

No. S117081  
Vancouver Registry

**IN THE SUPREME COURT OF BRITISH COLUMBIA**  
**IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985,**  
**c. C-36, AS AMENDED**

**AND**

**IN THE MATTER OF THE *CANADA BUSINESS CORPORATIONS ACT*,**  
**R.S.C. 1985, c. C-44**

**AND**

**IN THE MATTER OF STERLING SHOES INC. and STERLING SHOES GP INC.**

**FIFTH REPORT OF THE MONITOR**  
**ALVAREZ & MARSAL CANADA INC.**

**April 25, 2012**

**IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,**  
**R.S.C. 1985, c. C-36, AS AMENDED**  
**AND**  
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**AND**  
**IN THE MATTER OF STERLING SHOES INC. and STERLING SHOES GP INC.**

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1.0 **INTRODUCTION**

1.1 Alvarez & Marsal Canada Inc. (“**A&M**” or the “**Monitor**”) was appointed as Monitor pursuant to the order (the “**Initial Order**”) pronounced by this Honourable Court on October 21, 2011 (the “**Order Date**”) on the application of Sterling Shoes Inc. (“**Sterling**”) and Sterling Shoes GP Inc. (“**Sterling GP**”) (together, the “**Petitioners**”) under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the “**CCAA**”). The proceedings brought by the Petitioners under the CCAA will be referred to herein as the “**CCAA Proceedings**”. The Petitioners and Sterling Shoes Limited Partnership (the “**Partnership**”) will be referred to herein as the “**Petitioner Parties**” or the “**Company**”.

1.2 On December 9, 2011, on the application of the Petitioner Parties, this Honourable Court made an order approving among other things:

- a) the execution by the Partnership of an agreement between the Partnership and Century Services LP, by its general partner, Century Services Inc., which allowed the Company to undertake a liquidation of store merchandise in 53 retail locations in accordance with a store closure plan;
- b) a sale and investment solicitation process (“**SISP**”) to be undertaken with the assistance of, and in consultation with, the Company’s financial advisor, Capital West Partners (“**CapWest**”);
- c) a key employee incentive plan (“**KEIP**”) for select management and employees of the Company (the “**Key Employees**”) and a charge in favour of the Key Employees in respect of the Company’s obligations pursuant to the KEIP; and
- d) an extension of the forbearance agreement (the “**Forbearance Agreement**”) between the Company and its primary operating lender, Bank of Montreal (“**BMO**”) to March 31, 2012 (which has subsequently been extended to May 25, 2012).

1.3 On April 2, 2012, on the application of the Petitioner Parties, this Honourable Court made an order (i) approving a claims process (the “**Claims Process**”) for the determination of the nature and quantum of claims against the Petitioner Parties, and (ii) extending the stay of proceedings under the Initial Order to June 30, 2012.

1.4 The Petitioner Parties have filed a notice of application dated April 18, 2012 (the “**Notice of Application**”) to be heard on April 30, 2012 seeking orders:

- a) approving and authorizing Sterling GP and the Partnership to enter into the asset purchase agreement dated April 16, 2012 (the “**APA**”) among Sterling GP, the Partnership, Town Shoes Limited (“**Town**”) and the Monitor; and
  - b) assigning to Town certain leases of retail premises located in British Columbia, Alberta, Manitoba, Saskatchewan and Ontario (the “**Leases**”) and certain contracts required for the continued operation of the Company’s business (the “**Assignment of Contracts**”).
- 1.5 In support of the Notice of Application, the Petitioner Parties are relying on the Sixth Affidavit of Mr. Daniel Gumprich (Sterling’s Chief Financial Officer), sworn April 17, 2012 (the “**Gumprich #6 Affidavit**”), the Second Affidavit of Ms. Kimberly Grierson sworn April 17, 2012 (the “**Grierson #2 Affidavit**”) and the First Affidavit of Mr. Peter Gerhardt (Chief Financial Officer of Town) sworn April 17, 2012 (the “**Gerhardt #1 Affidavit**”).
- 1.6 The Initial Order, with the Notice of Application, the aforementioned affidavits and select motion material and other documents filed in the CCAA Proceedings, are posted on the Monitor’s website at [www.alvarezandmarsal.com/sterling](http://www.alvarezandmarsal.com/sterling).
- 2.0 **PURPOSE OF REPORT**
- 2.1 This is the Monitor’s fifth report (the “**Fifth Report**”) and it has been prepared as a special purpose report to advise this Honourable Court of the Monitor’s comments and recommendations in respect of the Notice of Application.
- 3.0 **TERMS OF REFERENCE**
- 3.1 In preparing this report, A&M has necessarily relied upon unaudited financial and other information supplied, and representations made to us, by certain senior management of the Company (“**Management**”) and CapWest. Although this information has been subject to review, A&M has not conducted an audit nor otherwise verified the accuracy or completeness of any of the information prepared by Management or otherwise provided by the Petitioner Parties. Accordingly, A&M expresses no opinion and does not provide any other form of assurance on the accuracy of any information contained in this report, or otherwise used to prepare this report.
- 3.2 Certain of the information referred to in this report consists of financial forecasts and/or projections prepared by Management. An examination or review of financial forecasts and projections and procedures, as outlined by the Canadian Institute of Chartered Accountants, has not been performed. Readers are cautioned that since financial forecasts and/or projections are

based upon assumptions about future events and conditions that are not ascertainable, actual results will vary from the projections and the variations could be material.

- 3.3 Unless otherwise stated, all monetary amounts contained in this report are expressed in Canadian dollars.

4.0 **SALE AND INVESTMENT SOLICITATION PROCESS**

**Background and Engagement of CapWest**

- 4.1 Pursuant to an agreement dated August 19, 2011 between CapWest and a special committee of Sterling's Board of Directors, CapWest was engaged to assist the Company in identifying strategic alternatives, including refinancing and recapitalization options.
- 4.2 On December 9, 2011, this Honourable Court approved the engagement of CapWest as part of the SISP to be undertaken by the Company. Details of the timelines and milestones contained in the SISP are included in the Monitor's Second Report dated December 7, 2011 and are not repeated herein.
- 4.3 Select highlights of CapWest's efforts to market the assets and/or business of the Company since December 9, 2011, include the following:
- a) contacting 72 prospective purchasers/investors (approximately one third of which could be characterized as 'strategic' buyers with the balance, being 'financial' buyers);
  - b) receiving 20 executed non-disclosure agreements from interested parties;
  - c) preparing and distributing a confidential information memorandum to qualified interested parties;
  - d) managing and maintaining a virtual data room containing in excess of 800 documents and 20,000 pages of information for review by qualified interested parties;
  - e) providing regular updates to Management, the Monitor and BMO (as required under the Forbearance Agreement) and its advisors as to the status of the SISP and related matters;
  - f) negotiating and extensive involvement in the due diligence undertaken by qualified interested parties resulting in the receipt of 7 non-binding letters of intent (collectively, the "**LOIs**") by February 10, 2012; and
  - g) negotiating and extensive involvement with Town in settling the terms of the APA resulting in the finalization and execution of the APA on April 16, 2012.
- 4.4 As noted above, the Monitor was regularly updated and consulted throughout the SISP, as was the Company's primary secured lender, BMO. The Monitor undertook an independent review of

the LOIs received by the Company as well as a detailed review of the APA (including legal review by, and advice from, the Monitor's legal counsel) to which the Monitor is a signatory.

