

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

**IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT
ACT
R.S.C. 1985 c.C - 36, as amended**

- and -

**IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT
OF
KOREX DON VALLEY ULC**

APPLICANT

**SUPPLEMENTARY SECOND REPORT OF
IRA SMITH TRUSTEE & RECEIVER INC.**

**IN ITS CAPACITY AS PROPOSED COURT-APPOINTED MONITOR OF
KOREX DON VALLEY ULC**

DATED FEBRUARY 2, 2009

1.0 INTRODUCTION

This Supplementary Second Report (the "**Supplementary Second Report**") is filed by Ira Smith Trustee & Receiver Inc. ("**ISI**") in its capacity as proposed court-appointed monitor (the "**Monitor**") of all of the assets, undertakings and properties of Korex Don Valley ULC ("**Korex**"). This is supplementary to the Monitor's First Report dated January 9, 2009 (the "**First Report**") and the Supplementary First Report dated January 22, 2009.

On January 2, 2009, by Endorsement of the Honourable Mr. Justice Campbell, the Monitor was directed to perform certain work as part of an adjournment on a consent basis of the within

application. A copy of the Endorsement and Consent was included as Exhibit “A” in the First Report.

On January 12, 2009, the parties attended before the Honourable Madam Justice Pepall to seek an adjournment of the hearing of Korex’s motion. By endorsement of Justice Pepall, the First Report was not filed with this Honourable Court at that time. A copy of Her Honour’s Endorsement was attached to the Supplementary First Report as Exhibit “A”.

On January 19, 2009, the parties attended before the Honourable Mr. Justice Morawetz to seek a further adjournment of the hearing of Korex’s motion. By endorsement of Justice Morawetz on that same date, His Honour directed that the Monitor file a further report for the next attendance on January 23, 2009 providing an up to date summary of key events. A copy of that Endorsement was attached to the Supplementary First Report as Exhibit “B”.

Purpose of this Report

On January 23, 2009, the parties attended before the Honourable Mr. Justice Cumming and scheduled the hearing of the Korex motion for February 3, 2009. The First Report and the Supplementary First Report were filed with this Honourable Court on this attendance. Mr. Justice Cumming further directed the Monitor to file a Supplementary Second Report on February 2, 2009 in his endorsement (the “**January 23 Endorsement**”). Attached as **Exhibit “A”** is a copy of January 23 Endorsement.

As indicated in Korex’s Motion Record, the sole secured creditor is Comerica Bank (“**Comerica**”). The Monitor has been communicating on a regular basis with representatives of

Comerica. Both Comerica and Korex, and their respective legal counsel, have received a copy of this Supplementary Second Report.

2.0 Disclaimer

The Monitor has relied upon the financial records and financial statements of Korex, as well as other information supplied by Messrs. S. Pensler (President) and Mr. J. Bojkovski (Chief Financial Officer). Our procedures did not constitute an audit or review engagement.

Our procedures and enquiries did not include verification work or constitute an audit in accordance with generally accepted auditing standards. In the event any of the information we relied upon was inaccurate or incomplete, the results of our analysis could be materially affected. As well, we have assumed that Korex will continue for as long as required in order to properly liquidate at least its accounts receivable and inventory for the benefit of Comerica, as a going-concern, and that current business conditions will remain status quo, including but not limited to, commodity and other input prices. As well, the Monitor did not review internal plans and support budgets such as sales, manufacturing and marketing plans or budgets. The Monitor's analysis is subject to the reasonableness of all of the assumptions used in such plans and budgets, and the future business conditions Korex will encounter.

Therefore, the Monitor is unable to and does not express an opinion on any financial statements, or elements of accounts referred to in this Supplementary Second Report, or any of the attached Appendices or Exhibits forming part of this Supplementary Second Report. We reserve the right to review all calculations included or referred to in this Supplementary Second Report and, if we consider it necessary, to revise our calculations or conclusions in light of new information as such information becomes available.

3.0 FINANCIAL UPDATE

The Monitor requested updated financial information for the purpose of this Supplementary Second Report. Korex was able to provide certain updated information, which is commented on below. The Monitor cannot make any comment on categories where no additional information was provided.

