

**ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)**

BETWEEN:

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

**AND IN THE MATTER OF JAMES ROBERT TUCKER,
RICHARD HEIS AND ALLAN WATSON GRAHAM OF
KPMG LLP, AS JOINT ADMINISTRATORS**

Applicants

**AND IN THE MATTER OF AERO INVENTORY (UK)
LIMITED and AERO INVENTORY PLC**

Respondents

**APPLICATION UNDER SECTION 46 AND FOLLOWING OF
THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C.
1985, C. C-36, AS AMENDED**

**FACTUM OF AIR CANADA
(returnable January 6, 2011)**

**STIKEMAN ELLIOTT LLP
Barristers & Solicitors
5300 Commerce Court West
199 Bay Street
Toronto, Canada M5L 1B9**

**Sean F. Dunphy LSUC#: 24941J
Tel: (416) 869-5662
Alexander D. Rose LSUC#: 49415P
Tel: (416) 869-5261
Kathryn Esaw LSUC#58264F
Tel: (416) 869-6820
Fax: (416) 947-0866**

Lawyers for Air Canada

**ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)**

BETWEEN:

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

AND IN THE MATTER OF JAMES ROBERT TUCKER,
RICHARD HEIS AND ALLAN WATSON GRAHAM OF
KPMG LLP, AS JOINT ADMINISTRATORS

Applicants

AND IN THE MATTER OF AERO INVENTORY (UK)
LIMITED and AERO INVENTORY PLC

Respondents

APPLICATION UNDER SECTION 46 AND FOLLOWING OF
THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C.
1985, C. C-36, AS AMENDED

**FACTUM OF AIR CANADA
(returnable January 6, 2011)**

PART I - OVERVIEW

1. KPMG Inc., as trustee in bankruptcy (the "Trustee") for Aero Inventory (UK) Limited and Aero Inventory plc (together, "Aero") has brought a motion to have certain transactions entered into between Aero and Air Canada declared void as against it pursuant to section 95 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985 c. B-3, as amended (the "BIA") in the present proceedings under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the "CCAA"). The Trustee is not

bringing the motion to ensure that all unsecured creditors are treated equally nor to provide any other benefit to unsecured creditors. The Trustee's stated purpose is to enable certain of Aero's secured creditors (namely a syndicate of lenders led by Lloyds TSB Commercial Finance Limited, "Lloyds") who did not realize on their security outside of the insolvency proceedings to take the total benefit of any transaction that would be voided as against the Trustee.

2. While Air Canada does not believe that any of the transactions at issue constitutes a preference, it does not dispute the Trustee's ability to bring a preference motion. However, in doing so, the Trustee should not effectively be acting as Lloyd's agent, "taking up the cudgels" on its behalf. That is inconsistent with its role as trustee and contrary to the requirements of the BIA. Furthermore, the Trustee can not pursue relief pursuant to s. 95 of the BIA on behalf of secured creditors whose security can not extend to assets recovered by the Trustee. The proceeds, if any, of a preference motion do not fall to be distributed to secured creditors who have no ownership or interest in the preference motion or its proceeds. To allow secured creditors to realize on the proceeds of a preference action would be inconsistent with the scheme of the BIA and the principles established by courts over more than 130 years.

3. Air Canada asks this Court to determine a threshold issue before the Trustee's preference motion proceeds. It seeks a declaration that any recovery from a

preference action by the Trustee is only for the benefit of the general body of unsecured creditors.

4. Air Canada also seeks an order regularizing the CCAA proceedings, the parallel proceedings under the BIA and the preference motion and directing the Trustee to involve the unsecured creditors for whose benefit any preference motion pursuant to section 95 of the BIA must be brought. To date, the unsecured creditors have been largely ignored. Neither the Trustee nor any other party has sought proofs of claim from unsecured creditors. No meeting of creditors has been convened to consider the affairs of the bankrupts or to hold a vote of the unsecured creditors to affirm the appointment of the Trustee or substitute another in place thereof and to appoint inspectors to give such directions to the Trustee as the creditors may see fit. Accordingly, Air Canada seeks an order directing the Trustee to comply with its statutory obligations under the BIA.

PART II - FACTS

Relationship between Air Canada, Aveos and Aero

5. The facts relating to the present threshold motion are largely undisputed. Throughout the relevant period from late 2007 to late 2009, Air Canada was in a unique relationship with two other companies relating to the maintenance of its aircraft: Aveos Fleet Performance Inc. (“Aveos”) and Aero.

6. Aveos, which was formerly Air Canada's in-house maintenance division but is now a standalone entity, performed all of Air Canada's heavy maintenance, including by managing and procuring the inventory needed to conduct that maintenance. By contrast, Air Canada continued to perform its own line maintenance.

Affidavit of Alan Butterfield, sworn August 13, 2010 ("Second Butterfield Affidavit"), Air Canada's Responding Motion Record, Vol. 1 ("Responding Motion Record"), Tab 1, pp. 6 and 7, at para. 14. "Line maintenance" is generally considered to be minor maintenance performed on an aircraft that is in service but between flights. "Heavy maintenance" as used herein refers to airframe, engine and component maintenance.

7. Pursuant to a supply contract entered into in late 2007, Aveos outsourced the supply and management of consumable and expendable "Category 3 Inventory" ("CAT 3 Inventory") aircraft parts to Aero. Aero supplied Aveos with the CAT 3 Inventory it needed to perform heavy maintenance on Air Canada's aircraft. Aveos then incorporated the cost of those parts into its invoices to Air Canada.

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, pp. 7 and 8, at paras. 16 and 18.

8. With respect to line maintenance, Air Canada and Aero executed an agreement in December 2008 (the "Line Maintenance Agreement"). Aero became Air Canada's exclusive supplier for practically all of its CAT 3 Inventory used for line maintenance. Aero assumed responsibility for managing all aspects of the procurement and delivery of CAT 3 Inventory for line maintenance, including monitoring and planning for Air Canada's consumption and use of the inventory.

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, p. 9, at paras. 20 and 21.

9. On January 28, 2009 Aero and Air Canada entered into an agreement (the "**January Purchase Agreement**") whereby Aero sold to Air Canada a pool of CAT 3 Inventory that it warranted to be of a nature, kind and quality that would be consumed within a year (the "**January Inventory Pool**"). Over the course of the year, Aero was expected to purchase parts from the January Inventory Pool in order to supply Aveos (for heavy maintenance) or Air Canada (for line maintenance).

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, pp. 13, 15 and 16, at paras. 30 and 37-39.

10. In return, Air Canada provided Aero with nine US\$10 million principal bills of exchange (Nos. 1 to 9) and one similar bill of exchange (No. 10) for approximately US\$10.7 million (collectively, the "**Bills of Exchange**"). Each of the Bills of Exchange was payable to Aero and drawn on Air Canada. Each Bill was scheduled to mature on February 8, 2010, after the twelve month period during which the January Inventory Pool was to be consumed. With the exception of transfers of the Bills of Exchange to Deutsche Forfait (which never in fact occurred), the January Purchase Agreement required Air Canada's consent to any transfer of the Bills of Exchange. From Air Canada's perspective, the essence of the transaction was to allow Air Canada to delay payment on CAT 3 Inventory for a year.