#### **Asset Purchase Agreement**

4.5 As indicated above, Sterling GP, the Partnership, Town and the Monitor are parties to the APA, the material terms and certain other provisions of which are as follows<sup>1</sup>:

- a) for the Purchase Price of \$17.5 million plus certain Assumed Liabilities, Town will acquire the Company's inventories, intellectual property (including trademarks), furniture, fixtures and equipment and certain real property leases located at or relating to 72 retail store locations (with a limited right to augment or decrease the number of store locations) as well as select service contracts, the Company's books and records relating to such assets, pre-paid expenses relating to such assets, and certain leased assets, receivables and bank accounts (but not any cash on hand) (collectively, the "**Assets**"). The Purchase Price is subject to normal post closing adjustments relating primarily to working capital on hand at the time of Closing;
- b) excluded from the Assets are all cash on hand, insurance policies in effect, real property leases or contracts not specified as Assets in the APA and all refunds, credits and claims for taxes arising prior to the Closing Date;
- c) a deposit of \$1.0 million was to be paid to the Monitor upon execution of the APA. The Monitor confirms that it has received the deposit amount;
- d) the Company will seek (i) a Vesting Order which would approve the APA and the transactions contemplated thereby and vest all of the Assets in Town free and clear of all encumbrances, and (ii) concurrently, an Assignment Order assigning to Town the Leases and certain contracts that are included in the Assets (the "**Assigned Agreements**");
- e) Town will be offering employment to approximately 575 Transferred Employees;
- f) the Closing Date is May 22, 2012 or such other date as may be agreed in writing by the Company and Town;
- g) transition arrangements between the Company and Town to facilitate the completion of the Petitioners' restructuring efforts after the Closing and to allow Town to effect the integration of the Assets and operations it acquires. The transition services arrangements include specific short term employment arrangements (the "**Employment**

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<sup>1</sup> Capitalized terms used herein and not otherwise defined are as defined in the APA, a copy of which is attached as Exhibit "A" to the Grierson #2 Affidavit.

**Arrangements**”) with certain of the Company’s current employees, the costs of which are to be funded by Town;

- h) \$3.0 million of the Purchase Price is to be paid to, and held in escrow by, the Monitor until such time as all Purchase Price adjustments and other potential indemnity claims are settled or expire; and
- i) amounts due to BMO (including estimated interest, charges and professional fees) as at the Closing Date will be paid to the Monitor and subsequently paid out to BMO.

4.6 As indicated above, pursuant to the APA, Town is to acquire 72 of 105 store locations currently being operated by the Company. The remaining 33 stores (the “**Remaining Stores**”) will continue to be operated subsequent to the Closing Date, but it is the Monitor’s understanding that the intention of the Petitioners is to seek court approval (on a date to be determined) to initiate a process to carry out an orderly liquidation of the merchandise inventories at the Remaining Stores similar to the process approved by this Honourable Court on December 9, 2011. The leases in respect of the Remaining Stores would be terminated by no later than the conclusion of this final liquidation process. Management forecasts that the book value of inventory on hand at the Remaining Stores as at April 30, 2012 will be between \$4.0 and \$5.0 million.

#### **Summary of the Monitor’s Review**

- 4.7 The Monitor undertook an independent review of the LOIs received by the Company, and reviewed a comparative analysis prepared by CapWest. The Monitor’s review of the competing LOIs included an assessment of the following factors:
- a) the degree to which the bids conformed to the SISP guidelines, including the indicative timelines noted for all interested parties;
  - b) the total consideration being offered, and the estimated net proceeds realized for the benefit of the Company’s stakeholders after consideration of any potential Purchase Price adjustments;
  - c) the extent and nature of additional due diligence required prior to the submission of a non-binding asset purchase agreement;
  - d) the overall execution risk associated with closing a transaction with the particular interested party including consideration of required assignments, approvals and conditions;
  - e) the time required to complete the transaction recognizing the operating performance of the Company during the last fiscal quarter; and
  - f) the reputation and financial wherewithal of each of the qualified interested parties.

4.8 The Monitor's review and analysis involved regular consultation with CapWest and the decision to move forward on an exclusive basis with Town (as the indicated offer in its letter of intent was superior to the other LOIs received) was endorsed by Sterling's Board at a meeting held February 17, 2012.

