Court File No. 09-CL-8456-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

B E T W E E N :

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 July 24, 2014)

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PART I - OVERVIEW

1. On November 11, 2009, the Foreign Representatives obtained an order recognizing Aero's U.K. Administration Proceedings under the CCAA. On the same day, the Foreign Representatives repudiated Aero's agreement with Air Canada that had been the cornerstone of Air Canada's procurement system for so-called consumable and expendable "CAT 3 Parts". The Foreign Representatives terminated Aero's employees, shut down its business and left Air Canada's parts commingled with, and inseparable from, Aero's parts. That put Air Canada in a very difficult position.

2. While Air Canada tried to separate out its parts unilaterally, it could not do so. Its legacy technology systems were simply not up to the task. It had been wholly reliant upon Aero to manage the inventory.

3. Both Air Canada and the Foreign Representatives wanted Aero's parts removed from Air Canada's facilities but there was no practical way to do it. Accordingly, over the next two and a half years, Air Canada and Aveos (Aero's two customers in Canada) worked to develop a computer algorithm that, using a given set of assumptions, would attribute post-filing consumption of the CAT 3 Parts amongst Air Canada, Aveos and Aero. Air Canada spent countless hours and hundreds of thousands of dollars developing and funding the Algorithm, for which the Foreign Administrators have never paid. While admittedly not a perfect proxy for actual consumption, it was the best system available. Using the Algorithm and related software, the parties were able to conduct an uplift and removal of Aero's parts from Air Canada's facilities.

4. Air Canada did not want to consume any parts belonging to Aero during the post-filing period and it believed that it was not using them. Air Canada had built up a cushion of inventory during the pre-filing period that it believed would be sufficient to carry it through until it could procure its own inventory. Those facts have not been challenged. On these facts, as perceived by Air Canada at the time, there was no urgency to pursue its motion to set aside the relevant portions of the Recognition Order.

5. However, in 2012, the results from the Algorithm finally became available. Instead of attributing Air Canada's post-filing consumption to the cushion of inventory it had acquired pre-filing, the Algorithm ascribed approximately $9 million of Air Canada's consumption to parts belonging to Aero. The fact that any such consumption by Air Canada was unforeseeable and unintentional has not been contested. At the same time, the Algorithm indicated that Aero had consumed quantities of Air Canada's inventory during the same period. While neither result can be completely explained, it

is clear that any consumption by Air Canada was a direct result of the situation in which Aero had placed the parties.

6. In their motion, the Foreign Representatives now ask this Court to order Air Canada to pay for its post-filing consumption of Aero's parts (as determined by the Algorithm) without allowing for set-off. Indeed, the Foreign Representatives even ask this court to prevent Air Canada from setting off obligations incurred by Aero during the post-filing period; for example, amounts attributable to Aero's consumption of Air Canada's parts during the same time period; Aero's share of the cost of developing the Algorithm; the portion of the rent attributable to storing Aero's parts post-filing; or any other amounts owed to Air Canada. In fact, the Foreign Representatives seek to permanently eliminate any and all such rights of set-off that Air Canada might otherwise be able to advance as a defence to the Foreign Representatives' claim for payment – all without a hearing or determination of the validity of such rights. For the purposes of this motion, the Court is not asked to determine the existence or validity of Air Canada's set-off rights - be they legal, equitable, post-filing to post-filing or otherwise. The Court should assume that Air Canada has valid rights of set-off.

7. The Foreign Representatives attempt to justify the permanent elimination of Air Canada's set-off rights by reference to Justice Newbould's Recognition Order, which included a temporary stay of set-off rights for "new purchases" of inventory. While Justice Newbould intended to avoid the threat of "creditor enforcement action" that would jeopardize Aero's attempt to continue as a going concern, there is no reason to believe that Justice Newbould intended a permanent stay of set-off rights, or that he could possibly have foreseen what ultimately took place. His Honour was never advised, for example, that Air Canada might be determined to have consumed Aero's inventory without knowing it, and he did not know that Aero would incur debts to Air Canada during the post-filing period.

8. There is no basis in law upon which valid set-off claims can be permanently eliminated. In the insolvency context, set-off claims are expressly preserved by statute both in the *Companies' Creditors Arrangement Act* (the "**CCAA**") and *Bankruptcy and Insolvency Act* ("**BIA**"). Moreover, there is also no equitable reason to deprive Air Canada of its set-off claims. Air Canada did not choose to be in the position in which it now finds itself. Its set-off claims arose unintentionally, and the Foreign Representatives have allowed similarly situated Aveos to set off certain amounts owing for post-filing consumption in comparable circumstances.

9. The Foreign Representatives' motion should be dismissed and Air Canada should be allowed the opportunity to establish that it is owed certain amounts and entitled to set them off against any amounts owed to Aero including with respect to post-filing consumption attributed to it by the Algorithm.

PART II - FACTS

I. Aero Allows for Commingling of Parts; Ownership Cannot Be Identified

10. Until September 2004, maintenance, repair and overhaul services were provided to Air Canada by an in-house maintenance division that, subsequent to Air Canada's CCAA proceedings in 2003-2004, ultimately became a separate business entity. As of 2009, maintenance for Air Canada's aircraft was being performed by Aveos Fleet Performance Inc. ("**Aveos**") and Air Canada. Aveos performed airframe maintenance, engine maintenance, component maintenance and supply chain business and operations, including the sourcing and management of inventory such as CAT 3 Parts, while Air Canada performed line maintenance. Aveos provided CAT 3 Parts for both lines of operations.

> Affidavit of Gilles Neron, sworn May 15, 2014 ("**Neron Affidavit**"), Tab 1 to Air Canada's Responding Motion Record at paras. 8-14.

11. In order to accommodate maintenance operations on Air Canada's fleet, Air Canada's and Aveos' storage facilities must contain sufficient inventory levels to service any of the company's aircraft in need of service at any time. Millions of dollars' worth of CAT 3 Parts were stored for that purpose. These CAT 3 Parts were - and continue to be - stored in many thousands of bins located across the floor of those facilities.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 13.

12. In November 2007, Aveos signed a ten-year exclusive supply contract and strategic partnership with Aero (the "**Aveos Agreement**"). Pursuant to the Aveos Agreement, Aveos outsourced the supply and management of CAT 3 Parts to Aero. Aveos sold Aero its existing stock of CAT 3 Parts, which remained at Aveos' and Air Canada's facilities. However, Aero did not physically or otherwise audit Aveos' stock of CAT 3 Parts at the time to verify its condition, ownership or even existence. Accordingly, Aero may purport to have acquired parts that actually belonged to Air Canada or that did not physically exist at all.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 14.

13. With respect to line maintenance, the Aveos Agreement created a significant problem for Air Canada, which had no material stock of CAT 3 Parts, no relationship with Aero and could no longer rely on Aveos to manage and procure CAT 3 Parts. Accordingly, Air Canada was faced with either having to buy its own CAT 3 Parts and manage them or enter into an arrangement with Aero.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 15.

