

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

**IN THE MATTER OF THE PROPOSAL OF
CLOTHING FOR MODERN TIMES LTD.
A COMPANY DULY INCORPORATED IN THE PROVINCE OF ONTARIO WITH A
HEAD OFFICE IN THE CITY OF TORONTO
IN THE PROVINCE OF ONTARIO**

FIRST REPORT OF THE PROPOSAL TRUSTEE

JULY 6, 2011

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INTRODUCTION

1. On June 27, 2011, Clothing for Modern Times Ltd. (“**CMT**” or the “**Company**”) filed a Notice of Intention to Make a Proposal (“**NOI**”) under Section 50.4 of the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, as amended (the “**BIA**”). A. Farber & Partners Inc. (“**Farber**”) was appointed as Trustee in the Proposal of the Company (the “**Proposal Trustee**”). A copy of the Certificate of Filing a Notice of Intention to Make a Proposal is attached hereto as **Appendix “A”**.
2. CMT is an Ontario-incorporated company that has designed, produced and marketed trendy apparel styles for ‘fashion forward’ men and women since 1989 under the retail banners: Urban Behavior, Costa Blanca and Costa Blanca X. At the date of the NOI filing, CMT operated 116 leased store locations throughout Canada under the retail banners as follows:

<u><i>Retail Banners</i></u>	<u><i>No. of Stores</i></u>
Urban Behavior	44
Costa Blanca	65
Costa Blanca X	7
	<hr/>
	116
	<hr/>

3. CMT leases its head office premises, which are located at 300 Supertest Road, Toronto, Ontario.
4. At the time of filing the NOI, the Company employed approximately 1,682 employees, of which approximately 1,316 are hourly retail employees.

5. A corporate search conducted on CMT indicates that the Company has two active directors: Arif Noor and Chris Johnson. Mr. Noor is the majority (95%) shareholder of CMT.
6. CMT has experienced declining sales and reduced profit margins over the past 3 years attributed mainly to the poor economic climate for retail operations and the entry of direct competitors, such as H&M and Forever 21, to the Urban Behavior banner in the Canadian marketplace.
7. In contemplation of the impending restructuring proceedings and its participation therein, on June 24, 2011, the Company's primary secured lender, Roynat Asset Finance, a Division of Roynat Inc. ("**Roynat**") demanded repayment of its loans and issued a Notice of Intention to Enforce Security under Section 244 of the BIA. CMT consented to the immediate enforcement of Roynat's security.
8. In addition, Roynat, CMT and other related entities to CMT, as guarantors, entered into a forbearance agreement dated June 24, 2011 (the "**Forbearance Agreement**"), whereby Roynat agreed to forbear from taking certain actions under its security and agreed to maintain its credit facilities pursuant to the Roynat Loan (as defined below), subject to the terms and conditions contained in the Forbearance Agreement. A copy of the Forbearance Agreement is attached hereto as **Appendix "B"**.
9. The Proposal Trustee has reviewed the sworn affidavit of Chris Johnson dated July 5, 2011 (the "**Johnson Affidavit**"), in support of the Company's motion.

PURPOSE OF THIS REPORT

10. The purpose of this First Report of the Proposal Trustee (“**First Report**”) is to address:

- a) the establishment of a post-filing financing arrangement with CMT’s existing lender, Roynat.;
- b) the establishment of an administrative professionals’ charge in favour of the Proposal Trustee, its legal counsel and the legal and financial advisors of CMT;
- c) the approval and the implementation of a liquidation offer solicitation process for the sale of inventory and fixtures of certain CMT stores and the disclaimer of various leases associated therewith;
- d) the establishment of a Key Employee Retention and Incentive plan; and
- e) CMT’s desire to establish a bi-weekly rent payment schedule on the 1st and 15th of each month, effective August 1, 2011.

DISCLAIMER

11. Farber has relied upon the financial records and financial statements of CMT, as well as other information supplied by management, accountants, auditors and financial advisors to CMT. Our procedures and enquiries did not constitute any audit or review engagement. Farber assumes no responsibility or liability for loss or damage occasioned by any party as a result of the circulation, publication, re-production or use of this First Report. Any use which any party,

other than Court, makes of this First Report or any reliance on or a decision made based upon it is the responsibility of such party.