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, pp. 17 and 18, at paras. 40-42.

January Purchase Agreement dated January 28, 2009, Exhibit B to the Affidavit of Alan Butterfield sworn January 28, 2010 ("First Butterfield Affidavit"), Air Canada's Motion Record, Tab B, p. 165, at s. 6.1.

11. Aero ultimately failed to comply with the most significant provisions of the January Purchase Agreement in two ways:

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, p. 25, at para. 63.

12. First, Aero failed to pay for any parts purchased from the January Inventory Pool. Aero was using CAT 3 Inventory from the January Inventory Pool in order to both supply Air Canada pursuant to the Line Maintenance Agreement and to supply Aveos with the inventory needed to perform heavy maintenance but paid none of the invoices issued by Air Canada.

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, p. 26, at paras. 64 and 65.

13. Second, inventory comprising the January Inventory Pool did not conform to Aero's warranty to Air Canada. Approximately \$40 million or more of the parts remaining in the January Inventory Pool were not expected to be used by Air Canada during the one-year period fixed by the January Purchase Agreement or at all.

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, p. 28, at paras. 71 and 72.

14. The parties worked together to try and resolve these issues. Ultimately, instead of paying cash for the amounts owing for parts consumed and in respect of

the breach of warranty, Aero paid by delivering two Bills of Exchange (Nos. 3 and 4) back to Air Canada in April 2009 and three more Bills of Exchange (Nos. 5-7) back to Air Canada in August 2009. On October 9, 2009, a term sheet was executed that represented the culmination of discussions as to settlement (the “**Term Sheet**”). Amongst other things, under the terms of the settlement:

- (a) The discount rate for the Bills of Exchange delivered to Air Canada (Nos. 3-7) was fixed at 5%;
- (b) Air Canada agreed to buy two additional Bills of Exchange (Nos. 8 and 9) at a discount of 15% (for a total of US\$17 million). US\$15 million would be paid in cash and US\$2 million would be applied against Aero payables as an offset;
- (c) Air Canada agreed to allow Bill of Exchange No. 10 to be sold by Aero to a third party, the K2 Principal Fund LP, at a discount of approximately 16%; and
- (d) Air Canada agreed to purchase an additional \$25.5 million in CAT 3 Inventory.

Second Butterfield Affidavit, Responding Motion Record, Vol. 1, Tab 1, pp. 26 and 27 and 33 and 34, at paras. 66 to 70 and 86-88.

Term Sheet, Exhibit L to the First Butterfield Affidavit, Air Canada’s Motion Record, Tab L, at p. 290.

15. The agreement between the parties memorialized in the Term Sheet was incorporated into a series of agreements dated and closed October 23, 2009 (with the exception of the sale of Bill of Exchange No. 10, which was sold on October 9th pursuant to the consent given by Air Canada in accepting the Term Sheet).

Exhibits C, J and M to the First Butterfield Affidavit, Air Canada's Motion Record, Tab C, Tab J and Tab M, at pp. 191, 276 and 295.

Lloyds Refuses to Support Aero; Forces It into Administration

16. Previously unknown (and to this day undescribed) issues with Aero's inventory surfaced for the first time in late October 2009 during the course of an audit being conducted in connection with its move from the junior board to the main market of the London Stock Exchange. On October 26, 2009, Aero issued a press release stating that issues regarding the valuation of a parcel of inventory "may have a material impact on the 2008 audited accounts and the 2009 accounts, although the precise impact is still being evaluated." On November 3, 2009, Aero issued a further press release stating that the stock valuation issue was broader than first thought and that the Board was "also reviewing the accuracy of recent financial reports provided to its banks."

October 26, 2009 Press Release, Exhibit GG to the Affidavit of Martin Webster sworn April 23, 2010 ("First Webster Affidavit"), Motion Record of the Trustee in Bankruptcy ("Trustee's Motion Record"), Tab GG, at p. 156.

November 3, 2009 Press Release, Exhibit HH to the First Webster Affidavit, Trustee's Motion Record, Tab HH, at p. 158.

17. On November 6, 2009, Aero's board of directors resolved to place Aero into administration. The reason given was that the accounting error had resulted in Aero being unable to prepare and deliver the audited accounts for 2009 to Lloyds, which constituted a breach of various financial covenants. The board minutes provide:

It was noted that a meeting had been held with the Banks on Friday 6 November 2009 in an attempt to secure additional funding from the Banks to allow the Company to continue trading while it looked to rectify the current accounting issues. The directors confirmed that the Banks were not willing to continue to financially support the Company. [Emphasis added]

The directors noted that they had been advised that in these circumstances and on the basis that there were no other restructuring or refinancing options available to the Company, it would be in the best interests of the creditors of the Company to consider the appointment of administrators....

November 9, 2009 Board Minutes, Exhibit JJ to the First Webster Affidavit, Trustee's Motion Record, Tab JJ, at p. 162.

UK Administration Proceedings, CCAA Proceedings Commence

18. Administration proceedings were commenced on November 11, 2010 in the High Court of Justice of England and Wales (Chancery Division, Companies Court) (collectively, the "**Foreign Proceedings**"). Messrs. Tucker, Heis and Graham of KPMG LLP were appointed as joint administrators (the "**Administrators**") of Aero. KPMG LLP had previously acted as advisor to Lloyds (in its capacity as agent for the lending syndicate) immediately prior to the commencement of Administration proceedings and KPMG Inc. had provided some assistance in fulfilling that mandate.

Endorsement of Newbould J., November 12, 2009, 09-CL-8456—00CL, at paras. 2 and 11.

Pre-filing Report of KPMG Inc. as proposed Information Officer, November 11, 2009, Application Record returnable November 11, 2009, Tab, 2 at para. 27.

19. That same day, the Administrators obtained a recognition order (the “**Recognition Order**”) in the present proceedings commenced under the CCAA (the “**CCAA Proceedings**”).

Order of Newbould J., November 11, 2009, 09-CL-8456–00CL.

20. Among other things, the Recognition Order appointed KPMG Inc., an affiliate of KPMG LLP, as information officer (“**Information Officer**”) pursuant to sections 49(1) and 50 of the CCAA. KPMG Inc. was not appointed as monitor within the meaning of the CCAA.

Endorsement of Newbould J., November 12, 2009, 09-CL-8456–00CL,
at para. 12.

21. The Recognition Order placed limited powers and responsibilities upon the Information Officer. Justice Newbould directed KPMG Inc., as Information Officer, to:

- (a) provide assistance to the Administrators (in their capacity as foreign representatives) as might be required;
- (b) respond to reasonable information requests from stakeholders; and
- (c) deliver a report at least once every three months outlining the status of the Canadian and UK proceedings.

Order of Newbould J., November 11, 2009, 09-CL-8456–00CL, at
para. 12.

22. The powers and duties given to KPMG Inc. as “Information Officer” do not include the pursuant of a preference claim within the CCAA Proceedings.

Order of Newbould J., November 11, 2009, 09-CL-8456–00CL.

