

Court File No. 06-CL-6482

**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 CERVUS FINANCIAL GROUP INC., CERVUS
FINANCIAL CORP., AND CERVUS FUNDING CORP.**

**THIRD REPORT OF
KPMG INC., MONITOR**

July 5, 2006

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I. PURPOSE, QUALIFICATIONS AND RESTRICTIONS OF THIS REPORT

On June 8, 2006, Cervus Financial Group Inc. (“CFG”) and certain of its direct and indirect subsidiaries, Cervus Financial Corp. (“CFC”) and Cervus Funding Corp. (collectively the “Applicants” or the “Companies”) filed for and obtained protection from their creditors under the *Companies’ Creditors Arrangement Act* R.S.C. 1985 c. C-36, as amended (the “CCAA”). The terms of this proceeding are governed by an order of this Court dated June 8, 2006 (the “Initial Order”), as amended by a further order of this Court dated June 15, 2006. Pursuant to the Initial Order, KPMG Inc. (“KPMG”) was appointed as monitor (the “Monitor”) of the Applicants during these CCAA proceedings.

Capitalized terms not defined in this Third Report (as defined below) are as defined in the Initial Order or the Purchase and Sale Agreement between CFG, CFC and 6578268 Canada Inc. (the “Sale Agreement”).

The purpose of this Third Report of the Monitor (the “Report”) is to provide information to this Honourable Court and the Applicants’ stakeholders in connection with the following:

- (i) the status of the legal proceedings involving the Applicants;
- (ii) the status of the Companies’ operations and key stakeholder relationships in the period subsequent to their filing under the CCAA on June 8, 2006;
- (iii) the Companies’ post-filing cash flow and draws under the DIP Operating Facility;
- (iv) the anticipated timing for Closing of the Sale Agreement; and
- (v) CFG’s request to extend the stay of proceedings with respect to CFG, as well as with respect to the officers and directors of CFC and Cervus Funding Corp., until September 22, 2006.

The information contained in this report has been obtained from the records of the Companies and is based on discussions with, and representations made by, management of the Companies and other professional advisors retained in this matter.

The financial information of the Companies has not been audited, reviewed or otherwise verified by the Monitor as to its accuracy or completeness, nor has it necessarily been prepared in accordance with generally accepted accounting principles and the reader is cautioned that this report may not disclose all significant matters about the Companies. Accordingly, the Monitor does not express an opinion or any other form of assurance on the financial or other information presented herein. The Monitor may refine or alter its observations as further information is obtained or is brought to its attention after the date of this report.

The Monitor assumes no responsibility or liability for any loss or damage occasioned by any party as a result of the circulation, publication, reproduction or use of this report. Any use which any party makes of this report, or any reliance on or decisions to be made based on this report, is the sole responsibility of such party.

All references to dollars are in Canadian currency unless otherwise noted.

II. LEGAL PROCEEDINGS

On June 8, 2006, the Companies filed for and obtained protection from their creditors under the CCAA. The terms of this proceeding are governed by the Initial Order, as amended by a further order of the Court dated June 15, 2006, as described below. Also on June 8, 2006, this Honourable Court granted the Sale Approval Process Order which was described in the Supplement to First Report of the Monitor (the "Supplemental Report").

On June 15, 2006, this Honourable Court granted the Approval and Vesting Order which provided the Court's approval of, amongst other things, the following:

- (i) the Sale Agreement between CFG, CFC and 6578268 Canada Inc. (the "Purchaser"), and the transactions contemplated therein;
- (ii) effective immediately prior to the delivery of a certificate by the Monitor confirming that the Closing has been completed, in the form attached as Schedule "B" of the Approval and Vesting Order (the "Vesting Certificate"), all right, title, benefit and interest of CFG in the Intercompany Transferred Assets are to vest in CFC free and clear of and from any and all right, title, interest, security interest, estate, trusts or deemed trusts, liens, assignments, hypothecs, executions, options, adverse claims, charges, encumbrances or any other rights, rights of use, disputes and debts of any kind whatsoever and whether legal or equitable, contractual, statutory by operation of law, court order or otherwise, by or of any and all parties and all persons or entities of any kind whatsoever;
- (iii) effective immediately upon the delivery of the Vesting Certificate by the Monitor, all right, title and interest of CFG in the Purchased Assets are to vest in the Purchaser free and clear from any and all right, title, interest, security interest, estate, trusts or deemed trusts, liens, assignments, hypothecs, executions, options, adverse claims, charges, encumbrances or any other rights, rights of use, disputes and debts of any kind whatsoever and whether legal or equitable, contractual, statutory by operation of law, court order or otherwise, by or of any and all parties and all persons or entities of any kind whatsoever;
- (iv) the Monitor is to hold the proceeds of the Purchased Assets (the "Sale Proceeds") in trust in an interest bearing bank account. The Sale Proceeds are not be disbursed without further order of the Court (as discussed below, one such order was made on June 29, 2006); and
- (v) effective immediately upon the delivery of the Vesting Certificate by the Monitor, the CCAA proceedings in connection with CFC and Cervus Funding Corp. are to terminate and the terms and provisions of the Initial Order will no longer apply to CFC and Cervus Funding Corp. At that time, the Administrative Charge, the DIP Lender Charge and the D&O Charge are discharged as against CFC and Cervus Funding Corp. The Warehouse DIP Charge over all property of CFC shall continue after that time in such collateral until all borrowings under the Warehouse DIP Loan Agreement have been paid in full. The Sale Approval Process Order and Approval and Vesting Order are to remain in full force and effect notwithstanding the termination of these CCAA proceedings in connection with CFC and Cervus Funding Corp.