14. In December 2008, pursuant to the Agreement for the Supply and Maintenance of Consumable and Expendable Spares (the "**LMA**"), Aero became Air Canada's exclusive supplier for practically all CAT 3 Parts for line maintenance and assumed responsibility for managing all aspects of the procurement and delivery of CAT 3 Parts for line maintenance, including monitoring and planning for Air Canada's consumption and use of the inventory.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 16.

LMA, Tab 2B to the Third Report of the Information Officer dated April 6, 2013, (the "**Third Report**") Tab 2 of the Foreign Representatives' Motion Record.

15. Following the entry into the LMA, Aero was to be responsible for the procurement of substantially all CAT 3 Parts in the Aveos / Air Canada system. Identifying ownership of CAT 3 Parts was not required as Aero would own almost all of the CAT 3 Parts involved in the maintenance of Air Canada's aircraft.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 23-25.

16. Contrary to Air Canada's expectations, however, during the course of 2009, CAT 3 Parts stored at Air Canada's and Aveos' facilities became owned by more than just Aero. In late 2008, to provide it with a source of liquidity, Aero approached Air Canada with a proposal that Air Canada would buy a significant quantity of Aero's CAT 3 Parts, which resulted in an agreement in January 2009 whereby Air Canada acquired $100 million of Aero's CAT 3 Parts (the "**January Parts**") in return for Bills of Exchange. Furthermore, during the course of 2008-2009, Aveos was having problems with Aero's performance under its contract and had begun to assume greater responsibility for procuring its own CAT 3 Parts. At the same time, Air Canada was experiencing its own issues with Aero's performance. Aero was often late in producing, or unable to produce, the necessary parts. During the course of 2009, Air Canada began acquiring increasing quantities of CAT 3 Parts directly from original equipment manufacturers due to Aero's performance issues. Finally, in October 2009, Air Canada began to acquire an additional US$25.5 million of CAT 3 Parts (the "**October Parts**") from Aero under the terms of a Consumable and Expendable Spare Parts Purchase and Sale Agreement.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 19-22.

17. Nonetheless, Aero did not segregate its CAT 3 Parts at Air Canada's and/or Aveos facilities, took no steps to physically identify its parts during the course of 2009,

and purposefully arranged to provide services to Aveos and Air Canada under their respective supply agreements through commingled inventory.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 25.

18. As these parts were largely fungible and in the majority of cases were commingled, it was not possible for Air Canada's mechanics using any particular CAT 3 Part to determine which party owned it. There was no accepted basis to determine to whom ownership of a particular fungible part should be attributed at the time it was consumed (placed on one of Air Canada's aircraft). In fact, ARTOS (the legacy inventory management and planning software system used by Air Canada and Aveos) could not identify ownership of a particular part.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 26.

II. Aero's Insolvency and Recognition Order

19. On November 11, 2009, the Foreign Representatives sought and obtained an order from the Superior Court of Justice (Commercial List) recognizing the proceedings commenced in respect of the Foreign Debtors in U.K. (the "**Recognition Order**"). Later that day, Aero repudiated the LMA and stopped fulfilling its obligations thereunder. Air Canada understood that, at or about that time, Aero terminated most of its employees and ceased operating as a going concern.

Recognition Order, Tab 1C to Air Canada's Responding Motion Record, p. 88.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 33 and 40.

20. As Air Canada could no longer rely upon Aero for procurement and inventory management, Air Canada was compelled to:

(a) expand its inventory management group to take over the functions that Aero was supposed to perform; and

(b) begin to purchase all necessary CAT 3 Parts for line maintenance from parts suppliers.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 42.

21. Following the repudiation of the LMA, the parties agreed that it was impossible to establish ownership of CAT 3 Parts. The Trustee and Information Officer has acknowledged that:

(a) Aero's CAT 3 Parts were commingled with other CAT 3 Parts owned by Aveos and Air Canada; and

(b) CAT 3 Parts owned by Aero, Air Canada and Aveos were fungible and did not bear any marks identifying ownership.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 5.

Third Report of the Trustee and Information Officer, Tab 2 of the Foreign Representatives' Motion Record at paras. 23-24.

22. These issues stemmed from the fact that Aero had completely failed in its inventory management and procurement function. Amongst other things:

(a) Multiple owners were introduced into a system designed to have one owner of parts (Aero);

(b) Some of the CAT 3 Parts believed to be owned by Aero did not physically exist. Aero had never conducted a physical audit to verify the condition, serviceability or existence of the CAT 3 Parts it had acquired;

(c) Although it had had responsibility for inventory procurement and management, Aero had never segregated its CAT 3 Parts from those owned by Aveos and Air Canada;

(d) Aero did not establish or develop any basis or system for ascribing consumption of the CAT 3 Parts and determining ownership amongst Air Canada, Aveos and Aero once the parts became commingled;

(e) Aero failed to develop updated software and adequately manage inventory for Aveos and Air Canada, leading both Aveos and Air Canada to ramp up procurement during the pre-filing period;

(f) Aero repudiated the LMA, causing Air Canada to assume all procurement functions for line maintenance. These new parts filled the commingled bins at Air Canada's warehouses, further complicating the question of establishing ownership; and

(g) Aero did not immediately categorize and remove its inventory after repudiating the LMA when it still had the personnel in place to do so.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 5 and 76.

III. Air Canada Attempted to Separate Inventory and Develop Systems to Identify Ownership

23. As Air Canada advised the Foreign Representatives, it neither wanted nor intended to consume Aero's parts during line maintenance operations. It believed the January Parts and the October Parts were sufficient to ensure that would not happen.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 5.

24. To try and eliminate the possibility that Aero parts might be inadvertently consumed, Air Canada, at entirely its own initiative and cost, attempted to perform a "tagging" operation to try and identify CAT 3 Parts belonging to Air Canada, Aveos and Aero, and to physically separate or label the inventory accordingly so that only Air Canada's parts would be consumed by Air Canada. However, tagging efforts were significantly hindered by, among other things, the volume of parts in the facilities, the

fact that maintenance operations continued and parts continued to be freshly purchased and consumed by Air Canada and Aveos in significant volumes, and, most importantly, the limitations of the inventory management tools available to Air Canada.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 44-45.

25. Despite the issues with establishing ownership of CAT 3 Part that were later acknowledged by the Information Officer, the Foreign Representatives then believed that Air Canada had consumed quantities of Aero's parts post-filing and that, by July 2010, they were in a position to invoice Air Canada. In July and August 2010, Aero, through the Information Officer, delivered invoices to Air Canada for alleged consumption of Aero-owned inventory and services rendered to Air Canada between October 1, 2009 and May 31, 2010 (together, the "**2010 Invoices**").

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 46.

26. It was apparent to Air Canada that there were real problems with the 2010 Invoices. By that time, given its inventory position and the fact that Air Canada was ordering new CAT 3 Parts in amounts consistent with average consumption, Air Canada believed that if there was any use of Aero parts, it was not material. Moreover, new CAT 3 Part procurement was expected to "re-fill" the bins such that sufficient CAT 3 Parts would be available to satisfy quantities claimed to be owned by Aero and consumed by Air Canada.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 47-48.