Foreign Representatives Assign Aero into BIA Proceedings

23. On January 22, 2010, this Court authorized the Administrators to assign Aero into bankruptcy in Canada and temporarily lifted the stay for that purpose (Court File Nos. 31-456351 and 31-456352, together, the “**Bankruptcy Proceedings**”). KPMG Inc. was appointed as Trustee.

Order of Morawetz J., January 22, 2010, 09-CL-8456-00CL, at para. 2.

24. In seeking the January 22, 2010 order, the Administrators advised the Court that they wished to assign Aero into bankruptcy to preserve the right to pursue any reviewable preferences that may have taken place during the statutory review period prescribed by the BIA. The Administrators further advised the Court that their security searches had revealed two secured creditors, Lloyds (asserting a general security interest in Aero’s assets) and Air Canada. The Administrators reported that the secured creditors would suffer a shortfall in realizing upon their security and that the Administrators perceived their obligation to be the maximization of recoveries for the secured creditors.

Report of KPMG Inc. as proposed Trustee in Bankruptcy dated January 19, 2010, Applicants’ Motion Record returnable January 21, 2010, Tab 2, pp. 12 and 14, at paras. 3 and 15-16.

25. On February 4, the Trustee reported that, although no claims process has been run, all creditors had been advised of the Administrators’ view that the secured

creditors would suffer a significant shortfall and that there will be no funds available for distribution to unsecured creditors. The Trustee further reported its expectation that the secured creditors' security would extend to any funds generated from a preference claim under section 95 or 96 of the BIA. The report states:

9. The assets of the Foreign Debtors are subject to a security interest in favour of a lending syndicate. At this time, it appears that the secured lenders will suffer a significant shortfall.

...

11. The Trustee's role is expected to be limited, given the existence of creditors with security over the property and undertakings of the Foreign Debtors and the expectation that such security will extend to any funds generated from an action under section 95 or 96 of the BIA. [Emphasis added]

Report of KPMG Inc. as the Information Officer and Trustee
in Bankruptcy, February 4, 2010, at paras. 9 and 13.

26. Lloyds affirmed this view in a letter sent to the service list where it stated:

We understand the Trustee's position to be that Lloyds TSB will have priority to the proceeds of a successful claim by the Trustee. We also understand Air Canada's position to be that the proceeds ought to go to the unsecured creditors. On behalf of Lloyds TSB, we write to advise that Lloyds TSB intends to pursue its remedies against Air Canada in the event that the claims for breach of the Intercreditor Agreement are not fully satisfied by the recoveries from the preference claim. [Emphasis added]

27. The Trustee also reported that, in light of the expectation that there would be no recoveries to unsecured creditors, it saw no value in incurring the expense associated with the discharge of its statutory obligations under the BIA.

Report of KPMG Inc. as the Information Officer and Trustee in
Bankruptcy, February 4, 2010, at paras. 9 and 13.

28. The Court issued an order in the CCAA Proceedings dated February 10, 2010 (the “February 2010 Order”) extending the time periods for the Trustee to perform its statutory obligations under the BIA (including convening a meeting of creditors and holding a vote of the unsecured creditors) until further order of the Court. The February 2010 Order further authorized the Administrators to provide direction to, and supervise the Trustee in pursuing the contemplated preference motion, subject to the review of the Court.

Order of Morawetz J., February 10, 2010, 09-CL-8456-00CL, at paras.
1-5.

29. Accordingly, no meeting of unsecured creditors has been held, no claims process has been conducted, no inspectors have been appointed and the appointment of the Trustee has not been affirmed. On the record, the Administrators have taken no such steps in respect of the unsecured creditors either.

Preference Motion

30. On April 27, 2010, the Trustee brought a motion in the CCAA Proceedings pursuant to section 95 of the BIA. The Trustee seeks a declaration that the following transactions are preferences within the meaning of s. 95(1) and are therefore void against the Trustee:

- (a) The transactions whereby Air Canada acquired Bills of Exchange 3-7;
- (b) The transaction whereby Bills of Exchange 8 and 9 were sold to Air Canada for \$17 million, comprised of \$15 million in cash and \$2 million to be applied against Aero payables; and
- (c) The purchase by Air Canada of an additional \$25.5 million in CAT 3 Inventory, to be paid for in three instalments.

Notice of Motion dated April 27, 2010, at Tab 1, Trustee's Motion Record, at pp. 1-2.

31. The Trustee further seeks an order requiring Air Canada to deliver to the Trustee Bills of Exchange Nos. 3-7 (or \$50 million in lieu thereof), \$2 million in cash, and the transferred inventory or \$25.5 million in lieu thereof. As described above, to the extent the order is granted, the Trustee intends to allow Lloyds to recover from the proceeds of the preference motion pursuant to its security.

Notice of Motion dated April 27, 2010, at Tab 1, Trustee's Motion Record, at p. 2.

PART III - ISSUES AND THE LAW

Issues

32. Three issues need to be determined at the hearing on the present threshold motion:

- (a) Can the Trustee pursue the preference motion solely on behalf of, and for the benefit of, a secured creditor?
- (b) Is the preference motion properly brought within the CCAA Proceedings, or should it be reconstituted in the Bankruptcy Proceedings?

- (c) Should the February 2010 Order be varied to reinstate the time periods for the Trustee to perform its statutory obligations under the BIA?

Trustee Can only Pursue a Preference Motion for the Benefit of Unsecured Creditors

Trustee Is an Impartial Court Officer

33. Air Canada does not contest the Trustee's ability to pursue preference claims in the Bankruptcy Proceedings. However, the Trustee cannot pursue a preference claim as an advocate for Lloyds or for its exclusive benefit.

34. As an initial matter, section 13.4 of the BIA expressly precludes the Trustee from assisting a creditor with the assertion of a claim against the estate unless strict pre-conditions are met. Under s. 13.4, a trustee cannot "act for or assist a secured creditor to assert a claim against the estate" unless the trustee has received a written opinion from independent counsel. The trustee must also notify the Superintendent and other creditors of its intention to act, provide the contents of the written opinion and provide remuneration details. On the record, it does not appear that any of these pre-conditions have been met by the Trustee.

35. The purpose of section 13.4 is clear. As Maher J. of the Saskatchewan Queen's Bench held in *Pratchler Agro Services*:

The purpose of s. 13.4 is obviously to protect the unsecured creditors from the secured creditor accessing its close

relationship with the trustee, causing the trustee to not act in the best interests of the unsecured creditors, but rather in the best interests of the secured creditor.

Pratchler Agro Services Inc. (Trustee of) v. Cargill Ltd. (1999), 11 C.B.R. (4th) 104 (Sask. Q.B.) at para. 9

36. More generally, a bankruptcy trustee is an officer of the Court. As an officer of the court, a trustee's role in a preference motion under section 95 of the BIA is to provide the Court with a neutral, balanced presentation of the facts. A trustee should not "take up the cudgels" for a creditor and should not adopt an adversarial or hostile role. In fact, the trustee is expected not only to speak in favour of finding a preference, but also disclose to the court any facts which weigh against such a finding. That has not been done to date.

Re Beetown Honey Products Inc. (2003), 46 C.B.R. (4th) 195 (Ont. S.C.J.) at para. 22, *aff'd* (2004), 3 C.B.R. (5th) 204 (Ont. C.A.)