Cash

In the First and Supplementary First Reports, the Monitor reported on the bank accounts which Korex established outside of Comerica's control maintained at The Toronto-Dominion Bank (the "**Bank**"). The Monitor further reported that the Monitor believed that, as at November 30, 2008, the proper reconciled CDN dollar equivalent balance in accounts not controlled by Comerica was \$1,050,925. The Monitor advises that based on its review, it believes the balance as at January 29, 2009 is \$1,403,983.

Below is an update to the summary previously provided by the Monitor on such cash balance maintained at the Bank.

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	\$			
	BALANCE			
	<u>31-Dec-08</u>	<u>6-Jan-09</u>	<u>22-Jan-09</u>	<u>29-Jan-09</u>
CDN CHEQUING ACCOUNT ENDING IN 229	482,291	451,786	499,076	677,258
CDN INVESTMENT ACCOUNT ENDING IN 237	<u>303,240</u>	<u>303,240</u>	<u>387,184</u>	<u>379,834</u>
	<u>785,531</u>	<u>755,026</u>	<u>886,260</u>	<u>1,057,092</u>
US CHEQUING ACCOUNT ENDING IN 052	<u>650,599</u>	<u>596,693</u>	<u>308,113</u>	<u>280,384</u>
CDN TOTAL (US\$=CDN\$1.2372)	<u>1,590,452</u>	<u>1,493,255</u>	<u>1,267,457</u>	<u>1,403,983</u>

Therefore, there has not been any diminution in the funds on hand in these accounts. The overall increase in the cash balance of \$136,526 can be summarized as follows:

	\$
Receivable collections	<u>860,955</u>
<u>Disbursements</u>	
CDN supplier payments	81,546
US supplier payments (CDN \$)	83,060
Payroll	253,693
Hydro	135,443
Gas	170,687
Total expenditures	<u>724,429</u>
Net cash increase	<u>136,526</u>

Accounts receivable

The Monitor reported on the trade accounts receivable in both prior Reports. The Monitor advises that based on the trade accounts receivable listing reviewed as at January 29, 2009, the combined converted balance of US and CDN accounts receivable as at that date is CDN\$5,150,583 (CDN\$5,899,468 as at November 30, 2008 as described in the First Report, CDN\$5,753,144 as at December 31, 2008, and CDN\$5,842,683 as described in the Supplementary First Report).

The Monitor notes that during the one week period ending January 29, the accounts receivable in the ninety-one (91) day plus category was reduced by \$105,631. Of this total reduction, \$68,776 was a result of cash collections and the balance of \$36,855 was a result of credit notes being

4.0 CASH FLOW

In the available time, the Monitor has performed an initial review of Korex's cash flow statement and resultant estimated income statement and balance sheet for the four (4) weeks ending February 28, 2009. Attached hereto as **Exhibit "B"** is a copy of the estimated statements. Attached as **Exhibit "C"** is a copy of an email sent by Mr. Bojkovski explaining the reasons why the actual January 2009 loss of \$829,000 differs from the original projected loss of \$339,000.

With respect to these projections, the Monitor notes:

1. Projected net cash flow for the month of January 2009 in the amount of \$249,000 will be closer to the calculated amount of \$136,526 described above.
2. Projected operating income for February 2009 in the amount of \$96,000 is subject to at least certain implicit assumptions that there will be no further negative inventory

revaluations, negative material usage variances, inventory write-offs and no outsourcing costs.

The Monitor has considered these implicit assumptions in connection with the historic information available for the Monitor to review and in connection with Korex's planned self liquidation. The Monitor believes that these assumptions may prove to be optimistic. To the extent the assumptions are incorrect and that Korex experiences negative variances and further inventory revaluations or write offs, the monthly projected operating income will actually be a net loss.

5.0 OTHER MATTERS

Comerica's borrowing base

Korex advises that as Comerica has frozen Korex's borrowings, and as Korex has not paid any amounts to Comerica, the amount of Korex indebtedness to Comerica has not changed, except for accrued interest and costs. The Monitor requested an updated borrowing base calculation, which Korex provided.

The Monitor's review of the updated borrowing base report indicates that:

1. There is currently a deficiency in Comerica's collateral position. Korex's collateral is deficient by \$867,057 to support existing borrowings under the current margining formulae.
2. Korex's eligible accounts receivables have decreased by \$722,865.

