Trust Fund represents the invoice amount of the s. 81.1 Assets subject to Equistar's s. 81.1 Claim that were in the possession of the Companies on June 11, 2012 and subsequently used or consumed by the Purchaser.
34. Other than the distribution of this amount (which has not been done because there has been no determination of such s.81.1 Claim) and the other outstanding items discussed herein, the Receiver has substantially completed its duties and obligations in this receivership and wishes to proceed with its discharge. To facilitate this process, the Receiver proposes that the funds remaining in the s. 81.1 Trust Fund be deemed to be transferred to the Trustee, and held by the Trustee pending an agreement amongst the parties or further order of the Court.

BIA PRIORITY CHARGES

35. In its Second Report, the Receiver reported that all amounts owing to employees of the Companies in respect of outstanding wages and vacation pay that may be considered to have priority to Red Ash's security under sections 81.3 and 81.4 of the BIA and all amounts owing to employees of the Companies in respect of outstanding contributions to defined benefit or defined contribution pension plans that may be considered a priority to Red Ash's security under sections 81.5 and 81.6 of the BIA (together, the charges created under sections 81.3, 81.4, 81.5 and 81.6 are the "**BIA Charges**") were paid by the Companies prior to the Date of Bankruptcy.
36. As reported in the Second Report, the Receiver estimated \$24,500 as an appropriate reserve amount in respect of (a) outstanding disbursements of terminated employees deemed as travelling sales persons under the BIA; (b) outstanding wages, vacation pay and unpaid pension contributions owing to an estimated number of employees offered employment with the Purchaser but who may decline such offer; and (c) any unpaid current service pension contributions under the BIA. As such, on Closing, pursuant to the Sale Agreement, the Purchaser made a cash payment to the Receiver in the amount of \$24,500 to fund such reserve ("**Priority Claims Reserve**") to satisfy any potential liability in respect of the BIA Charges.
37. As at the date of this Fourth Report, nine of the Companies' 782 former employees have filed proofs of claim in the total amount of approximately \$229,630 in respect of the BIA Charges. The Receiver has reviewed and taken steps to quantify the proofs of claims received in accordance with the statutory priority afforded under the BIA Charges.

38. The majority of these claims relate to termination pay and/or severance, which amounts do not have priority to Red Ash's security as they are not subject to the BIA Charges pursuant to s. 81.4 of the BIA. As a result, the Receiver has issued notices of disallowance in the amount of approximately \$228,711 to certain employees to advise them of the terms of s. 81.4 of the BIA and the portion of their claim (if any) which has a statutory priority pursuant thereto. The Receiver has assessed the total value of valid claims subject to the BIA Charges to be approximately \$919 ("**Allowed Claims**").
39. These Allowed Claims under the BIA Charges will be paid from the Priority Claims Reserve as contemplated by the Sale Agreement. However, as at the date of this Fourth Report, the Receiver has not paid any of the Allowed Claims due to concerns with duplicate payments as discussed below.
40. The Receiver has recently received subrogation notices from Service Canada in respect of certain WEPPA claims filed by former employees of the Companies that were paid by Service Canada. To avoid duplicate payment of any Allowed Claims (by the Receiver and Service Canada) the Receiver is waiting for potential additional subrogation notices from Service Canada in respect of the Allowed Claims prior to remitting payment of the Allowed Claims to the applicable claimants. The Allowed Claims will be paid in due course, either to the applicable claimant or to Service Canada pursuant to a subrogation notice delivered to the Receiver by Service Canada.
41. Other than the payment of the Allowed Claims and the other outstanding items discussed herein, the Receiver has substantially completed its duties and obligations in this receivership and wishes to proceed with its discharge. To facilitate this process, the Receiver proposes that any funds remaining in the Priority Claims Reserve be deemed to be transferred to the Trustee to fund any additional claims filed in respect of the BIA Charges in the bankruptcy and to pay the Allowed Claims not yet paid by the Receiver. The Receiver proposes that, upon the Trustee's discharge, any remaining funds in the Priority Claims Reserve be returned to the Purchaser.

REPAIR AND STORAGE LIENS ACT CLAIMS

42. The Receiver understands that prior to the Date of Bankruptcy, Miller Electric Limited ("**Miller**") registered a lien under the *Repair and Storage Liens Act*, R.S.O. 1990, c. R.25 against KI, in respect of certain repairs conducted on equipment and the premises of KI. The Sale Agreement and Sale Approval and Vesting Order provide that a lien of this nature, to the

extent that it is a valid Priority Claim (as defined in the Sale Agreement), is a Permitted Encumbrance (as defined in the Sale Agreement) in respect of the Purchased Assets.

43. As discussed earlier in this Fourth Report, the Receiver did not take possession of the Purchased Assets upon its appointment. Moreover, as the sale of the Purchased Assets was by way of an assumption of secured debt, the Receiver did not receive any proceeds from the sale of the Purchased Assets (other than the Priority Claims Reserve). As such, the Receiver understands that the Purchaser is directly in discussions with Miller regarding this lien claim and the Receiver has no involvement.

D. REAL PROPERTY LEASES AND OTHER CONTRACTS

REAL PROPERTY LEASES

44. The Sale Agreement sets out that, provided that the Receiver has the funds to do so, it would make commercially reasonable efforts to make arrangements with either the Trustee or the landlord of each of the warehouses located in Toronto, Winnipeg, Edmonton and Vancouver occupied and leased by the Companies prior to the Date of Bankruptcy (collectively the “**Leased Warehouses**”), for the Purchaser to occupy the Leased Warehouses and pay rent and related expenses, if applicable, on terms substantially similar to those in place prior to the Date of Bankruptcy, for a period of up to 90 days, until a decision was made by the Purchaser whether or not to assume the real property leases in respect to the Leased Warehouses (“**Real Property Leases**”).
45. On June 11, 2012, the Receiver and the Trustee entered into occupation agreements permitting the Receiver to occupy certain of the Leased Warehouses for a maximum of 90 days at the option of the Receiver. The Receiver also entered into access agreements with the Purchaser in respect of certain of these warehouses.
46. Upon its appointment, the Receiver reviewed the Companies’ existing insurance coverage in respect of the Leased Warehouses and made arrangements with the Companies’ insurance broker to have the Receiver listed as named insured and loss payee on the Companies’ and subsequently the Purchaser’s insurance policies.
47. Pursuant to the Sale Agreement, the Receiver subsequently made arrangements with the property managers of each of the Leased Warehouses for the payment of rent and related

expenses, if applicable, in respect of the Real Property Leases for a period of up to 90 days.

48. As provided for in the Sale Agreement and the Term Sheet, Red Ash provided the Receiver with sufficient funds to pay rent and related expenses for the Leased Warehouses.
49. The Receiver occupied the Winnipeg warehouse during the period from June 11, 2012 to August 31, 2012. The Receiver occupied the Toronto, Edmonton and Vancouver warehouses during the period from June 11, 2012 to September 8, 2012.
50. The Receiver understands that subsequent to its occupation of the Leased Warehouses, the Purchaser entered into new lease agreements with the property managers of each of the Leased Warehouses.

OTHER CONTRACTS

51. As reported in the Second Report, on Closing, there were a significant number of Contracts which the Purchaser had not yet determined whether or not it intended to assume.
52. The Sale Agreement provided that, if the Receiver had sufficient funding, it would perform any post-Closing executory obligations of a financial or monetary nature under the Contracts (other than Real Property Leases) that were not assigned to the Purchaser on Closing for a period of up to 30 days post Closing. During this time the Purchaser would determine if the Contracts would be assumed pursuant to terms agreed upon by the applicable counterparties.
53. Shortly after the Closing, the Purchaser assessed the Companies' Contracts to determine which Contracts would be assumed by the Purchaser. The Receiver understands that the majority of the Companies' Contracts were assumed by the Purchaser and that the Purchaser directly made the necessary payments under such assumed Contracts in the period from the Closing to the date of the assumption of these Contracts. As such, the Receiver was not required to make payments in respect of these Contracts post Closing.
54. The Receiver understands that for those Contracts that were not assumed by the Purchaser, the Purchaser paid for services under the Contract during the period from the Date of Bankruptcy until the Purchaser informed the counterparty that the Contract would not be assumed by the Purchaser.

E. RECEIVER'S STATEMENT OF RECEIPTS AND DISBURSEMENTS

55. The Receiver's Statement of Receipts and Disbursements for the period from June 11, 2012 to October 2, 2012 ("R&D") is summarized as follows:

PricewaterhouseCoopers Inc. Court Appointed Receiver of 3851168 Canada Inc. (formerly known as Kraus Canada Inc.) 798862 Ontario Limited (formerly known as Strudex Fibres Limited) 1743122 Ontario Inc. (formerly known as Kraus Inc.) & 538626 B. C. Ltd.	
Consolidated Statement of Receipts and Disbursements for the period June 11 to October 2, 2012	
RECEIPTS	
Funds Received from Red Ash	1,077,567
HST Refunds	87,829
Pre-Appointment HST Refunds	30,848
Interest	553
Total Receipts	1,196,797
DISBURSEMENTS	
Rent	400,760
Legal Fees	275,616
Receiver Fees & Disbursements	154,982
HST (I.T.C.)	92,923
Property Taxes	65,226
Pre Appointment HST Refund to Secured Creditor	30,848
Operating Expenses	577
OSB Filing Fees	280
Bank Charges	75
Total Disbursements	1,021,286
Estimated Remaining Fees and Disbursements	34,500
EXCESS RECEIPTS OVER DISBURSEMENTS	141,011

56. As discussed in the Second Report and earlier in this Fourth Report, pursuant to the Sale Agreement, the Purchased Assets were sold by way of an assumption of secured debt. The Purchased Assets included all of the Companies assets, other than certain excluded Contracts. Accordingly, the Receiver received no proceeds from the sale of the Purchased Assets in the receivership (other than the Priority Claims Reserve) and there were no residual assets.
57. Pursuant to the Sale Agreement, upon the appointment of the Receiver, Red Ash agreed to fund the Receiver for certain costs and expenses incurred by the Receiver in connection with the receivership proceedings. The Term Sheet between Red Ash, as lender, and PwC, in its capacity as proposed Receiver, as borrower, sets out the terms and conditions of any advances to the Receiver in connection with the receivership proceedings.
58. As reported in its Second Report, on June 8, 2012, Red Ash advanced \$527,140 to PwC in its capacity as proposed Receiver which was to be held in escrow pending PwC's appointment as Receiver and the satisfaction of certain conditions precedent as set out in the Sale Agreement. Upon its appointment, the Receiver confirmed and ratified the Term Sheet.

59. Red Ash advanced further funds to the Receiver, as required, throughout the receivership. As at the date of this Report, Red Ash has advanced an aggregate of approximately \$1,077,567 to fund certain costs and expenses incurred by the Receiver in the exercise of its powers and duties under the BIA, the Receivership Order, the Sale Approval and Vesting Order and the Sale Agreement.
60. The Receiver estimates that there is approximately \$34,500 in fees and disbursements required to complete the receivership proceedings, primarily related to the professional fees and expenses of the Receiver and its legal counsel.
61. As detailed in the R&D above, receipts in the receivership consisted primarily of funds received from Red Ash under the Term Sheet to fund the Receiver's expenses, certain HST refunds related to expenses incurred by the Receiver during the receivership, and a pre-appointment HST refund in respect of Strudex that was paid to Red Ash, as the refund was subject to its security.
62. The Term Sheet provided that at the end of its appointment, the Receiver shall, after paying all obligations incurred, reimburse Red Ash, as lender under the Term Sheet, any excess or residual funds. Accordingly, the Receiver is seeking the approval of this Court, pursuant to the Term Sheet, to distribute to Red Ash any excess or residual funds remaining in the receivership upon the conclusion of the receivership and the payment of all obligations incurred.
63. The Receivership Order provides that the Receiver and its legal counsel shall only be required to pass their accounts if Red Ash makes a written request to the Receiver for such passing of accounts. Red Ash has been provided with a copy of all accounts of the Receiver and its legal counsel and has not requested a passing of such accounts. Accordingly, the Order sought by the Receiver does not include approval of the Receiver's or its counsel's fees or expenses.

F. REMAINING DUTIES

64. As summarized in this Fourth Report, the Receiver has completed its duties and obligations, as set out in the Receivership Order, the Sale Approval and Vesting Order, the Sale Agreement and the BIA except for the following outstanding matters:
 - a) pursuing the recovery of certain HST refunds;
 - b) transferring the balance of the Priority Claims Reserve to the Trustee;

- c) transferring the balance of the s. 81.1 Trust Fund to the Trustee;
 - d) completion and filing of a statutory report pursuant to section 246 (3) of the BIA; and
 - e) distributing the remaining funds in the Receiver's trust account, if any, after payment of all obligations incurred, to Red Ash, to reimburse Red Ash for advances under the Term Sheet.
65. After the above outstanding matters have been completed, the Receiver will have no remaining activities to complete and the Receiver respectfully submits that it is appropriate to discharge the Receiver.

G. CONCLUSION

66. To the best of the Receiver's knowledge and belief, all duties of the Receiver have been properly carried out and completed, other than those outstanding matters listed in paragraph 64 above. Accordingly, the Receiver brings this motion and respectfully requests that this Court make an Order:
- a) approving the Third Report and this Fourth Report and the actions and activities of the Receiver set out therein and herein;
 - b) authorizing the Receiver to transfer to the Trustee (by way of a deeming provision in the Order) the residual balance of the Priority Claims Reserve in the amount of approximately \$24,500 in trust to satisfy any valid claims that are subject to the BIA Charges, and authorizing the Trustee, upon the its discharge, to distribute the remaining balance of the Priority Claims Reserve to the Purchaser;
 - c) authorizing the Receiver to transfer to the Trustee (by way of a deeming provision in the Order) the residual balance of the s. 81.1 Trust Fund in trust to be held pending an agreement amongst the parties or further order of the Court with respect to Equistar's s. 81.1 Claim;
 - d) authorizing the Receiver, pursuant to the Term Sheet, to distribute to Red Ash any excess or residual funds remaining in the receivership after payment of all obligations incurred;
 - e) discharging the Receiver, subject to the Receiver completing its administration of the estate herein and subject to the Receiver filing a Discharge Certificate certifying same with the

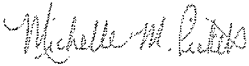
Court; and

- f) declaring that the Receiver has duly and properly discharged its duties, responsibilities and obligations and is released from any further obligations as Receiver and any and all liability relating to these receivership proceedings, save and except for any gross negligence or wilful misconduct on the part of the Receiver.

All of which is respectfully submitted on this 9th day of October, 2012.

PricewaterhouseCoopers Inc.

In its capacity as Receiver of
743122 Ontario Inc., 3851168 Canada Inc.,
798862 Ontario Limited (formerly Kraus Inc., Kraus Canada Inc.,
and Strudex Fibres Limited, respectively), and 538626 B.C. Ltd.,
and not in its personal capacity.



Michelle Pickett
Senior Vice President

APPENDIX “A”

Court File No. CV-12-9731-00CL

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

THE HONOURABLE MR)	MONDAY, THE 11 th
)	
JUSTICE MORAWETZ)	DAY OF JUNE, 2012

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

SALE APPROVAL AND VESTING ORDER

THIS MOTION, made by PricewaterhouseCoopers Inc. ("**PwC**") in its capacity as Interim Receiver (the "**Interim Receiver**") appointed by Order of this Court dated May 28, 2012 (the "**Interim Receivership Order**") and in its capacity as the proposed Court-appointed receiver (the "**Proposed Receiver**") pursuant to section 243 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (the "**BIA**") now appointed by Order of this Court dated June 11, 2012 (the "**Receivership Order**") with such appointment to be effective as of the Effective Time as defined in such Order (the "**Receiver**") of the undertaking, property and assets of Kraus Inc.

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("KI"), Kraus Canada Inc. ("KCI"), Strudex Fibres Limited ("Strudex") and 538626 B.C. Ltd. ("538") (collectively, the "Debtor") for an order approving the sale transaction (the "Transaction") contemplated by an asset purchase agreement between the Receiver and Kraus Brands LP or from time to time, after the date hereof, its nominee (the "Purchaser") dated June 11, 2012 (the "Sale Agreement") the form of which is appended to the First Report of the Interim Receiver and Proposed Receiver dated May 29, 2012 (the "First Report"), as amended and described in the Second Report of the Interim Receiver and Proposed Receiver dated June 10, 2012 (the "Second Report") and as further amended and filed with this Court, as Exhibit "A" to the Affidavit of Jenna Willis sworn June 11, 2012, and vesting in the Purchaser, or any replacement or substitute thereof, the Receiver's right, title and interest, if any, and the Debtor's right, title and interest in and to the Purchased Assets (as defined in the Sale Agreement), was heard this day at 330 University Avenue, Toronto, Ontario.

ON READING the First Report, the Second Report, the Affidavit of Chris Emmott sworn May 25, 2012 (the "Emmott Affidavit"), and the supplementary affidavit of Chris Emmott sworn June 7, 2012, and on hearing the submissions of counsel for the Interim Receiver, the Receiver, the Applicant, the Financial Services Commission of Ontario, Nylene Canada Inc., Propex Operating Company, LLC, Tri-tex Co. Inc. and Equistar Chemicals, LP, no one appearing for any other person on the service list, although properly served as appears from the affidavits of Natalina Arvaj sworn May 30, June 5, 6 and 7, 2012, the Affidavits of Tim Lenchan sworn May 30 and June 6, 2012, the Affidavits of Wondimu Feleke sworn May 31, 2012, the Affidavits of Paul Young sworn June 4, 2012 and the Affidavit of Matthew Simpson sworn June 11, 2012, filed,

AND ON BEING ADVISED that the Pension Plan Members (as defined in the First Report) were sent a copy of the Notice as directed by the Interim Receivership Order, and upon bankruptcy orders having been granted earlier this day in respect of KI, KCI and Strudex (the "Bankruptcy Orders") and upon the Receivership Order having been granted earlier this day to be effective immediately prior to the Effective Time (as defined in the Receivership Order),

1. **THIS COURT ORDERS** that that the time for service of the Notice of Motion and the Motion Record, including the First Report and the Second Report, be and is hereby abridged and that the Motion is properly returnable today and further that the requirement for service of the

Notice of Motion and Motion Record, including the First Report and Second Report, upon interested parties, other than those served, is hereby dispensed with and that the service of the Notice of Motion and Motion Record, including the First Report and Second Report, as effected by the Interim Receiver and Proposed Receiver is hereby validated in all respects.

2. **THIS COURT ORDERS AND DECLARES** that the Transaction is hereby approved, and the execution of the Sale Agreement, along with any ancillary agreements contemplated therein, by the Receiver is hereby authorized and approved, with such minor amendments as the Receiver may deem necessary. The Receiver is hereby authorized and directed to take such additional steps and execute such additional documents as may be necessary or desirable for the completion of the Transaction and for the conveyance of the Purchased Assets for the Purchase Price as defined in the Sale Agreement all in accordance with the Sale Agreement.

3. **THIS COURT ORDERS AND DECLARES** that, subject to paragraphs 5 and 6 below, upon the delivery of the Receiver's Certificate to the Purchaser substantially in the form attached as **Schedule "A"** hereto (the "**Receiver's Certificate**"), all of the Receiver's right, title and interest, if any, and the Debtor's right, title and interest in and to Purchased Assets (as defined in the Sale Agreement) shall vest absolutely in the Purchaser, or any replacement or substitute thereof, free and clear of and from any and all security interests (whether contractual, statutory, or otherwise), hypothecs, mortgages, trusts or deemed trusts (whether contractual, statutory, or otherwise), liens, executions, levies, charges, or other financial or monetary claims, whether or not they have attached or been perfected, registered or filed and whether secured, unsecured or otherwise (collectively, the "**Claims**") including, without limiting the generality of the foregoing: (i) any encumbrances or charges created by the Order of the Honourable Mr. Justice Morawetz dated June 11, 2012; (ii) all charges, security interests, hypothecs, or claims evidenced by registrations pursuant to the *Personal Property Security Act* (Ontario) or any other personal property registry system (all of which are collectively referred to as the "**Encumbrances**", which term shall not include the permitted encumbrances, easements and restrictive covenants listed on **Schedule "D"** hereto) and, for greater certainty, this Court orders that all of the Encumbrances affecting or relating to the Purchased Assets are hereby expunged and discharged as against the Purchased Assets.

4. **THIS COURT ORDERS** that upon the registration in the Land Registry Office for the Land Titles Division of Waterloo North (No. 58) of an Application for Vesting Order in the form prescribed by the *Land Titles Act*, the Land Registrar is hereby directed to enter Kraus Brands Inc., as general partner of Kraus Brands LP, as the owner of the Real Property as identified in **Schedule "B"** hereto in fee simple, and is hereby directed to delete and expunge from title to the Real Property all of the Claims and Encumbrances listed in **Schedule "C"** hereto.