Touche Ross Ltd. v. Weldwood of Canada Sales Ltd. (1983), 48 C.B.R. (N.S.) 83 (Ont. S.C. in Bankruptcy) at para. 9

Re Norris (1996), 44 C.B.R. (3d) 218 (Alta. C.A.) at para. 24

37. As an officer, of the court, a trustee must act impartially, equitably, even-handedly, dispassionately and in a non-adversarial manner, presenting facts to the Court for decision without becoming the advocate of any particular class of creditors.

This Court has found that:

It is the duty of the trustee, who is an officer of the court, to represent impartially the interest of all creditors; he is obligated to hold an even hand as between competing classes of creditors; he must act for the benefit of the general body of

creditors; he is not an agent of the creditors, but an administrative official required by law to gather in and realize on the assets of the bankrupt and to divide the proceeds in accordance with the scheme of the Bankruptcy Act among those entitled. And perhaps most importantly, he must conduct himself in such a manner as to avoid any conflict, real or perceived, between his interest and his duty.

Re Beetown Honey Products Inc. (2003), 46 C.B.R. (4th) 195 (Ont. S.C.J.) at para. 22, *aff'd* (2004), 3 C.B.R. (5th) 204 (Ont. C.A.), citing *PEI v. Bank of Nova Scotia* (1988), 70 C.B.R. (N.S.) 209 (P.E.I.S.C.) and *Re Confederation Trust Services Ltd.*, [1995] O.J. No. 3993 (Gen. Div.).

38. This duty was put more directly by Justice Farley, who held: "The trustee is an impartial officer of the Court; woe be to it if it does not act impartially towards the creditors of the estate."

Re Confederation Trust Services Ltd., [1995] O.J. No. 3993 (Gen. Div.) at para. 14.

39. In the present case, the Trustee's admitted sole purpose is to assist Lloyds in recovering against Aero's estate. The Trustee is proceeding with its preference motion (subject only to the oversight of the Administrators) in circumstances where it believes that all proceeds from the preference motion will be used in satisfaction of Lloyd's secured claims and nothing will remain for unsecured creditors. It does so without meeting the statutory preconditions described above, without disclosing the competing considerations in taking that position and without the involvement of the body of unsecured creditors.

Purpose of Section 95 Is to Ensure Equal Treatment of Unsecured Creditors

40. The rights of secured creditors are exercised outside of the bankruptcy scheme. They are permitted “to realize their security as if there were no bankruptcy.” Secured creditors get relief outside of the BIA as a function of their security agreements and as a matter of provincial law.

See e.g., *BIA*, ss. 69.3, 70(1), 136(1) and 141.

L.W. Houlden, G.B. Morawetz & Janis Sarra, *Bankruptcy and Insolvency Law of Canada*, looseleaf, 4th ed., (Toronto: Carswell, 2009) vol. 2 at F§161(4).

Husky Oil Operations Ltd. v. Minister of National Revenue (1995), 35 C.B.R. (3d) 1 (S.C.C.), at para. 10 (provincial bodies attempting, through provincial legislation, to escape the designation of “preferred creditor” and instead be “secured creditors” so as to be free from the distribution scheme were in violation of the *BIA*).

41. For unsecured creditors, subject to the priorities in section 136 of the BIA, the general principle is that all ordinary creditors rank equally within the bankruptcy scheme. Section 95 of the BIA is a means of enforcing that principle. Section 95 allows the trustee to challenge transactions that may diminish the value of the insolvent debtor’s estate, reducing the amount of money available for distribution to creditors. As a corollary of that principle, the trustee may not challenge transactions that are otherwise impermissible preferences but that do not reduce the amount available for distribution to unsecured creditors (e.g., where exempt property has been transferred).

BIA, s. 141.

L.W. Houlden, G.B. Morawetz & Janis Sarra, *Bankruptcy and Insolvency Law of Canada*, looseleaf, 4th ed., (Toronto: Carswell, 2009) vol. 2 at F§201(2).

Husky Oil Operations Ltd. v. Minister of National Revenue (1995), 35 C.B.R. (3d) 1 (S.C.C.)

Re H.S. Shannon & Company Limited, [1932] 1 W.W.R. 12 (Alta. S.C.) at paras. 41 and 42.

42. This view was confirmed by the Supreme Court in *Hudson v. Benallack*. The Court determined that, in the context of a preference action in bankruptcy, it is unnecessary to demonstrate an intent on the part of the creditor to defraud because the purpose is to preserve the right of other creditors to equal treatment. The Court held:

The object of the bankruptcy law is to ensure the division of the property of the debtor rateably among all his creditors in the event of his bankruptcy. Section 112 of the Act provides that, subject to the Act, all claims proved in the bankruptcy shall be paid pari passu. The Act is intended to put all creditors upon an equal footing. Generally, until a debtor is insolvent or has an act of bankruptcy in contemplation, he is quite free to deal with his property as he wills and he may prefer one creditor over another but, upon becoming insolvent, he can no longer do any act out of the ordinary course of business which has the effect of preferring a particular creditor over other creditors. If one creditor receives a preference over other creditors as a result of the debtor acting intentionally and in fraud of the law, this defeats the equality of the bankruptcy laws.

The cognizance of the creditor or its absence should be irrelevant. One can sympathize with the rationale of concurrent intent, which is the desire to protect an innocent creditor who accepts payment of a debt in good faith, but it is hard to reconcile this point of view with the language of the statute, with the history of bankruptcy legislation, and with the right of other innocent creditors to equal protection. [Emphasis added]

Hudson v. Benallack, [1976] 2 S.C.R. 168 at paras. 21 and 22.

43. The principle of equal treatment does not extend to secured creditors who can realize outside of the bankruptcy regime. Secured creditors do not require the assurance of equal treatment provided by section 95 of the BIA and (as described below) they cannot use the BIA to collect more than they would otherwise be allowed under their security agreement and prevailing provincial law.

Secured Creditors Cannot Avail Themselves of the Proceeds of a s. 95 Action

44. Where the result of recovering property alleged to have been delivered to a creditor by way of fraudulent preference would not benefit the bankrupt estate generally, but only a particular secured creditor, the trustee should not take proceedings to attack the transaction. In *Ex parte Cooper*, the English Divisional Court considered the case where a creditor held security on a shipment of goods consigned to the debtor. When the bills of lading for the goods arrived, the debtor pledged them to an unsecured creditor. It was held that the trustee should not attack the pledge as a preference, since it could not benefit the general creditors of the estate but only the creditor who received the first security agreement with respect to the goods. The Court held that an application can not be made to recover property allegedly given to a creditor by way of fraudulent preference, except for the benefit of all creditors.

Ex parte Cooper (1875) L.R. 10 Ch. 510 at 511-512, cited in L.W. Houlden, G.B. Morawetz & Janis Sarra, *Bankruptcy and Insolvency Law of Canada*, looseleaf, 4th ed., (Toronto: Carswell, 2009) vol. 2 at F§202.

