


Sworn:  D. Gray #9
24, 2009

No. S-088488
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 HYDROXYL SYSTEMS INC.

PETITIONER

AFFIDAVIT

I, DAVID GRAY, CA-CIRP, of 1000 - 570 Granville Street, Vancouver, British Columbia,
MAKE OATH AND SAY AS FOLLOWS:

1. I am the President of The Summit Group Business Consultants Ltd. ("Summit") and, as such, I have personal knowledge of the matters hereinafter deposed to, except where stated to be on information, in which case, because of my belief in the veracity of the informant I identify, I believe both the information and the resulting statement I make to be true.
2. Capitalized terms used in this Affidavit have the same meaning as ascribed to them in my earlier Affidavits in this proceeding.

3. I make this Affidavit in support of an application by the Petitioner for an Order in the form attached to the Notice of Motion in support of which this Affidavit is sworn.
4. The Order, in essence, would allow the Petitioner to sell certain of its assets to a company called Headworks, Inc. (“Headworks”). It would also allow the Petitioner to terminate two licence agreements. The rationale for these terminations, which are a condition precedent to the implementation of the sale, is explained below. First, however, I wish to provide the Court with some background to the application.

Background to the Plan

5. As the Court is aware from my numerous previous Affidavits in this proceeding, the Petitioner has been searching for some time for an investor, partner or purchaser who would be prepared to carry on the Petitioner’s existing contracts, retain the Petitioner’s employees and continue to exploit the Petitioner’s Intellectual Property.
6. Any such deal, of course, would require the cooperation or consent of the Petitioner’s major secured creditors, who include:

Creditor	Approximate Amount Owed	Security
RBC	\$300,000	First place charge on all assets except Intellectual Property
BDC	\$2,000,000	First place charge on Intellectual Property, second place charge on all other assets
Seaspan	\$167,000	Third place charge on all assets
Charles Croft	\$100,000	Fourth place charge on all assets
FPFC	\$4,500,000	Fifth place charge on all assets

7. As Chief Restructuring Officer for the Petitioner, I and my partner Harvey Lee initially focused our efforts on attempting to secure an equity investor. Over time, however, it became apparent to us that the potential investors with whom we have had discussions and negotiations since the early part of this year have mainly been interested in an asset acquisition.
8. Furthermore, the Petitioner’s inability to generate significant new work made it

challenging to attract investors. As well, as time went on, the Petitioner began to run out of cash, and the Petitioner's main backer, Mr. Croft, expressed to me his unwillingness to support the Petitioner indefinitely, or continue to incur further risk.

9. Another major concern expressed to me and Mr. Lee has been the uncertainty surrounding Hydroxyl's potential future warranty obligations. None of the investors that we have spoken to were prepared to take on these potential contingent liabilities. Rather, all of the seriously interested parties that we negotiated with, including Headworks, insisted on an asset purchase deal.

The Headworks Agreement

10. Ultimately, our efforts led to the receipt of an offer from Headworks, a leading supplier of water and wastewater screening systems, based in Houston, Texas. That offer, in turn, led to the Petitioner presenting a counter-offer to Headworks, which the parties have now signed, a copy of which is now shown to me, marked and attached as Exhibit "A" to this my Affidavit. I will call this the "Headworks Agreement".
11. I will be frank with the Court. The Headworks Agreement is a significantly less attractive agreement for the Petitioner than what it had hoped to achieve. However, given the amount of secured indebtedness of the Petitioner, and its inability to attract new contracts, the Petitioner found itself with little alternative but to accept this offer. (Indeed, even certain aspects of the Headworks offer are less attractive to the Petitioner and, indirectly, Mr. Croft, than an offer received some three weeks ago; that offer, however was withdrawn. In the interim, the Petitioner attempted to negotiate comparable arrangements with two other interested parties, who ultimately backed out of negotiations).
12. Pursuant to the material terms of the Headworks' Agreement, Headworks, or its nominee, will purchase the following property of Hydroxyl:
 - (a) All items currently listed on the Inventory Schedule of Hydroxyl (attached as a Schedule to the Agreement); and
 - (b) Any statutory or common law rights of Hydroxyl in any jurisdiction, including the registration or application for registration of such rights, provided under:
 - (i) patent law;

- (ii) copyright law;
- (iii) trade-mark law, including trade names;
- (iv) design patent or industrial design law; and
- (v) any other statutory provision or common law principle which may provide a right in either:
 - (1) ideas, formulae, algorithms, concepts, inventions or know-how generally, including confidential information or trade secret law; or
 - (2) the expression of such ideas, formulae, algorithms, concepts, inventions or know-how.