5. **THIS COURT ORDERS AND DECLARES** that upon the delivery of the Receiver's Certificate to the Purchaser, all of the Receiver's right, title and interest, if any, and the Debtor's right, title and interest in and to the capital stock of Northstate Capital Mills PTY Ltd. described in the Sale Agreement (collectively, the "**Northstate Shares**") shall vest absolutely in the Purchaser, in trust for Red Ash Capital Partners II Limited Partnership, or any replacement or substitute thereof, free and clear of and from any and all Claims and Encumbrances (except those permitted encumbrances, easements and restrictive covenants listed on **Schedule "D"** hereto) and, for greater certainty, this Court orders that all of the Encumbrances (except those permitted encumbrances, easements and restrictive covenants listed on **Schedule "D"** hereto) affecting or relating to the Northstate Shares are hereby expunged and discharged as against the Northstate Shares.

6. **THIS COURT ORDERS THAT** certain of the Purchased Assets are subject to claims of the parties listed on **Schedule "E"** delivered pursuant to s. 81.1 of the BIA at the time of the granting of the bankruptcy orders in respect of KI, KCI and Strudex (individually a "**s. 81.1 Asset**" and collectively, the "**s. 81.1 Assets**"). The following provisions apply to such s. 81.1 Assets:

- (a) The Receiver shall file a report advising as to the s. 81.1 Assets in the possession of the Companies as at the date hereof and, to the extent ascertainable, as at May 28, 2012.
- (b) Until such time as the claim to a s. 81.1 Asset is determined, by court order or by agreement amongst the Receiver, the applicable claimant to the s. 81.1 Asset and the Purchaser (the "**Determination**"), such s. 81.1 Asset shall remain the property of KI, KCI or Strudex respectively and shall not vest in the Purchaser pursuant to paragraph 3 above.

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(c) Until a Determination in respect of a s. 81.1 Asset, the Purchaser shall segregate and preserve in the same state and condition the s. 81.1 Asset and provide reasonable access to the Receiver and such claimants to the s. 81.1 Assets for the purpose of assessing the rights thereto.

(d) On a Determination that the applicable claimant to a s. 81.1 Asset does not have a claim thereto, such s. 81.1 Asset shall immediately vest in the Purchaser in accordance with paragraph 3 above. On a Determination that the applicable claimant to a s.81.1 Asset has a valid claim thereto pursuant to section 81.1 of the BIA, such s.81.1 Asset shall immediately be made available for recovery by the applicable claimant or shall be purchased by the Purchaser, on terms acceptable to the claimant and the Purchaser.

(e) Notwithstanding the foregoing, the Purchaser shall be entitled to use and consume any s.81.1 Assets, provided the Purchaser pays to the Receiver in trust forthwith the invoice amount for any s.81.1 Assets used and consumed by the Companies or the Purchaser from and after the date hereof. The cash payment shall stand in place and stead of the s.81.1 Asset, with such cash to be disposed of in accordance with a Determination. The fact that any such s.81.1 Assets may not have been segregated prior to such use and consumption shall not be raised as a reason to defeat a claim to a s.81.1 Asset that is used and consumed.

7. **THIS COURT ORDERS AND DECLARES** that the Receiver and/or any director or officer of each Debtor, following the completion of the Transaction, is authorized to execute, deliver and file any document, including without limitation, any articles of amendment, required in order to effect a change of the corporate name of each of KI, KCI and Strudex, and waives any third party requirement or required consent pursuant to any Canadian federal or provincial legislation.

8. **THIS COURT ORDERS AND DIRECTS** that the documents marked as Confidential Appendices A, B and C to the First Report contain confidential information and shall remain confidential and shall not form part of the permanent court record pending further order of this Court.

9. **THIS COURT ORDERS AND DECLARES** that the First Report is deemed to be the First Report of the Receiver and the Second Report is deemed to be the Second Report of the Receiver, and the conduct and activities of the Interim Receiver, the Proposed Receiver and the Receiver outlined in the First Report and the Second Report are hereby approved.

10. **THIS COURT ORDERS AND DIRECTS** the Receiver to file with the Court a copy of the Receiver's Certificate, as soon as practicable after delivery thereof.

11. **THIS COURT ORDERS** that, pursuant to clause 7(3)(c) of the Canada *Personal Information Protection and Electronic Documents Act*, the Receiver is authorized and permitted to disclose and transfer to the Purchaser all human resources and payroll information in the Debtor's records pertaining to the Debtor's past and current employees. The Purchaser shall maintain and protect the privacy of such information and shall be entitled to use the personal information provided to it in a manner which is in all material respects identical to the prior use of such information by the Debtor.

12. **THIS COURT ORDERS** that, notwithstanding:

(a) the pendency of these proceedings; and

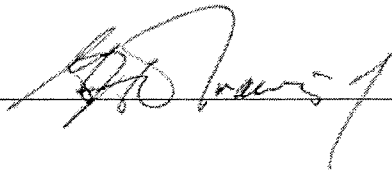
(b) the Bankruptcy Orders,

the vesting of the Purchased Assets in the parties specifically described in paragraphs 3 and 5 above pursuant to this Order shall be binding on the trustee in bankruptcy appointed in respect of the Debtor (and any replacement or substitute thereof) and shall not be void or voidable by creditors of the Debtor, nor shall it constitute nor be deemed to be a ~~settlement~~⁵⁰, fraudulent preference, assignment, fraudulent conveyance, transfer at undervalue, or other reviewable transaction under the BIA or any other applicable federal or provincial legislation, nor shall it constitute oppressive or unfairly prejudicial conduct pursuant to any applicable federal or provincial legislation.

13. **THIS COURT ORDERS AND DECLARES** that the Transaction is exempt from the application of the *Bulk Sales Act* (Ontario), section 31 of the Ontario *Mortgages Act* and subsection 63(4) of the Ontario *Personal Property Security Act*.

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14. **THIS COURT HEREBY REQUESTS** the aid and recognition of any court, tribunal, regulatory or administrative body having jurisdiction in Canada, Australia or in the United States to give effect to this Order and to assist the Receiver and its agents in carrying out the terms of this Order. All courts, tribunals, regulatory and administrative bodies are hereby respectfully requested to make such orders and to provide such assistance to the Receiver, as an officer of this Court, as may be necessary or desirable to give effect to this Order or to assist the Receiver and its agents in carrying out the terms of this Order.



Schedule A – Form of Receiver's Certificate

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 INVESTMENTS II LIMITED PARTNERSHIP

Applicant

- and -

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

Respondents

RECEIVER'S CERTIFICATE

RECITALS

A. Pursuant to an Order of the Honourable Mr. Justice Morawetz of the Ontario Superior Court of Justice (the "**Court**") dated June 11, 2012 (the "**Order**"), PricewaterhouseCoopers Inc. was appointed as the receiver (the "**Receiver**") of the undertaking, property and assets of Kraus Canada Inc., Kraus Inc., Strudex Fibres Limited and 538626 B.C. Ltd. (collectively, the "**Debtor**") effective as of the Effective Time as defined in such Order.

B. Pursuant to an Order of the Court dated June 11, 2012, the Court approved the sale transaction (the "**Transaction**") contemplated by the asset purchase agreement made as of June 11, 2012 (the "**Sale Agreement**") between the Receiver and Kraus Brands LP or from time to time, after the date hereof, its nominee (the "**Purchaser**") and provided for the vesting in the Purchaser and the Purchaser in trust for Red Ash Capital Partners II Limited Partnership (the "**Purchasing Entities**") of the Receiver's, if any, and the Debtor's right, title and interest in and

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to the Purchased Assets as defined in the Sale Agreement, which vesting is to be effective, subject to paragraph 6 of the Order, upon the delivery by the Receiver to the Purchasing Entities of a certificate confirming (i) the satisfaction of the Purchase Price for the Purchased Assets pursuant to the Sale Agreement; (ii) that the conditions to Closing as set out in Article 5 of the Sale Agreement have been satisfied or waived by the Receiver and the Purchaser; and (iii) the Transaction has been completed to the satisfaction of the Receiver.

C. Unless otherwise indicated herein, terms with initial capitals have the meanings set out in the Sale Agreement.

THE RECEIVER CERTIFIES the following:

1. The Purchase Price for the Purchased Assets was satisfied on the Closing Date pursuant to the Sale Agreement;
2. The conditions to Closing as set out in Article 5 of the Sale Agreement have been satisfied or waived by the Receiver and the Purchaser; and
3. The Transaction has been completed to the satisfaction of the Receiver.
4. This Certificate was delivered by the Receiver at [] TIME on [] [DATE].

PricewaterhouseCoopers Inc., solely in its capacity as Receiver of the undertaking, property and assets of Kraus Canada Inc., Kraus Inc., Strudex Fibres Limited and 538626 B.C. Ltd. and not in its personal capacity

Per: _____

Name: _____

Title: _____

Schedule B**Description of Real Property**Legal Description:

PIN: 22280-0071 (LT)

Part of Lot 8 German Company Tract Township of Waterloo, Parts 1, 2, 3, 4, 5 & 6 on Plan 58R-4092; Subject to Instruments 369437, 465123E and B45015; Waterloo.

Municipal Address:

65 Northfield Drive West
Waterloo, Ontario

Schedule C**Claims to be deleted and expunged from title to Real Property**

1. Nil.

Schedule D

Permitted Encumbrances, Easements and Restrictive Covenants related to the Real Property and the LP Purchased Assets

The Permitted Encumbrances shall include:

- (a) The reservations, limitations, exceptions, provisos and conditions, if any, expressed in any original grants from the Crown relating to the Real Property including, without limitation, the reservation of any mines and minerals in the Crown or in any other Person.
- (b) Applicable municipal by-laws, development agreements, subdivision agreements, site plan agreements, airport zoning regulations and other similar agreements with government authorities or private or public utilities affecting the development or use of the Real Property, other agreements, building and other restrictions, easements, servitudes, rights of way and licences.
- (c) Defects or irregularities in title to the Real Property which are of a minor nature.
- (d) In respect of the Real Property, instrument No. B45015 being a Transfer of Easement in favour of the The Hydro - Electric Power Commission of Ontario for the purpose of installing and maintaining power transmission lines and underground conductors.
- (e) In respect of the Real Property, instrument No. 369437 being a Transfer of Easement in favour of The Public Utilities Commission of the City of Waterloo for the purpose of installing and maintaining underground power lines and cables.
- (f) In respect of the Real Property, instrument No. Z373176 being a Restrictive Covenant Agreement between The Corporation of the City of Waterloo and Kraus Carpet Mills Limited, partially released by instrument No. 571904.
- (g) In respect of the Real Property, instrument No. Z411919 being a Restrictive Covenant Agreement between The Corporation of the City of Waterloo and Kraus Carpet Mills Limited, partially released by instrument No. 571904.
- (h) In respect of the Real Property, instrument No. E465123 being a Transfer of Easement in favour of The Corporation of the City of Waterloo for the purpose of constructing and maintaining a storm and sanitary sewer.

- (i) In respect of the Real Property, instrument No. Z465123 being a Restrictive Covenant Agreement between The Corporation of the City of Waterloo and 236753 Investment Limited, partially released by instrument No. 571904.
- (j) In respect of the Real Property, instrument No. 767172 being an Agreement between The Corporation of the City of Waterloo and Kraus Carpet Mills Limited.
- (k) In respect of the Real Property, instrument No. WR305984 being a Charge registered in favour of National Bank of Canada securing the principal sum of \$165,000,000.00 as assigned to Pinnacle Capital Resources Limited as general partner of Red Ash Capital Partners II Limited Partnership by instrument No. WR687890.
- (l) In respect of the Real Property, instrument No. WR312710 being a Charge in favour of BMO Capital Corporation securing the principal sum of \$12,500,000.00 as assigned to Pinnacle Capital Resources Limited as general partner of Red Ash Capital Partners II Limited Partnership by instrument No. WR687891.
- (m) Existing Senior Security (as defined in the Sale Agreement).
- (n) Existing Subordinated Security (as defined in the Sale Agreement).
- (o) Existing Nelson Security.
- (p) Liens and Encumbrances to the extent they secure a Priority Claim and to the extent not paid or discharged on Closing (all as defined in the Sale Agreement).
- (q) Any validly perfected purchase money security interest relating to the Purchased Assets.

Schedule E

1. American Berber Inc.
2. Beaulieu Group, LLC
3. Huntsman Corporation of Canada, Inc.
4. Nylene Canada, Inc.
5. Don& Low Ltd.
6. Equistar Chemicals, LP
7. Tri-tex Co. Inc.
8. Propex Operating Company, LLC
9. Carpet & Rug Backing and Supplies, Inc.

Court File No. CV12-9731-00CL

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

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

ONTARIO
SUPERIOR COURT OF JUSTICE
 (COMMERCIAL LIST)

Proceeding commenced at Toronto

SALE APPROVAL AND VESTING ORDER

BLAKE, CASSELS & GRAYDON LLP
 Suite 4000, Commerce Court West
 199 Bay Street, Suite 4000
 Toronto, Ontario M5L 1A9

Pamela Huff LSUC No.: 27344V
 Tel: (416) 863-2958

Line Rogers LSUC No.: 43562N
 Tel: (416) 863-4168

Jenna Willis LSUC No.: 58498U
 Tel: (416) 863-3348
 Fax: (416) 863-2653

Lawyers for PricewaterhouseCoopers Inc. in its capacity as
 the Court-appointed Receiver of Kraus Inc., Kraus Canada Inc.
 and Strudex Fibres Limited

APPENDIX “B”

Court File No. CV12-9731-00CL

**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

**FIRST REPORT OF PRICEWATERHOUSECOOPERS INC.
AS INTERIM RECEIVER AND PROPOSED RECEIVER**

MAY 29, 2012

INTRODUCTION

1. PricewaterhouseCoopers Inc. ("**PwCI**") understands that applications (the "**Bankruptcy Application I**") have been made before the Ontario Superior Court of Justice (Commercial List)(the "**Court**") by Pinnacle Capital Resources Limited, in its capacity as general partner of Red Ash Capital Partners II Limited Partnership (collectively "**Red Ash**" or the "**Lender**"), for an order (the "**Bankruptcy Order I**") appointing PwCI as a trustee in bankruptcy (the "**Trustee**") pursuant to Section 43 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (the "**BIA**") over the assets, undertakings and properties ("**Property**") of Strudex Fibres Limited ("**Strudex**") and the Property of Kraus Inc. ("**KI**").
2. PwCI understands that a separate application ("**Bankruptcy Application II**") has been made before the Court of Queen's Bench in Winnipeg, Manitoba by Red Ash, for an order (the "**Bankruptcy Order II**") appointing PwCI as Trustee pursuant to section 43(1) of the BIA over the Property of Kraus Canada Inc. ("**KCI**"). PwCI understands that Red Ash has not made an application to appoint a Trustee of 538626 B.C. Ltd. ("**Kraus BC**") as Kraus BC is dormant. (Bankruptcy Order I and Bankruptcy Order II are hereinafter collectively referred to as the "**Bankruptcy Orders**".)
3. An application (the "**Receivership Application**") has been made in these proceedings by Red Ash, for an order (the "**Receivership Order**") appointing PwCI as receiver (the "**Receiver**") pursuant to section 243(1) of the BIA over the Property of Strudex, KI, KCI and Kraus BC (together the "**Companies**").
4. As a result of Bankruptcy Application I and Bankruptcy Application II (together the "**Bankruptcy Applications**") and the Receivership Application, PwCI was appointed as Interim Receiver on May 28, 2012 (the "**Interim Receiver**") in respect of KI, KCI and Strudex pursuant to the application brought by Red Ash, in these proceedings. Red Ash, as assignee, is the principal secured creditor of the Companies as described in detail in this report and in the affidavit of Christopher Emmott sworn May 25, 2012 (the "**Emmott Affidavit**") in support of the relief sought in these proceedings.
5. In anticipation of PwCI's appointment as Receiver, Kraus Brands LP ("**Kraus Brands**" or the "**Purchaser**"), an affiliate of Red Ash, has made a binding offer to PwCI in its capacity as the proposed receiver ("**Proposed Receiver**") for the purchase of substantially all of the Property that is subject to the Receivership Application. The offer is set out in an Asset Purchase

Agreement between the Receiver (to be executed upon its appointment, and authorization by the Court to do so) and the Purchaser (the “**KB APA**”).

6. PwCI is a licensed trustee within the meaning of section 2 of the BIA. PwCI has consented to act as Receiver and Trustee in these proceedings in the event that this Court grants the Receivership Order and the Bankruptcy Orders. PwCI has extensive knowledge of the Companies and its affiliates (the “**Kraus Group**”) as it was previously retained to act as the Companies’ financial advisor in addressing liquidity concerns, providing strategic advice and negotiating with the Companies’ various lenders, including the Companies’ Senior Syndicate (as defined below).
7. We are writing this first report of the Interim Receiver and of PwCI in its capacity as the Proposed Receiver of the Companies (the “**First Report**”) in the same manner as if we had already been appointed as Receiver by this Court. This report has been prepared to:
 - a) provide this Court with background information in respect of:
 - (i) an overview of the Kraus Group, including its corporate structure, operations, and debt structure, etc.;
 - (ii) the Kraus Group’s current financial position and liquidity issues; and
 - (iii) the causes of its insolvency;
 - b) report on the marketing and sales process undertaken by PricewaterhouseCoopers Corporate Finance Inc. (“**PwCCF**”), an affiliate of PwCI, to refinance or effect a sale of the Companies’ assets;
 - c) provide this Court with information regarding the proposed asset sale (the “**Sale Transaction**”) of substantially all of the Companies’ assets to be entered into between the Receiver (once appointed and if authorized by the Court to do so) and Kraus Brands and provide their comments on the KB APA;
 - d) provide this Court with information on Priority Claims (as defined in the KB APA) and Deemed Trust Claims (as defined herein);
 - e) provide this Court with the Proposed Receiver’s view that there is no benefit or financial ability of the Companies to conduct a further sales process;
 - f) provide this Court with information regarding the proposed Notice to Stakeholders of the KB APA;
 - g) summarize the results of a liquidation analysis prepared by the Proposed Receiver; and

- h) provide this Court with a summary of the independent security opinions commissioned by the Proposed Receiver in respect of Red Ash's security;
 - i) recommend that, in the event this Court appoints PwCI as Receiver, the Court issue an order (the "**Approval and Vesting Order**"):
 - (i) approving the KB APA and the Sale Transaction and authorizing and directing the Receiver to execute the KB APA and take such additional steps as are necessary to complete the Sale Transaction;
 - (ii) sealing the confidential appendices of the First Report filed with this Court from the public record until after the closing of the Sale Transaction, or further order of this Court;
 - (iii) vesting in the Purchaser, as at closing, all of the Receiver's and the Kraus Group's right, title and interest, if any, in and to the Purchased Assets as defined in the KB APA, free and clear of all liens, charges, security interests and other encumbrances, other than Permitted Encumbrances (as identified in the KB APA); and
 - (iv) authorizing the Receiver to change the corporate names of each of KI, KCI and Strudex.
8. In preparing this report, the Interim Receiver and the Proposed Receiver have relied upon unaudited and draft, internal financial information of the Companies provided to it by the Companies. The Interim Receiver and the Proposed Receiver have not audited, reviewed or otherwise attempted to verify the accuracy or completeness of the information provided to them and expresses no opinion, or other form of assurance, in respect of the information contained in this report. The Interim Receiver and Proposed Receiver reserve the right to refine or amend their comments and findings as further information is obtained or brought to their attention subsequent to the date of this First Report.
9. Unless otherwise noted, all currency amounts contained in this report are expressed in Canadian dollars.

A. BACKGROUND

10. Reference is made to the Emmott Affidavit for a more detailed overview of the Companies.

COMPANY OVERVIEW

11. The Kraus Group is a vertically integrated manufacturer of carpet and a distributor of flooring products for the commercial and residential markets in Canada, the United States and Australia. The Kraus Group operates two carpet mills:
- a) an 850,000 square foot flagship operation in Waterloo, Ontario that includes both carpet and fibre manufacturing; and
 - b) a smaller 80,000 square foot carpet mill in Queensland, Australia, that manufactures carpet using fibre produced in Waterloo.
12. In addition, the Kraus Group has eight leased distribution centres, five in Canada (in Vancouver, Edmonton, Winnipeg, Toronto and Dartmouth, (collectively the “**Leased Premises**”) and three in the United States (Shipperville, Pennsylvania, Renton, Washington and Dalton, Georgia).
13. Ninety four percent of the sales of the Kraus Group are from North America (Canada (52%) and the United States (42%)) with the remaining 6% from sales in Australia and New Zealand. Approximately 60% of the sales of the Kraus Group are to the residential flooring market and approximately 40% of its annual sales are in respect of commercial flooring.
14. Carpet sales make up approximately 60% of the annual revenue of the Kraus Group. The remaining approximately 40% of its revenue is derived from a mixture of sales of private label and branded laminate, hardwood, cork and other flooring product.
15. Anneleen Eckhardt Holdings Limited (“**Anneleen**”), a holding company owned by the Eckhardt family, is the ultimate parent of the Kraus Group. An organization chart in respect of the Kraus Group is attached as Appendix “A”.
- a) As set out in the organization chart, Anneleen owns a majority interest (either directly or indirectly) in the following Canadian based companies: (1) Strudex; (2) KI; (3) KCI; and (4) Kraus BC. These legal entities, except Kraus BC, are subject to these Interim Receivership proceedings and all entities are subject to the Receivership Application. As discussed earlier, Kraus BC is dormant, hence it is not a party to the Bankruptcy Applications.