On June 15, 2006, this Honourable Court granted the Order Amending Initial Order (the “Amending Order”) which replaced paragraph 38 of the Initial Order with the following:

“38. THIS COURT ORDERS that in addition to all existing security held by RBC (which shall be deemed to secure, among other things, all obligations under the Warehouse DIP Facility), all of the Property of the Applicants, but not the Merrill Assets, including, without limitation, all Property defined as the “Inventory Mortgages” in the Warehouse DIP Loan Agreement and any other mortgages financed by Borrowings thereunder (as defined therein) and all proceeds of any of the foregoing (such Inventory Mortgages and any other mortgages so financed by Borrowings and proceeds thereof being collectively referred to in this Order as the “RBC Collateral”) is hereby charged by a lien, mortgage, hypothec and security interest (such lien, mortgage hypothec and security interest, together with any lien, mortgage, hypothec or security interest created by the Warehouse DIP Documents, (the “Warehouse DIP Charge”) in favour of RBC as security for all obligations of the Applicants to RBC with respect to all amounts owing under or in connection with the Warehouse DIP Documents.”

On June 29, 2006, this Honourable Court granted the Order Approving Settlement (the “Settlement Order”) which provided the Court’s approval of, amongst other things, the following:

- (i) the Settlement Agreement between the Companies, CyberNorth Ventures Inc. (“CyberNorth”) and Gary Bartholomew (“Mr. Bartholomew”) dated as of June 28, 2006 (the “Settlement Agreement”);
- (ii) effective immediately upon the delivery of the Vesting Certificate by the Monitor, the Applicants are authorized, empowered and directed to implement and complete the settlement in accordance with the Settlement Agreement, including to execute, consent to and deliver any releases, documents or instruments and agreements contemplated therein, or as may be appropriate, or necessary, to complete the Settlement; and
- (iii) upon the delivery of the Vesting Certificate by the Monitor, the Monitor shall pay the Settlement Amount as defined in and payable under the Settlement Agreement to CyberNorth out of the Sale Proceeds received by the Monitor as directed by the Approval and Vesting Order.

The Monitor has made all orders issued by this Honourable Court in this matter, and other information, available on its website at www.kpmg.ca/cervus (the “Website”).

III. MONITOR'S ACTIVITIES AND KEY STAKEHOLDER UPDATE

A. Overview

Management has informed the Monitor that, to date, it is not aware of any material changes to the Companies' operations which have occurred subsequent to the date of the Supplemental Report. Information provided to the Monitor from the Companies in the post-filing period indicates that mortgage origination and sales volumes are continuing at levels consistent with the pre-filing period. Additionally, management has informed the Monitor that the Companies' relationships with various stakeholders, including its primary mortgage brokers, suppliers, employees, shareholders and lenders have continued in a satisfactory manner and that the Companies' operations continue to experience general support from their stakeholders.

Management has also informed the Monitor that the situation regarding Canada Mortgage and Housing Corporation ("CMHC"), as described in the Supplemental Report, has been resolved to management's satisfaction. CMHC has reinstated the insurance arrangements that were in place prior to the Companies' CCAA filing and has reaffirmed CFC's approved lender status.

B. Financial Controls

As described in the Supplemental Report, the Companies maintain accounting and treasury functions at their head office in Toronto, Ontario which are responsible for the orderly administration and record-keeping of the Applicants. In addition to the Companies' regular controls over cash receipts and disbursements, at the Monitor's request the Companies have implemented certain additional controls as described below.