45. It has been the general rule since *Ex parte Cooper* (discussed below) that a secured creditor can not take advantage of the trustee's statutory ability to recover property conveyed in a preference transaction. Property recovered by the trustee as a result of a fraudulent preference is held by the trustee and available for the general benefit of creditors and will not be subject to any security interest. That reflects the special nature of the power conferred by provisions like section 95 of the BIA. The result of a preference action is to declare a particular transaction void as against the trustee even though the debtor is bound by the transaction – the statute provides for no such declaration as against the interests of any other party including a secured creditor who is thus confined to contract and relevant secured creditor laws. Property recovered by the trustee pursuant to section 95 is not subject to any security interest but is held for the benefit of the unsecured creditors. That principle reinforces the pre-existing positions of the parties and prevents the secured creditor from enhancing its position.

BIA, s. 95.

Re Yagerphone Ltd., [1935] All E.R. 803 (Ch. D.) at 395.

L.W. Houlden, G.B. Morawetz & Janis Sarra, *Bankruptcy and Insolvency Law of Canada*, looseleaf, 4th ed., (Toronto: Carswell, 2009) vol. 2 at F§202, citing *Anron Mechanical Ltd. v. L'Abbe Construction (Ontario) Ltd. (Trustee of)* (1991), 5 C.B.R. (3d) 133 (Ont. Gen. Div.); *Re Yagerphone Ltd.*, [1935] All E.R. 803 (Ch. D.); and *Re Maybank Foods Inc.* (1990), 78 C.B.R. (N.S.) 79, (Ont. S.C.).

Canadian Imperial Bank of Commerce v. Canotek Development Corp. (1997), 35 O.R. (3d) 247 (C.A.) at para. 26.

46. In the seminal case of *Re Yagerphone*, a secured creditor with a general security interest argued that the funds recovered by the liquidator as a preference became the property of the company and subject to its security interest. The English Chancery Division disagreed, holding as follows:

There have been two cases which establish quite clearly that, whether in bankruptcy or in the liquidation of a company, a secured creditor has no right to enforce for his benefit the remedy which is given to the trustee in bankruptcy or the liquidator of the company of avoiding a payment or setting aside a transaction made or entered into with a view to preferring a creditor of the bankrupt or a company in liquidation. The authorities are *Ex parte Cooper* and *Willmott v. London Celluloid Co.*

...

The right to recover a sum of money from a creditor who has been preferred is conferred for the purpose of benefitting the general body of creditors, and I think Mr. Montgomery White was right when he said that the sum of money, when recovered by the liquidators by virtue of s. 265 of the Companies Act, 1929, and s. 44 of the Bankruptcy Act, 1914, did not become part of the general assets of Yagerphone, Ltd., but was a sum of money received by the liquidators impressed in their hands with a trust for those creditors amongst whom they had to distribute the assets of the company. [Emphasis added]

Re Yagerphone Ltd., [1935] All E.R. 803 at 395-396 (Ch. D.).

L.W. Houlden, G.B. Morawetz & Janis Sarra, *Bankruptcy and Insolvency Law of Canada*, looseleaf, 4th ed., (Toronto: Carswell, 2009) vol. 2 at F§202, citing *Anron Mechanical Ltd. v. L'Abbe Construction (Ontario) Ltd. (Trustee of)* (1991), 5 C.B.R. (3d) 133; *Re Yagerphone Ltd.*, [1935] All E.R. 803 (Ch. D.); and *Re Maybank Foods Inc.* (1990), 78 C.B.R. (N.S.) 79, (Ont. S.C.).

See, however, *Anron Mechanical Ltd. v. L'Abbe Construction (Ontario) Ltd. (Trustee of)* (1991), 5 C.B.R. (3d) 133 (moneys originally impressed with a trust and directly traceable and identifiable with that trust do not lose that quality and impression simply because they were paid out fraudulently and recovered by the trustee).

47. The decision in *Yagerphone* was affirmed on a number of occasions, including by the English Court of Appeal in 1997 in *Re Oasis Merchandising Services*. In that case, the Court again drew a distinction between two types of assets: assets that were the insolvent debtor's property upon liquidation, which may be subject to a secured creditor's general security interest, and those assets that were conveyed to another creditor but were returned to the liquidator by means of a preference action after liquidation, which are not.

Re Oasis Merchandising Services Ltd., [1997] 2 W.L.R. (C.A.) [*Re Oasis*] at 773.

See also *Re M.C. Bacon Ltd.* [1991] Ch. 127 (affirming *Re Yagerphone*: "it was thus established long before 1986 that any sum recovered from a creditor who has been wrongly preferred enures for the benefit of the general body of creditors, not for the benefit of the company or the holder of a floating charge.").

48. In *S-Marque Inc. v. Homburg Industries Ltd.*, the Supreme Court of Nova Scotia considered the situation where a secured creditor sold the assets subject to its security but suffered a shortfall. It then argued that the proceeds of a successful preference action should go to satisfy the balance of what it was owed. Justice Hood denied the secured creditor's claim. Reviewing *Re Yagerphone* and the line of cases that followed, Hood J. concluded:

The effect of all these decisions is that overturning a fraudulent preference puts the property back in the hands of the trustee. The transaction is void as against the trustee in bankruptcy. The property does not, however, revert to the bankrupt to be available as part of the security over which a secured creditor has rights of seizure. [Emphasis added]

S-Marque Inc. v. Homburg Industries Ltd., [1998] N.S.J. No. 550 (S.C.) at para. 147 [*S-Marque*] *aff'd* [1999] N.S.J. No. 94 (C.A.).

See also *Re L'Abbe Construction (Ontario) Limited*, [1991] O.J. No. 299 (Gen. Div.) and *Re Maybank Foods Inc.*, [1990] O.J. No. 3262 (H.C.J.) (where it was conceded by the respondent that moneys recoverable by a trustee from a creditor who has been preferred do not become part of the bankrupt estate subject to the claims of secured creditors, but rather are received by the trustee subject to a trust in favour of the creditors represented by the trustee).

49. The concept was expressed more simply in *CIBC v. Canotek Development Corporation*, where the Ontario Court of Appeal stated that section 95 of the BIA provides that a fraudulent preference is void as against the trustee in bankruptcy; it is not rendered void as against the secured creditor.

BIA, s. 95.

Canadian Imperial Bank of Commerce v. Canotek Development Corporation (1997), 35 O.R. (3d) 247 (C.A.) at para. 26.

50. The Trustee's preference motion raises the same issues that were before the courts in the cases described above. Lloyds asserts a general security interest over Aero's property and argues that such a security interest will apply to the proceeds of a successful preference motion by the Trustee. However, the Bills of Exchange sought to be recovered were conveyed to Air Canada in April and August 2009. If the transactions conveying the Bills of Exchange to Air Canada are held to be void as

against the Trustee, s. 95 of the BIA would still not render them void as against Lloyds. Any property recovered by the Trustee would not return to Aero subject to Lloyd's security interest but would be held by the Trustee and available only for distribution to unsecured creditors.

Preference Claim Belongs in the Bankruptcy Proceedings

51. The Trustee has brought its preference motion for a declaration pursuant to section 95 of the BIA. The Court has no jurisdiction to make a declaration under section 95 of the BIA in the present CCAA Proceedings. The only forum in which the Trustee can seek relief pursuant to section 95 of the BIA is in the Bankruptcy Proceedings. Indeed, KPMG's "express purpose" for bringing Aero into Bankruptcy Proceedings was to "pursue any reviewable transactions, settlements and preferences or conveyances under value which may have taken place during the statutory time period prescribed by the BIA."