- b) The Companies also own a majority interest in the following United States based companies: (1) Kraus USA, Inc.; (2) Barrett Carpet Mills, Inc.; (3) Royal Scot Floorcovering Distribution LLC; and (4) Kraus Floors LLC. These United States based legal entities are not subject to the Interim Receivership proceedings, nor are they subject to the Receivership Application or Bankruptcy Applications. The Proposed Receiver understands that only Kraus USA, Inc., and Barrett Carpet Mills, Inc. are currently operating. Royal Scot Floorcovering Distribution LLC and Kraus Floors LLC are dormant companies. It is proposed that the shares of each of these United States entities will be sold to the Purchaser pursuant to the KB APA.
- c) The Kraus Group holds a majority interest in Australia based Northstate Carpet Mills Pty Ltd. (“**Northstate**”), which is also not subject to the Interim Receivership proceedings, or Receivership Application or Bankruptcy Applications. It is proposed that the shares of Northstate owned by the Kraus Group will be sold to the Purchaser pursuant to the KB APA.

SHAREHOLDER BUYOUT

- 16. As noted above, the Kraus Group is wholly owned by the Eckhardt Family. However, prior to June 2007, the Eckhardt family owned only a 50% interest in the Kraus Group with Nelson Kraus Holdings Limited (“**NKHL**”) owning the remaining 50% interest. In June 2007, the Eckhardt family acquired NKHL’s 50% interest in the Kraus Group. PwCCF served as advisor to the Eckhardt family in respect to the acquisition (the “**Shareholder Buyout**”).
- 17. Prior to the Shareholder Buyout, the Kraus Group had a history of strong and consistent financial performance. For the fiscal year ended December 31, 2006 (the fiscal year prior to the Shareholder Buyout), the Kraus Group reported revenue of \$324.6 million and normalized earnings before interest, taxes, depreciation and amortization (“**EBITDA**”) of \$33.9 million. For the five year period ended December 31, 2006, the Kraus Group reported average annual revenue of \$293.2 million and average annual normalized EBITDA of \$36.0 million. (Normalization adjustments to EBITDA in these years consisted of discretionary shareholder bonuses, charitable donations and restructuring related expenses.)
- 18. NKHL’s 50% interest in the Kraus Group was acquired in June 2007 for an amount of approximately \$70.0 million. Consideration for the Shareholder Buyout included a cash payment of \$30.5 million paid on closing and the issuance of a subordinated, secured vendor take back note (the “**VTB Note**”).

in the amount of approximately \$37.7 million. It is relevant to note that the purchase price of this transaction equates to an enterprise valuation multiple of approximately 5.8 times normalized EBITDA for 2006.

19. The terms of the VTB Note included twenty equal quarterly installments of approximately \$1.6 million and a balloon payment in the amount of \$5.0 million at the end of the five year term. The VTB Note was secured by a third ranking security interest in substantially all of the personal property of Strudex, Kraus Carpet Mills Limited (now KI), 1029011 Ontario Inc. (now KI), and W. G. McMahon Canada Ltd. (now KCI), and a third ranking pledge of the shares of Strudex owned by Anneleen. The VTB Note and related security were assigned to Nelson Kraus ("NK") in December 2010.

DEBT STRUCTURE

20. As part of the Shareholder Buyout discussed above, in addition to the VTB Note, the Kraus Group arranged a \$139 million senior debt facility (the "**Senior Debt**"), which was subject to an availability formula, and a \$10 million subordinated debt facility to finance the \$30.5 million cash payment to NKHL and to refinance the existing debt of the Kraus Group.
21. The Senior Debt was underwritten by the National Bank of Canada and the Bank of Montreal (the "**Agents**"), which subsequently syndicated a portion of this facility to certain additional lenders (the "**Senior Syndicate**").
22. The \$10 million subordinated secured debt facility (the "**BMOCC Debt**") was provided by the Bank of Montreal Capital Corporation ("**BMOCC**"). The BMOCC debt was assigned to the Bank of Montreal in November 2011.

23. The table below provides a summary of the Kraus Group's outstanding secured debt as at April 30, 2012:

Lender Name	Lien Ranking	Amount Outstanding as at April 30, 2012 (\$'000)	Security	Status
Syndicate led by National Bank of Canada and Bank of Montreal	First	71,115	General security agreement over the property, rights and assets of the Kraus Group; hypothec over the property of KCI located in Quebec; pledge by Anneleen of securities, including shares of Strudex and Northstate; and charge over the manufacturing facility in Waterloo, Ontario (65 Northfield Drive West, Waterloo).	Default as of May 26, 2008; 5 Amendment Agreements, 14 Forbearance Agreements
Bank of Montreal	Second	19,714	General Security Agreement over the property, rights and assets of the Kraus Group; hypothec over the property of KCI located in Quebec; pledge by Anneleen of securities, including shares of Strudex and Northstate; pledge by Anneleen of indebtedness owed to Anneleen by Strudex and KI; and charge over the manufacturing facility in Waterloo, Ontario (65 Northfield Drive West, Waterloo).	4 Agreement Amendments; Assignment of Loan from BMOCC to Bank of Montreal
Nelson Kraus	Third	35,407	General security agreement over the property, rights and assets of the Kraus Group (other than Kraus B.C.) and pledge by Anneleen of shares of Strudex.	Amendment Agreement in November, 2010; Loan extension to January 31, 2020
	Total	126,236		

24. The Interim Receiver and Proposed Receiver understand that on or about May 7, 2012, Red Ash, an affiliate of Hilco UK Limited ("**Hilco**"), took an assignment of all of the Senior Debt, BMOCC Debt and VTB Note (together the "**Secured Debt**") having a face value of approximately \$126.2 million as at April 30, 2012. The Interim Receiver and Proposed Receiver were not privy to the terms of the transaction, but understand that Red Ash purchased the Secured Debt for an amount that was less than the face value of the Secured Debt.

CAUSES OF FINANCIAL DIFFICULTIES

25. Subsequent to the Shareholder Buyout being completed in June 2007, the Kraus Group's financial performance deteriorated significantly, primarily for three reasons:
- Significant Decline in Carpet Sales.** The sharp and sustained downturn in the North American housing market that began in late 2007 and subsequent recession in both Canada and the United States significantly reduced carpet sales. By 2009/2010 carpet volumes had declined 40% from their peak in 2005/2006;
 - Increased Strength of the Canadian Dollar.** As a Canadian based manufacturer and exporter, the strong Canadian dollar negatively impacted revenue and margins as US dollar

denominated revenue was converted back to Canadian dollars at progressively higher exchange rates; and

- c) **Higher Input Prices.** Higher oil prices over the past several years have led to rising prices for resin, the Companies' principal raw material, which has adversely impacted the Companies' margins. While the industry as a whole has consistently raised its prices to recover the increase in resin costs, there is generally a time lag between the rise in input costs and the rise in product prices, which had negatively impacted margins.

RECENT FINANCIAL RESULTS

26. As is evident from the table below, the impact of the cyclical North American economic downturn and resultant sharp decrease in carpet volume demand was particularly challenging for the Kraus Group, as the size and scale of its Waterloo manufacturing facility, with its high fixed cost structure, limited the ability of the Kraus Group to reduce overhead. At the same time, the Kraus Group was challenged by the additional financing costs associated with the Shareholder Buyout. As a result, starting in late 2007, the Kraus Group began incurring declining EBITDA and significant net losses:

The Kraus Group (Consolidated)						
(CAD '000s)						
Year ¹	Revenue Including Discontinued Operations	Net Income/(Loss) Including Disc. Operations	Revenue from Continuing Operations	EBITDA ² from Continuing Operations	Cash flow from Continuing Operations	Net Income/(Loss)
2011	195,089	(14,612)	195,089	4,814	26	(14,612)
2010	202,767	(8,130)	202,767	8,306	(3,043)	(8,130)
2009	230,641	(9,003)	223,076	8,843	19,923	(7,827)
2008	280,408	(35,295)	242,309	7,352	(16,643)	(23,687)
2007	310,291	(2,717)	260,510	22,552	25,670	327
2006	324,639	13,662	324,639	27,575	5,082	13,662
¹ The 2011 Financial Statement figures are unaudited						
² The EBITDA figure is calculated as earnings from operations before Interest, Bank Charges, Depreciation, Amortization of Intangible Assets, FX Currency Translation Gains/Losses, Restructuring Costs, Income Taxes and other non-recurring expenditures.						

27. In 2008, the downturn in flooring demand led to a \$15.2 Million (67.4 %) decline in the Kraus Group's EBITDA to \$7.4 million for the fiscal year and, in particular, the Kraus Group experienced significant losses in its distribution business and exited unprofitable markets in the US Southeast and US Midwest.
28. To address the significant downturn in profitability, in 2008 the Kraus Group commenced an aggressive cost reduction plan which rationalized its distribution operations from 21 locations and

1,000,000 square feet of space in 2007, to 8 locations and 665,000 square feet currently. In addition, the Kraus Group integrated a smaller manufacturing facility located in Dalton, Georgia into its main manufacturing facility in Waterloo, Ontario and centralized the administration of its call centre operations. Management of the Kraus Group (“**Management**”) estimates that as a result of these operational restructuring initiatives, the Kraus Group’s operating costs decreased by approximately \$20 million annually.

29. Since 2008, the Kraus Group has also made a focused effort to discount slow moving inventory and reduce its net working capital investment, resulting in a reduction in inventory levels in the amount of approximately \$24 million or 32% from December 31, 2008 to December 31, 2011.
30. In addition, the Kraus Group has continued to launch new product lines, such as carpet tile and expand its sales channels to include big box stores in an attempt to increase revenue.
31. While the cost reductions and new product line initiatives have had a positive impact on the performance of the Kraus Group, any benefit has been outweighed by the financial constraints imposed on the Kraus Group as a result of servicing the additional debt associated with the Shareholder Buyout and the significant fixed overhead costs required to maintain the 850,000 square foot manufacturing facility in Waterloo, Ontario.
32. Notwithstanding the cost cutting and profitability improvement initiatives implemented by Management, the Kraus Group continued to generate unsatisfactory EBITDA of \$8.8 million, \$8.3 million and \$4.8 million in the fiscal years ended 2009, 2010 and 2011 respectively. During this time period, while the total secured debt was reduced from \$137.8 million as at December 2008 to \$124.7 million as at December 2011 (primarily due to cash generated from working capital investment reductions being applied to the debt), the Kraus Group was unable to make all the significant contractual repayments on the debt incurred from the Shareholder Buyout.

FINANCING ISSUES – DEFAULTS, FORBEARANCES AND INSOLVENCY

33. As a result of the financial decline of the Kraus Group brought on by the factors described above, in 2008 the Kraus Group retained an affiliate of PwCI to assist in negotiating with its various lenders, including negotiating several forbearance agreements and loan amendments and two major debt restructurings.

34. The Kraus Group first breached the covenants on the Senior Debt on May 26, 2008 and subsequently in 2008, an affiliate of PwCI assisted the Kraus Group in negotiating a forbearance on the Senior Debt and VTB Note, and restructuring the terms of the BMOCC Debt to provide warrant considerations in return for revised financial covenants and revisions to the interest payment terms.
35. From July 31, 2008 to November 23, 2010, the Kraus Group entered into 13 additional forbearance agreements in respect of the Senior Debt.
36. By November, 2010, the profitability of the Kraus Group had not recovered and PwCI advised the Kraus Group on a second major debt restructuring including renegotiating and extending the terms of the BMOCC Debt and VTB Note, which were due in June, 2012. The term of the BMOCC Debt was extended from July 2012 to July 2015 and the Kraus Group extended its ability to use payment-in-kind (“PIK”) interest until July 2012 in order to preserve liquidity. The revised payment terms of the BMOCC Debt required no scheduled principal repayments until July 2015; however the Kraus Group was required to make principal repayments upon reaching certain threshold levels.
37. The maturity date on the VTB Note was extended from 2012 to 2020 to provide the Kraus Group with increased time to repay the debt once the profitability improved. The revised terms of the VTB Note allowed the Kraus Group to make PIK interest payments until 2020 in order to preserve liquidity until the Kraus Group met certain threshold levels that required the payment of cash interest and principal. As part of the debt restructuring, the Kraus Group entered into a forbearance agreement on the Senior Debt under which it was subject to a number of covenants, including an EBITDA covenant requiring the Kraus Group to meet a minimum EBITDA level.
38. The Kraus Group’s financing issues came to a head in September 2011 when it did not meet the minimum EBITDA covenant set out in the forbearance agreement. In consideration for continued forbearance, the Senior Syndicate requested that Management put the Kraus Group assets up for sale and/or obtain replacement financing, or face a default under the Senior Debt credit agreement.
39. As is described in greater detail below, in the fall and winter of 2011/2012, PwCCF ran an extensive sale and refinancing process (the “**Sale Process**”) in respect of the Kraus Group.

LIQUIDITY CONSTRAINTS

40. Despite concessions from its secured lenders, the sustained weak demand and low carpet volumes, coupled with its high fixed cost structure continued to take its toll on the Kraus Group, because internally generated cash flow was insufficient to sustain operations.
41. In February 2012, the Kraus Group's cash flow had deteriorated to the extent that it was unable to reduce its borrowings to below the maximum permitted under the monthly borrowing base formula specified in the Senior Debt credit agreement. As such, since February 20, 2012, the Kraus Group has at all times exceeded the monthly borrowing base limit by up to \$3.1 million.
42. Unable to access additional trade credit or borrowings under its Senior Debt credit agreement, the Kraus Group drew down on inventory levels to support ongoing sales. As a result, total inventory decreased from \$50.7 million at December 31, 2011 to \$43.0 million at March 31, 2012, which the Interim Receiver and Proposed Receiver understands is \$9.0 million below historical levels required to meet the spring seasonal peak in sales.
43. Based on a cash flow forecast prepared by Management, the consolidated cash balance of the Kraus Group is forecasted to decrease from approximately \$3.8 million to \$0.9 million between May 19 and June 8, 2012, resulting in a net cash outflow of approximately \$2.9 million over the period. The Interim Receiver and Proposed Receiver note this forecast does not assume any potential disruptions to the collection of receivables or procurement of goods and services as a result of the Bankruptcy Applications.
44. In summary, because of its continuing poor operating performance, the Kraus Group has insufficient working capital to efficiently operate the business and is insolvent. Furthermore, there has been a demand for payment of the Senior Debt as described in the Emmott Affidavit.

B. SALE AND MARKETING PROCESS

45. As discussed earlier in this First Report, in September 2011 when the Kraus Group did not meet the minimum EBITDA covenant set out in its forbearance agreement with the Senior Syndicate, the Senior Syndicate requested that, in consideration for its continued forbearance, the Kraus Group put its assets up for sale and/or obtain replacement financing, or face a default under the Senior Debt credit agreement.

46. On September 30, 2011, Management, after consulting with PwCI, sent a letter to the Senior Syndicate outlining the comprehensive plan of the Kraus Group to assess the available options to generate liquidity and allow for a possible restructuring of the balance sheet of the Kraus Group. The plan consisted of a multi-track, parallel process (the “**Strategic Options Review**”) to determine the feasibility of the following three alternative courses of action:
 - a) an *en bloc* asset sale;
 - b) the listing and sale of redundant real estate; and
 - c) seeking additional financing or partial replacement financing.
47. Management requested that the Senior Syndicate waive the Kraus Group’s breach of the minimum EBITDA covenant until December 15, 2011 to enable the Kraus Group to pursue the options outlined in the Strategic Options Review, which was agreed to by the Senior Syndicate.
48. As part of the Strategic Options Review, PwCCF was engaged to conduct a Sale Process and to solicit offers to purchase the Kraus Group’s assets or to provide financing for the Kraus Group.

SOLICITATION PROCESS

49. PwCCF, with input from Management, prepared a list of potential strategic and financial buyers for the Kraus Group (the “**Prospective Purchasers**”). The list of Prospective Purchasers included domestic and international strategic and financing purchasers, and was prepared based on several sources including:
 - a) flooring industry association membership listings;
 - b) analyst reports and research reports on the global carpet and flooring sectors;
 - c) input from Management;
 - d) previous buyer lists from sales processes conducted by PwCCF in respect to other distressed sales mandates; and
 - e) industry research conducted by PwCCF, including research to identify financial buyers with a focus on operational turnaround/distressed situations and/or current or historical investments in the carpet or flooring sectors.
50. The initial contact list (the “**Initial List**”) was completed on September 30, 2011 and consisted of twenty-five (25) Prospective Purchasers, including eleven (11) strategic buyers and fourteen (14) financial buyers. The Initial List also included four (4) potential lenders.

51. The Initial List was provided to the Senior Syndicate. PwCCF also requested that the Senior Syndicate provide PwCCF with its input regarding Prospective Purchasers or financing sources. Similarly, Management sent copies of the Initial List to the holders of the BMOCC Debt and VTB Note.
52. On November 3, 2011, PwCCF contacted both BMOCC and NK and requested that they explore the possibility of making further investments in the Kraus Group. PwCCF also requested that BMOCC identify any additional Prospective Purchasers or financing sources. BMOCC subsequently identified three additional Prospective Purchasers and all three were contacted by PwCCF as part of the Strategic Options Review. NK did not identify any additional Prospective Purchasers.
53. As part of the Sale Process, PwCCF worked with Management to prepare a **"Teaser Letter"** and confidentiality agreement (**"CA"**) to send to Prospective Purchasers and financing sources commencing on October 20, 2011. As is the custom in these processes, the Teaser Letter outlined the acquisition/financing opportunity available on a "no-names" basis, while the CA provided protection for the Kraus Group's interests during the due diligence process. A copy of the Teaser Letter is attached as Appendix **"B"**.
54. The Teaser Letter was distributed to Prospective Purchasers and financiers on October 20, 2012.
55. PwCCF, with the assistance of Management, prepared a Confidential Information Memorandum (**"CIM"**) and an electronic data room (**"Data Room"**) for the Sale Process. If a Prospective Purchaser/financier was interested in exploring the opportunity, it was required to execute the CA and was then provided with the CIM and given access to the Data Room.
56. The CIM described the Kraus Group's business in significant detail. It provided an overview of the Kraus Group, an examination of its manufacturing, sales and distribution capacity, an outline of issues concerning Management and employees, an overview of the carpet and flooring industry, a summary of relevant financial information, and a description of the transaction process for both the asset purchase and financing options. The CIM placed a particular emphasis on the operational improvements and restructuring initiatives implemented by the Kraus Group that were expected to improve profitability. A copy of the CIM is attached as Confidential Appendix **"A"**.

57. The Data Room consisted of financial, operational, human resources, legal, customer and supplier information to assist Prospective Purchasers/financiers in analyzing the Kraus Group and determining whether they would submit a non-binding expression of interest ("EOI"). PwCCF distributed a draft EOI template to Prospective Purchasers/financiers.
58. In addition to providing the CIM and access to the Data Room, PwCCF also facilitated due diligence - meetings and conference calls between Management and Prospective Purchasers/financiers as required.
59. Given the terms of the covenant waiver provided by the Senior Syndicate, PwCCF set a submission deadline of December 7, 2011 in respect of the receipt of EOIs from Prospective Purchasers/financiers. In some cases, extensions were provided to Prospective Purchasers to allow them to submit EOIs (including, as discussed below, Hilco).
60. The list of Potential Purchasers/financiers ultimately contacted by PwCCF over the course of the Sale Process was significantly larger than the Initial List. In total, PwCCF contacted 48 parties by either phone or email, including sixteen (16) strategic purchasers, twenty-four (24) financial purchasers, and eight (8) lenders.
61. Of the 48 parties contacted, 35 parties (71% of the parties contacted) executed a CA and were provided with copies of the CIM and received access to the Data Room.

THE RESULTS OF THE SOLICITATION PROCESS

62. The Strategic Options Review concluded in mid-December 2011, and PwCCF had received seven (7) EOIs for the purchase of the Kraus Group's assets and six (6) EOIs for the refinancing of the Kraus Group. Neither BMOCC nor NK provided an offer to purchase the assets or to provide financing to the Kraus Group. The indicated purchase prices for six of the seven EOIs to purchase the Kraus Group's assets were for less than the amount of debt owing to the Senior Syndicate and the seventh EOI provided for the possibility of a relatively nominal recovery for BMOCC at the high end of the indicated value range included in the EOI, depending on the results of further due diligence.
63. Additionally, all six of the EOIs to refinance the business were for amounts that were less than the amount of the debt due to the Senior Syndicate. As a result, the Senior Syndicate elected to discontinue the refinancing process.