27. Furthermore, Air Canada did not believe that there was an accepted means to identify whose parts had been consumed. Following receipt of the 2010 Invoices and disputing same, Air Canada realized that any unilateral attempt at determining inventory usage and reconciling the invoices would be difficult and any alternative calculation proposed by Air Canada would be challenged by the Foreign Representatives. Therefore, the calculations would need to be done in conjunction with

the Foreign Representatives, the Information Officer, and Aveos. While Air Canada tried a number of times to get the other parties to agree to an algorithmic solution to the problem of establishing consumption, the Information Officer believed that the solutions being proposed did not serve Aero's needs and was unwilling to participate at the time.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 49.
>
> Affidavit of Nicholas Brearton, sworn May 28, 2014 ("Brearton Affidavit"), Tab 1 to the Foreign Representatives' Second Supplementary Motion Record at para. 14.

28. Following an October 12, 2010 case conference with Justice Morawetz, Air Canada again suggested that the three parties work together to agree on a common set of principles and rules, which would be incorporated into an algorithm that would allow the parties to attribute consumption of CAT 3 Parts as between each of Air Canada, Aero and Aveos.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 50-51.

29. Aveos took the lead on developing the Algorithm. Air Canada engaged an outside consultant to assist on its end. By December 23, 2010, Aero (by the Foreign Representatives), Aveos and Air Canada entered into an agreement (the "**Algorithm Agreement**"), under which the parties acknowledged the creation of an Algorithm to allocate ownership among Aveos, Aero and Air Canada and provided that each of the parties would work together, in good faith, to establish and confirm the business rules applicable to the Algorithm.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 52, 53, and 55.
>
> Algorithm Agreement, Tab 1I to Air Canada's Responding Motion Record.

30. Over the next several months, the parties worked together to create the business rules applicable to the Algorithm. As ultimately designed, the Algorithm works by importing ARTOS data regarding past consumption and then applying agreed-upon

rules (based on certain accepted business principles) to attribute that consumption to the three parties and adjust their share of the baseline inventory. In addition to the Algorithm, Air Canada and Aveos had to develop another algorithm (the "**Bin Allocation**" algorithm) in conjunction with Aero (through the Foreign Representatives) that would assign CAT 3 Parts ownership to each of Aero, Aveos and Air Canada on a per bin basis. The Bin Allocation algorithm was developed between May and September 2011.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 56 and 58.

31. On or about March 9, 2012, an agreement was reached with respect to the Algorithm, as reflected in the endorsement of Justice Morawetz.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 59.

March 9, 2012 Endorsement, Tab 1K to Air Canada's Responding Motion Record.

32. The Algorithm, which was a highly complex piece of software, was developed entirely at Air Canada and Aveos' cost with no financial contribution from Aero.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 60.

33. While the Algorithm represents the only means available to attribute consumption, it has various shortcomings. Among other things, the Algorithm does not actually identify ownership of individual CAT 3 Parts. There is no way to determine who owns any particular part used in line maintenance operations at the time of consumption. Nor does the Algorithm account for "vapour" or "overages" (discrepancies between the quantity of a type of part in a specific location as shown on ARTOS and the actual count in that location). Rather, the Algorithm allows the parties to attribute consumption to a party based on an agreed upon set of rules on an *ex post facto* basis. Furthermore, because the Algorithm relies on the inputs from the ARTOS system, it cannot account for human error in inputting data by maintenance personnel.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 57.

34. By July 2011, Air Canada had reiterated its desire to move Aero's parts out of its facilities because it lacked the capacity to store them and believed them to be an impediment to its operations. It was similarly clear that the Foreign Representatives wanted Aero-owned parts removed from Air Canada facilities so that they could be sold. However, it was not until December 2012, that an agreement had been entered into and the uplift of Aero's CAT 3 Parts had been completed. It was not until March 2013 that the Trustee and Information Offer reported that the bulk of the Aero-owned CAT 3 Parts had been sold.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 68, 71 and 75.
>
> Sixth Report of the Trustee and Information Officer dated March 27, 2013, Tab 6 of the Air Canada Reports Compendium at paras. 17, 20-26 and 45.
>
> Eighth Report of the Trustee and Information Officer dated January 16, 2014, Tab 8 of the Air Canada Reports Compendium at para. 23.

35. Following the uplift, certain discrepancies came to the attention of the parties regarding the Algorithm's attribution of consumption of the CAT 3 Parts. For instance, in respect of certain types of parts, the Foreign Representatives had received significantly less inventory than expected while in respect of other types of parts, they had received significantly more inventory than expected. In addition, in its Supplement to the Third Report the Information Officer notes that over the period from July 1, 2012 to December 31, 2012, the Algorithm shows that Aero consumed US$710,652 of Air Canada's CAT 3 Parts. Aero had no ongoing business during that period and the Foreign Representatives cannot account for this consumption.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 72-74.

PART III - ISSUES

36. The only issue to be determined at the hearing of the present motion is whether the Foreign Representatives can permanently eliminate whatever rights of set-off Air

Canada might otherwise be able to advance as a defence to the Foreign Representatives' claim for payment for the CAT 3 Parts that are characterized by the Algorithm as having been consumed by Air Canada during the period from November 11, 2009 to December 2012.

37. The Foreign Representatives concede that the existence and validity of Air Canada's set-off rights (be they legal, equitable, post-filing to post-filing or otherwise) are not at issue in this motion.

38. Air Canada respectfully submits that there is no legal or equitable basis upon which Air Canada's set-off rights can or should be eliminated.

PART IV - LAW AND ARGUMENT

I. Rights of Set-Off Cannot Be Eliminated

Rights Are Preserved by Statute

39. A Court cannot eliminate or permanently stay rights of set-off in insolvency proceedings. Parliament has provided for the preservation of set-off in both CCAA and bankruptcy proceedings. Under the BIA, s. 97(3) provides that:

> The law of set-off or compensation applies to all claims made against the estate of the bankrupt and also to all actions instituted by the trustee for the recovery of debts due to the bankrupt in the same manner and to the same extent as if the bankrupt were plaintiff or defendant, as the case may be, except in so far as any claim for set-off or compensation is affected by the provisions of this Act respecting frauds or fraudulent preferences.
>
> *BIA*, s. 97(3).

40. The CCAA contains a nearly identical provision at s. 21:

> The law of set-off or compensation applies to all claims made against a debtor company and to all actions instituted by it for the recovery of debts due to the company in the same manner and to the same extent as if the company were plaintiff or defendant, as the case may be.
>
> *CCAA*, s. 21.

41. Sections 21 of the CCAA and 97(3) of the BIA are drafted to make it clear that set-off is not *created* by the insolvency statutes, but is rather preserved. Thus, the application of the principles of set-off in insolvency law is generally the same as their application outside of insolvency.

> Kelly R. Palmer, *The Law of Set-Off in Canada*, (Toronto: Canada Law Book, 1993) at p. 158, Air Canada's Book of Authorities at Tab 1.

