

CANADA

DISTRICT OF QUÉBEC
DIVISION NO.: 01-MONTREAL
COURT NO.: 500-11-034874-087
ESTATE NO.: 41-341678

SUPERIOR COURT
(Commercial Division)

IN THE MATTER OF THE PROPOSAL OF:

Direct Source Special Products Inc.

a body politic and corporate, duly incorporated
according to law and having its head office and its
principal place of business at:
2695 Dollard Street
Lasalle QC H8N 2J8

Debtor

- and -

RSM Richter Inc.

Trustee

**TRUSTEE'S REPORT ON THE STATE OF THE INSOLVENT PERSON'S
BUSINESS AND FINANCIAL AFFAIRS
(Pursuant to 50.4(7)(b)(ii) and 50.4(9) of the Bankruptcy and Insolvency Act)**

I, Yves Vincent, FCA, CIRP, of RSM Richter Inc. ("Richter"), Trustee, with respect to the Notice of Intention to Make a Proposal ("Notice of Intention") filed by Direct Source Special Products Inc. (the "Company" or "Debtor"), an insolvent person, do hereby report to the Court the following:

INTRODUCTION

1. On November 21, 2008, the Debtor filed a Notice of Intention to Make a Proposal in accordance with the *Bankruptcy and Insolvency Act* (the "Act"), a copy of which is annexed hereto as **Exhibit "A."**
2. On November 27, 2008, documents were sent by regular mail to all creditors of the Debtor, as identified by it, which included a copy of the Debtor's Notice of Intention, as annexed hereto as **Exhibit "B."**
3. On November 27, 2008, the Debtor filed with the Official Receiver a Statement of Projected Cash Flow ("Forecast") together with his report pursuant to Section 50.4(2)(c) of the Act, covering the period from November 24, 2008 to December 19, 2008, which included the major Assumptions used in the preparation of the aforementioned Forecast. Concurrently therewith, the Trustee filed its Report on the reasonableness of the Forecast in accordance with Section 50.4(2)(b) of the Act, all of which is annexed hereto as **Exhibit "C"**.

4. On December 18, 2008, the Court granted the Motion filed by the Debtor to Extend the Delay for the Filing of a Proposal until February 3, 2009. A copy of the Court Order is annexed hereto as **Exhibit "D"**.
5. On December 19, 2008, the Debtor filed with the Official Receiver a Statement of Projected Cash Flow ("Forecast") together with his report pursuant to Section 50.4(2)(c) of the Act, covering the period from December 15, 2008 to February 6, 2009, which included the major Assumptions used in the preparation of the aforementioned Forecast. Concurrently therewith, the Trustee filed its Report on the reasonableness of the Forecast in accordance with Section 50.4(2)(b) of the Act, all of which is annexed hereto as **Exhibit "E"**.
6. On January 29, 2009, the Debtor filed a Motion to Extend the Delay for the Filing of a Proposal until March 20, 2009. On February 2, 2009, the Court granted the Motion and the delay to file a Proposal was extended until March 19, 2009. A copy of the Court Order is annexed hereto as **Exhibit "F"**
7. On February 2, 2009, the Debtor filed with the Official Receiver a Statement of Projected Cash Flow ("Forecast") together with his report pursuant to Section 50.4(2)(c) of the Act, covering the period from January 26, 2009 to March 20, 2009, which included the major Assumptions used in the preparation of the aforementioned Forecast. Concurrently therewith, the Trustee filed its Report on the reasonableness of the Forecast in accordance with Section 50.4(2)(b) of the Act, all of which is annexed hereto as **Exhibit "G"**.
8. This report from the Trustee has been prepared in order to inform the Court and is presented under the following sections:
 - I. Actual Financial Results
 - II. Projected Financial Results
 - III. Restructuring Process
 - IV. Motion for an Extension of Delay
 - V. Recommendation of the Trustee
9. However, the Court should be aware that the information contained herein has not been the subject of a formal audit by the Trustee and comes from the books and records of the Debtor made available to the Trustee and from conversations with the Company's management.
10. The Statement of Projected Cash Flow attached hereto has been prepared by the management of the Company and is based on various assumptions. As these projections depend on future events, which are beyond the control of the Debtor, the results indicated in the projections could differ significantly from the actual results.