64. As a condition for continued forbearance by the Senior Syndicate, the Kraus Group invited the four Prospective Purchasers that had submitted EOIs with the highest offers in respect to the purchase of the Kraus Group's assets, which included the Hilco Offer, as defined and described below, to participate in the second portion of the Sale Process ("**Phase II**"), which included additional Data Room information, a tour of Kraus Group's facilities, and a presentation by Management.
65. At this time, PwCCF also verbally advised BMOCC and NK that based on the EOIs received pursuant to the Sale Process, BMOCC and NK would receive little, if any, of the proceeds of the sale in the event that Kraus Group was to sell the assets under the terms set out in any of the EOIs.
66. Over the next several weeks, PwCCF and Management negotiated with the four Phase II participants, whose binding offers were due on January 31, 2012. On January 20, 2012, PwCCF distributed a draft asset purchase agreement to the Phase II participants.
67. Of the four Phase II participants, after further due diligence, one participant declined to participate further in the Sale Process. Two other participants submitted revised offers for amounts less than the offers included in their initial EOIs. The highest offer at the end of Phase II was the offer submitted by the final Phase II participant, Hilco (the "**Hilco Offer**"). A detailed summary of the four highest offers received in December 2011 and the three revised offers received in January 2012 are enclosed as Confidential Appendix "**B**".

THE HILCO DEBT ACQUISITION

68. PwCCF received Hilco's initial EOI on December 13, 2011 to purchase the business and assets of the Kraus Group.
69. Over the course of the next five months, after extensive negotiations between Management (with PwCCF) and the Senior Syndicate, Hilco revised the Hilco Offer to wholly acquire the Senior Debt, the BMOCC Debt and the VTB Note (the "**Hilco Debt Acquisition**"), as described in the Emmott Affidavit.
70. The Interim Receiver and Proposed Receiver understand that the Senior Syndicate was advised by the restructuring group of Ernst & Young Inc. and Osler Hoskin and Harcourt LLP, in negotiating the Hilco Debt Acquisition, both of whom were knowledgeable about the Kraus

Group and transactions of this nature.

71. The Interim Receiver and Proposed Receiver understand that BMOCC was advised by the restructuring group of Gowling Lafleur Henderson LLP, in negotiating the Hilco Debt Acquisition, who is knowledgeable about the Kraus Group and transactions of this nature.
72. The Interim Receiver and Proposed Receiver understand that NK was advised by Geneva Merger & Acquisition Services of Canada (Ont.) Inc. and Fasken Martineau DuMoulin LLP, both of whom were knowledgeable of the Kraus Group and transactions of this nature.
73. The Interim Receiver and Proposed Receiver understand that on or about May 7, 2012, Red Ash, an affiliate of Hilco, completed the Hilco Debt Acquisition purchasing the Secured Debt, with a total face value of \$126.2 million as at April 30, 2012, as described in the Emmott Affidavit

C. PROPOSED SALE TRANSACTION

74. As discussed earlier in this report, in anticipation of PwCI's appointment as Receiver, Kraus Brands made an offer to the Proposed Receiver (in the form of the KB APA) for the purchase of the Purchased Assets as defined therein, which is substantially all of the Property that is subject to the Receivership Application.
75. Set out below is a summary of the principal terms and conditions of the KB APA, a copy of which, together with a letter from Kraus Brands confirming that the KB APA constitutes a binding offer capable of acceptance by the Receiver (upon its appointment by the Court), is attached as Appendix "C". All capitalized terms used in this section but not otherwise defined have the meanings given to them in the KB APA.
76. Kraus Brands will acquire, on an "as is, where is" basis, all of the properties, assets, interests and rights which are related to the operation of, and are necessary to conduct, the Business as now conducted (the "**Purchased Assets**"), with the exception of certain Excluded Assets as discussed in greater detail below. A list of the Purchased Assets is included as Schedule A to the KB APA and includes, *inter alia* Accounts Receivable, Inventory, Intellectual Property, Personal Property, Transferred Contracts and Real Property.
77. The Proposed Receiver understands that pursuant to the KB APA, Kraus Brands will also acquire all of the shares of Kraus USA, Inc., Royal Scot Floorcovering Distribution LLC, Barrett

Carpet Mills, Inc., Kraus Floors LLC, and Kraus Inc.'s 84% interest in Northstate.

78. The gross consideration of the KB APA is estimated to be in excess of \$82.8 million, and consists of:
- a) the assumption of certain portions of the Secured Debt owing by the Kraus Group to Red Ash in the amount of approximately \$80.2 million ("**Assumed Secured Debt**");
 - b) the cash payment of certain Priority Claims ranking in priority to the Assumed Secured Debt (being the priority claims under sections 81.3, 81.4, 81.5, and 81.6 of the BIA), as set out in Schedule I of the KB APA, in an amount estimated to be approximately \$220,000; and
 - c) the assumption of the Assumed Liabilities (in an amount currently estimated to be approximately \$2.2 million) and the assumption of other Priority Claims that are not paid or discharged on Closing, as set out in Schedule I of the KB APA, in an amount currently estimated at approximately \$154,000.
79. On Closing, the Purchaser will deposit with the Receiver sufficient funds to cover the payment of certain Priority Claims ranking in priority to the Assumed Secured Debt as set out in Schedule I of the KB APA, which are to be paid by the Receiver. The Proposed Receiver understands that any Priority Claims listed on Schedule I that are not to be paid by the Receiver will be assumed by the Purchaser on Closing.
80. On Closing, the Purchased Assets are to be conveyed by the Receiver to the Purchaser by the Approval and Vesting Order. Furthermore on Closing, the Receiver is to transfer and assign all right, title and interest of the Companies and the Receiver, if any, in the Real Property and any Licenses (including Environmental Permits) related to the Real Property to Kraus Properties Inc., as general partner of Kraus Properties LP. Kraus Properties LP shall assume the Assumed Liabilities (as discussed below) relating solely to the Real Property.
81. Certain assets, principally all of the Real Property Leases and certain other Contracts, are excluded under the KB APA, however the Real Property Leases and Contracts are not being terminated on Closing. Provided the Receiver has sufficient funding, on Closing, the Receiver shall use commercially reasonable efforts to make arrangements with either the Trustee or the landlord of each of the Leased Premises, on terms substantially similar to those currently in place for the Companies, for continued occupation and access to the Leased Premises for a period ending on the earliest of:

- a) 90 days following Closing;
 - b) the date upon which the Purchaser elects to assume the Real Property Lease for the Leased Premises and such Real Property Lease is assigned and transferred to the Purchaser pursuant to the KB APA; and
 - c) the date upon which the Purchaser advises the Receiver that it will not elect to assume the Real Property Lease for the Leased Premises.
82. With respect to the Contracts (other than Real Property Leases) that are not to be assigned to the Purchaser on Closing, provided the Receiver has sufficient funding, the Receiver shall perform any post-Closing executory obligations of a financial or monetary nature under the Contracts for a period ending on the earliest of:
- a) 30 days following Closing;
 - b) the date upon which the Purchaser elects to assume the Contract and such Contract is assigned and transferred to the Purchaser pursuant to the KB APA; and
 - c) the date upon which the Purchaser advises the Receiver that it will not elect to assume the Contract.

The Proposed Receiver understands that the Contracts in question are primarily personal property leases with regularly scheduled payment obligations.

83. As was set out in paragraph 78 above, on Closing, the Purchaser will assume, pay and discharge certain liabilities related to the Purchased Assets which include:
- a) all ordinary course debt, liabilities and obligations with respect to the Purchased Assets arising from and or after the Closing Date;
 - b) liabilities for any property taxes owing in respect of the Real Property arising on or after the Closing Date;
 - c) all debts, liabilities and obligations to the Transferred Employees arising on or after the Closing Date;
 - d) all Transfer Taxes arising from or relating to the Sale Transaction;
 - e) all debts, liabilities and obligations to the Unionized Employees, but only to the extent provided under the New Collective Agreements (that is, the new collective bargaining agreements to be agreed between the Purchaser and the applicable unions on terms

- satisfactory to the Purchaser) or as expressly assumed by the Purchaser;
- f) all accrued but unpaid wages and vacation pay owing to the Transferred Employees and the Unionized Employees by the Companies as at Closing, irrespective of whether such accrued and unpaid wages or vacation pay for Unionized Employees are provided for in the New Collective Agreements or the Collective Agreements (amounts in respect of any accrued or unpaid wages and vacation owing to the Non-Transferred Employees will be paid to the Receiver on Closing by the Purchaser);
 - g) all Cure Costs in relation to obtaining any consent to assign any Transferred Contracts assigned to the Purchaser. Transferred Contracts assigned under the KB APA are as set out in Schedule H of the KB APA (and may be added to post-Closing, as described in paragraphs 81 and 82 above);
 - h) all Priority Claims to the extent they are not paid or discharged on the Closing Date; and
 - i) other specific debts, liabilities and obligations identified in Schedule C of the KB APA, if any.
84. The KB APA states that the following liabilities are not being assumed by the Purchaser:
- a) all debts, obligations and liabilities related to any of the Excluded Assets identified in paragraph 81 above;
 - b) all Accounts Payable outstanding at Closing, other than those specifically assumed by the Purchaser and listed on Schedule C of the KB APA;
 - c) all intercompany liabilities owing between any member or affiliate of the Kraus Group;
 - d) all liabilities of any member of the Kraus Group for any warranty, representation or guaranty made prior to Closing and in any way related to product sold or delivered, or services provided prior to Closing;
 - e) all liabilities for or related to Taxes that are not expressly assumed by the Purchaser;
 - f) all liabilities arising from ownership or use of the Purchased Assets prior to Closing, other than the Cure Costs payable in connection with Transferred Contracts;
 - g) all debts, liabilities and obligations to Employees (including people actively working or those on lay-off or other leaves of absences) that arise prior to the Closing, except as specifically agreed to by the Purchaser in the New Collective Agreements or as otherwise specifically agreed to by the Purchaser in writing (i.e., other than those liabilities assumed

by the Purchaser set out in paragraph 83 above);

- h) all liabilities in respect of the Employee Plans, which includes all employee contracts and agreements, health and benefit plans and pension plans that are maintained, administered or contributed to by or on behalf of the Kraus Group and which cover any employee or former employee of the Kraus Group, except as specifically agreed to by the Purchaser under the New Collective Agreements, or as otherwise specifically agreed to by the Purchaser in writing;
- i) all liabilities under any of the Collective Agreements except to the extent specifically provided for under the New Collective Agreements or as otherwise specifically agreed to be assumed by the Purchaser under the KB APA;
- j) all debts, liabilities and obligations under or in relation to the Excluded Real Property Leases;
- k) all debts, liabilities and obligations relating to, including any Contract related to, the premises located at 2285 Place Transcanadienne, Dorval, Quebec;
- l) all Environmental Liabilities, except as required to be assumed by applicable law; and
- m) the Non-Assumed Secured Debt – the portion of the Secured Debt (the secured debt owed by the Kraus Group to Red Ash) which is not assumed by the Purchaser and remains owing by the Kraus Group at Closing.

CONDITIONS PRECEDENT

85. The obligation of the Purchaser to complete the purchase of the Purchased Assets pursuant to the KB APA is subject to the satisfaction or waiver of, or compliance with, at or before Closing, each of the following significant conditions precedent:
- a) the Receiver shall have performed or complied with, in all materials respects, all of its obligations, covenants and agreements under the KB APA and any ancillary agreements to the KB APA;
 - b) the issuance by the Court of the Appointment Order, Bankruptcy Orders, and the Approval and Vesting Order;
 - c) the Purchaser shall have obtained the Competition Act Approval;
 - d) there shall be no determination by the Court or any other Governmental Authority that any Claims related to any Employee Plans constitute Priority Claims other than Claims

secured by the BIA Charges and there shall have been no determination by the Court or any other Governmental Authority the result of which would be that the Priority Claims exceed the amount of \$500,000;

- e) each of the New Collective Agreements shall have been duly approved and ratified by the applicable Unionized Employees;
 - f) there shall have been no determination by the Court or any other Governmental Authority that the Purchaser is liable and responsible for any Claims under any Employee Plans, other than as specifically agreed to by the Purchaser in the New Collective Agreements; and
 - g) the Purchaser shall have received at or before Closing all third party consents, approvals and authorizations in connection with the completion of any of the transactions contemplated by the KB APA and any ancillary agreements to the KB APA.
86. The obligation of the Receiver to complete the sale of the Purchased Assets pursuant to the KB APA is subject to the satisfaction or waiver of, or compliance with, at or before Closing, each of the following significant conditions precedent:
- a) the issuance by the Court of the Appointment Order, Bankruptcy Orders, and the Vesting and Approval Order;
 - b) the Purchaser shall have obtained the Competition Act Approval;
 - c) the Purchaser shall have performed or complied with, in all material respects, all of obligations, covenants and agreements under the KB APA and the Ancillary Agreements;
 - d) the Funding Term Sheet shall have been executed and delivered by Red Ash to the Receiver; and
 - e) all third party consents, approvals, and authorizations in connection with the completion of any of the transactions contemplated by the KB APA and any ancillary agreements to the KB APA shall have been obtained.
87. The Proposed Receiver understands that the Purchaser is vigilantly pursuing the satisfaction of the conditions precedent. To this end, the Purchaser has completed or has undertaken the following:
- a) on May 25, 2012, the Purchaser submitted an Advance Ruling Request to the Competition Bureau of Canada in respect of Competition Act Approval of its proposed acquisition of

the Kraus Group;

- b) the Purchaser and the Union Representatives (as defined below) for the Old KI CBA and Old Strudex CBA (both as defined below) have negotiated separate memoranda of understanding in respect of amendments to each of the Old CBAs. The Proposed Receiver understands that a ratification vote in respect of the New Collective Agreements will take place shortly after the Interim Receiver is appointed. The Proposed Receiver also understands that the Purchaser intends to meet with the Union Representatives of the Teamsters Union (as defined below) during the Interim Sale Period (as defined below) to discuss and negotiate certain amendments to the Old KCI CBA; and
 - c) the Purchaser has advised that in the period between May 25, 2012 and June 11, 2012 (the **"Interim Sale Period"**), it will work with the respective landlords of the Leased Premises to negotiate amendments to the Real Property Leases that are acceptable to the Purchaser, failing which the Real Property Leases will be terminated.
88. The Proposed Receiver intends to file a second pre-appointment report (the **"Second Report"**) with the Court prior to the hearing for the motion to approve the sale to include, among other matters, an update on the status of the conditions precedent.

TERMINATION OF THE KB APA

89. The KB APA may be terminated at any time prior to Closing under the following circumstances:
- a) by mutual written consent of the Purchaser and Receiver;
 - b) by the Purchaser, if any of the Appointment Order, Bankruptcy Orders, or the Approval and Vesting Order have not been issued by June 11, 2012;
 - c) by the Purchaser or the Receiver, if the Closing has not occurred on or before June 25, 2012; or
 - d) by the Purchaser, if there has been material damage to the Purchased Assets prior to Closing.

TRANSITION PERIOD

90. The KB APA requires that the Receiver and the Purchaser shall cooperate and use reasonable efforts to assist each other with certain post-Closing actions, such as, but not limited to the following:

- a) the Receiver shall assist the Purchaser in obtaining any Licenses or consents required for the operation of the Business by the Purchaser from and after Closing in the ordinary course of business;
- b) the Receiver shall transfer to the Purchaser any funds received post-Closing at any bank account of the Kraus Group relating to the Purchased Assets or the Business;
- c) the Receiver shall use commercially reasonable efforts to make arrangements with the Trustee or the landlord of each of the Leased Premises for the continued occupation of and access to the Leased Premises on terms substantially similar to those in place for the Kraus Group (as discussed in paragraph 81 above). If such arrangements are made, the Receiver shall permit full access to the Leased Premises to the Purchaser, on such terms as may be agreed to by the Receiver and Purchaser. However, the Receiver will not be carrying on any activities at these facilities or employing any employees – all such activities will be undertaken by the Purchaser; and
- d) the Purchaser shall assist the Receiver with carrying out its statutory duties regarding the bankruptcy and receivership of the Companies, which includes but is not limited to the following:
 - (i) completing and filing of any outstanding HST and RST returns;
 - (ii) cooperating with Canada Revenue Agency in respect to any required payroll and/or HST audits;
 - (iii) preparing and issuing of records of employment for the Companies' employees terminated by the Bankruptcy Orders and operation of law; and
 - (iv) preparing and issuing of T4s for employees employed by the Companies for the period January 1, 2012 to the date of the Bankruptcy Orders.

IMPACT OF PROPOSED KB APA ON KRAUS GROUP EMPLOYEES

91. At May 23, 2012 the Kraus Group employed 782 unionized and salaried employees as follows:

Kraus Group Employees as at May 23, 2012			
Company Name	Number of Employees		Total
	Non-Unionized ¹	Unionized	
Kraus Inc.	89	185	274
Kraus Canada Inc.	145	5	150
Strudex Fibres Limited	20	127	147
US operations	174	0	174
Australian operations	37	0	37
Total	465	317	782
Note:			
1. Non-Unionized includes all salaried and non-unionized hourly employees.			

92. By operation of law, all employees of KI, KCI and Strudex at the date of Bankruptcy will be terminated on issuance of the Bankruptcy Orders. The Proposed Receiver understands that all Unionized Employees will be employed by the Purchaser post-Closing, under New Collective Agreements. The Proposed Receiver also understands that the Purchaser intends to extend offers of employment to substantially all of the Non-Unionized Employees employed by the Companies on June 8, 2012 ("**Designated Employees**"). Employment offers will be made to Designated Employees in the Interim Sale Period, and for those that accept ("**Transferred Employees**"), employment will be effective on Closing.
93. Designated Employees who do not accept employment offers from the Purchaser ("**Non-Transferred Employees**"), and any employees that are terminated may be entitled to Priority Claims pursuant to Sections 81.3, 81.4, 81.5 and 81.6 of the BIA ("**BIA Charges**") in respect of accrued and unpaid wages, vacation pay and applicable pension benefits (discussed in greater detail below).

UNION COLLECTIVE BARGAINING AGREEMENTS

94. The Companies are party to the following Collective Agreements ("**CBAs**"):
 - a) Strudex Fibres Limited and United Food & Commercial Workers Canada ("**UFCW**"), Local 175 (March 1, 2008 to February 28, 2011; renewed March 1, 2011 to February 28, 2014) ("**Old Strudex CBA**");

- b) Kraus Inc. and UFCW, Local 175 (July 1, 2009 to June 30, 2012) ("**Old KI CBA**"); and
 - c) Kraus Canada Inc. and Teamsters Local Union No. 213 ("**Teamsters Union**") (October 1, 2010 to September 30, 2011) ("**Old KCI CBA**").
95. The Interim Receiver and Proposed Receiver understand that representatives from Kraus Brands and Management have recently held a number of formal negotiations with the executive and the bargaining committees (together the "**Union Representatives**") in respect of each of Old Strudex CBA and Old KI CBA regarding the financial challenges facing the Kraus Group, the Kraus Group's constrained and deteriorating liquidity position and Hilco's interest in investing in the Companies, provided the members subject to the Collective Agreements agree to certain amendments to be set out in the New Collective Agreements.
 96. The Interim Receiver and Proposed Receiver understand that following these formal negotiations between Management, Kraus Brands and the Union Representatives, on May 7, 2012 memoranda of understanding were entered into concerning certain wage concessions and other amendments to the Old KI CBA (the "**New KI CBA**") and Old Strudex CBA ("**New Strudex CBA**"). The Proposed Receiver understands that representatives of Management and Kraus Brands have not held any discussions or meetings with the Union Representatives of the Old KCI CBA to date. As set out in the Emmott Affidavit, representatives of Kraus Brands intend to meet with Union Representatives of the Old KCI CBA during the Interim Sale Period.
 97. The Kraus Group is scheduled to meet with its Unionized Employees shortly after the Interim Receiver is appointed, at which time it intends to notify the Unionized Employees of the Bankruptcy Applications, the Receivership Application, the proposed sale of the business to Kraus Brands and the conditions precedent in the KB APA, specifically that the union members approve or ratify New Collective Agreements.
 98. The Interim Receiver and Proposed Receiver understand that the meeting will be followed by separate votes on the New KI CBA and New Strudex CBA by the general members who are subject to each of the New Collective Agreements. Red Ash has advised the Interim Receiver and Proposed Receiver that, in the event the Unionized Employees do not accept the requested wage concessions and other requested amendments and ratify the New Collective Agreements, it will proceed with an immediate liquidation of the Kraus Group's assets.

IMPACT OF PROPOSED SALE TRANSACTION ON THE PENSION AND BENEFIT PLANS

DEFINED BENEFIT PLANS

99. The Kraus Group is party to the following four company-sponsored defined benefit (“DB”) pension plans (together the “**DB Plans**”), each of which is discussed in greater detail below:
- a) Registered Pension Plan For Employees of Kraus Canada Inc. (the “**Kraus Canada Plan**”);
 - b) Pension Plan for Employees of Kraus Inc. and Strudex Fibres Limited (the “**Strudex Plan**”);
 - c) Pension Plan for Executive Employees of Kraus Inc. (the “**Executive Plan**”); and
 - d) Pension Plan for Union Employees of Kraus Inc. (the “**Union Plan**”).