42. Set-off addresses the unfairness that would arise in a situation where parties A and B have mutual debts, but party A, who is solvent, is required to repay the debt in full while party B, who is insolvent, only has to pay a percentage of its debt. As described in *Houlden and Morawetz Bankruptcy and Insolvency Analysis*:

> The object of set-off is to avoid the perceived injustice to a person who has had mutual dealings with a bankrupt of having to pay in full what he or she owes to the bankrupt while having the rest content with a dividend on what the bankrupt owed him or her.
>
> L.W. Houlden and Geoffrey B. Morawetz, *Houlden and Morawetz Bankruptcy and Insolvency Analysis*, Thomson Reuters Canada Limited, electronic version, accessed June 21, 2014 ("**H&M Analysis**") at F§237, Air Canada's Book of Authorities at Tab 2.

43. Courts have held that the set-off provision is a valid exception to the rule that the claims of creditors should not be elevated as against each other. In *Husky Oil Operations Ltd. v. M.N.R.*, the Supreme Court of Canada considered the implications of set-off in bankruptcy, noting that courts should respect statutory decisions by Parliament:

> ...the law of set-off allows a debtor of a bankrupt who is also a creditor of the bankrupt to refrain from paying the full debt owing to the estate, since it may be that the estate will only fulfil a portion, if that, of the bankrupt's debt. Consequently, in this limited sense the party claiming set-off has Parliament's blessing for the "reordering" of his priority in bankruptcy by virtue of the operation of the law of set-off. [emphasis added]
>
> *Husky Oil Operations Ltd. v. Minister of National Revenue*, [1995] 3 SCR 453 at para. 60, Air Canada's Book of Authorities at Tab 3.

44. It is widely acknowledged that competing interests are at stake in insolvency-based set-off, as described by Justice Blair:

> In insolvency situations, setoff provides a creditor with an advantage which other creditors, ranking *pari passu* except for the setoff, do not have. It puts the advantaged creditor in what is tantamount to a secured position, something which was not a part of the bargain with the insolvent company in the first place. On the other hand, there is an inherent unfairness where a debtor/creditor is required to pay the liquidator everything that is legitimately owed to the insolvent company but is only able to collect a fraction of what is equally legitimately owing by the insolvent company, if anything.
>
> *Citibank Canada v. Confederation Life Insurance Co. (Liquidator of)*, [1996] OJ No. 3409 (S.C.J.) ("*Citibank*") at para. 30, Air Canada's Book of Authorities at Tab 4.

45. These competing interests were again recognized in *National Foundation for Hepatitis C (Trustee of) v. GWE Group Inc.*, where the Court stated that:

> It is correct that if a person who is both a creditor and a debtor of a bankrupt has a right of set-off he may be in a better position in the bankruptcy than he would be absent set-off. But that is a consequence of set-off. Parliament has explicitly recognized the right of set-off in s. 97(3). [emphasis added]
>
> *National Foundation for Hepatitis C (Trustee of) v. GWE Group Inc.* (1999), 8 CBR (4th) 281 (A.B.Q.B.) at para. 23, Air Canada's Book of Authorities at Tab 5.

46. Parliament has considered these competing interests and decided that the limited advantage set-off provides is appropriate in the context of insolvency law. As Justice Blair explained, set-off is "the policy mechanism whereby the competing "equities"... are balanced."

Citibank at para. 29, Air Canada's Book of Authorities at Tab 4.

47. The Foreign Representatives cite the 1990 decision in *Quintette Coal v. Nippon Steel Corp.* for the principle that set-off should not have the effect of giving one creditor an advantage over another. However, at the time *Quintette* was decided, the CCAA did not contain any language preserving set-off – s. 21 was enacted in 1997 (originally as s. 18.1).

Quintette Coal v. Nippon Steel Corp. (1990), 2 CBR (3d) 303 (B.C.C.A.) ("*Quintette*") at p. 7-8, Air Canada's Book of Authorities at Tab 6.

48. The principles relied upon in *Quintette* have been questioned since 1997. See, for example, the Court of Appeal's decision in *Blue Range Resources*, which confirms that Parliament's preservation of set-off through s. 21 renders inapplicable concerns about creditor priority or preference in allowing set-off claims in insolvency.

Re Blue Range Resource Corp., 2000 ABCA 200 ("***Blue Range CA***") at para. 13, Air Canada's Book of Authorities at Tab 7, reversing *Re Blue Range Resource Corp.*, 1999 ABQB 1038, Air Canada's Book of Authorities at Tab 8.

Application of Set-Off in Insolvency

49. In *Re Canadian Airlines Corp.*, Justice Paperny was asked to consider the availability of legal set-off in a CCAA proceeding. Justice Paperny applied the same test for legal set-off as applies outside of insolvency, deciding ultimately that legal set-off should be applied as between the debtor and Canadian tax authorities.

Re Canadian Airlines Corp., 2001 ABQB 146 at paras. 6, 19 and 33, Air Canada's Book of Authorities at Tab 9.

50. In *Blue Range CA*, the Alberta Court of Appeal considered the application of equitable set-off in CCAA proceedings for pre-filing to post-filing amounts. Again, the Court applied the same test for equitable set-off inside insolvency as outside of insolvency and ultimately determined that set-off applied in the circumstances.

Blue Range CA at paras. 8, 13-14, Air Canada's Book of Authorities at Tab 7.

51. Bankruptcy courts have suggested that the analysis in *Blue Range CA* would apply in bankruptcy proceedings, as well. In *NESI Energy Marketing Canada v. NGL Supply*, the Alberta Court of Appeal, although deciding that set-off was not available on the facts, noted that:

> Set-off in an insolvency context was considered by this court in Blue Range.... Equitable set-off was available to the creditors because all the obligations arose out of the same contracts. The creditors and the insolvent company both advanced a claim against each other and it would have been unjust to require the creditors to make a payment to the insolvent company when significant losses resulting from the insolvent company's breach were anticipated. The Blue Range case provides a useful framework for assessing set-off claims in CCAA proceedings and, by analogy, in bankruptcy proceedings. The requirements for set-off were not relaxed because of the insolvency context. Instead, the basic requirements (including cross-claims between the parties and, for equitable set-off, connection between the cross-claims resulting in a manifest lack of justice if set-off were not allowed) were applied to the creditors of the company under CCAA protection.

NESI Energy Marketing Canada Ltd. (Trustee of) v. NGL Supply (Gas) Co., 2001 ABCA 168 at paras. 74-76, Air Canada's Book of Authorities at Tab 10.