Without restricting the generality of the foregoing, the Property specifically includes any and all right, title and interest in registered patents Nos. 2,337,975 and 6,811,705, pending patents No. 2527525 and No. 2007/0114182, trademarks CLEANSEA, ACTIVECELL, ActiveCell, IFAS, ACTIVEFLOAT, HYDROXYL, Hydroxyl and Hydroxyl Water Results, the extrusion dies for manufacturing the ActiveCell™ biofilm carriers and/or the exclusive right to use thereof, the MediaPro Process Design Tool, the Aeration Grid Sizing Program, Standardized Component Drawings and Visio Stencil and Tools.

(the “Property”)

13. In addition to selling Headworks the Property, Hydroxyl has agreed to assign to Headworks all of its existing purchase orders, including purchase order (No. 77025) issued by Infilco Degremont, Inc. (“IDI”) to Hydroxyl on July 17, 2009 (the “IDI Purchase Order”), for the reasons I explain below.
14. In consideration for acquiring the Property and for the assignment of the IDI Purchase Order, Headworks Headworks has agreed to pay the Royal Bank (“RBC”) the sum of \$33,400. The Court will recall that RBC has a first-ranking charge on all of the Petitioner’s assets, except for its Intellectual Property. I understand that as of the date of this Affidavit, RBC is owed in excess of \$300,000 by the Petitioner.

15. Headworks also has agreed to pay Alterninvest II Fund L.P. ("BDC") the sum of \$90,000. In return, BDC will consent to the Vesting Order. (The Court will recall that BDC has a first ranking charge over the Petitioner's Intellectual Property, and a second ranking charge over all other assets, and accordingly BDC's consent to any sale of these assets is required.) I understand that as of today's date BDC is owed in excess of \$2,000,000 by the Petitioner.
16. Headworks also has agreed to employ certain of Hydroxyl's key employees, including Mr. Major, and I understand that those employees have now signed contracts with Headworks, which has agreed to be responsible for certain accrued liabilities of those employees, including accrued vacation pay.
17. Headworks also has agreed to use its reasonable best efforts to negotiate satisfactory contracts with each of the current customers of the Petitioner, to complete each such customer's projects in a professional manner, thereby reducing disruption and potential harm to both those customers and the Petitioner.
18. Headworks also has agreed to use its reasonable best efforts to negotiate a new lease with the Petitioner's existing landlord in Victoria, and to negotiate with Dell Computer for the purchase of certain computer hardware used by the Petitioner.
19. The fact of the matter is, in respect to the Petitioner's ongoing contracts, that the Petitioner has run out of funds to carry on with those contracts. Charles Croft, who has personally guaranteed the Petitioner's line of credit with the Royal Bank and who has, therefore, essentially been personally funding the Petitioner's post-filing operations, has advised me that he is simply not prepared to further extend himself in this regard.
20. Falcon Pacific, which is controlled by Mr. Croft and which is the Petitioner's largest creditor, holds security over all of the Petitioner's assets, and has contributed \$100,000 to Hydroxyl post-filing. Neither Mr. Croft nor Falcon Pacific will receive any direct benefit from the Headworks transaction. Because Headworks has agreed to employ the majority of the Petitioner's employees, Mr. Croft may be relieved of certain statutory obligations to those employees that might otherwise have accrued.
21. Falcon Pacific and Mr. Croft hope, as well, that Headworks will be able to negotiate satisfactory arrangements with certain of the Petitioner's existing key customers thereby

preserving certain receivables that are now due to the Petitioner. However, even if all of the Petitioner's receivables are collected, there is likely to still be a shortfall on the RBC line of credit, which Mr. Croft has personally guaranteed.

Tax Losses

22. As I have reported in previous affidavits, the Petitioner has tax losses which may have value to a qualified purchaser.
23. Mr. Lee and I have had extensive discussions with numerous interested parties who may have a use for the Petitioner's tax losses. At this time, however, no definitive agreement has been reached that would enable the Petitioner to sell or otherwise realize value from those tax losses. It may be that a transaction could be concluded to realize value from the Petitioner's tax losses. However, that would require the Petitioner, at a minimum, to incur significant legal and accounting expenses, which Mr. Croft and Falcon Pacific are not, at this point at least, prepared to fund.