The Kraus Canada Plan

100. KCI sponsors the Kraus Canada Plan, which was established on May 1, 1963 and is registered in Manitoba. The Proposed Receiver understands that a pension committee was not established as required under *The Pension Benefits Act* of Manitoba, and therefore, KCI acts as the *de facto* administrator of the Kraus Canada Plan.
101. The Proposed Receiver understands that effective December 31, 2009, Management closed the DB component of the Kraus Canada Plan, at which point the DB component was closed to new members and existing members ceased accruing benefits on a DB basis. Effective January 1, 2010, a Defined Contribution (“DC”) component was added, and effective that date all new and existing members of the Kraus Canada Plan commenced accruing pension benefits on a DC basis.
102. Management advised the Proposed Receiver that, as at May 23, 2012, the DB component of the Kraus Canada Plan had 187 members, composed of 94 active members who are currently active employees (the “**Active Members**”), 56 retired employees, or the surviving spouse or beneficiary thereof (the “**Retirees**”), and 37 other members, including former or current employees that are not retired and still have an entitlement in the DB component of the Kraus Canada Plan (the “**Deferred Members**”). The Kraus Canada Plan includes five members of the Teamsters Union as well as the salaried employees of KCI.

103. Management has advised the Proposed Receiver that the last actuarial valuation for the DB component of the Kraus Canada Plan was prepared by AON Hewitt as at December 31, 2010 (the “**AON Hewitt Report**”). The AON Hewitt Report stated that as at December 31, 2010 the Kraus Canada Plan had a surplus of \$956,000 on a going concern basis, and a deficiency of \$2,072,000 on a solvency basis. The going concern valuation looks at the plan’s funded status on the basis that the plan will continue to operate indefinitely, whereas the solvency valuation tests whether the plan has sufficient assets to provide an immediate payout of all benefits if the plan were to be wound-up on the valuation date. The Proposed Receiver understands that the Kraus Canada Plan would experience a sizeable deficiency if the plan were wound-up as at the date of this First Report.
104. The Proposed Receiver understands that the Kraus Canada Plan is not being assumed by the Purchaser.

Strudex Plan

105. The Strudex Plan was established on January 1, 1965 and registered in Ontario. The plan sponsor and administrator is KI, and the custodian is Manulife Insurance Company. Each full-time non-union employee of KI and Strudex became a member of the Strudex Plan after one year of continuous service.
106. The Proposed Receiver understands that effective December 31, 2009, Management closed the DB component of the Strudex Plan, at which point the DB component was closed to new members and existing members ceased accruing benefits on a DB basis. Effective January 1, 2010, a DC component was added, and effective that date all new and existing members of the Strudex Plan commenced accruing pension benefits on a DC basis.
107. Management advised the Proposed Receiver that as at December 31, 2011, the DB component of the Strudex Plan had 150 members, composed of 81 Active Members, 41 Retirees and 28 Deferred Members.
108. Management has advised the Proposed Receiver that the last actuarial valuation for the DB component of the Strudex Plan was prepared by Morneau Shepell Ltd. (“**Morneau**”) as at January 1, 2011 (the “**Morneau Salaried Report**”). The Morneau Salaried Report stated that as at January 1, 2011:
- a) “On a going-concern basis, the actuarial liability exceeds the actuarial value of assets by \$316,836”;

- b) "According to the solvency test required by the Ontario *Pension Benefits Act* ("PBA"), the actuarial liability exceeds the actuarial value of assets by \$1,064,765"; and
- c) "The Plan assets would be less than the actuarial liability by \$1,776,693 if the Plan were to be wound up on the valuation date"

The Proposed Receiver understands that the Strudex Plan would experience a sizeable windup deficiency if the plan were wound-up as at the date of this First Report.

109. The Proposed Receiver understands that the Strudex Plan is not being assumed by the Purchaser.

The Union Plan

- 110. KI is the sponsor of the Union Plan, which is registered in Ontario. The plan sponsor and administrator is KI. Prior to this plan being closed effective December 31, 1989, each Unionized Employee of KI and Strudex became a member of the Union Plan on the first day of the month after one year of continuous service.
- 111. The Proposed Receiver understands that effective December 31, 1989, Management closed the Union Plan to new members and existing members ceased accruing benefits.
- 112. Effective January 1, 1990, all existing members of the Union Plan and all new Unionized Employees of Strudex and KI have been enrolled and participate in a UFCW multi-employer sponsored pension plan, known as the Canadian Commercial Workers Industry Pension Plan ("CCWIPP"). Pursuant to the applicable Collective Agreements, KI and Strudex are required to make fixed per hour contributions to the CCWIPP on behalf of KI and Strudex Unionized Employees.
- 113. Management advised the Proposed Receiver that as at December 31, 2011, the Union Plan had 330 members, composed of 180 Active Members, 107 Retirees and 43 Deferred Members.
- 114. Management has advised the Proposed Receiver that the last actuarial valuation for the Union Plan was prepared by Morneau as at December 31, 2010 ("**Morneau Union Report**"). The Morneau Union Report stated that as at December 31, 2010;
 - a) "The Plan is fully funded. The actuarial value of the assets, on a going-concern basis, exceeds the actuarial liability by \$29,986";
 - b) "According to the solvency test required by the Ontario *Pension Benefits Act*, the

actuarial liability exceeds the value of assets by \$216,494"; and

- c) "The Plan assets would be less than the actuarial liability by \$309,875 if the Plan were to be wound up as at the valuation date".

The Proposed Receiver understands that the Union Plan would experience a windup deficiency if the plan were wound-up as at the date of this First Report.

- 115. The Proposed Receiver understands that the Union Plan is not being assumed by the Purchaser.

The Executive Plan

- 116. The Executive Plan is a DB plan that was established on May 1, 1968 and is registered in Ontario. The plan sponsor and administrator is KI, and the custodian is Manulife Insurance Company. Executive employees are eligible to participate in the Executive Plan after two years of continuous service.
- 117. Management advised the Proposed Receiver that as at December 31, 2011, the Executive Plan had 13 members, composed of seven Active Members, six Retirees and no Deferred Members.
- 118. The Proposed Receiver understands that the last actuarial valuation for the Executive Plan was prepared by Morneau as at April 30, 2011 ("**Morneau Executive Report**"). The Morneau Executive Report stated that as at April 30, 2011;
 - a) "The Plan is not fully funded on a going-concern basis. The actuarial liabilities exceed the actuarial value of assets by \$2,373,591";
 - b) "The Plan is not fully funded on a Maximum Funding basis. The actuarial value of liabilities exceeds the actuarial value of assets by \$990,238";
 - c) "According to the solvency test required under the Ontario *Pension Benefit Act*, the Plan is not funded. On a solvency basis, the actuarial liabilities exceed the value of assets by \$2,097,154";and
 - d) "The Plan assets would have been less than the actuarial liability by \$3,930,792 if the Plan had been wound up on the valuation date".

The Proposed Receiver understands that the Executive Plan would experience a significant windup deficiency if the plan were wound-up as at the date of this First Report.

119. The Proposed Receiver understands that the Executive Plan is not being assumed by the Purchaser.
120. In summary, pursuant to the KB APA, the Purchaser does not intend to assume the liability or obligations associated with any of the four DB Plans.
121. As discussed in greater detail later in this First Report, the Lender is expected to experience a deficiency on its Secured Debt and, as a result, no recovery is expected for the unsecured creditors. As such, there will be no assets available to fund the deficiencies under the DB Plans and consequently, the Proposed Receiver expects that the DB Plans will be wound up post bankruptcy with deficits.

THE DC BENEFITS

122. As discussed briefly above, the Kraus Canada Plan and the Strudex Plan each has a DC component.
123. Pursuant to the terms of the KB APA, the Purchaser will not be assuming the DC component of the Kraus Canada Plan or the Strudex Plan. The Proposed Receiver understands that the Purchaser will be establishing new DC plans for the Employees on similar terms and conditions, which will be discussed in the Second Report, once those terms are finalized.

EMPLOYEE BENEFIT PLANS

124. In addition to the changes to the Pension Plans as discussed above, there are a number of other material changes to the conditions of employment required by the Purchaser.
125. As discussed in paragraph 84 in respect of Excluded Liabilities under the KB APA, in addition to Pension Plans, the Purchaser will not be assuming the other Employee Plans (including Benefit Plans) or any pre-Closing accrued liability in respect of the other Employee Plans, and on Closing, Transferred Employees will cease to accrue benefits under the other Employee Plans.
126. The Proposed Receiver understands that the Purchaser intends to put in place its own benefit plan ("**New Benefit Plan**") post-Closing. Details of the New Benefit Plan were not available at the date of filing this First Report. The Proposed Receiver will provide further details in respect of the benefits contemplated under the New Benefit Plan in its Second Report.

D. PRIORITY CLAIMS

127. As discussed above, by operation of law all employees of KI, KCI and Strudex at the date of the Bankruptcy Orders (if granted) will be terminated, and may be entitled to Priority Claims pursuant to the BIA Charges.
128. As discussed earlier in this First Report, pursuant to the KB APA, the Purchaser intends to assume all liabilities in respect of all accrued but unpaid wages and vacation pay owing to the Transferred Employees and the Unionized Employees as at Closing. These amounts will be paid in the normal course. However, the Purchaser is not assuming any liabilities in respect of the Employee Plans, including any accrued but unpaid pension contributions. As such, the Unionized Employees, Transferred Employees and Non-Transferred Employees may be entitled to a Priority Claim for unpaid pension contributions pursuant to the BIA Charges. The Purchaser has agreed to make a cash payment to the Receiver on Closing to satisfy these amounts.
129. Non-Transferred Employees under Sections 81.5 and 81.6 may also be entitled to any amounts owing in respect of the priority for unpaid wages and vacation pay under Sections 81.3 and 81.4 of the BIA.
130. Non-Transferred Employees and any Terminated Employees may also be entitled to a claim under the *Wage Earner Protection Plan Act*.
131. As noted earlier in this First Report, the Proposed Receiver understands that claims in connection with the BIA Charges estimated as of May 25, 2012, including amounts owing to Unionized Employees and Transferred Employees under Sections 81.5 and 81.6 of the BIA, total approximately \$220,000. This amount will be updated and will be commented on in the Second Report. The KB APA provides that on Closing, the Purchaser shall pay the Receiver sufficient cash to fund the BIA Charges (subject to the Purchaser's condition precedent that there is no judicial determination that would result in the Priority Claims exceeding \$500,000 (the "**Priority Claims Cap**")). Pursuant to the KB APA, and as discussed earlier in this First Report, if there is a judicial determination that the actual value of Priority Claims exceeds the Priority Claims Cap, the Purchaser has the ability to terminate the KB APA and not close the Sale Transaction.

132. Once the Sale Transaction closes, however, any Priority Claims that are not paid or discharged on Closing will be assumed by the Purchaser. Even if the Priority Claim is not identified on Schedule I of the KB APA, if a judicial determination is made that a claim constitutes a Priority Claim, the Purchaser is obliged to assume it.
133. The estimate of the potential Priority Claims is subject to adjustment depending on the number of employees who do not receive or decline offers of employment from the Purchaser and therefore may be entitled to a Priority Claim.

DEEMED TRUST CLAIM

134. In addition to the Priority Claim in respect of the BIA Charges described above, the Proposed Receiver understands, based on its discussions with Management, that as at the date of the Bankruptcy Orders (if granted), the Canada Revenue Agency may be entitled to a priority claim in respect of deducted but unremitted source deductions ("**Deemed Trust Claim**") in the amount of approximately \$154,000. The Proposed Receiver understands that the Purchaser will assume the liability in respect of the Deemed Trust Claim on Closing.

E. NECESSITY FOR RECEIVER TO CONDUCT ANOTHER SALES PROCESS

135. The Interim Receiver and Proposed Receiver have determined that it is not economic, necessary or feasible to run a further sales process in respect of the Property for the following reasons:
- a) as detailed earlier in this First Report, PwCCF recently ran a comprehensive Sale Process that fully canvassed the market, and the highest and best offer for the Property generated from the Sale Process was the Hilco Offer;
 - b) the Interim Receiver and Proposed Receiver understand that, following the Sale Process conducted by PwCCF, the Senior Lenders, each of which was represented by reputable and knowledge financial and legal advisers, agreed to sell their debt to Hilco at a discount from its face value, which reflects an informed view of the market value of the Property, although the Interim Receiver and Proposed Receiver were not a party or privy to the terms thereof;
 - c) based on the unaudited fiscal 2011 EBITDA of \$4.8 million reported by the Kraus Group, an EBITDA multiple of at least 26 times would have to be offered by a third party purchaser before any such offer would exceed the Secured Debt held by Red Ash. This multiple compares to the multiple of approximately 5.8 times annual EBITDA paid in the

2007 Shareholder Buyout (with NKHL) and current public company transaction comparables of 7.4 times annual EBITDA. In the current circumstances of the Kraus Group, receiving an offer greater than 26 times 2011 annual EBITDA is highly improbable;

- d) under the circumstances, the only creditor with an economic interest in the sale is the secured creditor, Red Ash. As at April 30, 2012, the Kraus Group had outstanding Secured Debt in the amount of approximately \$126.2 million. The proceeds from a sale would need to be in excess of \$126.2 million plus any Receiver's borrowings and professional fees and expenses in respect of the enforcement, before the unsecured creditors would be entitled to any recovery. The offers received during the recent Sale Process run by PwCCF were substantially below the amount of Secured Debt currently owing to Red Ash;
- e) the Liquidation Analysis (as discussed later in this First Report) indicates that Red Ash would incur a significant shortfall on the Secured Debt should the Companies' business and assets be liquidated; and
- f) the Kraus Group is insolvent. Red Ash has advised the Proposed Receiver that it does not intend to support or provide funding to the Companies during another sales process.

F. NOTICE TO STAKEHOLDERS

- 136. The KB APA requires the appointment of the Trustee, followed by the appointment of the Receiver and the same day sale of the Purchased Assets.
- 137. Notice of a motion to approve the Sale Transaction (the "**Sale Approval Motion**") has been served to known stakeholders, such as the Department of Justice Canada, Ontario Ministry of Finance, Financial Services Commission of Ontario, Manitoba Finance - Taxation Division, British Columbia Ministry of Finance, CCWIPP, the Teamsters Union, UFCW, and the Office of the Superintendent of the Manitoba Pension Commission.
- 138. In addition, the Interim Receiver is required to mail a notice (as attached to the Interim Receivership Order) advising of the appointment of the Interim Receiver and of the Sale Approval Motion scheduled to be heard on June 11, 2011 to all members of the DB Plans, all members of the DC Plans, and all members of CCWIPP for which Management has provided mailing addresses.
- 139. The Interim Receiver will also establish a dedicated toll free telephone number (1-877-332-1688) by which members of the DB Plans, the DC Plans and/or CCWIPP (collectively the

“**Pension Plan Members**”) can contact the Interim Receiver to request copies of the court materials, which will be emailed or couriered upon request. The Interim Receiver will also establish a website at which Pension Plan Members can access additional information and court materials in respect of the proceedings (www.pwc.com/car-krauscarpets). However, neither the Interim Receiver nor the Proposed Receiver will be providing advice on how to respond to the applications and will advise all Pension Plan Members who inquire to contact their own legal counsel.

140. As at the date of this Report, Management has advised that the Company does not have current mailing addresses for approximately 67 of the Pension Plan Members. The Interim Receiver will work with Management to attempt to contact these individuals.

G. LIQUIDATION ANALYSIS

141. The Proposed Receiver conducted a liquidation analysis of the assets and business of the Kraus Group as an alternative to the proposed KB APA discussed herein. The liquidation analysis (the “**Liquidation Analysis**”) of the assets of the Kraus Group is based on net book values as of March 31, 2012, unless otherwise stated, and the book values used are assumed to be representative of the assets of the Kraus Group at or about the date of this Report.
142. In preparing the Liquidation Analysis, the Proposed Receiver relied upon unaudited Company prepared financial information, records and discussions with Management. Furthermore, the estimated realizations are based upon a desktop review of the assets of the Kraus Group, as a physical inspection has not been made. However, where possible, the Proposed Receiver relied upon recent third party appraisals/estimates of value, and current market conditions, in determining the estimated recovery values through an orderly liquidation.
143. The Liquidation Analysis is based upon the following significant assumptions:
- a) immediate shut down of the Kraus Group’s operations and the disposition of all assets pursuant to the following proceedings. As Kraus USA, Inc., Barrett Carpet Mills, Inc., and Northstate are each economically dependent upon the Companies for the supply of goods and distribution, a liquidation of the Companies would likely result in an immediate shutdown of operations for each of the aforementioned entities:
 - (i) liquidation of the assets of the Companies through a non-operating court-appointed receivership with concurrent bankruptcy;

- (ii) liquidation of Kraus USA, Inc. and Barrett Carpet Mills, Inc., through Chapter 7 filings in the U.S. The Proposed Receiver has not obtained an independent review of the validity of the security over the assets owned by these U.S. companies, but has assumed the security is valid. In the event it was invalid, the deficit to the Secured Lenders would be greater than calculated; and
 - (iii) liquidation of Northstate through a non-operating court-appointed receivership in Australia. The Proposed Receiver has not obtained an independent review of the validity of the security over the Australian assets, but has assumed it is valid. In the event it was invalid, the deficit to the Secured Lenders would be greater than calculated;
- b) sale of substantially all of the inventory of the Kraus Group over a two to six month period;
 - c) sale of the real property owned by the Kraus Group over a 12 to 18 month period;
 - d) sale of substantially all of the fixed assets of the Kraus Group over a three month period;
 - e) collection of substantially all of the receivables of the Kraus Group over a six month period;
 - f) priority for pension contributions limited to normal cost payments only and excludes any potential priority for solvency deficiencies; and
 - g) asset realizations were at nominal amounts and did not consider the discounting of values over time.

144. In its Liquidation Analysis, the Proposed Receiver took into account such things as:

- a) quality of the outstanding receivables and inventory;
- b) potential volume rebates and other set-offs by customers and the impact on outstanding accounts receivable collections;
- c) third party appraisals of machinery and equipment of Strudex and KI, and estimated realizable values in a liquidation;
- d) third party formal appraisals or estimates of value of the real property in Waterloo, Canada and Queensland, Australia;
- e) third party appraisal of the inventory, and the estimated realizable values in an orderly liquidation;
- f) potential priority claims and/or amounts that may need to be paid by a receiver; and

- g) holding costs related to liquidation, excluding professional fees.
145. Attached as Confidential Appendix “C” is a copy of the Liquidation Analysis prepared by the Proposed Receiver which will be filed with the Court on a sealed and confidential basis. If the KB APA is not approved by this Court or does not close, it would be prejudicial to the interests of the creditors of the Kraus Group if this Liquidation Analysis became available to future prospective purchasers or liquidators of the assets of the Kraus Group. In summary, the Liquidation Analysis reflects that Red Ash would incur a substantial shortfall on the Senior Debt owed to it by the Kraus Group should the business and assets of the Kraus Group be liquidated.

H. REVIEW OF SECURITY POSITION

146. The Proposed Receiver has obtained independent legal opinions in respect of Red Ash’s security interests as against Strudex, KI, KCI and Kraus BC (as assigned by each of the Agents, BMO and NK to Red Ash) from (i) its independent Ontario, Quebec, Alberta and British Columbia counsel, Blake, Cassels & Graydon LLP (“**Blakes**”), (ii) its independent Nova Scotia counsel, Cox & Palmer LLP (“**C&P**”) and (iii) its independent Manitoba counsel, Pitblado LLP (“**Pitblado**”) as follows:
- a) Pitblado has opined that such security interests in the personal property of KCI to which the Personal Property Security Act (“**PPSA**”) of Manitoba applies are valid under the laws of Manitoba and have been properly registered under the PPSA of Manitoba;
 - b) C&P has opined that such security interests in the personal property of KCI to which the PPSA of Nova Scotia applies are valid under the laws of Nova Scotia and have been properly registered under the PPSA of Nova Scotia; and
 - c) Blakes has opined that (i) the documents creating such security interests are legal, valid and binding obligations of each Company that is a party to the relevant security document, (ii) such security interests in the personal property of the relevant Company to which the PPSA of the relevant province applies are valid and would be enforceable against a trustee in bankruptcy under the laws of Ontario, British Columbia and Alberta, (iii) such security interests (i.e., hypothec) in the property of KCI to which the *Civil Code* of Quebec (“**CCQ**”) applies are valid under the laws of Quebec and would be enforceable against a trustee in bankruptcy of KCI (iv) such security interests have been properly registered under the Ontario PPSA (in the case of the security interests granted by KI, KCI and Kraus BC), the British Columbia PPSA (in the case of the security interests granted by KCI and

Kraus BC), the Alberta PPSA (in the case of the security interests granted by KCI) and CCQ (in the case of the security interests granted by KCI).

147. The Proposed Receiver notes that each of these opinions remain subject to the standard assumptions, qualifications and limitations contained in the respective opinion and in the case of the Blakes opinion, to an assumption that the BMOCC Debt was validly assigned to BMO.