52. Legal and equitable set-off in bankruptcy was recognized and applied in *Coopers & Lybrand Ltd. v. Lumberland Building Materials*. In *Lumberland*, a customer owed about $11,000 to the bankrupt on the date of bankruptcy. However, the customer was also participating in a rebate program. As at the date of bankruptcy, the customer had purchased goods that would have ultimately entitled it to a rebate of about $6,000,

payable on a date that was after the date of bankruptcy. The trustee pursued the customer for the $11,000 debt and argued that set-off wasn't available to the customer as (a) mutuality was broken and (b) the amount due to the customer hadn't crystallized at the date of bankruptcy. The court disagreed, noting the test for equitable set-off had been met. Among other things, the court noted that the defendant had purchased the goods in accordance with the requirements for qualifying for a rebate and that it was therefore equitable that it be able to set-off. The court went on to say that, even if the debt was not liquidated or there was lack of mutuality, it would qualify for equitable set off due to the close relation of the claims and other sympathetic facts.

> *Coopers & Lybrand Ltd. v. Lumberland Building Materials Ltd.*, (1983), 50 CBR (NS) 150 (B.C.S.C.) at paras. 17 and 20, Air Canada's Book of Authorities at Tab 11.

53. A concern is sometimes expressed over the potential misuse of set-off in insolvency proceedings. While the ability to set-off may be challenged as a fraudulent preference in circumstances where a debt is intentionally created for the purposes of set-off, that is <u>not</u> the case at hand. In this case, Air Canada's post-filing consumption, if any, was unforeseen and unintentional and therefore could not have been done for the purpose of availing itself of set-off.

54. The Foreign Representatives' reliance on the excerpted quotation at paragraph 56 in their factum (the first paragraph quoted and reproduced below) is therefore misplaced. The Foreign Representatives use that excerpt from *Bankruptcy and Insolvency Law of Canada* to suggest that set-off is not permitted in the context of proposals. However, the portion of the text that immediately follows the excerpt (the second paragraph reproduced below), which was omitted from the Foreign Representatives' factum, makes clear that it was the potential for misuse that was being addressed, not the availability of set-off generally:

> It is customary in a proposal to provide that creditors shall have no right of set-off for goods or services purchased by them from the debtor after the date of the filing of the notice of intention or the proposal if no notice of intention was filed. This provision [prevents] creditors from purchasing goods from the debtor after the date of the proposal and claiming a right of set-off. Even if such a provision is not contained in the proposal, it would appear that there is no right of set-off in these circumstances.
>
> The New Brunswick Court of Queen's Bench would not authorize set-off for a deposit paid after a notice of intention as the debtor was clearly insolvent and hence this would constitute a preference for the purposes of s. 97(3) of the BIA. However, where the contractual right of set-off was in existence well in advance of the subsequent bankruptcy and where the contractual right of set-off arises in the ordinary course of dealing between parties, the application of such set-off does not constitute a fraudulent preference within the meaning of s. 97(3) of the BIA: *Re Brunswick Chrysler Plymouth Ltd.* (2004), 2004 CarswellNB 705, 11 C.B.R. (5th) 10, 6 B.L.R. (4th) 300, 2005 NBQB 83 (N.B. Q.B.).

55. In *Re Brunswick* (cited in the excerpt above) in commenting on the previous version of the excerpt from *Bankruptcy and Insolvency Law in Canada* relied on by the Foreign Representatives, the Court confirmed the basic principle that rights or set-off are preserved:

> A valid set-off will inevitably affect and alter the priorities in a bankruptcy but that is what the BIA contemplates. The right of set-off in this case arises in the ordinary course of business, dealings between DaimlerChrysler and its dealer, Brunswick, pursuant to the Sales and Service Agreement which was in effect for a considerable period of time prior to Brunswick's Bankruptcy and which agreement contains a specific set-off provision. As mentioned, it was not put in place on the eve of Brunswick's insolvency. The right of set-off is clearly preserved in Section 97(3) of the BIA. In my opinion, a valid right of set-off that arises in the ordinary course of dealings between parties does not give rise to a preference that can be set aside under the BIA. [emphasis added]

Re Brunswick Chrysler Plymouth Ltd. (2004), 11 C.B.R. (5th) 10 (N.B. Q.B.) at paras. 27, 30, 31, and 42, Air Canada's Book of Authorities at Tab 12.

56. The Court in *Re Brunswick* then goes through the many decisions of various Canadian Courts (many of which are cited and described above) which have upheld the now well-accepted proposition that valid rights of set-off are preserved and must be applied in the insolvency context.

Part IV Proceedings Should Comply with the Rest of the CCAA

57. Section 49(2) of the CCAA provides that any order made in respect of a debtor company under Part IV of the CCAA must be consistent with any order that may be made in any proceedings under the CCAA. Therefore, any order dealing with set-off rights must be consistent with section 21 of the CCAA.

CCAA, s. 49.

58. The Foreign Representatives rely on *Re Hartford* for the principle that Part IV CCAA orders do not need to comply with the other sections of the CCAA.

Re Hartford Computer Hardware, Inc., [2012] OJ No. 715 (S.C.J. [Comm. List]) ("***Hartford***"), Air Canada's Book of Authorities at Tab 13..

59. *Re Hartford* involved a foreign main proceeding in the United States with Part IV recognition proceedings running parallel to the American process in Canada. Justice Morawetz granted an order recognizing certain U.S. orders, including debtor-in-possession ("DIP") financing which had the effect of permitting the DIP lender to secure some of its pre-filing debt through the insolvency process, known as a "roll up." DIP roll ups are prohibited in Canada pursuant to s. 11.2 of the CCAA.

Hartford at paras. 10 and 15, Air Canada's Book of Authorities at Tab 13.

60. The Foreign Representatives misapprehend *Re Hartford*, particularly the principles underlying the CCAA court's reasons for granting the recognition of the DIP order. Unlike in the Aero CCAA proceedings, the *Re Hartford* proceedings involved only the recognition of a U.S. order, the subject matter of which order was expressly permitted in that jurisdiction.

Hartford at paras. 7-8 and 12, Air Canada's Book of Authorities at Tab 13.

61. In contrast, paragraph 10 of the Recognition Order dealt with new subject matter under the CCAA that had not been considered at the UK hearing. Justice Morawetz emphasized at paragraphs 12 and 14 of the *Re Hartford* decision that His Honour's approval of the DIP roll up depended on the fact that these orders had been considered and granted in the U.S. jurisdiction after a full hearing, where all stakeholders had the opportunity to express their views and test the strength of the debtors' evidence and case law. In the case at bar, the Foreign Representatives sought new protections under the CCAA that had not been granted in the foreign main proceeding and had not been subject to scrutiny by the court. It is incorrect to equate a recognition order with an order granting new relief.

Hartford at paras. 12 and 14, Air Canada's Book of Authorities at Tab 13.

Temporary Stay

62. While rights of set-off cannot be eliminated, there is some suggestion that they can be temporarily stayed if necessary to preserve the business as a going concern. In Air Canada's own restructuring, which commenced in 2003, the initial CCAA order included paragraph 9, which stated as follows:

> THIS COURT ORDERS that persons may exercise only such rights of set off as are permitted under Section 18.1 of the CCAA as of the date of this order. For greater certainty, no person may set off any

> obligation of an Applicant to such person which arose prior to such date. [emphasis added]

63. The "no set-off" provision (underlined above) was challenged by certain of Air Canada's lenders, who were also the financial institutions at which Air Canada's bank accounts were located. On the day the initial order was granted, the lenders removed and segregated a portion of the amounts shown as being held by them for Air Canada's account in order to set-off those amounts against portions of the pre-filing debt owed to the lenders. The lenders brought a motion to strike the no set-off provision on the grounds that it was contrary to the CCAA. However, the lenders were prepared to agree to a temporary stay of their set-off rights against new deposits made during the post-filing period that were to be used to fund Air Canada's operations during the restructuring.