I. ACTUAL FINANCIAL RESULTS

11. Since the initial filing of November 21, 2008, the Trustee has been provided by the Company with the information on its current affairs which they considered relevant as well as given access to their books, records and other important documents.
12. The Company has advised the Trustee that it is paying its suppliers and employees, on a timely basis, for goods and services provided subsequent to the date of the filing of the Notice of Intention, according with the current business terms.

13. The Trustee has reviewed on a weekly basis the financial performance of the Debtor in comparison to the budget submitted for the period from January 26, 2009 to March 20, 2009.
14. The actual results for the period from January 26, 2009 to March 13, 2009 have been favourable and can be summarized as follows (refer to “**Exhibit H**” for details on the variances):
 - Cash receipts for the period amounted to approximately \$2,614K, a \$1,084K favourable variance as compared to budget (\$1,530K);
 - Cash disbursements for the period were \$1,293K, representing a \$182K unfavourable variance as compared to the budgeted expenses of \$1,111K;
 - The net cash flow for the period was positive \$1,321K as compared to the budgeted positive net cash flow of \$419K, resulting in a \$902K positive variance over budget.
15. The summary of the cumulative actual results as compared to budget for the period since the filing of the Notice of Intention (November 24, 2008 to March 13, 2009) is annexed hereto as **Exhibit “I”**. The salient facts can be summarized as follows:
 - Cash receipts for the period totalled approximately \$3,456K, a \$1,729K favourable variance as compared to budget (\$1,727K);
 - Cash disbursements for the period were \$1,917K, representing a \$398K positive variance as compared to the budgeted expenses of \$2,315K;
 - The net cash flow for the period was positive \$1,539K as compared to the budgeted negative net cash flow of \$587K, resulting in a \$2,126K positive variance over budget.

II. PROJECTED FINANCIAL RESULTS

16. The Debtor has prepared an additional Cash Flow Forecast for the period ending May 8, 2009. Annexed hereto as **Exhibit “J”** is the Statement of Projected Cash Flow covering the period from March 16, 2009 to May 8, 2009 which includes the major Assumptions used in the preparation of the aforementioned Forecast, the Trustee’s Report on the reasonableness of the Forecast in accordance with Section 50.4(2)(b) of the Act and the Debtor’s Report pursuant to Section 50.4(2)(c) of the Act.
17. The salient facts of the Statement of Projected Cash Flow can be summarized as follows:
 - The projected cash receipts for the period are estimated at \$1,396K;
 - The budgeted expenses are estimated at \$758K;
 - The Company projects a net positive cash flow of approximately \$638K;
 - The bank loan at the beginning of the period is approximately \$10,893K;
 - If the Company generates the budgeted level of cash receipts, as at May 8, 2009, the bank loan is projected to reduce to approximately \$10,255K.

18. The Trustee is of the opinion that the assumptions used by the Company's management in the preparation of the Statement of Projected Cash Flow appear to be realistic and reasonable given the current economic conditions.