I. RECOMENDATION

148. The Proposed Receiver recommends, for the following reasons, that in the event this Court appoints PwCI as Receiver, that this Court issue an order approving the KB APA and Sale Transaction and authorizing and directing the Receiver to execute the KB APA and take such steps as necessary to complete the Sale Transaction:
- a) a comprehensive Sale Process was recently conducted and all offers received during the Sale Process were substantially less than the consideration under the KB APA, which is in excess of \$82.8 million;
 - b) the Liquidation Analysis demonstrates that Red Ash would incur a significant shortfall on approximately \$126.2 million of the indebtedness owed to it should the assets and business of the Kraus Group be liquidated;
 - c) the Senior Syndicate, BMOCC and NK, each of which was represented by reputable financial and/or legal advisors in the insolvency and restructuring industry, sold their respective components of the Secured Debt to Red Ash at a discount thereby recognizing that the market value of the Secured Debt was less than its face value;
 - d) the unsecured creditors are not being prejudiced by the Sale Transaction as the only creditor with an economic interest in the Sale Transaction is Red Ash, which will also suffer a shortfall on the Senior Debt extended to the Kraus Group under this Sale Transaction; and
 - e) the KB APA provides for continued employment for all of the Kraus Group employees employed as of June 8, 2012.


All of which is respectfully submitted on this 29th day of May, 2012.

PricewaterhouseCoopers Inc.

In its capacity as Interim Receiver of
Kraus Inc., Kraus Canada Inc.,
Strudex Fibres Limited, and Proposed
Receiver of the Respondents,
and not in its personal capacity.



John McKenna
Senior Vice President



Michelle Pickett
Vice President

APPENDIX “C”

Court File No. CV12-9731-00CL

**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

**SECOND REPORT OF PRICEWATERHOUSECOOPERS INC.
AS INTERIM RECEIVER AND PROPOSED RECEIVER**

June 10, 2012

INTRODUCTION

1. By Order dated May 28, 2012 (the "**Interim Receivership Order**"), PricewaterhouseCoopers Inc. ("**PwCI**") was appointed as Interim Receiver ("**Interim Receiver**") in respect of Kraus Inc. ("**KI**"), Kraus Canada Inc. ("**KCI**") and Strudex Fibres Limited ("**Strudex**") pursuant to Bankruptcy Applications (as defined herein) and a Receivership Application (as defined herein) brought by Pinnacle Capital Resources Limited, in its capacity as general partner of Red Ash Capital Partners II Limited Partnership (collectively "**Red Ash**" or the "**Lender**") in these proceedings.
2. PwCI understands that applications (the "**Bankruptcy Application I**") have been made before the Ontario Superior Court of Justice (Commercial List) (the "**Court**") by Red Ash, for an order (the "**Bankruptcy Order I**") appointing PwCI as a trustee in bankruptcy (the "**Trustee**") pursuant to Section 43 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (the "**BIA**") over the assets, undertakings and properties ("**Property**") of Strudex and the Property of KI.
3. PwCI understands that a separate application ("**Bankruptcy Application II**") (Bankruptcy Application I and Bankruptcy Application II are collectively referred to as the "**Bankruptcy Applications**") has been made before the Court of Queen's Bench in Winnipeg, Manitoba (the "**Winnipeg Court**") by Red Ash, for an order (the "**Bankruptcy Order II**") appointing PwCI as Trustee pursuant to section 43 of the BIA over the Property of KCI.
4. PwCI understands that Red Ash has not made an application to appoint a Trustee of 538626 B.C. Ltd. ("**Kraus BC**") as Kraus BC is dormant. (Bankruptcy Order I and Bankruptcy Order II are hereinafter collectively referred to as the "**Bankruptcy Orders**".)
5. An application (the "**Receivership Application**") has been made in these proceedings by Red Ash, for an order (the "**Receivership Order**") appointing PwCI as receiver (the "**Receiver**") pursuant to section 243(1) of the BIA over the Property of Strudex, KI, KCI and Kraus BC (together the "**Companies**").
6. On June 5, 2012, the Winnipeg Court issued an order transferring Bankruptcy Application II to the Court in Ontario. The Interim Receiver understands that Bankruptcy Application II will be heard concurrently with Bankruptcy Application I on June 11, 2012.
7. In anticipation of PwCI's appointment as Receiver, Kraus Brands LP ("**Kraus Brands**" or the "**Purchaser**"), an affiliate of Red Ash, has made a binding offer to PwCI in its capacity as the

proposed receiver ("**Proposed Receiver**") for the purchase of substantially all of the Property that is subject to the Receivership Application (the "**Sale Transaction**"). The offer is set out in an Asset Purchase Agreement between the Receiver (to be executed upon its appointment, and authorization by the Court to do so) and the Purchaser (the "**KB APA**"). The original KB APA is attached as Appendix "C" to the first report of the Interim Receiver and Proposed Receiver dated May 29, 2012 (the "**First Report**"), but has since been amended with such non-material amendments as described herein. The Interim Receiver and Proposed Receiver seek approval of and authority of the Receiver, if appointed, to execute the form of KB APA attached hereto as Appendix "A". Unless otherwise defined herein, defined terms have the meaning ascribed to them in the First Report.

8. PwCI is a licensed trustee within the meaning of section 2 of the BIA. PwCI has consented to act as Receiver and Trustee in these proceedings in the event that this Court grants the Receivership Order and the Bankruptcy Orders. PwCI has extensive knowledge of the Companies and their affiliates (the "**Kraus Group**") as it was previously retained to act as the Companies' financial advisor in addressing liquidity concerns, providing strategic advice and negotiating with the Companies' various lenders, including the Companies' Senior Syndicate.
9. The Interim Receiver and Proposed Receiver filed its First Report in respect of the Receivership Application and its motion for approval of the KB APA (the "**Sale Approval Motion**").
10. We are writing this Second Report of the Interim Receiver and the Proposed Receiver of the Companies (the "**Second Report**") in the same manner as if we had already been appointed as Receiver by this Court. This Second Report has been prepared to:
 - a) provide this Court with a summary of the Interim Receiver's actions since its appointment, including its interactions with stakeholders;
 - b) report on the Companies' business operations since the appointment of the Interim Receiver; and
 - c) provide this Court with updated information regarding the Sale Transaction and to provide the Interim their comments on the KB APA including:
 - (i) minor amendments to the KB APA;

- (ii) update on Priority Claims, BIA Charges, Source Deduction Claim and Assumed Liabilities (all as defined in the KB APA);
 - (iii) an update on the assumption of Real Estate Leases and Contracts (all as defined in the KB APA); and
 - (iv) an update on the status of conditions precedent in the KB APA.
11. In preparing this Second Report, the Interim Receiver and the Proposed Receiver have relied upon unaudited and draft, internal financial and other information of the Companies provided by the Companies. The Interim Receiver and the Proposed Receiver have not audited, reviewed or otherwise attempted to verify the accuracy or completeness of the information provided and express no opinion, or other form of assurance, in respect of the information contained in this report. The Interim Receiver and Proposed Receiver reserve the right to refine or amend their comments and findings as further information is obtained or brought to their attention subsequent to the date of this Second Report.
 12. Unless otherwise noted, all currency amounts contained in this report are expressed in Canadian dollars.

A. INTERIM RECEIVER'S ACTIVITIES SINCE ITS APPOINTMENT

MAILING TO PENSION BENEFICIARIES

13. Pursuant to the Interim Receivership Order, on May 28, 2012, the Interim Receiver sent by regular mail a copy of the notice advising of the appointment of the Interim Receiver (the "Notice") and of the Sale Approval Motion scheduled to be heard on June 11, 2012 to all members of the DB Plans, all members of the DC Plans, and all members of CCWIPP (collectively the "Pension Plan Members") for which management of the Companies ("Management") has provided mailing addresses. In total, the Interim Receiver has mailed 1,242 Notices.
14. As of the date of this Second Report, 42 of the Notices have been returned to the Interim Receiver as undeliverable.
15. In addition to the 42 returned Notices, the Companies do not have current mailing addresses for approximately 67 of the Pension Plan Members. The Interim Receiver has worked with Management to attempt to contact these individuals. For the most part these individuals have

not been employed by the Companies for several years and Management does not have current, if any, employee files on these individuals.

16. The Interim Receiver understands that the external administrators of the pension plans may be able to conduct certain searches through Human Resources and Skills Development Canada ("HRSDC") to locate current addresses for these individuals with which the Companies have lost contact; however such searches may take several weeks to several months. The Interim Receiver understands that the right to request such searches is unavailable to the Companies.

WEBSITE & HOTLINES

17. Pursuant to the Interim Receivership Order, the Interim Receiver established a website (www.pwc.ca/car-krauscarpets) at which stakeholders, including Pension Plan Members and creditors could access additional information and court materials in respect of the proceedings.
18. In addition, the Interim Receiver established two dedicated toll free telephone numbers, one exclusively for Pension Plan Members through which Pension Plan Members could request copies of the court materials, and a second toll free telephone number for general inquiries.
19. As of June 8, 2012, the Interim Receiver has received and responded to 21 calls from Pension Plan Members and the Interim Receiver has couriered copies of the court materials to 11 Pension Plan Members who requested same.
20. As of the date of this Second Report, the Interim Receiver had received and responded to more than 25 general inquiries from stakeholders, both through email, the hotline and direct calls, in respect of these proceedings.

MONITORING RECEIPTS AND DISBURSEMENTS

21. Pursuant to the Interim Receivership Order, during the period May 28, 2012 to June 8, 2012 (the "**Monitoring Period**"), the Interim Receiver has attended at the Companies' premises on several occasions to monitor the receipts and disbursements of the Companies and obtain an understanding of any issues that developed during the Monitoring Period. During the Monitoring Period, the Interim Receiver has observed the following:
 - a) receipts and disbursements during the Monitoring Period were largely as forecast, however as described in detail later in this Second Report, the Companies have made payments in respect

of certain Priority Claims (as defined in the KB APA) that were not forecast to be paid during the Monitoring Period;

- b) for the most part, the Companies paid on a cash on delivery basis ("COD") for all goods and services ordered and delivered during the Monitoring Period. The Interim Receiver understands that a number of creditors provided credit terms to the Companies during the Monitoring Period. The Purchaser has advised the Interim Receiver and Proposed Receiver that it will assume (on Closing of the KB APA) all outstanding liabilities in respect of goods and services ordered by the Companies, which were delivered or provided to the Companies on or after the commencement of the Monitoring Period, but excluding any such obligations relating to goods not required and offered back to suppliers for collection or repossession substantially in the same state in which they were delivered;
- c) employees were paid in the ordinary course during the Monitoring Period and all required employee source deductions and employer contributions were remitted to Canada Revenue Agency ("CRA");
- d) the Interim Receiver understands that the Companies made payments in the amount of approximately \$222,000 in respect of pre-filing obligations. For the most part these payments were made to transportation and logistics companies, and satisfied certain lien rights held by the transportation companies. In addition, the Companies paid certain amounts to employees, in respect of certain Priority Claims in a bankruptcy;
- e) the Companies have remitted payments in respect of the Leased Premises in Toronto, Edmonton, Vancouver and Winnipeg for the period June 1 – 10, 2012. The Companies did not remit payment in respect of the Leased Premises in Dartmouth ("**Dartmouth Premises**"). The Interim Receiver and Proposed Receiver have been advised by Management that it is no longer using the Dartmouth Premises. The Purchaser has also advised that it will not be assuming the Real Property Lease in respect of the Dartmouth Premises;
- f) during the Monitoring Period, the Companies have remitted to the pension plans all pension contributions that were due and payable and would be subject to a Priority Claim under s. 81.5 and s. 81.6 of the BIA;
- g) at the end of the Monitoring Period, the Companies had cash balances totaling approximately \$1.4 million; and

- h) the Companies did not require any advances under the Red Ash facility during the Monitoring Period, but have paid expenses from the collection of accounts receivables.

INTERACTIONS WITH STAKEHOLDERS

22. Since its appointment, the Interim Receiver has responded to various calls and emails from suppliers, lessors and Pension Plan Members. In general, the Interim Receiver has directed stakeholders to the website for further information on the proceedings and access to the court applications, court orders and the Interim Receiver's First Report.
23. The Interim Receiver and Proposed Receiver have not provided advice on how to respond to these court proceedings and have advised all Pension Plan Members who inquire to contact their own legal counsel.

Section 81.1 claims

24. Since the date of its appointment, the Interim Receiver and/or the Companies (or their respective counsel) have received and responded to seven claims for the repossession of property pursuant to section 81.1 of the BIA ("**30 Day Goods Claims**") in a total gross amount of approximately \$1,773,868.
25. The Interim Receiver has responded in writing to all 30 Day Goods Claims irrespective of whether the 30 Day Goods Claim was delivered to the Interim Receiver or the Companies. The Interim Receiver has notified all claimants that it has not been appointed as Trustee or Receiver under subsection 243(2) of the BIA and as such is not in possession of the property of the Companies, and therefore the right to repossess property under section 81.1 of the BIA has not been triggered.
26. Although, there is no requirement for it to do so, the Interim Receiver has, in order to further assist the Court, considered the validity of the 30 Day Goods Claims ("**Assessment**") on the basis of the criteria set out in s. 81.1 of the BIA. One of the seven 30 Day Goods Claims, in respect of Tri-Tex Co Inc. (the "**Tri-Tex Claim**"), was delivered to the Interim Receiver on the afternoon of June 8, 2012. As such, the validity of the Tri-Tex Claim was not considered in the Assessment discussed below.
27. Assuming the Bankruptcy Orders are granted by this Court on June 11, 2012 and the Companies have continued to operate in the normal course and have continued to consume goods at

expected levels in the period to June 11, 2012, the Interim Receiver estimates the value of valid 30 Day Goods Claims (excluding the Tri-Tex Claim) as at June 11, 2012 to be in the amount of approximately \$80,694, less than 5.2% of the aggregate amount of 30 Day Goods Claims delivered to the Interim Receiver and/or Companies.

28. The Interim Receiver attributes the significant difference between the amount claimed and the Interim Receiver's estimate of what would be valid on June 11, 2012 to the following:
 - a) many of the 30 Days Goods Claims included invoices for goods delivered more than 30 days prior to June 11, 2012, which would not be eligible for repossession under s. 81.1 of the BIA;
 - b) goods delivered to affiliate companies that are not part of these proceedings were invoiced to the Companies. The goods were for the benefit and use of the affiliates and are not in the possession of the Companies. Therefore, these goods would not be in the possession of the Trustee on June 11, 2012, should this Court grant the Bankruptcy Orders;
 - c) the goods delivered within the 30 day period prior to June 11, 2012 were currently not or were not expected to be in the possession of the Trustee on June 11, 2012 as the goods had been or would be consumed in the normal course of the Companies' operations and production; and
 - d) goods delivered such as resin, had been added to silos or vats and mixed with previously delivered goods. Hence, it was not possible to identify and differentiate the goods shipped within the 30 days prior to June 11, 2012.
29. The Interim Receiver's Assessment has not been reviewed and/or agreed to by the parties asserting the 30 Day Goods Claims, the Companies, the Purchaser or other potentially interested parties.
30. The proposed form of Approval and Vesting Order has been revised to exclude any assets subject to 30 Day Goods Claims, pending determination of the validity of the 30 Day Goods Claim by the Court or agreement by the parties.
31. The forgoing addresses section 81.1 claims actually received as of the date hereof only and does not include potential claims of other unpaid suppliers that could potentially assert rights under section 81.1 of the BIA. However, the Interim Receiver notes that:
 - a) in addition to the other eligibility criteria set out in the BIA, such claims cannot be validly asserted once the goods in question become subject to a sale; and

- b) the majority of recently ordered goods and services delivered to the Companies from and after May 28, 2012 (the date of the appointment of the Interim Receiver) were paid for in full by the Companies. The KB APA provides that any amounts owing to suppliers for the delivery of goods after May 28, 2012 as at the Closing Date will either be assumed by the Purchaser and discharged as an Assumed Liability or goods received during this period will be made available by the Purchaser for collection or repossession by the supplier, substantially in the same state in which the goods were delivered. Accordingly, safeguards have been put in place to protect the rights of parties that have provided trade credit to the Companies following the appointment of the Interim Receiver.

B. UPDATE ON THE BUSINESS OPERATIONS SINCE FILING

NEW CREDIT GIVEN/ ASSUMED LIABILITIES

32. As discussed earlier, during the Monitoring Period, the Companies' business operations have continued largely in the normal course, with the exception that goods and services have been provided principally on a COD basis. However, certain suppliers of goods and service have continued to provide the Companies with trade credit in the amount of approximately \$819,000. The Proposed Receiver understands that on Closing the Purchaser will assume all liabilities associated with goods and services ordered by the Companies, which are delivered or provided since May 28, 2012, but excluding any such obligations relating to goods not required and offered back to suppliers for collection or repossession substantially in the same state in which they were delivered.

TERMINATED EMPLOYEES

33. During the period May 25, 2012 to June 8, 2012, the Companies terminated 22 Non-Unionized employees (the "Terminated Employees").
34. The Terminated Employees have been paid all outstanding wages and vacation pay, and earned but unpaid defined benefit pension contributions as at the date of their termination have been remitted to the applicable pension plans. The Companies did not pay Terminated Employees any termination pay or severance pay. As such, the Terminated Employees may be entitled to an unsecured claim should this Court issue the Bankruptcy Orders and the Companies be adjudged bankrupt on June 11, 2012. Terminated employees may also be entitled to a claim

under the *Wage Earner Protection Program Act* ("WEPPA") in respect of unpaid severance and termination pay.

NON-UNIONIZED EMPLOYEES

35. On May 28, 2012, Management and the Purchaser met with the Non-Unionized Employees to notify these employees of the Bankruptcy Applications, the Receivership Application, and the proposed sale of the business to Kraus Brands.
36. In addition, Non-Unionized Employees were notified that although the Purchaser intended to extend offers of employment to substantially all Non-Unionized Employees, pursuant to the KB APA, the Purchaser would not be assuming the Employee Plans (as defined in the KB APA), which includes all employee contracts and agreements, health and benefit plans and pension plans that are maintained, administered or contributed to by or on behalf of the Kraus Group and which cover any employee or former employee of the Kraus Group.
37. The Proposed Receiver understands that the Purchaser is in the process of setting up new benefit plans (the "**New Benefit Plans**") and defined contribution pension plans (the "**New DC Plans**") in respect of the Non-Unionized Employees, which will be effective on Closing.
38. The Proposed Receiver understands that the New DC Plans will be substantially similar to the existing DC Plans sponsored by the Companies, prior to the appointment of the Interim Receiver.
39. The Proposed Receiver understands that the New Benefit Plans are similar to the existing benefit plans provided by the Companies, however the New Benefit Plans require employees to contribute a higher co-pay percentage in respect of certain medical and dental benefits.
40. The Proposed Receiver has been advised by Management that most employees are understanding of the requirement for changes in their terms of employment. This is supported by the high rate of acceptance of the offers of employment ("**Offers**") extended to Non-Unionized Employees as detailed below.

OFFERS OF EMPLOYMENT

41. Pursuant to the KB APA, on June 5, 2012 and June 6, 2012, the Purchaser extended Offers to some 224 Non-Unionized Employees ("**Designated Employees**"). Pursuant to the

Supplemental Affidavit of Chris Emmott, sworn June 7, 2012, the Purchaser does not intend to extend Offers to some 30 Non-Unionized Employees who are on long term disability. The Offers are conditional on Closing. For those Non-Unionized Employees that accept the Offers ("**Transferred Employees**"), employment will be effective on Closing or retroactive to Closing.

42. As of the date of this Second Report, the Proposed Receiver understands that the Companies have received signed acceptances from 215 of the 224 Designated Employees representing an acceptance rate of approximately 96%. Only one Designated Employee has advised that he would not be accepting the Offer. The remaining outstanding Offers are primarily in respect of Management and Designated Employees who are either on vacation, maternity leave or short term disability.

UNIONIZED EMPLOYEES

43. Management held meetings with its Unionized Employees and notified the Unionized Employees of the Bankruptcy Applications, the Receivership Application, the proposed sale of the business to Kraus Brands and the conditions precedent in the KB APA, including that the union members approve or ratify New Collective Agreements (that is, the new collective bargaining agreements to be agreed between the Purchaser and the applicable union on terms satisfactory to the Purchaser).
44. On May 31, 2012, Management met with the unionized employees that were subject to the collective bargaining agreement ("**CBA**") between Strudex and United Food & Commercial Workers Canada ("**UFCW**"), Local 175 (March 1, 2008 to February 28, 2011; renewed March 1, 2011 to February 28, 2014) (the "**Old Strudex CBA**"). Following this meeting, the unionized employees held a vote to consider the terms and conditions under the New Collective Agreement, and as detailed later in this Second Report, approved and ratified the New Collective Agreement.
45. On May 31, 2012, Management met with the unionized employees that were subject to the CBA between KI and UFCW, Local 175 (July 1, 2009 to June 30, 2012) (the "**Old KI CBA**"). Following this meeting, the unionized employees held a vote to consider the terms and conditions under the New Collective Agreement and as detailed later in this Second Report, approved and ratified the New Collective Agreement.