3. Korex's inventory lending summary indicates that the eligible inventory value has also decreased by \$481,730.

The Monitor has made regular requests of both Korex and Comerica, to keep the Monitor apprised of any matters of importance that the Monitor should be reporting on to this Honourable Court in this Supplementary Second Report. Both Korex and Comerica have kept the Monitor apprised of such matters, which since the date of the Supplementary First Report have revolved around negotiations upon what basis Korex could expect Comerica's support on its application for protection under the *Companies' Creditors Arrangement Act* R.S.C. 1985 c.C - 36, as amended ("CCAA").

In the Supplementary First Report the Monitor reported on the material adverse change to Korex's business, leading it to the conclusion that any CCAA restructuring could only be a liquidating CCAA, to permit Korex to realize primarily on the assets subject to the existing Comerica security (which the Monitor understands to be cash, accounts receivable and inventory) to firstly retire the Comerica indebtedness and then secondly, reach a compromise with its unsecured creditors through a Plan of Arrangement. Korex has advised the Monitor that its aim is to restructure its business operations, so that it can continue as a going concern after the Comerica indebtedness is repaid in full and the unsecured debt has been compromised. The Monitor also previously reported to this Honourable Court that it supported Korex's aim to conduct such restructuring under a liquidating CCAA Plan of Arrangement. The Monitor advises this Honourable Court that it continues to support Korex's decision (as further described below).

Based on the above, it is obvious that Korex cannot continue as a going-concern in its current form. The above information may lead the reader to the conclusion that Korex should be liquidated for the benefit of its secured and unsecured creditors, under Comerica led enforcement

proceedings, rather than through a liquidating CCAA. The Monitor has carefully considered this.

In the Supplementary First Report, the Monitor advised that:

“The Monitor has considered Korex’s position that its restructuring under CCAA, should such protection be granted by this Honourable Court, must now take the form of a debtor in possession self-liquidation of assets in order to retire the Comerica indebtedness, while attempting to restructure its business and affairs for the benefit of its other stakeholders. The Monitor believes that Korex liquidating its inventory and accounts receivable, while continuing to produce product on a more limited basis, in order to support its customer base for as long as necessary for those customers who will not be continuing as Korex customers, and to support those customers that Korex wishes to attempt to continue with as part of its restructuring, will produce the highest realizable value on the inventory and accounts receivable, as opposed to a recovery under either a non-operating receivership or bankruptcy proceeding.

The Monitor also notes that in the Affidavit of Mr. Bojkovski, previously filed in Korex’s motion record, Mr. Bojkovski provides information concerning the unionized Korex employees on strike and the circumstances under which Korex has been attempting to operate in that unionized employee environment. The Monitor also understands that Korex’s Toronto manufacturing facility provides challenges from an environmental perspective.

The Monitor believes that by pursuing a debtor in possession self-liquidation plan, Korex is also aiding Comerica Bank. The Monitor believes that without a secured creditor providing either a receiver or trustee in bankruptcy a significant indemnity, it may not be possible to find a firm willing to take on a mandate to act as either receiver or trustee in bankruptcy for the purpose of liquidating the assets of Korex. The Monitor does not believe that any secured creditor would be willing to give an indemnity to allow such receiver or trustee to operate the business.

The Monitor further believes that the combination of the unionized environment, environmental challenges and a reduced realization if Korex ceases to operate, will assure no recovery for the unsecured creditors. This conclusion is tentative and subject to change.

Therefore, the Monitor supports Korex’s view that it should seek CCAA protection in order to self-liquidate the assets subject to Comerica’s security for the benefit of Comerica, under the supervision of this Honourable Court, while attempting to restructure its financial affairs and business for the benefit of its other stakeholders. This support is subject to Comerica’s right to information on whatever basis it requires during the initial stay period, and any extensions to be granted by this Honourable Court, and Korex’s cash flow projections supporting such endeavour.”¹

¹ Page 9, Section 7.0 MONITOR’S INITIAL ASSESSMENT OF KOREX REACTION, Supplementary First Report of Ira Smith Trustee & Receiver Inc. in its capacity as Proposed Court-appointed Monitor of Korex Don Valley ULC dated January 22, 2009.

The Monitor has not changed its opinion. Although the Monitor has not been requested to provide an Estimated Realization statement under secured creditor enforcement, the Monitor continues to believe, based on its experience, that Comerica will suffer a substantial shortfall if it enforces its security. Therefore, the only chance of their being a successful restructuring of Korex, a full repayment of the Comerica indebtedness and some distribution to the unsecured creditors is through a debtor in possession liquidation, as requested by Korex. The Monitor cannot state that Korex will be successful in its attempt to fully repay Comerica, but the Monitor is certain that secured creditor enforcement will provide no realization for the unsecured creditors.