Report of KPMG Inc. as proposed Trustee in Bankruptcy, January 19, 2010, Applicants' Motion Record returnable January 21, 2010, Tab 2, p. 12, at para 3.

52. While s. 36.1 of the CCAA allows a preference motion to be brought in the CCAA (incorporating section 95 of the BIA by reference), the Trustee has not proceeded pursuant to that section. Furthermore, it cannot do so. As an initial matter, section 36.1 of the CCAA only applies "in respect of a compromise or arrangement unless the compromise or arrangement provides otherwise." No

compromise or arrangement has been proposed, and KPMG as Information Officer does not have the power to make such a proposal. In addition, the ability to commence a preference motion under the CCAA is limited to a CCAA monitor appointed under section 11.7 with the duties and functions set out in section 23 of the CCAA. KPMG Inc. was not appointed as monitor and the powers granted to it as Information Officer do not include the pursuit of preference claims.

CCAA, ss. 11.7, 23 and 36.1.

Order of Newbould J., November 11, 2009, 09-CL-8456–00CL.

Time Periods for the Trustee to Perform Its Statutory Obligations under the BIA Should Be Reinstated

53. The February 2010 Order of Justice Morawetz excused the Trustee from performing its statutory obligations prescribed by sections 16, 21, 22, 24, 27 (save for such reports as may be required pursuant to subsection 27(c)) and 102 of the BIA pending further Order of the Court. In the February 4, 2010 Report of the Information Officer and Trustee in Bankruptcy, the Trustee stated its belief that there was no purpose in incurring the expense associated with the discharge of such statutory obligations, “given the existence of creditors with security over the property and undertakings of [Aero] and the expectation that such security will extend to any funds generated from an action under section 95 or 96 of the BIA.”

Order of Morawetz J., February 10, 2010, 09-CL-8456-00CL, at para. 2.

Report of KPMG Inc. as the Information Officer and Trustee in Bankruptcy, February 4, 2010, at para. 11.

54. As described above and contrary to the position taken by the Trustee, the proceeds of a successful preference motion by the Trustee can only benefit Aero's unsecured creditors. Accordingly, the Bankruptcy Proceedings should be regularized to ascertain the identities and interests of the unsecured creditors, including by scheduling a first meeting of creditors, distributing and reviewing proofs of claim, holding a vote of the unsecured creditors to affirm the appointment of the Trustee or substitute another in place thereof and to appoint inspectors to give such directions to the Trustee as the creditors may see fit.

PART IV - ORDER REQUESTED

55. A declaration that any recovery from a preference action by the Trustee is only for the benefit of the general body of unsecured creditors; a direction to the Trustee to reconstitute the preference motion within the Bankruptcy Proceedings; and an order directing the Trustee to comply with its statutory obligations under the BIA. The parties have agreed that, in the event of the Court making such a finding, the Trustee shall have a reasonable period of time to propose to the Court a timetable and method of compliance.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

December 10, 2010

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

STIKEMAN ELLIOTT LLP
Barristers & Solicitors
5300 Commerce Court West
199 Bay Street
Toronto, Canada M5L 1B9

Sean F. Dunphy LSUC#: 24941J

Tel: (416) 869-5662

Alexander D. Rose LSUC#: 49415P

Tel: (416) 869-5261

Kathryn Esaw LSUC#58264F

Tel: (416) 869-6820

Fax: (416) 947-0866

Lawyers for Air Canada

SCHEDULE "A"
LIST OF AUTHORITIES

Authorities

1. *Pratchler Agro Services Inc. (Trustee of) v. Cargill Ltd.* (1999), 11 C.B.R. (4th) 104 (Sask. Q.B.)
2. *Re Beetown Honey Products Inc.* (2003), 46 C.B.R. (4th) 195 (Ont. S.C.J.)
3. *Touche Ross Ltd. v. Weldwod of Canada Sales Ltd.* (1983), 48 C.B.R. (N.S.) 83 (Ont. S.C. in Bankruptcy)
4. *Re Norris* (1996), 44 C.B.R. (3d) 218 (Alta. C.A.)
5. *PEI v. Bank of Nova Scotia* (1988), 70 C.B.R. (N.S.) 209 (P.E.I.S.C.)
6. *Re Confederation Trust Services Ltd.*, [1995] O.J. No. 3993 (Gen. Div.)
7. *Husky Oil Operations Ltd. v. Minister of National Revenue* (1995), 35 C.B.R. (3d) 1 (S.C.C.)
8. *Re H.S. Shannon & Company Limited*, [1932] 1 W.W.R. 12 (Alta. S.C.)
9. *Hudson v. Benallack*, [1976] 2 S.C.R. 168
10. *Ex parte Cooper* (1875) L.R. 10 Ch. 510
11. *Re Yagerphone Ltd.*, [1935] All E.R. 803 (Ch. D.)
12. *Anron Mechanical Ltd. v. L'Abbe Construction (Ontario) Ltd. (Trustee of)* (1991), 5 C.B.R. (3d) 133 (Ont. Gen. Div.)
13. *Re Maybank Foods Inc.* (1990), 78 C.B.R. (N.S.) 79 (Ont. S.C.)
14. *Canadian Imperial Bank of Commerce v. Canotek Development Corp.* (1997), 35 O.R. (3d) 247 (C.A.)
15. *Re Oasis Merchandising Services Ltd.*, [1997] 2 W.L.R. (C.A.)
16. *Re M.C. Bacon Ltd.* [1991] Ch. 127
17. *S-Marque Inc. v. Homburg Industries Ltd.*, [1998] N.S.J. No. 550 (S.C.)
18. *Homburg v. S-Marque Inc.*, [1999] N.S.J. No. 94 (C.A.)

Texts

19. L.W. Houlden, G.B. Morawetz & Janis Sarra, *Bankruptcy and Insolvency Law of Canada*, looseleaf, 4th ed.

SCHEDULE "B"
RELEVANT STATUTES

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3

Trustee may act for secured creditor

13.4 (1) No trustee may, while acting as the trustee of an estate, act for or assist a secured creditor to assert a claim against the estate or to realize or otherwise deal with a security that the secured creditor holds, unless the trustee has obtained a written opinion from independent legal counsel that the security is valid and enforceable against the estate.

Notification by trustee

(1.1) Forthwith on commencing to act for or assist a secured creditor of the estate in the manner set out in subsection (1), a trustee shall notify the Superintendent and the creditors or the inspectors

- (a) that the trustee is acting for the secured creditor;
- (b) of the basis of any remuneration from the secured creditor; and
- (c) of the opinion referred to in subsection (1).

Trustee to provide opinion

(2) Within two days after receiving a request therefor, a trustee shall provide the Superintendent with a copy of the opinion referred to in subsection (1) and shall also provide a copy to each creditor who has made a request therefor.