46. The Proposed Receiver understands that the Purchaser has not required any changes to the terms and conditions of the collective bargaining agreement between the KCI and the Teamsters Local Union No. 213 ("**Teamsters Union**") (October 1, 2010 to September 30, 2011) (the "**Old KCI CBA**") and will assume the KCI CBA in accordance with the terms of the KB APA.

MATERIAL ADVERSE CHANGE

47. As of the date of this Second Report, the Interim Receiver has not been advised of any material adverse change by either Management or the Purchaser.

C. SALE TRANSACTION – ASSET PURCHASE AGREEMENT

SALE APPROVAL AND VESTING ORDER

48. As reported previously in this Second Report, on May 28, 2012, Kraus Brands made a binding offer to the Proposed Receiver to purchase substantially all of the Property of the Companies that is subject to the Receivership Application. The offer, which is set out in the KB APA, is subject to Court approval and authorization for the Receiver to execute the KB APA, clearance of the conditions precedent as well as updates to the Purchase Price. Subsequent to the offer being made, the Purchaser made certain minor amendments with the consent of the Proposed Receiver. These amendments are discussed below.
49. All capitalized terms used in this section but not otherwise defined have the meanings given to them in the KB APA.
50. The gross consideration of the KB APA is currently estimated to be in excess of \$83.0 million, and consists of:
- a) the assumption of certain portions of the Secured Debt owing by the Kraus Group to Red Ash in the amount of approximately \$80.2 million ("**Assumed Secured Debt**");
 - b) the cash payment of certain Priority Claims ranking in priority to the Assumed Secured Debt (being the priority claims under sections 81.3, 81.4, 81.5, and 81.6 of the BIA), in an amount estimated to be approximately \$24,500. Priority Claims will be discussed in greater detail later in this Second Report; and
 - c) the amount of the Assumed Liabilities is estimated to be approximately \$2.8 million.

Assumed Liabilities include:

- (i) trade credit advanced by suppliers in respect of goods and services ordered and delivered during the Monitoring Period in the amount of approximately \$819,000, unless reduced for goods returned or offered for return to the applicable supplier;
- (ii) assumed outstanding wages and vacation pay of Transferred Employees in the amount of approximately \$2.0 million; and
- (iii) the assumption of other Priority Claims that are not paid or discharged on Closing, which are currently estimated at \$0.

PRIORITY CLAIMS

- 51. As reported previously in this Second Report, the Companies have paid all outstanding wages, vacation pay and unremitted pension contributions in respect of Terminated Employees. As such, the Priority Claim in respect of Terminated Employees is estimated to be \$0.
- 52. The estimated Priority Claim in respect of the BIA Charges related to unpaid pension contributions owing on behalf of Unionized and Non-Unionized employees pursuant to sections 81.5 and 81.6 of the BIA is estimated at \$0 as at the date of the Bankruptcy Orders (if granted). The Proposed Receiver understands that as of the date of this Second Report, there are no unpaid pension contributions as all outstanding amounts have been remitted to the various pension plans when due.
- 53. The Proposed Receiver has estimated a Priority Claims reserve ("**Priority Claims Reserve**") in the amount of approximately \$24,500 in respect of:
 - a) the outstanding disbursements of Terminated Employees deemed as travelling sales persons under the BIA;
 - b) outstanding wages, vacation pay and unpaid pension contributions owing to an estimated number of Designated Employees who are not expected to accept Offers from the Purchaser; and
 - c) a reserve in respect of any unpaid current service pension contributions under the BIA.
- 54. Finally, the Priority Claim of CRA in respect of deducted but unremitted source deductions ("**Source Deduction Claim**") as at the date of the Bankruptcy Orders (if granted) is estimated

to be \$0 because, as at the date of this Second Report, the Companies have remitted all required source deductions to the CRA. Pursuant to the KB APA, the Purchaser will assume the liability for any Source Deduction Claim in respect of the Companies that comes to its attention post Closing.

55. The Purchaser has deposited \$24,500 with the Proposed Receiver in respect of the Priority Claims Reserve discussed above. The Receiver (if appointed) will use the Priority Claims Reserve to fund any payments in respect of Priority Claims ranking in priority to the Assumed Secured Debt. The Proposed Receiver understands that any Priority Claims listed on Schedule I of the KB APA that are not to be paid by the Receiver will be assumed by the Purchaser on Closing.

REAL PROPERTY LEASES AND OTHER CONTRACTS

56. The Companies currently have five Leased Premises.
57. The Interim Receiver understands that the Companies vacated the Leased Premises in Dartmouth, Nova Scotia ("**Dartmouth Premises**") in late May 2012 and, accordingly the June 1, 2012 rent was not paid in respect of this Leases Premises. The Purchaser has confirmed that it does not intend to assume the Real Property Lease for the Dartmouth Premises ("**Dartmouth Lease**").
58. The Purchaser has not identified any of the remaining four Real Property Leases to be assumed immediately upon Closing. The KB APA provides that, providing the Receiver has the funds to do so, it will make commercially reasonable efforts to make arrangements with either the Trustee or the landlord directly of each of the Leased Premises, on terms substantially similar to those currently in place for the Companies and will pay rent and related expenses, if applicable, in respect of the Real Property Leases for a period of up to 90 days, until a decision has been made by the Purchaser whether or not to assume the Real Property Leases.
59. The Purchaser has identified certain Contracts that will be assumed and/or assigned to the Purchaser immediately on Closing. These assumed Contracts, which are primarily personal property leases, are set out in Schedule H of the KB APA. There are still a significant number of other Contracts where the Purchaser has not yet determined whether or not it intends to assume the Contracts.

60. The KB APA provides that if the Receiver has sufficient funding, it shall perform any post-Closing executory obligations of a financial or monetary nature under the Contracts (other than Real Property Leases) that are not assigned to the Purchaser on Closing for a period of up to 30 days post Closing. During this time the Purchaser will determine if the Contracts will be assumed pursuant to terms agreed upon by the counterparties. The Receiver understands that the primary monetary obligation to be fulfilled is the payment of rent pursuant to personal property leases.
61. As set out in the budget appended to the Funding Term Sheet, the form of which has been agreed to by the parties and attached as Appendix "B" hereto, the Purchaser has provided or has committed to provide the Proposed Receiver with cash in the amount of approximately \$1.0 million to fund Contracts and Real Property Lease obligations during the 30 day and 90 day period respectively that it needs to consider which Contracts and Real Property Leases it intends to assume.

STATUS OF CONDITIONS PRECEDENT

62. Pursuant to the KB APA there are certain significant conditions precedent to the completion of the sale of the Purchased Assets. The Interim Receiver understands that as of the date of its Second Report, with the exception of the conditions precedent to be considered and determined by this Court at a hearing on June 11, 2012, specifically the granting of the Bankruptcy Orders, the Receivership Order and the Sale Approval Motion, the conditions precedent have been met as follows:
- a) **The Purchaser shall have received Competition Act Approval** – On May 25, 2012, the Purchaser made an application to the Competition Bureau of Canada for an advance ruling certificate exempting Kraus Brands, the Proposed Receiver and the Kraus Group of Companies from the requirement to file a Part IX notification of the Competition Act. On June 5, 2012, the Commissioner of Competition, on behalf of the Competition Bureau, issued an advance ruling certificate. As such, this condition precedent has been satisfied;
 - b) **Each of the New Collective Agreements shall have been duly approved and ratified by the Applicable Unionized Employees**
 - (i) On May 31, 2012, union members that were subject to the Old Strudex CBA voted on its New Collective Agreement. The Proposed Receiver understands that 89

union members (approximately 85%) took part in the vote with 72 union members (approximately 81%) voting in favor of the New Collective Agreement. On May 31, 2012 union members that were subject to the Old KI CBA voted on its New Collective Agreement. The Proposed Receiver understands that 145 union members (approximately 85%) took part in the vote with 122 union members (approximately 85%) voting in favor of the New Collective Agreement; and

- (ii) The Proposed Receiver understands that there will be no changes to Old KCI CBA and the Old KCI CBA will be assumed by the Purchaser. The Purchaser has confirmed that the condition precedent in respect to amending the Old KCI CBA has been waived.

As such, the condition precedent in respect of each of the New Collective Agreements being approved and ratified by the applicable Unionized Employees has been satisfied or waived;

- c) **Funding Term Sheet** – As of the date of this Second Report, the terms of the Funding Term Sheet (as defined in the KB APA) have been agreed by Red Ash and the Proposed Receiver, thereby satisfying this condition precedent;
- d) **Additional Priority Claims** – As of the date of this Second Report, there has been no determination by the Court or any other Governmental Authority that the Purchaser is liable and responsible for any Claims under any Employee Plans, other than specifically agreed to by the Purchaser in the New Collective Agreements; and
- e) **Third Party Consents, Approvals and Authorizations** – Currently neither the Proposed Receiver nor the Purchaser are aware of any other consents, approvals or authorizations required for Closing.

MINOR AMENDMENTS

- 63. Since the execution of the KB APA by the Purchaser, the Purchaser has made certain minor amendments to the KB APA with the consent of the Proposed Receiver, described below:
 - a) Originally, the Purchaser intended to satisfy the Purchase Price by assuming portions of the first ranking and second ranking secured debt (amongst other consideration). The Purchaser now intends, for tax planning purposes to also assume a portion of the third ranking secured debt. As noted previously, the Purchaser and Red Ash, the secured creditor, are related parties;

- b) Under the KB APA, cash in the bank accounts of the Kraus Group constitutes a Purchased Asset, but not the actual bank accounts themselves. Under the amended KB APA, the Receiver will convey all of the Kraus Group's interests in such bank accounts as well. The Purchaser advises that it will deal directly with the Kraus Group's bank with respect to the operation of such accounts, post-Closing;
 - c) The Purchaser has confirmed that it will not be assuming the Dartmouth Lease and this has now been clarified in the amended KB APA;
 - d) The Purchaser has confirmed it has waived the condition to reach a New Collective Agreement with the Teamsters Union and will assume the obligations under the Old KCI CBA. This has been reflected in the amended KB APA; and
 - e) There have been other agreed upon amendments that the Proposed Receiver considers to be in the nature of "drafting clean up". The Purchaser has also updated certain Schedules, which updated Schedules are now incorporated in the amended KB APA. The ability to update certain Schedules - pre- and post- Closing, was contemplated by the terms of the Purchaser's original offer.
64. The Proposed Receiver notes that the requested Approval and Vesting Order provides for the approval of the KB APA, subject to such minor amendments as the Receiver deems necessary. For ease of comparison, attached as Appendix "C" is a blackline of only the amendments to the form of KB APA attached to the First Report. Attached as Appendix "A" is a clean copy of the amended and resubmitted KB APA for which approval is sought on the Sale Approval Motion.

D. RECOMENDATION

65. Based on the foregoing, the Proposed Receiver continues to recommend, for the following reasons, that in the event this Court appoints PwCI as Receiver, that this Court issue an order approving the KB APA and Sale Transaction and authorizing and directing the Receiver to execute the KB APA and take such steps as necessary to complete the Sale Transaction:
- a) a comprehensive Sale Process was recently conducted and all offers received during the Sale Process were substantially less than the consideration under the KB APA, which is in excess of \$83.0 million;
 - b) the Liquidation Analysis demonstrates that Red Ash would incur a significant shortfall on

approximately \$126.2 million of the indebtedness owed to it should the assets and business of the Kraus Group be liquidated;

- c) the Senior Syndicate, BMOCC and NK, each of which was represented by reputable financial and/or legal advisors in the insolvency and restructuring industry, sold their respective components of the Secured Debt to Red Ash at a discount thereby recognizing that the market value of the Secured Debt was less than its face value;
- d) the unsecured creditors are not being prejudiced by the Sale Transaction as the only creditor with an economic interest in the Sale Transaction is Red Ash, which will also suffer a shortfall on the Senior Debt extended to the Kraus Group; and
- e) the KB APA provides for continued employment for the vast majority of the Kraus Group's employees.

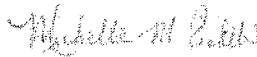
All of which is respectfully submitted on this 10 day of June, 2012.

PricewaterhouseCoopers Inc.

In its capacity as Interim Receiver of
Kraus Inc., Kraus Canada Inc.,
Strudex Fibres Limited, and Proposed
Receiver of the Respondents,
and not in its personal capacity.



John McKenna
Senior Vice President



Michelle Pickett
Vice President

APPENDIX “D”

Court File No. CV12-9731-00CL

**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

**THIRD REPORT OF PRICEWATERHOUSECOOPERS INC.
AS RECEIVER**

June 14, 2012


pwc

INTRODUCTION

1. By Order of the Ontario Superior Court of Justice (Commercial List) (the “**Court**”) dated May 28, 2012, PricewaterhouseCoopers Inc. (“**PwCI**”) was appointed as interim receiver (“**Interim Receiver**”) in respect of Kraus Inc. (“**KI**”), Kraus Canada Inc. (“**KCI**”), and Strudex Fibres Limited (“**Strudex**”).
2. By Orders of the Court dated June 11, 2012, PwCI was appointed as trustee in bankruptcy of KI, KCI and Strudex pursuant to bankruptcy applications brought by Pinnacle Capital Resources Limited, in its capacity as general partner of Red Ash Capital Partners II Limited Partnership (collectively “**Red Ash**”).
3. The bankruptcy application in respect of KCI was initially brought before the Manitoba Court of Queen’s Bench (the “**Manitoba Court**”) in Winnipeg, Manitoba and was transferred to the Court in Toronto on June 5, 2012, pursuant to an Order of the Manitoba Court.
4. On June 11, 2012, the Court issued an order (the “**Receivership Order**”) appointing PwCI as Receiver (“**Receiver**”) in respect of KI, KCI, Strudex and 538626 B.C. Ltd. (“**Kraus BC**”) (collectively the “**Companies**” or “**Debtor**”) pursuant to a receivership application brought before the Court by Red Ash in these proceedings (the “**Receivership Application**”). PwCI was discharged as Interim Receiver when the Receivership Order became effective in accordance with its terms.
5. On June 11, 2012, the Court issued an order (the “**Sale Approval and Vesting Order**”) approving the sale transaction contemplated by an asset purchase agreement between the Receiver and Kraus Brands LP (the “**Purchaser**”) dated as of June 11, 2012 (the “**Sale Agreement**”), vesting in the Purchaser the Receiver’s right, title and interest, if any, and the Debtor’s right, title and interest in and to the Purchased Assets (as defined in the Sale Agreement).
6. PwCI, in its capacity as Interim Receiver and proposed Receiver, filed its first report in respect of its motion for approval of the Sale Agreement on May 29, 2012.
7. PwCI, in its capacity as Interim Receiver and proposed Receiver, filed its second report dated June 10, 2012 (“**Second Report**”) to update the Court with respect to the Sale Transaction (as defined in the Second Report) including minor amendments in the Sale Agreement, the status of Priority Claims, BIA Charges, Source Deduction Claims and Assumed Liabilities (all as defined in the

Sale Agreement) as well as to update the Court on the status of the Debtor's business operations since the appointment of the Interim Receiver, and to report on the Interim Receiver's activities since its appointment.

8. At the time the Sale Approval and Vesting Order became effective, certain of the Purchased Assets were subject to claims delivered in advance to the Interim Receiver and/or the Companies pursuant to s. 81.1 of the *Bankruptcy and Insolvency Act* (the "**s. 81.1 Claim(s)**"). A list of the claimants that delivered s. 81.1 Claims (the "**s.81.1 Claimants**") as at June 11, 2012 is set out below:

List of s. 81.1 Claims Filed as at June 11, 2012		
Name of Claimant	Date Claim Received	Amount of Claim (USD)
American Berber Inc.	30-May-12	75,117
Nylene Canada, Inc.	31-May-12	732,190
Beaulieu Group, LLC	4-Jun-12	20,390
Huntsman Corporation of Canada, Inc.	4-Jun-12	17,992
Don & Low Ltd.	7-Jun-12	155,097
Equistar Chemicals, LP	8-Jun-12	551,951
Tri-Tex Co Inc.	8-Jun-12	221,130
Propex Operating Company, LLC	10-Jun-12	414,981
Carpet & Rug Backing and Supplies, Inc.	11-Jun-12	59,886
Total		\$ 2,248,734

* For the purpose of this table, any claims in CDN have been converted to USD at an exchange rate of 1.00 USD/CAD.

9. Pursuant to paragraph 6 of the Sale Approval and Vesting Order, the Receiver was required to file a report advising as to the assets in the possession of the Companies as of June 11, 2012 that were subject to s. 81.1 Claims (individually a "**s.81.1 Asset**" and collectively, the "**s.81.1 Assets**") and to the extent ascertainable, the s. 81.1 Assets in the possession of the Companies as at May 28, 2012.
10. This third report of the Receiver ("**Third Report**") is delivered in satisfaction of that requirement.

A. S. 81.1 ASSETS IN THE POSSESSION OF THE COMPANIES ON JUNE 11, 2012

RECEIVER'S INSPECTION OF GOODS

11. With the exception of the s. 81.1 Claim from American Berber Inc. ("**American Berber Claim**"), for the most part all s.81.1 Claims are against s. 81.1 Assets delivered to KI and Strudex prior to

May 28, 2012, the date that the Interim Receiver was appointed.

12. The American Berber Claim is in respect to goods delivered during the interim receivership period. Pursuant to the terms of the Sale Agreement, the liability for payment of these goods has been assumed by the Purchaser and will be paid in due course. The Receiver has been in contact with American Berber Inc., which has confirmed in writing that the assumption of the payment obligation by the Purchaser is satisfactory to American Berber Inc. and that American Berber Inc.'s s. 81.1 Claim has been resolved. Therefore the American Berber Claim is excluded from this analysis.
13. The Receiver attended at the premises of KI and Strudex in Waterloo, Ontario on June 11, 2012.
14. The Receiver met with the Chief Operating Officer and the plant manager of KI and Strudex to develop a plan to identify the s. 81.1 Assets.
15. Commencing at 9:00 A.M. on June 11, 2012, the Receiver and the plant manager of each of KI and Strudex conducted a five hour tour of the KI and Strudex plants in an effort to identify the s.81.1 Assets.
16. The Receiver subsequently consulted with the respective accounting and production staff of KI and Strudex to generate inventory status reports for s.81.1 Assets such as yarn and backing goods to cross-reference with quantities of these potential s.81.1 Assets identified on the plant tours.
17. Where accurate real-time readings were not available (i.e. resin in silos), the Receiver reviewed production data and consulted with the plant managers to determine the quantity of potential s. 81.1 Assets remaining on site.
18. The Receiver also consulted with the Companies' controller to track and determine the location of s. 81.1 Assets that were in transit and not located at the KI and Strudex plants in Waterloo, Ontario.
19. The Receiver has prepared a list of the s. 81.1 Assets, excluding the assets subject to the American Berber Claim, which the Receiver has identified as being in the possession of the Companies as at June 11, 2012, a copy of which is attached as **Appendix "A"**. The Receiver intends to communicate its assessment of the validity of each s. 81.1 Claim to the applicable claimant and/or their counsel (excluding American Berber Inc.) and the Purchaser with a view

to facilitating an agreement as to the disposition of the s. 81.1 Claim, as contemplated by the Sale Approval and Vesting Order without the need for further Court order.

SEGREGATION OF S.81.1 ASSETS

20. Pursuant to paragraph 6(c) of the Sale Approval and Vesting Order, the Purchaser has segregated and preserved in the same state and condition the s. 81.1 Assets in its possession as identified by the Receiver (subject to the Purchaser's right under paragraph 6(e) of the Sale Approval and Vesting Order to use and consume the s. 81.1 Assets in the ordinary course of business provided cash collateral for the invoiced amount of such s.81.1 Asset is deposited with the Receiver) as follows:
- a) to the extent that there is sufficient space and it is practical and safe, the Companies have physically segregated the s. 81. Assets in respect of each of the s. 81.1 Claims from the Companies' other assets; and
 - b) in instances where it is not practical to do so, such as the case of the large vessels containing the resin or the large rolls of carpet backing, these goods have not been physically segregated from the Purchaser's other assets but have been tagged and clearly identified as s. 81.1 Assets.

B. INSPECTIONS BY S. 81.1 CLAIMANTS

21. To date, two of the s. 81.1 Claimants have conducted a plant tour and inspection to identify s. 81.1 Assets in respect of their s. 81.1 Claim that were in the possession of the Purchaser:
- a) a representative of Equistar Chemicals, LP ("Equistar") attended at the Waterloo premises of KI and Strudex on June 12, 2012. The representative was shown the silos where Equistar's goods are normally delivered, namely Silo C and Silo 3. The representative did a visual inspection of the goods remaining in Silo C and was provided with the production records for Silo 3. A digital meter reading of Silo 3 was also taken in the representative's presence; and
 - b) a representative of Nylene Canada, Inc. ("Nylene") attended the Waterloo premises of KI and Strudex on June 13, 2012 and conducted an indepth two hour tour and inspection of the KI and Strudex facility to identify all s. 81.1 Assets on the premises that were subject to Nylene's s.81.1 Claim. The representative was provided an opportunity to tour through the areas where all yarn inventory is located. The representative was provided an opportunity to take pictures

of the Nylene yarn that was subject to its s.81.1 Claim and conducted an accounting of the Nylene yarn on the premises on a case by case basis consistent with its packing slips. The representative did not tour the polymer resin area as there were no Nylene polymer resin boxes remaining as of June 11, 2012.