5.0 ONGOING NEGOTIATIONS BETWEEN KOREX AND COMERICA

On January 28, 2009, Comerica served its Motion Record on the parties, and on January 30, 2009 Korex served its Supplementary Application Record on the parties. The matters raised in these materials describe largely the current impasse between Korex and Comerica. The Affidavits supporting these materials may also be the subject of examinations to be held on February 2, 2009. Accordingly, it would be inappropriate for the Monitor to comment on such materials.

The Monitor has participated in various email communications with each of Korex and Comerica representatives and legal counsel, as well as telephone conference call meetings with such Korex and Comerica representatives and respective legal counsel, both independently and together. The Monitor has also been provided with, and has reviewed and commented on, the form of initial stay CCAA Order the Applicant is attempting to seek.

Although there appears to be agreement between Korex and Comerica on many matters involved in the seeking of the initial stay Order, there remain certain outstanding requirements of Comerica in order to support the application that Korex does not believe it can comply with.

Accordingly, the Monitor believes that it must bring certain matters to the attention of this Honourable Court regarding the proposed initial stay Order as sought by Comerica and the effect it may have on various of Korex's stakeholders, and the Monitor. The Monitor's current understanding of the differences between Comerica and Korex, as it relates to the proposed initial stay Order only, is summarized in an email dated January 30, 2009 from Comerica's legal counsel to Korex's and the Monitor's legal counsel, sent after a conference call that the Monitor and its legal counsel participated in with the Korex representatives and Comerica's legal counsel

(the “**post conference call email**”). A representative of Comerica was not available for that conference call. Attached as **Exhibit “D”** is a copy of the post conference call email which refers to the draft Order contained in Exhibit “F” to the Comerica affidavit.

The Monitor’s comments on the matters raised in the post conference email are:

1. **Proposed paragraph 30** – Comerica is seeking a charge over all assets and undertaking of Korex as security for **existing** (emphasis added) as well as future obligations of Korex. The Monitor’s understanding is that proposed charge would cover equipment of Korex against which Comerica currently does not have security. The Monitor believes that if such a charge was granted, it may be prejudicial to other Korex stakeholders, including governmental entities with priority over secured creditors such as Canada Revenue Agency and also unsecured creditors. The unsecured creditors have made credit decisions to advance credit to Korex based on their understanding of the limited security granted by Korex to Comerica.

2. **All moneys held in TD Bank accounts are transferred forthwith to Comerica**
Comerica is seeking to have all funds in the TD Bank accounts transferred to accounts controlled by Comerica. There are surplus funds contained in the TD Bank accounts that are not required for current operations. The Monitor has advised the parties that at the hearing, it will be requesting this Honourable Court direct a sum equal to the full amount of the Administrative Charge be directed to be paid into the to the Monitor’s trust account to stand as security for the Administrative Charge. The Monitor’s concern is that if all cash is directed to the

Comerica account, there will be no cash available to fund the Administrative Charge if Korex continues to be out of margin in its Comerica borrowing base, as described above.

3. **Proposed paragraph 37(a)** – Comerica is seeking confirmation that any forbearance agreement it may enter into with Korex will not constitute a breach of any agreement of the debtor. As at the time of the writing of this Supplementary Second Report the Monitor does not know whether the parties have agreed on the terms of a forbearance agreement or the terms of same. The Monitor cannot comment on the effect that they may have on other agreements of Korex. Neither Korex nor Comerica have put forward any evidence on this point.

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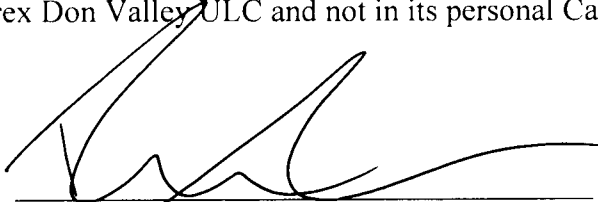
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All of which is respectfully submitted at Toronto, Ontario this 2nd day of February, 2009.

IRA SMITH TRUSTEE & RECEIVER INC.

solely in its capacity as the Proposed Court-Appointed Monitor
of Korex Don Valley ULC and not in its personal Capacity

Per:



Estate Manager

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