III. RESTRUCTURING PROCESS

19. The Company's business consists primarily in selling and distributing music CDs, DVDs and videos and focuses on a market niche within the music industry selling as well as repackaging low or modest priced motion pictures and non major labels music discs. In the past year, the Company has experienced a sharp and long term decline of their sales and reported significant losses. Management attributes this decline in sales volume to various factors, in particular to both legal and illegal downloads of music and movies coupled with the major music labels decreasing the prices of their products in an attempt to adapt to this trend, thus making these products more competitive with those sold by the Company.
20. Since the filing of the Notice of Intention, the Company's principal banker, BNP Paribas, was replaced by Euro Canadian Corporation (hereinafter "EURO") who has entered into an interim financing agreement with the Debtor.
21. In addition, the Debtor is presently in negotiation with its other secured creditor, the *Caisse de Dépôt et Placement du Québec* (hereinafter "CDPQ") to finalize the terms of a settlement to be considered in conjunction with the filing of a Proposal to its creditors.
22. However, it is unlikely that these discussions will be completed before the end of the current Extension of Delay to File a Proposal which expires on March 19, 2009.
23. It is crucial that the outcome of these discussions be determined by the Debtor before the filing of a Proposal to its creditors.
24. Pursuant to the initial filing of the Notice of Intention, the Company had suspended, on a temporary basis, its operations which resulted in layoffs of approximately 15 employees. In addition, the Debtor has dealt with the key elements of its affairs as follows:
 - Updated the Company's books and records;
 - Reduced the operating expenses;
 - Established a scenario to maximise the collection of remaining accounts receivable;
 - Determined the best course of action to reduce and dispose of the inventory;
 - Assessed its business plan going forward and prepared financial projections to support same;
 - Analyzed the possible terms of a viable Proposal to settle with its unsecured creditors;
 - Analyzed the royalty exposure, including the review and validation of the current royalty liability and reporting requirements;
 - Pursued negotiation efforts to recover inventory located in the United States.

IV. MOTION FOR AN EXTENSION OF DELAY

25. The Debtor requires additional time before filing a Proposal to its creditors in order to complete the following:
- Finalize the current negotiations with CDPQ in order to settle their claim in the context of a Proposal;
 - Complete the analysis of its royalty exposure, including the validation of the pre and post-filing royalty obligation as well as finalizing the reporting requirements;
 - Complete the update of its books and records, including the finalization of the list of unsecured creditors (amounts owed relating to the pre and post-filing period) in order to validate the proofs of claim that will be filed by its creditors;
 - Complete the analysis of its accounts receivable;
 - Complete the analysis of the saleability and potential value of its inventory on hand, including the recovery of inventory located in the United States;
 - Complete the liquidation of its non-core inventory;
 - Assess the various alternatives to restructure its business and prepare financial projections supporting same.
26. Therefore, the Debtor is filing a Motion to Extend the Delay for the Filing of a Proposal until May 4, 2009.

V. RECOMMENDATION OF THE TRUSTEE

27. The Trustee agrees with the Debtor's request for the granting by the Court of an extension of delay to file a Proposal for a period of 45 days, until May 4, 2009, given the following factors:
- The request for an extension of delay is necessary to allow the Debtor additional time to complete its dealings with regards to the above-mentioned key elements and to determine its financing requirements as well as to enable the formulation of a viable Proposal to its creditors.
 - The requested delay will give the Debtor the additional time considered necessary to more fully develop its new business plan as well as the terms of a viable Proposal which will ensure its survival for the benefit of its creditors as well as the various parties with whom the Company does business.
 - The Company's major supplier, Disque Americ, does not object to the request for an extension of delay.
 - The Debtor's secured creditors, namely EURO and CDPQ, support the Company in its reorganization efforts and do not object to the requested extension of delay.
 - The Debtor has continued to act diligently, in good faith and in the interest of its creditors.
 - If the extension of delay is granted, we are not aware of any facts or matters indicating that any of the Debtor's creditors would suffer a prejudice.

- In the event that the extension of delay is not granted and a Bankruptcy ensues, any reorganization efforts of the business would cease. Given the quantum of the secured debts, the piecemeal disposition of the Company's assets would likely result in a no dividend to the unsecured creditors. Consequently, the creditors' best opportunity to maximize recovery in this matter is to allow the Company time to continue its reorganization efforts and to formulate a viable Proposal.

Respectfully submitted,

DATED AT MONTREAL, this 17th day of March 2009.

RSM Richter Inc.

Trustee

A handwritten signature in black ink, appearing to be 'Yves Vincent', written over a horizontal line.

Per: Yves Vincent, FCA, CIRP