> *Re Air Canada*, [2003] OJ No. 6058 (S.C.J. [Comm. List]) (*"Air Canada"*) at paras. 1-3, Air Canada's Book of Authorities at Tab 14.

64. Justice Farley struck the no set-off provision, noting that while a temporary stay was appropriate to allow Air Canada to stabilize, permanent set-off was not permitted because of s. 21 of the CCAA. With respect to the temporal stay, Justice Farley stated:

> With respect to the question of what I have described as a temporal stay, there does not appear to be any opposition by the Moving Creditors to the proposition that whatever their rights of set-off in substance are determined to be, that such determination and enforcement of such determined rights should await until a convenient time when AC has stabilized (or I suppose, alternatively cratered). It would seem to me that the likely time for this would be in conjunction with the formation of a reorganization plan of arrangement and compromise. However, I leave that question open pending future submissions and further order of the court emanating as a result thereof.

> *Air Canada* at para. 25, Air Canada's Book of Authorities at Tab 14.

II. Justice Newbould's Order

Justice Newbould Did Not Intend to Permanently Eliminate Air Canada's Statutory Rights

65. The Foreign Administrators' motion for an order eliminating Air Canada's right to set-off is based on the November 11, 2009 Recognition Order of Justice Newbould.

66. As part of the relief sought and obtained in the Recognition Order, the Foreign Representatives requested that the Court temporarily stay the rights of set-off of third parties.

67. The Recognition Order was obtained without notice to Air Canada. Paragraph 10 of the Recognition Order provides:

> **THIS COURT ORDERS** that the determination and enforcement of any Person's right of set-off from and after the effective time of this Order shall be stayed pending further order of this Court and any new purchases of goods from the Foreign Debtors under existing supply contracts or otherwise from and after the effective time of this Order shall be paid by the customers on terms acceptable to the Foreign Representatives without counterclaim or deduction. [Emphasis added]
>
> Recognition Order dated November 11, 2009, Tab 1C to Air Canada's Responding Motion Record at para. 10.

68. In his endorsement, Justice Newbould gave his reasons for paragraph 10 of the Recognition Order. He first accepted that "a court may temporarily stay the right of set-off protected in section 21 of the CCAA. How temporary that stay should be will obviously depend on the circumstances existing at the relevant time". Citing to the evidence of Mr. Trupp, a director of Aero, he acknowledged Aero's concern that the inventory was out of its control, noting the threat of creditor enforcement action and the

fact that creditors could seize stock if concerned about Aero's solvency. Justice Newbould then stated:

> [31] ... It is apparent that the Canadian inventory comprises a substantial portion of the total inventory. That inventory should be properly protected to enable the foreign debtors to attempt to continue as a going concern.
>
> [32] Taking into account the purposes of part IV of the CCAA relating to cross-border insolvencies, as set out in section 44, including co-operation between the courts of jurisdictions involved and the maximization of the value of the debtor company's property, it is appropriate in the circumstances of this case to stay set-off rights pending further order of this Court. How long that stay should be is a matter of conjecture at this stage. The proceedings have just commenced and what the outcome will be is not possible to know. Thus the length of any stay of set-off rights is an unknown. [Emphasis added]
>
> November 11, 2009 Endorsement, Tab 1F to Air Canada's Responding Motion Record at paras. 27, 31-32.

69. The result of the order was that Aveos and Air Canada would be put to a choice in the short term. They could choose whether to (a) consume Aero's inventory under the existing terms of the LMA or on terms negotiated with the Foreign Representatives, or (b) not to consume Aero's inventory, if not content with the terms proposed.

70. Two things were not resolved by the Recognition Order. First, the Order does not indicate how the creditors' rights of set-off would be dealt with once the stay ended. The Order does not eliminate the rights of set-off that would have otherwise been applicable to purchases made while the Order was in place. Rather, as the Foreign Representatives acknowledge at paragraph 45(a) of their factum, Justice Newbould stayed the "determination and enforcement of any Person's right of set-off from and after the effective time... pending further order of this Court."

71. In other words, while Air Canada and Aveos may have been required to pay on specific terms during the effectiveness of the Order, ultimately there would be a determination of their rights of set-off. To the extent that Air Canada has paid in circumstances where it had valid rights of set-off that would otherwise of had applied, it will ultimately be entitled to a return of a portion of the funds. To hold otherwise would be to order a permanent elimination of rights of set-off. Justice Newbould made clear that he did not intend to do that.

72. The Foreign Representatives state that Aero never intended to become a creditor in the post-filing period and would have required cash payments in advance but for the nature of its business. Air Canada never wanted this situation either. However, Air Canada now owes money for deemed post-filing consumption pursuant to the Algorithm but its right to demonstrate that it may be entitled to set-off is preserved by statute. Amongst other things, Air Canada is entitled to demonstrate that it is entitled to set off amounts that became owing to it by Aero during the post-filing period ("post-post" set-off), e.g., for Aero's consumption of Air Canada's parts. Not permitting such set-off would be grossly unfair and is inconsistent with the Foreign Representatives' stated justification for the order (to avoid altering the status quo on the filing date and conferring a preference on Air Canada as compared to other pre-filing creditors).

73. The second question that was not resolved by Justice Newbould's order was how long the stay would last and, therefore, when the determination and enforcement of set-off rights would occur.

74. Presumably, the stay was to remain in place for so long as it served its purpose, notably to preserve Aero's ability to operate as a going concern and to protect Aero's inventory from creditor enforcement action. Given that there is no ongoing business and the inventory has been uplifted, any need for the stay had expired, at the latest, by

the end of 2012. Therefore, at this point, it is appropriate to determine whether any rights of set-off exist and, if they do, enforce them.

Justice Newbould Did Not Have a Full Evidentiary Record

75. Justice Newbould did not have all of the pertinent information at hand at the time the Recognition Order was sought and granted. Indeed, the Information Officer admits that, at the time, it was not yet fully aware of the details of the relationship between Air Canada and Aero. Had all the pertinent information been before Justice Newbould, it is unlikely he would have granted paragraph 10 of the Recognition Order.

> Pre-Filing Report of the Information Officer dated November 10, 2009, Tab 1D to Air Canada's Responding Motion Record at paras. 13 and 18.

76. First, Justice Newbould granted the Recognition Order believing that it may enable the Foreign Debtors to continue as a going concern. He could not have known that:

(a) Aero would repudiate the LMA on the same day as the Recognition Order was made;

(b) Shortly after the Recognition Order was made, Aero terminated most of its employees and ceased operating as a going concern;

(c) By January 22, 2010, the Foreign Representatives assigned Aero into bankruptcy; and

(d) The aim of the insolvency proceedings became the liquidation of inventory for the benefit of secured creditors.

> Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 40 and 76.

77. Second, Justice Newbould clearly presumed that consumption would ultimately arise from either creditor enforcement action or intentional purchase. He was not advised and could not have foreseen that:

(a) It was not possible to identify Aero's inventory or to avoid consuming it; and

(b) It would require the development of a complex Algorithm over the course of two and a half-years before the parties could agree on an accepted basis to retroactively attribute consumption.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 6 and 43.

78. Third, Justice Newbould was told that paragraph 10 of the Recognition Order was needed to preserve the status quo. He would not have known that Aero would accrue its own post-filing debts to Air Canada, including as a result of:

(a) storage fees incurred by Aero for storing its inventory at Air Canada's premises pending the uplift;

(b) Significant expenditure to develop the Algorithm and the Bin Allocation Program to allow Aero to conduct the uplift and remove its parts for sale for the benefit of the estate; and

(c) The Algorithm's attribution of post-filing consumption of Air Canada's parts to Aero.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 60, 65, and 74.

79. Finally, Justice Newbould would not have known that Aero was prepared to, and did, recognize rights of set-off against post-filing consumption in similar circumstances. For example, Aveos and Aero agreed in the Settlement and Labour

Supply Agreement dated December 31, 2010 (the "**SALSA**") that Aveos would be able to set off certain amounts owing by Aero to Aveos after the Filing Date (such as storage fees) against amounts owning by Aveos to Aero for post Filing Date consumption of Aero's CAT 3 Parts.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 65.

See, e.g., SALSA, Tab 1L to Air Canada's Responding Motion Record, section 5.2

80. More generally, Justice Newbould would not have known that Air Canada would be unknowingly and unwillingly thrust into its current position because of the situation in which Aero left the parties. The evidence before Justice Newbould did not indicate that Air Canada could not know who owned a CAT 3 Part at the time it was being put on an aircraft during the course of line maintenance, which made it impossible for Air Canada to avail itself of the choice presented in the Recognition Order – to either pay for the CAT 3 Parts (as it was unintentionally consuming them) or to not consume them and source the CAT 3 Parts from a third party supplier. Any and all consumption of Aero-owned CAT 3 Parts attributed to Air Canada was done so only after the Algorithm was developed and agreed upon, two and a half years later.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 5.

81. Now, the Foreign Representatives seek to force the terms of "purchase" upon Air Canada *ex post facto* as though Air Canada had chosen to consume the CAT 3 Parts (which terms would have been rejected if Air Canada had actually been offered the choice contemplated by Justice Newbould). Furthermore, while acknowledging that they owe Air Canada amounts from the post-filing period, the Foreign Representatives also reject Air Canada's ability to set-off its own post-filing or other claims against Aero.

III. Air Canada Did Not Believe It was Consuming Aero's Parts; Did Not Set Aside the Recognition Order

82. Despite the foregoing, the Foreign Representatives maintain that Justice Newbould intended to, and did, permanently eliminate Air Canada's rights of set-off in respect of post-filing consumption. Assuming that to be true, they say that it is too late for Air Canada to do anything about it.

83. As an initial matter, the Foreign Representatives say that Air Canada should have moved to set aside portions of the Recognition Order sooner. However, Air Canada first brought a motion on January 28, 2010 to strike paragraph 10 of the Recognition Order. The motion never proceeded to a hearing because, at the time, Air Canada believed it was not consuming Aero-owned parts, so there was no point in going forward. In any event, the issues in the proposed motion overlapped greatly with the issues raised in the preference action initiated by the trustee in bankruptcy in April 2010 (the "**Preference Action**"). As the Trustee and Information Officer reported in its Second Report, any such motion was "expected to be heard in conjunction with the Preference Action." Once the Foreign Representatives brought the present motion in April 2012, it was clear that Air Canada's request for relief would be subsumed by it. The Foreign Representatives' failure to bring that motion on for more than two years does not rest with Air Canada; and it is disingenuous to suggest that Air Canada has failed to exercise any rights with respect to the Recognition Order "for over four years". Moreover, it is a gross mischaracterization for the Foreign Representatives to say that Air Canada has "still not brought its motion", as the agreed basis for the present motion is that it will deal with the issues raised in both Air Canada's and the Foreign Representatives' motions.

> Second Report of the Trustee and Information Officer, dated January 17, 2011, Tab 2 of the Air Canada Reports Compendium at para. 16.

84. Furthermore, the Foreign Representatives complain about certain statements made by Air Canada prior to the development of the Algorithm regarding its belief that

it was not consuming Aero-owned CAT 3 Parts. In particular, the Foreign Representatives note that Air Canada stated in 2009 and 2010 that it was not using any of Aero's parts but, to the extent it was, the use was immaterial and it was prepared to pay for that de minimus use. The Foreign Representatives intimate that Air Canada made those statements with the intention of misleading Aero to its detriment. They suggest that Air Canada has been "sitting in the weeds", gaining a tactical advantage as its payables have risen post-filing, and that Air Canada should be "estopped" from now resiling from those representations. Any such suggestion by the Foreign Representatives is factually incorrect and manifestly unfair. Not only is the evidence clear that Air Canada believed it was not consuming any such parts, but it is implausible to believe that Air Canada would have proposed the Algorithm – and then spent two years funding (without contribution from the Foreign Representatives) and developing it – if Air Canada had it wanted to mislead the Foreign Representatives as to the extent of its consumption.

85. Any statements by Air Canada must be taken in the context in which they were made. As described in the Neron Affidavit (which was not challenged by the Foreign Representatives), at the time of the Recognition Order, Air Canada believed that it was not consuming Aero-owned parts for, among other reasons:

(a) Air Canada had acquired a large amount inventory as a result of purchases under the January Purchase Agreement and the October Purchase Agreement;

(b) Air Canada significantly ramped up acquisitions of CAT 3 Parts from third party suppliers;

(c) Air Canada's purchases eventually rose to approximately $2 million per month of new CAT 3 Parts for line maintenance, which equalled its average monthly consumption; and

(d) new CAT 3 Part procurement was expected to "re-fill" the bins such that sufficient CAT 3 Parts would be available to satisfy quantities claimed to be owned by Aero.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at paras. 19, 22, 41, and 42.

86. Based upon its belief, Air Canada advised the Court on December 1, 2009 that Air Canada would not be consuming any Aero-owned parts and Mr. Butterfield stated in his January 28, 2010 affidavit that "because Air Canada holds CAT 3 Inventory purchased under the January Purchase Agreement and the October Purchase Agreement, it has not needed to purchase any CAT 3 Inventory from Aero under the Line Maintenance Agreement since the date of the Recognition Order, except certain parts in limited quantities."

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 41.