4.9 The Monitor is of the view that:

- a) the Company and CapWest have complied with the terms of the SISP and consistent with the objectives of the SISP, have undertaken a fair and effective process allowing sufficient time to attempt to maximize realizations for the Company's stakeholders;
- b) CapWest adequately marketed the assets, business and undertakings of the Company and in conjunction with Management, prepared and made available sufficient detailed information to allow qualified interested parties to conduct appropriate due diligence;
- c) the Company and CapWest have adequately consulted the Monitor and BMO with respect to the LOIs received and SISP in general;
- d) the terms of the APA, including the Purchase Price, are fair and commercially reasonable in the circumstances and represent net realizations that would be more beneficial to the secured and unsecured creditors than if the sale of the assets and operations of the Company was undertaken in a bankruptcy liquidation scenario;
- e) the ancillary benefits of the transaction as contemplated under the APA include continuity of the Company's business at a large number of current store locations (72 out of a total of 105) and the continued employment of approximately 575 employees in British Columbia, Alberta, Saskatchewan, Manitoba and Ontario;
- f) the assignment of the Assigned Agreements is necessary to ensure the continued operation of the business of the Petitioners at the locations being acquired, are integral to the APA and are, therefore, appropriate in the circumstances; and
- g) the integrity of the SISP has been maintained and the Monitor is satisfied that the Company and its advisors have negotiated or otherwise dealt with interested parties fairly and in good faith.

## 5.0 APPROVAL AND VESTING ORDER

5.1 The APA is conditional upon the Company obtaining the Vesting Order and the Assignment Order prior to April 30, 2012.

5.2 The form of Vesting Order being sought by the Company is attached to the Notice of Application. It provides for the Court's approval for specific provisions in the APA relating to certain



transitional services and arrangements involving the Company's use of and access to the books and records and information systems being acquired by Town, as well as certain employees to be employed by Town post closing. These provisions were required to enable the Company to complete any further restructuring initiatives, including the sales of inventories and other assets located at the Remaining Stores, and to address any outstanding matters, including in relation to a potential plan of arrangement and/or distribution of proceeds to secured and unsecured creditors.

- 5.3 In addition to the foregoing transition arrangements, Town will have access to and use of the Company's leased head office and warehouse premises for a period of time post Closing to assist with the transition and integration of the acquired business.
- 5.4 The form of Vesting Order also incorporates a term authorizing (but not directing) the Petitioners, with prior approval of the Monitor, to pay additional bonus amounts to certain employees of the Company provided that such payments do not exceed \$50,000 in the aggregate. While additional payments to certain employees have been agreed to by Town and included as Employment Arrangements in the APA, as well as a KEIP being in place for Key Employees, it is the Monitor's view that providing for this additional reserve to fund additional retention related bonuses during the final stages of the restructuring process is reasonable, and perhaps necessary, in the circumstances.
- 5.5 Under the terms of the APA, all amounts due to BMO under its credit facility as at the Closing Date, including estimated interest, charges and professional fees (collectively, the "**BMO Amount**") are to be paid to the Monitor by the Company following the receipt of the Purchase Price from Town. The proposed Vesting Order authorizes and directs the Monitor to pay BMO from the BMO Amount, the amount necessary to satisfy in full all of the Company's obligations to BMO. While it remains uncertain what the amount due to BMO will be on or around May 22, 2012, the latest forecast amount as provided in the Updated Cash Flow Statement appended to the Monitor's Fourth Report indicates that the Company's indebtedness to BMO will be approximately \$6.6 million on or around that time.

## 6.0 **ORDER APPROVING ASSIGNMENT OF CONTRACTS**

- 6.1 The APA is also conditional upon the Company obtaining the Assignment Order at the same time as the Vesting Order. The Assignment Order provides for the assignment of the Assigned Agreements, being the Leases and 30 other contracts or service agreements. Due to the practical difficulties of obtaining the consents to assignment of each of the Assigned Agreements from the

counterparties to such agreements prior to the Closing Date, the Company is relying on the CCAA and in particular, s. 11.3(1) of the CCAA to effect the assignment of these agreements.