SECURED CREDITORS

12. Roynat established a term loan in favour of CMT pursuant to a Debenture dated March 11, 2005 in the maximum principal amount of \$7 million. On or around the same time, CMT granted Roynat a security interest in all of its properties, assets and undertakings.
13. On or about February 19, 2010, Roynat paid out the debt owed to the previous operating lender and obtained an assignment of the debt owing by CMT including the security documents and instruments granted in favour of the previous lender.
14. Roynat consolidated its loans with CMT by entering into a loan agreement dated February 19, 2010, as amended by an amendment to the loan agreement dated June 29, 2010, as further amended by a second amendment to loan agreement dated April 6, 2011 (collectively, the **“Roynat Loan”**) between CMT, Roynat and various other related CMT entities, as guarantors.
15. The Roynat Loan was secured by a general security agreement dated February 19, 2010.
16. Crown Capital Partners Inc. (**“Crown Capital”**) established a term loan in favour of CMT in the maximum principal amount of \$10 million pursuant to a

Debenture dated March 11, 2005. On or around the same time, CMT granted Crown Capital a security interest in all of its properties, assets and undertakings.

17. On June 29, 2007, Crown Capital assigned the Crown Debenture to CIC Asset Management Inc., a company related to Crown Capital (collectively, “**Crown**”).
18. As at June 27, 2011, CMT was indebted to Roynat in the principal and interest amount of approximately \$10,801,826. Additionally, CMT is indebted to Crown in the amount of \$8,593,088.
19. The Proposal Trustee has received an independent legal opinion confirming the validity and perfection of the Roynat security in the Province of Ontario, which is more fully reported on below.
20. CMT Sourcing Group Ltd. (“**CMT Sourcing**”), a related company to CMT, manufactures and supplies a significant portion of the Company’s inventory. In addition to the security granted above, on or about May 18, 2011, CMT granted a general security interest charging the assets, property and undertaking of the Company to CMT Sourcing in respect of a demand loan provided to the Company in the amount of approximately \$4.0 million. As at June 27, 2011, CMT is indebted to CMT Sourcing in the approximate amount of \$4.0 million under the demand loan and approximately \$6.0 million for unpaid inventory purchases.

21. In addition to the financing statements registered by the secured lenders noted above, in Ontario there are also registrations by Citicorp Vendor Finance, Ltd., Xerox Canada Ltd, CIT Financial Ltd., Dell Financial Services Canada Limited and Hav-a-Kar Leasing Ltd. In addition, various landlords as well as KempenFelt Capital Inc. have effected registration of Personal and Moveable Real Rights in the Province of Quebec. KempenFelt Capital Inc. has also effected registrations against equipment located in the Province of Ontario and British Columbia. More details regarding these registrations can be found in the Johnson Affidavit.
22. At the time of the writing of this report and while certain of these charges appear to relate to specific pieces of equipment or vehicles, the Proposal Trustee is endeavouring to obtain more information concerning these additional charges and will communicate that information in due course as it is received.

OTHER LIABILITIES

23. We are advised (but have not yet verified) that CMT is substantially up to date with remittances of employee source deductions, except for most recent stub periods. In addition, the Company has advised the proposal Trustee that it owes approximately \$1.3 million to the various provincial Crowns for unremitted HST and GST pertaining to the pre-filing period.
24. At the present time, the Company has estimated that its employees are owed approximately \$1.1 million in accrued vacation pay. We are not aware of any arrears of wages owing by CMT.

25. At the time of the filing of the NOI, the unsecured creditors of the Company were owed in excess of \$16.4 million. These creditors include trade suppliers, landlords and other creditors of the Company and includes approximately \$6.0 million owed to CMT Sourcing for unpaid inventory purchases.