87. Similarly, by the summer of 2010, given its inventory position and the fact that it was ordering new CAT 3 Parts in amounts consistent with average consumption, and had set aside certain identified parts, Air Canada believed that if there was any use of Aero parts, it was not material and stated so in its correspondence with Aero. Accordingly, in his August 2010 affidavit, Mr. Butterfield stated that Air Canada was reviewing whether any inadvertent use occurred and was prepared to pay for such use. There is no evidence that any of those beliefs were not genuinely held. It was only with the development of the Algorithm that the parties adjusted the basis for tracking consumption. As noted above, the Algorithm does not itself establish ownership, but it serves as an agreed-upon basis for ascribing consumption amongst the parties. When the results of the Algorithm became available two years later, they were markedly and inexplicably higher.

Neron Affidavit, Tab 1 to Air Canada's Responding Motion Record at para. 47.

88. The Foreign Representatives now claim "estoppel by representation", indicating that Air Canada should not be able to resile from the approach taken when it believed that the amount of consumption was de minimus and not worth fighting over. Leaving aside the fact that estoppel by representation is not applicable to statements about future intent, there is no evidence that the Foreign Representatives (who bear the onus of establishing estoppel) actually relied upon the statements made by Air Canada. The Foreign Representatives knew at the time that they sought the Recognition Order from Justice Newbould that there were issues with the commingling of inventory. Aero's Canadian affiliate had admittedly been conducting its own review of consumption (rather than relying on Air Canada) since October 2009 and were working on their own uplift plan. Mr. Brearton admits that, by the spring of 2010, Aero personnel had reviewed the available data and already concluded that Aero's inventory was the subject of continued consumption by Air Canada. Still, Aero did not issue invoices to Air Canada for another four months. Even then, the Foreign Representatives did not seek to revisit the Recognition Order or ask for any additional protections. They were content to wait for more accurate consumption data to become available using the Algorithm.

> Brearton Affidavit, Tab 1 to the Foreign Representatives' Second Supplementary Motion Record at para. 22.
>
> Bruce MacDougall, *Estoppel* (Markham: Lexis Nexis, 2012) ("*Estoppel*") at §4.80-4.81 and §4.282, 4.288-4.289, Air Canada's Book of Authorities at Tab 15.
>
> First Report of the Trustee and Information Officer, dated June 30, 2010, Tab 1 of the Air Canada Reports Compendium at para. 42.

89. As discussed in detail above, the delay in seeking a determination of the issues on this motion is not the fault of Air Canada. It results principally from the fact that it took Air Canada and Aveos a considerable amount of time to develop the Algorithm and reach agreement relating thereto. Until that was done, no one knew where the parties stood with any certainty. In 2012, the Foreign Representatives brought a motion that clearly subsumed the relief that was sought by Air Canada, but did not pursue it

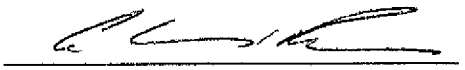
until now. It is not "inequitable" for Air Canada to now seek the determination of its rights of set-off.

PART V - ORDER REQUESTED

90. For the reasons set out above, Air Canada requests an Order dismissing the Foreign Representatives' motion and permitting Air Canada to seek the determination and enforcement of any rights to set-off against amounts owed by Air Canada to Aero with respect to post-filing consumption attributed to it by the Algorithm.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

July 10, 2014



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SCHEDULE "A"
LIST OF AUTHORITIES

Authorities

1. Kelly R. Palmer, *The Law of Set-Off in Canada*, (Toronto: Canada Law Book, 1993)
2. L.W. Houlden and Geoffrey B. Morawetz, *Houlden and Morawetz Bankruptcy and Insolvency Analysis*, Thomson Reuters Canada Limited, electronic version, F§237
3. *Husky Oil Operations Ltd. v. Minister of National Revenue*, [1995] 3 SCR 453
4. *Citibank Canada v. Confederation Life Insurance Co. (Liquidator of)*, [1996] OJ No. 3409 (S.C.J.)
5. *National Foundation for Hepatitis C (Trustee of) v. GWE Group Inc.* (1999), 8 C.B.R. (4th) 281 (A.B.Q.B.)
6. *Quintette Coal v. Nippon Steel Corp.* (1990), 2 CBR (3d) 303 (B.C.C.A.)
7. *Re Blue Range Resource Corp.*, 2000 ABCA 200
8. *Re Blue Range Resource Corp.*, 1999 ABQB 1038
9. *Re Canadian Airlines Corp.*, 2001 ABQB 146
10. *NESI Energy Marketing Canada Ltd. (Trustee of) v. NGL Supply (Gas) Co.*, 2001 ABCA 168
11. *Coopers & Lybrand Ltd. v. Lumberland Building Materials Ltd.*, (1983), 50 CBR (NS) 150 (B.C.S.C.)
12. *Re Brunswick Chrysler Plymouth Ltd.* (2004) 11 CBR (5th) 10 (N.B. Q.B.)
13. *Re Hartford Computer Hardware, Inc.*, [2012] OJ No. 715 (S.C.J. [Comm. List])
14. *Re Air Canada*, [2003] OJ No. 6058 (S.C.J. [Comm. List])
15. Bruce MacDougall, *Estoppel* (Markham: Lexis Nexis, 2012)

SCHEDULE "B"
RELEVANT STATUTES

BIA, s. 97(3)

The law of set-off or compensation applies to all claims made against the estate of the bankrupt and also to all actions instituted by the trustee for the recovery of debts due to the bankrupt in the same manner and to the same extent as if the bankrupt were plaintiff or defendant, as the case may be, except in so far as any claim for set-off or compensation is affected by the provisions of this Act respecting frauds or fraudulent preferences.

CCAA, s. 21

The law of set-off or compensation applies to all claims made against a debtor company and to all actions instituted by it for the recovery of debts due to the company in the same manner and to the same extent as if the company were plaintiff or defendant, as the case may be.

CCAA, s. 49

(1) If an order recognizing a foreign proceeding is made, the court may, on application by the foreign representative who applied for the order, if the court is satisfied that it is necessary for the protection of the debtor company's property or the interests of a creditor or creditors, make any order that it considers appropriate, including an order

> (a) if the foreign proceeding is a foreign non-main proceeding, referred to in subsection 48(1);
>
> (b) respecting the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor company's property, business and financial affairs, debts, liabilities and obligations; and
>
> (c) authorizing the foreign representative to monitor the debtor company's business and financial affairs in Canada for the purpose of reorganization.

Restriction

(2) If any proceedings under this Act have been commenced in respect of the debtor company at the time an order recognizing the foreign proceeding is made,

an order made under subsection (1) must be consistent with any order that may be made in any proceedings under this Act.

Application of this and other Acts

(3) The making of an order under paragraph (1)(a) does not preclude the commencement or the continuation of proceedings under this Act, the Bankruptcy and Insolvency Act or the Winding-up and Restructuring Act in respect of the debtor company

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

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

Court File No. 09-CL-8456-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE - COMMERCIAL LIST

Proceeding commenced at Toronto

FACTUM OF AIR CANADA (RETURNABLE JULY 24, 2014)

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