Termination of Licence Agreements

24. The Petitioner is a party to two licence agreements. The first is between the Petitioner and a company called Infilco Degremont, Inc. ("IDI"), and is called "Licence and Distribution Agreement" (the "IDI Licence"). A copy of the IDI Licence, which is dated as of August 3, 2005, is now shown to me, marked and attached to this my Affidavit as Exhibit "B".
25. The second licence agreement is between the Petitioner and Aquapoint Inc. ("Aquapoint"), and is called "Licence and Product Supply Agreement" (the "Aquapoint Licence"). A copy of the Aquapoint Licence, which is dated as of August 26, 2005, is now shown to me, marked and attached to this my Affidavit as Exhibit "C".
26. Pursuant to the material terms of the IDI Licence, the Petitioner has licensed to IDI its proprietary plastic floating media known as "Hydroxyl-Pac", which the Petitioner has developed and uses in a pre-engineered process for the treatment of wastewater, and which are referred to in the IDI Licence as the "HSI Products". The IDI Licence gives IDI the right to sell, install, build and service HIS Products within the geographical boundaries of the United States for use in municipal wastewater systems.

27. The IDI Licence is for a term of 10 years, expiring in August 2015.
28. I am informed by Mr. Croft that IDI has made it clear to him in discussions that they will consent to termination of the IDI licence, so long as both parties (Petitioner and IDI) will from that point forward be released from their non-competition obligations under the IDI licence. Now shown to me, marked and attached as Exhibit "C" to this my Affidavit is a copy of a letter from the Petitioner's counsel to in-house counsel for IDI, confirming that this is acceptable to the Petitioner.
29. Pursuant to the terms of the Aquapoint Licence, the Petitioner has granted Aquapoint a licence to use its Hydroxyl-Pac plastic floating media in connection with a pre-engineered process for the treatment of wastewater known as the "F³R Process" in certain regions of the United States.
30. The term of the Aquapoint Licence is also for 10 years, and it will expire therefore in August 2015.
31. As far as I am aware, the Petitioner has derived no benefit from the Aquapoint Licence. Aquapoint does not appear to have sold or distributed any of the Petitioner's products, nor generated any revenue for the Petitioner in the first five years of the agreement.
32. The termination of both the IDI and Aquapoint licences is a condition precedent to the Headworks Agreement.

Assignment of Purchase Orders

33. Under the terms of the Headworks Agreement, Headworks is taking on the obligation to pay current bills for goods and services for all of the Petitioner's current in-house projects in order to keep them moving forward. Accordingly, Headworks has asked that all of those purchase orders be transferred to Headworks. The list of the transferred purchase orders is attached as a Schedule to the Headworks Agreement.
34. One of the purchase orders being transferred is the IDI Purchase Order, a copy of which is now shown to me, attached and marked as "Exhibit "D" to this my Affidavit.
35. The Petitioner agreed to the terms of the IDI Purchase Order on July 17, 2009. Under the terms of the Purchase Order, the Petitioner has agreed to supply to IDI, through a third-

party manufacturer, Filtrona, “media” for use in a wastewater treatment system in the United States.


36. Without further funding, the Petitioner is concerned about its ability to complete the IDI Purchase Order. Accordingly, it has agreed with Headworks to assign the benefit of the IDI Purchase Order to Headworks, which has the financial wherewithal to ensure that the Purchase Order will be completed in accordance with its terms. It is my understanding that it is acceptable to IDI that the benefit of the Purchase Order be assigned to Headworks. RBC’s consent to the assignment is being sought.

Summary

37. Over the course of the past six months, the Summit Group has been diligently identifying, contacting and negotiating with numerous interested parties relating to the sale of the Petitioner’s assets. A number of letters of interest were received, reviewed and either rejected or, upon preliminary due diligence, withdrawn.
38. Unfortunately, the Petitioner’s deteriorating financial situation has made it difficult to attract interested investors. In the circumstances, in my judgment the Headworks offer is the best, and at this time only, viable offer on the table. It presents at least the following benefits:
- (a) The majority of the Petitioner’s employees will continue their employment within their chosen field;
 - (b) Business operations of the Petitioner would continue in Victoria, where the employees reside;
 - (c) The offer includes an acceptable payment to the BDC and a partial payment to RBC; and
 - (d) The business relating to the customers and suppliers of the Petitioner will continue with the same employees, thus minimizing disruption.
39. It is a condition precedent to the conclusion of the Headworks Agreement that the Vesting Order in support of which this Affidavit is submitted be obtained.
40. It is my opinion that the agreement with Headworks represents the best available

arrangement for the Petitioner, given its extremely constrained financial circumstances, and inability to continue to fund its operations.

SWORN BEFORE ME at the City of)
Vancouver, British Columbia,)
on July 24, 2009)
)
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_____)
A commissioner for taking)
affidavits in British Columbia)



DAVID GRAY