The general controls include review by the Monitor of:

- daily bank reconciliations for all bank accounts, including operating accounts, the settlement and funding account, and the mortgage servicing trust account;
- actual versus forecast cash receipts and disbursements on a weekly basis and investigation of any significant variances;
- the Companies' mortgage inventory position and Warehouse Facility availability on a daily basis; and
- ongoing purchase commitments.

The controls over cash receipts include review by the Monitor of:

- all receipts on a daily basis and reconciliation of such receipts to daily bank reconciliations; and
- actual versus forecast total receipts on a weekly basis and investigation of any significant variances.

The controls over disbursements include review by the Monitor of:

- all proposed disbursements greater than a minimum threshold amount prior to such disbursements being made; and

- actual versus forecast disbursements on a weekly basis and investigation of any significant variances.

C. Relationships with Key Stakeholders

In general, the Companies appear to be enjoying continued support from their key stakeholders as required to continue operations. Certain details regarding these relationships post-filing are provided below.

Mortgage Brokers

Since the date of the Initial Order, management advises that it has actively engaged in discussions with all of its major mortgage brokers in order to communicate that the Companies would be continuing on a “business as usual” basis and meeting their funding and servicing obligations in the ordinary course. Management has indicated that the mortgage brokers continue to support the Companies’ efforts as evidenced by the fact that the volume of mortgage originations post-filing has been consistent with originations during the pre-filing period.

Suppliers

Those suppliers which were identified as critical to the continued operations of the Companies were contacted by management immediately after the issuance of the Initial Order to arrange continued post-filing supply. The Monitor has received a number of inquiries from suppliers seeking information related to these proceedings. Generally, the supply of goods and services to the Companies has continued without interruption.

Employees

We are advised by management that the Companies continue to enjoy the general support of their workforce. Although a small number of employees have resigned since the filing date, such resignations have not materially impacted operations, and management is actively seeking replacements for those individuals through normal channels.

Shareholders

The Monitor has received a number of inquiries from shareholders seeking information related to these proceedings. Generally, the shareholders have been satisfied with the information made available through press releases issued by CFG and the Website.

Lenders

In accordance with the terms of the DIP Operating Facility and DIP Warehouse Facility, management has provided status updates and reporting information to the DIP lenders as required. Management has advised the Monitor that there has been no communication from these lenders that would indicate that the Companies are not in compliance with the terms of both facilities.

Customers

As previously indicated in this Report, management has advised the Monitor that mortgage origination and sales volumes are continuing at levels consistent with the pre-filing period, and that Merrill Lynch has continued to purchase the Companies' mortgages. However, management has advised that Merrill Lynch has revised its pricing and the Companies have incurred some margin compression as evidenced by an unfavourable variance in gains on the sale of mortgages as shown in the table in section IV. of this Report.

IV. CASH FLOW AND DRAWS UNDER THE DIP OPERATING FACILITY

The Companies' cash receipts and disbursements from June 9 to 25, 2006 are summarized below and are compared with the first three weeks of the Cash Flow Projection (as defined in the notes below).

Cervus Financial Group Inc., et al
Summary of actual versus projected cash flow
For the period June 9 to 25, 2006

| (unaudited) | Actual Results [1] | CCAA Projection [2] | Variance Favourable/ (Unfavourable) |
|---|-----------------------|------------------------|---|
| <i>Inflows</i> | | | |
| Servicing Revenue | 146,913 | 141,276 | 5,637 |
| Gain on Sale of Mortgages | 167,120 | 244,798 | (77,679) |
| Other [3] | 384,259 | - | 384,259 |
| Total Inflows | 698,292 | 386,074 | 312,217 |
| <i>Outflows</i> | | | |
| Payroll Expenses | (164,612) | (161,113) | (3,499) |
| Professional Fees | (156,946) | (400,000) | 243,054 |
| Consultants | (24,225) | (47,468) | 23,243 |
| Miscellaneous Office | (80,032) | (54,000) | (26,032) |
| Brokers | (100,479) | (242,468) | 141,988 |
| Other [4] | (2,429,003) | (2,245,033) | (183,970) |
| Total Outflows | (2,955,298) | (3,150,082) | 194,784 |
| <i>Net Cash Inflow/(Outflow)</i> | (2,257,006) | (2,764,007) | 507,001 |

Notes:

- [1] Actual results include actual cash flow experience for the period June 9 to 25, 2006. Amounts are presented on the basis that cheques/wire transfers are issued and cleared on the same day.
- [2] Projected amounts are those set out in the Cash Flow Projection that was appended to the Affidavit of Peter Williams, CEO of CFG, sworn June 8, 2006, and filed in support of the CCAA application.
- [3] Other inflows include unanticipated receipts of mortgage insurance claims and accrued interest.
- [4] Other outflows include mortgage insurance premiums outstanding as at June 8, 2006 of approximately \$2.1 million

Overall, the Companies have experienced net cash flow variances which are, in aggregate, approximately \$507,000 favourable relative to those set out in the Cash Flow Projection. Management attributes the variances to unanticipated receipts of mortgage insurance claims and significant timing differences in professional fees and broker fees, offset by less than expected gains on mortgages on sales to Merrill Lynch and pre-filing mortgage insurance premium payments.

The first draw on the DIP Operating Facility occurred on June 15, 2006 in the amount of \$782,487 which was required in order to remit payments to the Companies' mortgage insurers for premiums of approximately \$2.10 million for the period May 1, 2006 to June 8, 2006, as provided for in the Initial Order and to satisfy certain conditions of the Sale Agreement. The Cash Flow Projection showed payments of approximately \$1.88 million being made during the week beginning June 12, 2006 for the premium liabilities for the period May 1, 2006 to June 7, 2006, exclusive of PST and fees.

Draws of \$250,000 and \$200,000 were made on the DIP Operating Facility on June 22, 2006 and June 28, 2006, respectively, in order to fund day-to-day operations. As at July 5, 2006, total draws on the DIP Operating Facility were approximately \$1.2 million, as compared to projected draws in the Cash Flow Projection of \$1.9 million. Provided the Sale Agreement closes as anticipated on July 6, 2006, management does not expect to make any further draws on the DIP Operating Facility prior to Closing of the Sale Agreement.

V. ANTICIPATED CLOSING OF THE SALE TRANSACTION

As previously indicated in this Report, the Approval and Vesting Order was approved by this Honourable Court on June 15, 2006. Since that time, the Monitor has observed that the Companies, the Purchaser and their respective legal counsel have been working diligently to satisfy the Closing Conditions to the Sale Agreement.

The 21-day period under s.14(2) of the CCAA to appeal the Approval and Vesting Order expires on July 6, 2006. The Monitor has been informed by management and legal counsel to both the Companies and the Purchaser that all parties anticipate that Closing of the Sale Agreement will occur on July 6, 2006.

VI. CFG'S REQUEST TO EXTEND THE STAY PERIOD

The stay period provided by the Initial Order expires July 8, 2006. In order to allow sufficient time to conduct a claims identification procedure and to formulate a Plan of Arrangement, CFG is requesting an extension of the stay of proceedings with respect to CFG, as well as with respect to the officers and directors of CFC and Cervus Funding Corp., to September 22, 2006.

As described in this Report, the Companies' operations have generally been stable post-filing and management and legal counsel to both the Companies and the Purchaser anticipate that Closing of the Sale Agreement will occur on July 6, 2006.

The Monitor does not foresee any reason why an extension of the stay period would not benefit all affected stakeholders and recommends such an extension, subject to the approval of this Honourable Court.

VII. SUMMARY AND CONCLUSION

The Companies' operations have generally been stable post-filing and management and legal counsel to both the Companies and the Purchaser anticipate that Closing of the Sale Agreement will occur on July 6, 2006.

In order to allow sufficient time to conduct a claims identification procedure and to formulate a Plan of Arrangement, CFG is requesting an extension of the stay of proceedings with respect to CFG, as well as with respect to the officers and directors of CFC and Cervus Funding Corp., for 76 days, to September 22, 2006.

The Monitor does not foresee any reason why an extension of the stay period would not benefit all affected stakeholders and recommends such an extension, subject to the approval of this Honourable Court.

Accordingly, the Monitor respectfully recommends that the Court approve an extension of the Stay Date (as defined in the Initial Order) to September 22, 2006.

RESPECTFULLY SUBMITTED,

Dated the 5th day of July, 2006.

KPMG INC.

**In its capacity as Court-Appointed Monitor of
CERVUS FINANCIAL GROUP INC.,
CERVUS FINANCIAL CORP., AND
CERVUS FUNDING CORP.**



*Per: Alan J. Hutchens
Senior Vice-President
416-777-8916*

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

Court File No: 06-CL-6482

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF CERVUS FINANCIAL GROUP INC., CERVUS FINANCIAL CORP., AND CERVUS FUNDING CORP.

SUPERIOR COURT OF JUSTICE

Commercial List

Proceeding commenced at Toronto

THIRD REPORT OF KPMG INC., MONITOR

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