- 6.2 Under s. 11.3(3) of the CCAA, the factors to be considered by the Court in deciding whether to make the Assignment Order include, among other things:

*“(a) whether the monitor approved the proposed assignment;*

*(b) whether the person to whom the rights and obligations are to be assigned would be able to perform the obligations; and*

*(c) whether it would be appropriate to assign the rights and obligations to that person.”*

- 6.3 In addition to the consideration of the foregoing factors and pursuant to s. 11.3(4) of the CCAA, the Court may not make the Assignment Order unless it is satisfied that all monetary defaults under the contracts to be assigned (except any arising as a result of the CCAA Proceedings or the Petitioners’ insolvency) will be remedied on or before a date fixed by the Court.

- 6.4 The Monitor’s review of the Assigned Agreements included the following:

- a) the assessment of whether Assigned Agreements are required to operate the Company’s business in the normal course at the store locations being acquired. The Monitor is satisfied that the Assigned Agreements are so required;
- b) a review of the financial position and wherewithal of the Town as assignee of the Assigned Agreements. The Monitor has reviewed the contents of the Gerhardt #1 Affidavit in support of proposed assignments of Assigned Agreements and has independently supplemented that review with additional confidential information regarding the capitalization of Town by its principal shareholders, (which are entities controlled by Callisto Capital (GP) III Inc. and Alberta Investment Management Corporation), as well as the projected operating results of Town through April 30, 2013. Finally, the Monitor has had discussion with representatives of Town’s principal banker regarding the nature and extent of credit available under various operating, capital and term loans extended to Town.
- c) a review with Management of the Company’s current accounts payable ledgers and booked accrued liabilities to identify any monetary defaults that might exist with respect to any of the Assigned Agreements. The Monitor has not performed an exhaustive review of the Company’s records and the Claims Process is not yet complete, however, nothing has come to the Monitor’s attention that would suggest that there are any monetary defaults under the Assigned Agreements. At any point in time there are of

course, accruals of unpaid or unbilled amounts under these agreements, but the Monitor is satisfied that these amounts will be paid in the normal course. Should the Assignment Order be granted by this Honourable Court, the Monitor will endeavour to confirm that these current accounts payable and any accrued other amounts are discharged in the Company's normal payment cycle; and

- d) an assessment and analysis of the potential impact on the stakeholders and/or creditors of the Company, including an assessment of the potential additional creditor claims that would be created should there be a liquidation of the 72 store locations (as opposed to the transaction contemplated in the APA) to be acquired by Town and resultant termination or disclaimers of those particular leases. The 72 leases represent approximately \$5.0 million of annual base lease payments (before common area costs and property taxes), and should these leases be terminated or disclaimed, it would not be unreasonable to expect that those landlords impacted would have significant claims against the Company which would have a dilutive effect on other unsecured creditors. In addition to the possible avoidance of claims by the landlords, the continuity of the businesses at the 72 store locations will result in significant employment being extended to approximately 575 employees and, consequently, those employees will not have claims against the Petitioners for unpaid wages, vacation or severance.

- 6.5 Based on the foregoing, and the additional information contained in the Gerhardt #1 Affidavit and the Gumprich #6 Affidavit, the Monitor is satisfied that the assignment of the Assigned Agreements is appropriate in the circumstances and approves all such assignments. Accordingly, the Monitor recommends that this Honourable Court order the assignment of the Assigned Agreements.

## **7.0 MONITOR'S CONCLUSIONS AND RECOMMENDATIONS**

- 7.1 It is the Monitor's view that the consummation of the APA and the transactions contemplated therein are in the best interests of the Company's stakeholders as a whole, and that the Company has acted in good faith in relation to the SISP, the negotiation of the APA and its restructuring efforts generally during the pendency of the CCAA Proceedings. Accordingly, the Monitor respectfully recommends that this Honourable Court grant both the Vesting Order and the Assignment Order sought by the Company.

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All of which is respectfully submitted to this Honourable Court this 25<sup>th</sup> day of April, 2012

**Alvarez & Marsal Canada Inc.,  
in its capacity as Monitor of Sterling Shoes Inc.  
and Sterling Shoes GP Inc.**

A handwritten signature in black ink, appearing to read "T. Martin", written in a cursive style.

Per: Todd M. Martin  
Senior Vice President