Stays of proceedings – bankruptcies

69.3 (1) Subject to subsections (1.1) and (2) and sections 69.4 and 69.5, on the bankruptcy of any debtor, no creditor has any remedy against the debtor or the debtor's property, or shall commence or continue any action, execution or other proceedings, for the recovery of a claim provable in bankruptcy.

End of stay

(1.1) Subsection (1) ceases to apply in respect of a creditor on the day on which the trustee is discharged.

Secured creditors

(2) Subject to subsection (3), sections 79 and 127 to 135 and subsection 248(1), the bankruptcy of a debtor does not prevent a secured creditor from realizing or otherwise dealing with his or her security in the same manner as he or she would have been entitled to realize or deal with it if this section had not been passed, unless the court otherwise orders, but in so ordering the court shall not postpone the right of the secured creditor to realize or otherwise deal with his or her security, except as follows:

(a) in the case of a security for a debt that is due at the date the bankrupt became bankrupt or that becomes due not later than six months thereafter, that right shall not be postponed for more than six months from that date; and

(b) in the case of a security for a debt that does not become due until more than six months after the date the bankrupt became bankrupt, that right shall not be postponed for more than six months from that date, unless all instalments of interest that are more than six months in arrears are paid and all other defaults of more than six months standing are cured, and then only so long as no instalment of interest remains in arrears or defaults remain uncured for more than six months, but, in any event, not beyond the date at which the debt secured by the security becomes payable under the instrument or law creating the security.

Exception

(2.1) No order may be made under subsection (2) if the order would have the effect of preventing a secured creditor from realizing or otherwise dealing with financial collateral.

Secured creditors – aircraft objects

(3) If a secured creditor who holds security on aircraft objects under an agreement with the bankrupt is postponed from realizing or otherwise dealing with that security, the order under which the postponement is made is terminated

(a) if, after the order is made, the trustee defaults in protecting or maintaining the aircraft objects in accordance with the agreement;

(b) 60 days after the day on which the order is made unless, during that period, the trustee

(i) remedied the default of every other obligation under the agreement, other than a default constituted by the commencement of proceedings under this Act or the breach of a provision in the agreement relating to the bankrupt's financial condition, and

(ii) agreed to perform the obligations under the agreement, other than the bankrupt's obligation not to become insolvent or an obligation relating to the bankrupt's financial condition, until the day on which the secured creditor is able to realize or otherwise deal with his or her security; or

(c) if, during the period that begins 60 days after the day on which the order is made and ends on the day on which the secured creditor is able to realize or otherwise deal with his or her security, the trustee defaults in performing an obligation under the agreement, other than the bankrupt's obligation not to become insolvent or an obligation relating to the bankrupt's financial condition.

Precedence of bankruptcy orders and assignments

70. (1) Every bankruptcy order and every assignment made under this Act takes precedence over all judicial or other attachments, garnishments, certificates having the effect of judgments, judgments, certificates of judgment, legal hypothecs of judgment creditors, executions or other process against the property of a bankrupt, except those that have been completely executed by payment to the creditor or the creditor's representative, and except the rights of a secured creditor.

Preferences

95. (1) A transfer of property made, a provision of services made, a charge on property made, a payment made, an obligation incurred or a judicial proceeding taken or suffered by an insolvent person

(a) in favour of a creditor who is dealing at arm's length with the insolvent person, or a person in trust for that creditor, with a view to giving that creditor a preference over another creditor is void as against – or, in Quebec, may not be set up against – the trustee if it is made, incurred, taken or suffered, as the case may be, during the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy; and

(b) in favour of a creditor who is not dealing at arm's length with the insolvent person, or a person in trust for that creditor, that has the effect of giving that creditor a preference over another creditor is void as against – or, in Quebec, may not be set up against – the trustee if it is made, incurred, taken or suffered, as the case may be, during the period beginning on the day that is 12 months before the date of the initial bankruptcy event and ending on the date of the bankruptcy.

Preference presumed

(2) If the transfer, charge, payment, obligation or judicial proceeding referred to in paragraph (1)(a) has the effect of giving the creditor a preference, it is, in the absence of evidence to the contrary, presumed to have been made, incurred, taken or suffered with a view to giving the creditor the preference — even if it was made, incurred, taken or suffered, as the case may be, under pressure — and evidence of pressure is not admissible to support the transaction.

Exception

(2.1) Subsection (2) does not apply, and the parties are deemed to be dealing with each other at arm's length, in respect of the following:

- (a) a margin deposit made by a clearing member with a clearing house; or
- (b) a transfer, charge or payment made in connection with financial collateral and in accordance with the provisions of an eligible financial contract.

Definitions

(3) In this section,

“clearing house” means a body that acts as an intermediary for its clearing members in effecting securities transactions;

“clearing member” means a person engaged in the business of effecting securities transactions who uses a clearing house as intermediary;

“creditor” includes a surety or guarantor for the debt due to the creditor;

“margin deposit” means a payment, deposit or transfer to a clearing house under the rules of the clearing house to assure the performance of the obligations of a clearing member in connection with security transactions, including, without limiting the generality of the foregoing, transactions respecting futures, options or other derivatives or to fulfil any of those obligations.

Priority of claims

136. (1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:

- (a) in the case of a deceased bankrupt, the reasonable funeral and testamentary expenses incurred by the legal representative or, in the Province of Quebec, the successors or heirs of the deceased bankrupt;

- (b) the costs of administration, in the following order,

- (i) the expenses and fees of any person acting under a direction made under paragraph 14.03(1)(a),
 - (ii) the expenses and fees of the trustee, and
 - (iii) legal costs;
- (c) the levy payable under section 147;
- (d) the amount of any wages, salaries, commissions, compensation or disbursements referred to in sections 81.3 and 81.4 that was not paid;
- (d.01) the amount equal to the difference a secured creditor would have received but for the operation of sections 81.3 and 81.4 and the amount actually received by the secured creditor;
- (d.02) the amount equal to the difference a secured creditor would have received but for the operation of sections 81.5 and 81.6 and the amount actually received by the secured creditor;
- (d.1) claims in respect of debts or liabilities referred to in paragraph 178(1)(b) or (c), if provable by virtue of subsection 121(4), for periodic amounts accrued in the year before the date of the bankruptcy that are payable, plus any lump sum amount that is payable;
- (e) municipal taxes assessed or levied against the bankrupt, within the two years immediately preceding the bankruptcy, that do not constitute a secured claim against the real property or immovables of the bankrupt, but not exceeding the value of the interest or, in the Province of Quebec, the value of the right of the bankrupt in the property in respect of which the taxes were imposed as declared by the trustee;
- (f) the lessor for arrears of rent for a period of three months immediately preceding the bankruptcy and accelerated rent for a period not exceeding three months following the bankruptcy if entitled to accelerated rent under the lease, but the total amount so payable shall not exceed the realization from the property on the premises under lease, and any payment made on account of accelerated rent shall be credited against the amount payable by the trustee for occupation rent;
- (g) the fees and costs referred to in subsection 70(2) but only to the extent of the realization from the property exigible thereunder;
- (h) in the case of a bankrupt who became bankrupt before the prescribed date, all indebtedness of the bankrupt under any Act respecting workers'

compensation, under any Act respecting unemployment insurance or under any provision of the Income Tax Act creating an obligation to pay to Her Majesty amounts that have been deducted or withheld, rateably;

(i) claims resulting from injuries to employees of the bankrupt in respect of which the provisions of any Act respecting workers' compensation do not apply, but only to the extent of moneys received from persons guaranteeing the bankrupt against damages resulting from those injuries; and

(j) in the case of a bankrupt who became bankrupt before the prescribed date, claims of the Crown not mentioned in paragraphs (a) to (i), in right of Canada or any province, rateably notwithstanding any statutory preference to the contrary.

