

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:

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 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. In order to monitor the affairs and finances of the Debtor, the Trustee has been provided with access to the books, records and other important documents of the Company.
7. The Trustee has compared the actual results to those forecasted from December 15, 2008 to January 23, 2009, which is annexed as **"Exhibit F"**. The Company has been 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, except for the occupancy costs relating to its Montreal warehouse and head office. Management is currently in negotiation with its landlord to settle the post-filing rent obligation (estimated at \$125K as at January 23, 2009) and obtain a rent reduction or deferral going forward. The actual results to date have been favourable and can be summarized as follows:
 - Cash receipts for the period amounted to approximately \$700K, a \$569K favourable variance as compared to Budget (\$131K);
 - Cash disbursements for the period were \$374K, representing a \$170K positive variance as compared to the budgeted expenses of \$544K;
 - The net cash flow for the period was positive \$326K as compared to the budgeted negative net cash flow of \$413K, resulting in a \$739K positive variance over budget.
8. 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 January 23, 2009) is annexed hereto as **Exhibit "G"**. The salient facts can be summarized as follows:
 - Cash receipts for the period totalled approximately \$842K, a \$645K favourable variance as compared to Budget (\$197K);
 - Cash disbursements for the period were \$624K, representing a \$579K positive variance as compared to the budgeted expenses of \$1,203K;
 - The net cash flow for the period was positive \$218K as compared to the budgeted negative net cash flow of \$1,006K, resulting in a \$1,224K positive variance over budget.
9. The Company is engaged in the distribution of music CDs, DVDs, videos and other products and focuses on a market niche within the music industry selling and repackaging low or modest priced motion pictures and non major labels music discs. In the past years, 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.

10. Since the filing of the Notice of Intention, the Debtor has made some arrangements to have its principal banker, BNP Paribas, replaced by Euro Canadian Corporation (hereinafter "EURO") and has since negotiated an interim agreement with its new financiers.
11. In addition, the Debtor is currently in negotiation with its other secured creditor, the *Caisse de Dépôt et Placement du Québec* (hereinafter "CDPQ") to ensure its continued support.
12. Pursuant to the filing of the Notice of Intention, the Company had suspended, on a temporary basis, its operations which resulted in layoffs of approximately 15 employees. Moreover, the Debtor has been dealing with key elements of its affairs in the following manner:
 - Reduce the operating expenses;
 - Establish a scenario to maximise the collection of remaining accounts receivable;
 - Determine the best course of action to reduce and dispose of the inventory;
 - Assess its business plan going forward and prepare financial projections to support same;
 - Determine the terms of a viable proposal to settle with its unsecured creditors;
 - Analyze royalty exposure, including the review and validation of the current royalty liability and reporting requirements;
 - Pursue negotiation efforts to recover inventory located in the United States;
 - Update of the Company's books and records.
13. The Debtor is filing a Motion to Extend the Delay for the Filing of a Proposal, in order to allow it 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.
14. The Debtor's secured creditors, namely EURO and CDPQ does not object to the requested extension and support the Debtor in its reorganization efforts.
15. The Debtor has prepared an additional Cash Flow Forecast for the period ending March 20, 2009. Annexed hereto as **Exhibit "H"** is the Statement of Projected Cash Flow covering the period from January 26, 2009 to March 20, 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.
16. If the extension is granted, we are not aware of any facts indicating that any creditor would suffer a prejudice.
17. In the event that the extension 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 attempt to formulate a proposal.

18. Given the foregoing, the Trustee hereby recommends the granting of the extension by the Court to March 20, 2009.

DATED AT MONTREAL, this 29th day of January 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