PRELIMINARY SECURITY OPINION

26. Farber has engaged Norton Rose OR LLP (“**NRLLP**”) as counsel to conduct a review of the Security that was granted to Roynat, and to provide an opinion with respect to its validity and perfection under the laws of Ontario. NRLLP concludes that (subject to the assumptions and qualifications contained therein), the interests created by the security instruments in the collateral described therein have been perfected under the *Personal Property Security Act* (Ontario) (“**PPSA**”) (to the extent required) and rank in priority to the interest of a trustee in bankruptcy in the property, assets and undertaking of the Company which are described in the security instruments and are located in the Province of Ontario. The independent opinion is available for review upon request.
27. A review of the security interests held by the other principal secured creditors of the Company is pending.
28. The current debtor-in-possession financing arrangements contemplate a cash sweep to Roynat from the Company’s existing accounts. Though we are advised that insofar as receivables are concerned Roynat has good and valid security in the Province of Ontario, which is the relevant jurisdiction for determining the validity and perfection of security interests in the Company’s cash and

receivables, Roynat has also agreed that it will consent to an order obliging them to reimburse the Company should they receive any amounts for which they were not entitled to priority in the course of this proceeding.

FOREBEARANCE AGREEMENT AND OVER-ADVANCES

29. The Company, with the assistance of its financial advisors, RSM Richter Corporation (“**Richter**”) has prepared a weekly cash flow forecast and supporting schedules to the week ending September 24, 2011 (the “**Cash Flow**”).
30. The Proposal Trustee has reviewed the Company’s weekly cash flow forecast, notes and assumptions and has filed same with the Official Receiver on July 4, 2011. A copy of the Cash Flow is attached hereto as **Appendix “C”**.
31. The Company is currently operating under significant liquidity constraints with limited Roynat Loan availability; and is on COD terms with many of its suppliers. The Company has advised the Trustee that it intends to restructure its affairs around its profitable locations during a restructure process that is intended to last several months.
32. The Company will require additional financing in order to continue operating its business while it proceeds with its restructuring plan.
33. The Forbearance Agreement provides for Roynat to continue to make advances to the Company during the defined forbearance period. In addition, Roynat has agreed to provide over advances from the loan availability of the Company in

accordance with the Roynat Loan, to the maximum of the over advances as set out in the weekly Cash Flows plus 10% of such amount (the “**Over-Advances**”).

34. The Over-Advances as agreed in the Forbearance Agreement is conditional, *inter alia*, upon the following:

a) The Company shall deduct 5% from any inventory purchases payments made to its key supplier, CMT Sourcing, to be funded into a segregated account and pledged as cash collateral to Roynat until the earlier of full repayment of Roynat’s debt or subsequent to October 10, 2011 where the Company has maintained a minimum availability of \$1 million for 45 continuous days, and the Company maintains this minimum availability after the cash collateral has been released; and

b) The Company obtaining an Order of this Honourable Court approving:

i. the Forbearance Agreement and the continuing advances and Over-Advances contemplated in the Forbearance Agreement;

35. Crown and CMT Sourcing have provided their consent to the terms of the Over-Advances as set out in the Forbearance Agreement. At this time, we have not obtained opinions on the validity and perfection of the security held by Crown and CMT Sourcing. However, assuming such security is valid and enforceable against the assets of the Company generally, we would not expect there to be any value remaining for unsecured creditors if the assets of the Company were

to be liquidated. Accordingly, no creditor should be materially prejudiced as a result of the proposed Court-ordered charge in favour of Roynat securing the Over-Advances.

PROPOSAL TRUSTEE COMMENTS ON FORBEARANCE AGREEMENT AND OVER-ADVANCES

36. The Company will require additional funding to continue its operations and effect a restructuring of its business over the next while, though it is not anticipated that draws on such funding will be substantial in the initial stages of the process.
37. The Forbearance Agreement was heavily negotiated between Roynat on the one hand and CMT and Crown on the other hand.
38. The terms of the Forbearance Agreement appear reasonable given the tight time constraints and the tight liquidity requirements of the Company. The interest rate is the same as that currently provided for in the Roynat Loan, and the forbearance fee (\$200,000), while substantial, is appropriate given the nature of the Forbearance Agreement and the Over-Advances being contemplated.
39. Pursuant to the Cash Flow, the Over-Advances will be used in part to fund inventory purchases required for its upcoming “back to school” season, which are expected to be accretive in value to the stakeholders, including employees, as these Over-Advances allow the Company sufficient liquidity to effect a restructuring of its business going forward.