C. S. 81.1 ASSETS IN THE POSSESSION OF THE COMPANIES ON MAY 28, 2012

22. The Receiver has attempted to determine the s. 81.1 Assets in the possession of the Companies as at May 28, 2012 by reviewing the Companies' books and records and by discussions with the appropriate employees. The Receiver has identified the following challenges in connection with this determination:

- a) the Companies track inventory usage for dyes, chemicals and resin on a manual basis and not through automated recording systems. In addition, the Companies track usage for these goods on a per unit basis (i.e. per box, bag or drum) as opposed to a weight basis (per gram, kilogram, etc.). Hence, it is difficult to obtain accurate and detailed data on inventory usage;
- b) with the exception of yarn and backing material, inventory usage is reported at the product level and not at the purchase order ("PO") and/or stock keeping unit ("SKU") level. In addition, the Companies do not have a standardized policy with respect to inventory usage (i.e. last-in-first-out (LIFO) or first-in-first-out (FIFO)), making it difficult to trace historical usage back to a particular PO and/or SKU;
- c) most of the Companies' inventory systems provide real-time static snapshots of inventory usage and are therefore difficult to project back to a prior date in time; and
- d) the Companies run inventory reports on a monthly basis, at the end of each month. Therefore, any available reported inventory data would only be as at May 31, 2012.

23. Therefore, an accurate and precise determination of s.81.1 Assets as at May 28, 2012 is not ascertainable at this time. At this time, the Receiver does not propose to make any further investigations of s. 81.1 Assets that may have been in the possession of the Companies as at May 28, 2012. If the s. 81.1 Claimants wish to make their own investigations, the Receiver will attempt to facilitate such review with the Purchaser, and seek court direction if necessary. To date, the Purchaser has co-operated with any s. 81 Claimant that has wished to attend at Company premises to review the status of the s. 81.1 Assets.

24. Having completed its report on the s. 81.1 Assets in the possession of the Companies at June 11, 2012, pursuant to the Sale Approval and Vesting Order and where necessary, the Receiver will work with the Purchaser and the applicable s.81.1 Claimants to determine the eligible value of each s. 81.1 Claim. The Receiver will also provide s. 81.1 Claimants with an accounting of the s. 81.1 Assets used or consumed on or after June 11, 2012.

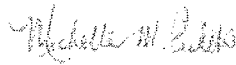
All of which is respectfully submitted on this 14th day of June, 2012.

PricewaterhouseCoopers Inc.

In its capacity as Receiver of
Kraus Inc., Kraus Canada Inc.,
Strudex Fibres Limited, and 538626 B.C. Ltd.,
and not in its personal capacity.



John McKenna
Senior Vice President



Michelle Pickett
Vice President

APPENDIX “E”

**Court Appointed Receivership of
Kraus Inc., Kraus Canada Inc., Strudex Fibres Limited and 538626 B.C. Ltd.**

List of s. 81.1 Claims Filed as at June 11, 2012		
Name of Claimant	Date Claim Received	Amount of Claim (USD)
American Berber Inc.	30-May-12	75,117
Nylene Canada, Inc.	31-May-12	732,190
Beaulieu Group, LLC	4-Jun-12	20,390
Huntsman Corporation of Canada, Inc.	4-Jun-12	17,992
Don & Low Ltd.	7-Jun-12	155,097
Equistar Chemicals, LP	8-Jun-12	551,951
Tri-Tex Co Inc.	8-Jun-12	221,130
Propex Operating Company, LLC	10-Jun-12	414,981
Carpet & Rug Backing and Supplies, Inc.	11-Jun-12	59,886
Total		\$ 2,248,734

* For the purpose of this table, any claims in CDN have been converted to USD at an exchange rate of 1.00 USD/CAD.

TAB 3

Court File No. CV-12-9731-00CL

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

THE HONOURABLE MR.)	TUESDAY, THE 16 th
)	
JUSTICE MORAWETZ)	DAY OF OCTOBER, 2012

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**

DISCHARGE ORDER

THIS MOTION, made by PricewaterhouseCoopers Inc. ("PwC") in its capacity as the Court-appointed receiver (in such capacity, the "Receiver") of the undertaking, property and assets of 1743122 Ontario Inc. (formerly Kraus Inc.) ("Kraus"), 3581168 Canada Inc. (formerly Kraus Canada Inc.) ("Kraus Canada"), 798862 Ontario Limited (formerly Strudex Fibres Limited) ("Strudex") and 538626 B.C. Ltd. (collectively, the "Debtor"), for an order:

1. abridging and validating service of the Notice of Motion and Motion Record;

2. approving the activities of the Receiver as set out in the third report of the Receiver dated June 14, 2012 (the “**Third Report**”) and the fourth report of the Receiver dated October 9, 2012 (the “**Fourth Report**”);

3. deeming any and all cash held by the Receiver (the “**Priority Charge Reserve**”) in trust pursuant to paragraph 2.7(a) of the Sale Agreement (as defined in the Sale Approval and Vesting Order dated June 11, 2012 (the “**Sale Order**”)) to satisfy any claims that may be subject to the charges created by Sections 81.3, 81.4, 81.5 and 81.6 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (collectively, the “**BIA Charges**”) to be held by PwC in its capacity as trustee in bankruptcy of Kraus, Kraus Canada and Strudex (in such capacities, the “**Trustee**”);

4. deeming any and all cash held by the Receiver (the “**s.81.1 Claims Reserve**”) in trust pursuant to paragraph 6(e) of the Sale Order, in place and stead of the applicable s.81.1 Asset (as defined in the Sale Order) to be held by the Trustee;

5. authorizing the distribution of any residual funds remaining in the receivership, after payment of all expenses and obligations incurred by the Receiver, to Red Ash Capital Partners II Limited Partnership (“**Red Ash**”), in its capacity as lender under the funding term sheet dated as of June 8, 2012 among Pinnacle Capital Resources Limited in its capacity as general partner of Red Ash and the Receiver (the “**Term Sheet**”);

6. discharging PwC as Receiver of the undertaking, property and assets of the Debtor upon the filing of the Receiver’s Discharge Certificate (as defined herein); and

7. releasing PwC from any and all liability, as set out in paragraph 7 of this Order,

was heard this day at 330 University Avenue, Toronto, Ontario.

ON READING the Third Report and the Fourth Report, and on hearing the submissions of counsel for the Receiver, no one else appearing although served as evidenced by the Affidavit of [NAME] sworn October [DATE], 2012, filed;

1. THIS COURT ORDERS that the time for service of the Notice of Motion and the Motion Record, including the Fourth Report, be and is hereby abridged and validated so that this motion is properly returnable today and hereby dispenses with further service thereof.

2. THIS COURT ORDERS that the activities of the Receiver, as set out in the Third Report and Fourth Report, are hereby approved.

3. THIS COURT ORDERS that any and all cash held by the Receiver in the Priority Charge Reserve is hereby deemed to be held by the Trustee, to be used by the Trustee to satisfy any claims that may be subject to the BIA Charges, and the Trustee is hereby authorized, upon its discharge, to distribute any and all remaining cash then held by the Trustee in the Priority Charge Reserve to Kraus Brands LP (the "**Purchaser**").

4. THIS COURT ORDERS that any and all cash held by the Receiver in the s.81.1 Claims Reserve is hereby deemed to be held by the Trustee, in trust, in place and stead of the applicable s.81.1 Asset, until such time as the claim to the applicable s.81.1 Asset is determined, by agreement amongst the Trustee, the claimant to the applicable s.81.1 Asset and the Purchaser, or further order of the Court.

5. THE COURT ORDERS that the Receiver is hereby authorized to distribute to Red Ash, in its capacity as lender under the Term Sheet, any and all residual funds remaining in the receivership after payment of all expenses and obligations incurred by the Receiver.

6. THIS COURT ORDERS that upon payment of the amounts set out in paragraph 5 hereof and upon the Receiver filing a certificate in the form attached as Schedule "A" hereto (the "**Receiver's Discharge Certificate**") certifying that such payments have been made, the Receiver shall be discharged as Receiver of the undertaking, property and assets of the Debtor, provided however that notwithstanding its discharge herein (a) the Receiver shall remain Receiver for the performance of such incidental duties as may be required to complete the administration of the receivership herein, including those set out in paragraph 64 of the Fourth Report, and (b) the Receiver shall continue to have the benefit of the provisions of all Orders made in this proceeding, including all approvals, protections and stays of proceedings in favour of PwC in its capacity as Receiver.

7. THIS COURT ORDERS AND DECLARES that effective as of the date that the Receiver files the Receiver's Discharge Certificate, PwC shall be released and discharged from any and all liability that PwC then has or may thereafter have by reason of, or in any way arising out of, the acts or omissions of PwC while acting in its capacity as Receiver herein, save and except for any

gross negligence or wilful misconduct on the Receiver's part. Without limiting the generality of the foregoing, PwC shall, upon filing the Receiver's Discharge Certificate, be thereby forever released and discharged from any and all liability relating to matters that were raised, or which could have been raised, in the within receivership proceedings, save and except for any gross negligence or wilful misconduct on the Receiver's part.

Schedule A – Form of Receiver’s Discharge Certificate

Court File No. CV-12-9731-00CL

**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 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**

RECEIVER’S DISCHARGE CERTIFICATE

WHEREAS pursuant to an Order of the Honourable Mr. Justice Morawetz of the Ontario Superior Court of Justice [Commercial List] made October 16, 2012 (the “**Discharge Order**”), PricewaterhouseCoopers Inc. (“**PwC**”) was discharged as receiver (the “**Receiver**”) of the undertaking, property and assets of 1743122 Ontario Inc. (formerly Kraus Inc.), 3581168 Canada Inc. (formerly Kraus Canada Inc.), 798862 Ontario Limited (formerly Strudex Fibres Limited) and 538626 B.C. Ltd. (collectively, the “**Debtor**”), with such discharge to be effective upon the Receiver filing a certificate with this Court certifying that it has completed the payments contemplated in paragraph 5 of the Discharge Order.

THE UNDERSIGNED HEREBY CERTIFIES as follows:

1. The payments contemplated in paragraph 5 of the Discharge Order have been completed in accordance with paragraph 6 of the Discharge Order.

DATED at Toronto, Ontario this ____ day of _____, 2012

**PRICEWATERHOUSECOOPERS INC., solely
in its capacity as receiver of the Debtor and not
in its personal or corporate capacity.**

Name:

Title:

**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

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

Proceeding commenced at Toronto

DISCHARGE ORDER

BLAKE, CASSELS & GRAYDON LLP
Suite 4000, Commerce Court West
199 Bay Street, Suite 4000
Toronto, Ontario M5L 1A9

Pamela Huff - LSUC No.: 27344V
Tel: (416) 863-2958

Linc Rogers - LSUC No.: 43562N
Tel: (416) 863-4168

Jenna Willis - LSUC No.: 58498U
Tel: (416) 863-3348
Fax: (416) 863-2653

Lawyers for PricewaterhouseCoopers Inc. in its
capacity as the Court-appointed Receiver of the
Respondents

TAB 4

Court File No. ———CV-12-9731-00CL

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

THE HONOURABLE ——— <u>MR.</u>)	WEEKDAY <u>TUESDAY</u> , THE # <u>16th</u>
)	
JUSTICE ——— <u>MORAWETZ</u>)	DAY OF MONTH <u>OCTOBER</u> , 20 <u>YR</u> <u>2012</u>

B E T W E E N:

PLAINTIFF PINNACLE CAPITAL RESOURCES LIMITED in its capacity as general partner of

Plaintiff

RED ASH CAPITAL PARTNERS II LIMITED PARTNERSHIP

Applicant

- and -

DEFENDANT

Defendant

**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**

DISCHARGE ORDER

THIS MOTION, made by [RECEIVER'S NAME] PricewaterhouseCoopers Inc. ("PwC")
in its capacity as the Court-appointed receiver (in such capacity, the "Receiver") of the
undertaking, property and assets of [DEBTOR] (the "1743122 Ontario Inc. (formerly Kraus Inc.)")

("Kraus"), 3581168 Canada Inc. (formerly Kraus Canada Inc.) ("Kraus Canada"), 798862 Ontario Limited (formerly Strudex Fibres Limited) ("Strudex") and 538626 B.C. Ltd. (collectively, the "Debtor"), for an order:

1. abridging and validating service of the Notice of Motion and Motion Record;
2. ~~1.~~ approving the activities of the Receiver as set out in the third report of the Receiver dated [DATE] (the "Report" June 14, 2012 (the "Third Report") and the fourth report of the Receiver dated October 9, 2012 (the "Fourth Report");
2. approving the fees and disbursements of the Receiver and its counsel;
3. deeming any and all cash held by the Receiver (the "Priority Charge Reserve") in trust pursuant to paragraph 2.7(a) of the Sale Agreement (as defined in the Sale Approval and Vesting Order dated June 11, 2012 (the "Sale Order") to satisfy any claims that may be subject to the charges created by Sections 81.3, 81.4, 81.5 and 81.6 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (collectively, the "BIA Charges") to be held by PwC in its capacity as trustee in bankruptcy of Kraus, Kraus Canada and Strudex (in such capacities, the "Trustee");
4. deeming any and all cash held by the Receiver (the "s.81.1 Claims Reserve") in trust pursuant to paragraph 6(e) of the Sale Order, in place and stead of the applicable s.81.1 Asset (as defined in the Sale Order) to be held by the Trustee;
5. ~~3.~~ approving the distribution of the remaining proceeds available in the estate of the Debtor; ~~[and]~~ authorizing the distribution of any residual funds remaining in the receivership, after payment of all expenses and obligations incurred by the Receiver, to Red Ash Capital Partners II Limited Partnership ("Red Ash"), in its capacity as lender under the funding term sheet dated as of June 8, 2012 among Pinnacle Capital Resources Limited in its capacity as general partner of Red Ash and the Receiver (the "Term Sheet");
6. ~~4.~~ discharging [RECEIVER'S NAME]PwC as Receiver of the undertaking, property and assets of the Debtor ~~f~~ upon the filing of the Receiver's Discharge Certificate (as defined herein);
and

7. ~~5.~~ releasing ~~[RECEIVER'S NAME]PwC~~ from any and all liability, as set out in paragraph ~~57~~ of this Order},

was heard this day at 330 University Avenue, Toronto, Ontario.

ON READING the Third Report, ~~the affidavits of the Receiver and its counsel as to fees (the "Fee Affidavits"), and the Fourth Report~~, and on hearing the submissions of counsel for the Receiver, no one else appearing although served as evidenced by the Affidavit of ~~[NAME]~~ sworn October [DATE], 2012, filed;

1. ~~THIS COURT ORDERS that the time for service of the Notice of Motion and the Motion Record, including the Fourth Report, be and is hereby abridged and validated so that this motion is properly returnable today and hereby dispenses with further service thereof.~~

2. ~~1.~~ THIS COURT ORDERS that the activities of the Receiver, as set out in the Third Report and Fourth Report, are hereby approved.

3. ~~2.~~ THIS COURT ORDERS that the fees and disbursements of the Receiver and its counsel, as set out in the Report and the Fee Affidavits, are hereby approved. any and all cash held by the Receiver in the Priority Charge Reserve is hereby deemed to be held by the Trustee, to be used by the Trustee to satisfy any claims that may be subject to the BIA Charges, and the Trustee is hereby authorized, upon its discharge, to distribute any and all remaining cash then held by the Trustee in the Priority Charge Reserve to Kraus Brands LP (the "Purchaser").

4. ~~THIS COURT ORDERS that any and all cash held by the Receiver in the s.81.1 Claims Reserve is hereby deemed to be held by the Trustee, in trust, in place and stead of the applicable s.81.1 Asset, until such time as the claim to the applicable s.81.1 Asset is determined, by agreement amongst the Trustee, the claimant to the applicable s.81.1 Asset and the Purchaser, or further order of the Court.~~

5. ~~3.~~ ~~THIS~~ THE COURT ORDERS that, ~~after payment of the fees and disbursements herein approved, the Receiver is hereby authorized to distribute to Red Ash, in its capacity as lender under the Term Sheet, any and all residual funds remaining in the receivership after payment of all expenses and obligations incurred by the Receiver shall pay the monies remaining in its hands to [NAME OF PARTY].~~

6. ~~4.~~ THIS COURT ORDERS that upon payment of the amounts set out in paragraph ~~35~~ hereof ~~[and upon the Receiver filing a certificate certifying that it has completed the other activities described in the Report]~~ in the form attached as Schedule "A" hereto (the "Receiver's Discharge Certificate") certifying that such payments have been made, the Receiver shall be discharged as Receiver of the undertaking, property and assets of the Debtor, provided however that notwithstanding its discharge herein (a) the Receiver shall remain Receiver for the performance of such incidental duties as may be required to complete the administration of the receivership herein, including those set out in paragraph 64 of the Fourth Report, and (b) the Receiver shall continue to have the benefit of the provisions of all Orders made in this proceeding, including all approvals, protections and stays of proceedings in favour of ~~[RECEIVER'S NAME]~~ PwC in its capacity as Receiver.

7. ~~5.~~ ~~[THIS COURT ORDERS AND DECLARES that [RECEIVER'S NAME] is hereby effective as of the date that the Receiver files the Receiver's Discharge Certificate. PwC shall be released and discharged from any and all liability that [RECEIVER'S NAME] now PwC then has or may hereafter thereafter have by reason of, or in any way arising out of, the acts or omissions of [RECEIVER'S NAME] PwC while acting in its capacity as Receiver herein, save and except for any gross negligence or wilful misconduct on the Receiver's part. Without limiting the generality of the foregoing, [RECEIVER'S NAME] is hereby PwC shall, upon filing the Receiver's Discharge Certificate, be thereby forever released and discharged from any and all liability relating to matters that were raised, or which could have been raised, in the within receivership proceedings, save and except for any gross negligence or wilful misconduct on the Receiver's part.]~~

Schedule A – Form of Receiver’s Discharge Certificate

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 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

RECEIVER’S DISCHARGE CERTIFICATE

WHEREAS pursuant to an Order of the Honourable Mr. Justice Morawetz of the Ontario Superior Court of Justice [Commercial List] made October 16, 2012 (the “**Discharge Order**”), PricewaterhouseCoopers Inc. (“**PwC**”) was discharged as receiver (the “**Receiver**”) of the undertaking, property and assets of 1743122 Ontario Inc. (formerly Kraus Inc.), 3581168 Canada Inc. (formerly Kraus Canada Inc.), 798862 Ontario Limited (formerly Strudex Fibres Limited) and 538626 B.C. Ltd. (collectively, the “**Debtor**”), with such discharge to be effective upon the Receiver filing a certificate with this Court certifying that it has completed the payments contemplated in paragraph 5 of the Discharge Order.

THE UNDERSIGNED HEREBY CERTIFIES as follows:

1. The payments contemplated in paragraph 5 of the Discharge Order have been completed in accordance with paragraph 6 of the Discharge Order.

DATED at Toronto, Ontario this _____ day of _____, 2012

**PRICEWATERHOUSECOOPERS INC., solely
in its capacity as receiver of the Debtor and not
in its personal or corporate capacity.**

Name:

Title:

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

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

Proceeding commenced at Toronto

DISCHARGE ORDER

BLAKE, CASSELS & GRAYDON LLP
Suite 4000, Commerce Court West
199 Bay Street, Suite 4000
Toronto, Ontario M5L 1A9

Pamela Huff - LSUC No.: 27344V
Tel: (416) 863-2958

Linc Rogers - LSUC No.: 43562N
Tel: (416) 863-4168

Jenna Willis - LSUC No.: 58498U
Tel: (416) 863-3348
Fax: (416) 863-2653

Lawyers for PricewaterhouseCoopers Inc. in its
capacity as the Court-appointed Receiver of the

Respondents

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10:33:14 AM

Input:	
Document 1 ID	PowerDocs://TOR_2024/12594482/1
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Document 2 ID	PowerDocs://TOR_2024/12594482/4
Description	TOR_2024-#12594482-v4-Kraus_-_Discharge_Order
Rendering set	Standard

Legend:	
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Moved from	
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Moved to	0
Style change	0
Format changed	0
Total changes	172

**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

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

Proceeding commenced at Toronto

**MOTION RECORD
(DISCHARGE OF RECEIVER)
(RETURNABLE OCTOBER 16, 2012)**

BLAKE, CASSELS & GRAYDON LLP
Suite 4000, Commerce Court West
199 Bay Street, Suite 4000
Toronto, Ontario M5L 1A9

Pamela Huff - LSUC No.: 27344V
Tel: (416) 863-2958

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