Payment as funds available

(2) Subject to the retention of such sums as may be necessary for the costs of administration or otherwise, payment in accordance with subsection (1) shall be made as soon as funds are available for the purpose.

Balance of claim

(3) A creditor whose rights are restricted by this section is entitled to rank as an unsecured creditor for any balance of claim due him.

Claims generally payable rateably

141. Subject to this Act, all claims proved in a bankruptcy shall be paid rateably.

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36

Court to appoint monitor

11.7 (1) When an order is made on the initial application in respect of a debtor company, the court shall at the same time appoint a person to monitor the business and financial affairs of the company. The person so appointed must be a trustee, within the meaning of subsection 2(1) of the Bankruptcy and Insolvency Act.

Restrictions on who may be monitor

(2) Except with the permission of the court and on any conditions that the court may impose, no trustee may be appointed as monitor in relation to a company

(a) if the trustee is or, at any time during the two preceding years, was

- (i) a director, an officer or an employee of the company,
 - (ii) related to the company or to any director or officer of the company,
or
 - (iii) the auditor, accountant or legal counsel, or a partner or an employee of the auditor, accountant or legal counsel, of the company;
or
- (b) if the trustee is
- (i) the trustee under a trust indenture issued by the company or any person related to the company, or the holder of a power of attorney under an act constituting a hypothec within the meaning of the Civil Code of Quebec that is granted by the company or any person related to the company, or
 - (ii) related to the trustee, or the holder of a power of attorney, referred to in subparagraph (i).

Court may replace monitor

(3) On application by a creditor of the company, the court may, if it considers it appropriate in the circumstances, replace the monitor by appointing another trustee, within the meaning of subsection 2(1) of the Bankruptcy and Insolvency Act, to monitor the business and financial affairs of the company.

Duties and functions

23. (1) The monitor shall

- (a) except as otherwise ordered by the court, when an order is made on the initial application in respect of a debtor company,
 - (i) publish, without delay after the order is made, once a week for two consecutive weeks, or as otherwise directed by the court, in one or more newspapers in Canada specified by the court, a notice containing the prescribed information, and
 - (ii) within five days after the day on which the order is made,
 - (A) make the order publicly available in the prescribed manner,
 - (B) send, in the prescribed manner, a notice to every known creditor who has a claim against the company of more than \$1,000 advising them that the order is publicly available, and

(C) prepare a list, showing the names and addresses of those creditors and the estimated amounts of those claims, and make it publicly available in the prescribed manner;

(b) review the company's cash-flow statement as to its reasonableness and file a report with the court on the monitor's findings;

(c) make, or cause to be made, any appraisal or investigation the monitor considers necessary to determine with reasonable accuracy the state of the company's business and financial affairs and the cause of its financial difficulties or insolvency and file a report with the court on the monitor's findings;

(d) file a report with the court on the state of the company's business and financial affairs – containing the prescribed information, if any –

(i) without delay after ascertaining a material adverse change in the company's projected cash-flow or financial circumstances,

(ii) not later than 45 days, or any longer period that the court may specify, after the day on which each of the company's fiscal quarters ends, and

(iii) at any other time that the court may order;

(d.1) file a report with the court on the state of the company's business and financial affairs – containing the monitor's opinion as to the reasonableness of a decision, if any, to include in a compromise or arrangement a provision that sections 38 and 95 to 101 of the Bankruptcy and Insolvency Act do not apply in respect of the compromise or arrangement and containing the prescribed information, if any – at least seven days before the day on which the meeting of creditors referred to in section 4 or 5 is to be held;

(e) advise the company's creditors of the filing of the report referred to in any of paragraphs (b) to (d.1);

(f) file with the Superintendent of Bankruptcy, in the prescribed manner and at the prescribed time, a copy of the documents specified in the regulations;

(f.1) for the purpose of defraying the expenses of the Superintendent of Bankruptcy incurred in performing his or her functions under this Act, pay the prescribed levy at the prescribed time to the Superintendent for deposit with the Receiver General;

(g) attend court proceedings held under this Act that relate to the company, and meetings of the company's creditors, if the monitor considers that his or her attendance is necessary for the fulfilment of his or her duties or functions;

(h) if the monitor is of the opinion that it would be more beneficial to the company's creditors if proceedings in respect of the company were taken under the Bankruptcy and Insolvency Act, so advise the court without delay after coming to that opinion;

(i) advise the court on the reasonableness and fairness of any compromise or arrangement that is proposed between the company and its creditors;

(j) make the prescribed documents publicly available in the prescribed manner and at the prescribed time and provide the company's creditors with information as to how they may access those documents; and

(k) carry out any other functions in relation to the company that the court may direct.

Monitor not liable

(2) If the monitor acts in good faith and takes reasonable care in preparing the report referred to in any of paragraphs (1)(b) to (d.1), the monitor is not liable for loss or damage to any person resulting from that person's reliance on the report.

Application of sections 38 and 95 to 101 of the Bankruptcy and Insolvency Act

36.1 (1) Sections 38 and 95 to 101 of the Bankruptcy and Insolvency Act apply, with any modifications that the circumstances require, in respect of a compromise or arrangement unless the compromise or arrangement provides otherwise.

Interpretation

(2) For the purposes of subsection (1), a reference in sections 38 and 95 to 101 of the Bankruptcy and Insolvency Act

(a) to "date of the bankruptcy" is to be read as a reference to "day on which proceedings commence under this Act";

(b) to "trustee" is to be read as a reference to "monitor"; and

(c) to "bankrupt", "insolvent person" or "debtor" is to be read as a reference to "debtor company".

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

Court File No. 09-8456-00CL

AND IN THE MATTER OF JAMES ROBERT TUCKER, RICHARD HEIS AND ALLAN WATSON GRAHAM OF
KPMG LLP, AS JOINT ADMINISTRATORS

AND IN THE MATTER OF AERO INVENTORY (UK) LIMITED and AERO INVENTORY PLC

**ONTARIO
SUPERIOR COURT OF JUSTICE -
COMMERCIAL LIST**

Proceeding commenced at Toronto

**FACTUM OF AIR CANADA
(RETURNABLE JANUARY 6, 2011)**

STIKEMAN ELLIOTT LLP
Barristers & Solicitors
5300 Commerce Court West
199 Bay Street
Toronto, Canada M5L 1B9

Sean F. Dunphy LSUC#: 24941J
Tel: (416) 869-5662
Alexander D. Rose LSUC#: 49415P
Tel: (416) 869-5261
Kathryn Esaw LSUC#58264F
Tel: (416) 869-6820
Fax: (416) 947-0866

Lawyers for Air Canada