ADMINISTRATIVE PROFESSIONAL CHARGE

40. The Company respectfully seeks an order to protect the fees and disbursements of its administrative professionals, including the fees and disbursements of the Proposal Trustee and its legal counsel, the fees and disbursements of Richter, and Chaitons LLP, the Company's legal counsel (collectively, the **"Professionals"**).
41. Richter is assisting the Company in its capacity as financial advisor, and is also the Company's auditor. The Company and Richter have advised the Proposal Trustee that the order being sought would not extend to any pre-filing amounts owed to Richter in its capacity as auditor of the Company; however, it is intended to apply to outstanding professional fees incurred by the Professionals, including Richter, prior to the NOI filing as it relates to the advance preparation required to file the NOI.
42. Accordingly, the Company seeks a charge (the **"Administrative Charge"**) on the properties, assets and undertakings of the Company, for the outstanding fees and disbursements of the Professionals, ranking in priority of all secured and unsecured creditors, subject to the DIP Charge in respect of the Over-Advances.
43. Roynat and Crown have consented to the Administrative Charge, subject to this Honourable Court's approval. If the Court approves the DIP Charge and Administrative Charge, such charges and the security of Roynat and Crown will rank as follows:
 - a) The DIP Charge in respect of the Over-Advances;

- b) The Administrative Charge for payment obligations up to a maximum of \$400,000;
- c) Advances made by Roynat under the Roynat Loan;
- d) Administrative Charge for payment obligation in excess of the amount in (b) above;
- e) Funds owing to Crown under the Crown Debenture.

LIQUIDATION PROCESS

- 44. As set out in the Johnson Affidavit, the Company, with assistance from its advisors, has concluded that a restructuring around profitable stores while downsizing unprofitable locations will maximize value for all stakeholders, and will allow the Company to make a proposal to its creditors.
- 45. CMT has determined that it will commence an assessment of the retail banner locations, identify the unprofitable stores that it will earmark for closure and commence a liquidation of the inventory and fixtures in those locations.
- 46. The Company has initially determined that self-liquidating unprofitable stores would be more beneficial to all stakeholders of the Company. However, in order to determine whether a self-liquidation will yield maximum greater net recoveries, CMT has commenced a process to solicit offers from liquidators specializing in retail liquidations.
- 47. The Company is proceeding with a dual track approach (the “**Liquidation Process**”) which provides for the Company to proceed with a self-liquidation

process while at the same time allow for the following process to solicit liquidation offers:

- a) Richter sent a letter and confidentiality agreement (“CA”) to specialist liquidator firms;
- b) A CA will also be provided to any unsolicited party that contact the Company, Richter or the Proposal Trustee;
- c) Prospective bidders will be provided with an opportunity to commence due diligence once a CA has been duly executed. In addition, prospective bidders will also be provided access to information in an online data room, be allowed to conduct store visits and meet with the Company’s management;
- d) An agency agreement will be prepared and prospective bidders will be requested to submit offers in the prepared form of agreement. The Company will provide a copy of the agency agreement to the Proposal Trustee for approval;
- e) The Company will establish an offer deadline date of July 18, 2011 to allow sufficient time to consider continuation of its self-liquidation plan or engage a liquidator for this purpose.

48. The Company has advised the Proposal Trustee that Roynat, Crown and CMT Sourcing are supportive of its Liquidation Process. In addition, the Company and/or Richter have communicated to the liquidators that the Company is

implementing the Liquidation Process and that any transaction resulting from the Liquidation Process would require Court approval.

49. Richter have advised that four CA's have been executed and those prospective bidders have been provided access to the Company's online data room.
50. Section 65.13 of the BIA requires that a debtor in the midst of a proposal process seek the court's approval to the sale of assets outside of the ordinary course of business. While there may some debate over whether the winding down of stores in the manner contemplated constitutes a sale out of the ordinary course of the Company's business for these purposes, the Company has adopted the common sense approach to treat the sales as requiring the approval of this Honourable Court pursuant to section 65.13 of the BIA.
51. The Proposal Trustee has reviewed the Liquidation Process contemplated by the Company and is supportive of the process.
52. The Company has initially identified 21 stores across Canada that it intends to close on or before August 31, 2011. Further, the Company has determined that of these 21 stores, 5 stores will close on August 4, 2011. Accordingly, the Company, with the Proposal Trustee's consent, issued notices of disclaimer pursuant to subsection 65.2(1) of the BIA for these 5 stores on July 4, 2011.

KEY EMPLOYEE RETENTION PLAN

53. The Company generally employs three salaried employees for each retail store including a store manager, assistant manager and a senior employee that has a

key to the store (collectively, the “**Key Store Employees**”). The Company has determined that a retention and incentive plan (the “**KERP**”) for Key Store Employees is an important tool in maximizing value for all stakeholders through the Liquidation Process.

54. The Company’s KERP consists of the following:
 - a) A one-time bonus payment to be made available to the Key Store Employees in the total amount of \$1,600 per store; and
 - b) An incentive plan based on the store’s overall revenue at the end of the liquidation compared to the prior year period. The incentive plan will only be triggered if the store improves its revenue by 150% compared with the prior period revenue amount and will vary depending on:
55. The Company has further noted that the maximum incentive plan payment for each store is \$6,400 and the maximum KERP payment for each store amounts to \$8,000.
56. The Company has not yet determined the number of store locations that it intends to close under the restructuring plan, however, the Proposal Trustee agrees that KERP payments are beneficial to an inventory liquidation as it provides an incentive for Key Store Employees to commence a robust liquidation sale while the discounts are not as substantial and maintain momentum as the liquidation sale progresses.

LANDLORDS

57. The Company has proposed to move to a bi-weekly rent payment schedule with its landlords. The Johnson Affidavit indicates that this measure is required to reduce the cash flow pressure on the Company during the first week of August when the first large Over Advance payment would be made. Managing cash flow is not an unreasonable objective for the Company in a restructuring of this nature.
58. The Proposal Trustee anticipates that the Company will dialogue with its affected landlords about this proposal along with the establishment of various parameters for the conduct of the liquidation sales as this process progresses. The Proposal Trustee would support and offer to facilitate this dialogue when requested and as necessary.

ACTIVITIES OF PROPOSAL TRUSTEE

59. Following its appointment as Proposal Trustee, Farber's activities included the following:
- a) entering into preliminary discussions with the Company's landlords and their legal counsel;
 - b) reviewed CMT's current financial position and nature of operations and assisted the Company in attending to prescribed mailings and filing of cash flow statements in accordance with the provisions of the BIA;

- c) answering queries from suppliers, landlords and employees regarding the operation of the NOI and the impact of this filing on the stakeholders and the business of CMT;
- d) monitoring and reviewing the continuing affairs of the Company in accordance with its obligations pursuant to the BIA;
- e) generally advising the company and its lenders on available options and matters related to the BIA process.

RECOMMENDATIONS

60. As a result of the above, the Proposal Trustee respectfully requests that this Honourable Court:

- a) Approve the post-filing financing arrangements with Roynat as more particularly set out in the Company's materials filed;
- b) Approve the establishment of the administrative professional's charge as contemplated;
- c) Approve the liquidation sales process as more particularly set out in the Johnson Affidavit and exhibits thereto; and
- d) Approve the establishment of the Key Employee Retention Plan as more particularly set out in the Johnson Affidavit and exhibits thereto.

All of which is respectfully submitted this 6th day of July 2011.

**A. FARBER & PARTNERS INC.
IN ITS CAPACITY AS TRUSTEE *IN RE*
THE PROPOSAL OF CLOTHING FOR MODERN TIMES LTD.**

A. Farber & Partners Inc.
