

**Tab 2**

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

Court File No. 31-456351

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

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

**AND IN THE MATTER OF 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 SECTIONS 46 AND FOLLOWING OF THE *COMPANIES'*  
*CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, C. C-36, AS AMENDED**

**AND**

**IN THE MATTER OF THE BANKRUPTCY OF AERO INVENTORY (UK)  
 LIMITED**

**DEBTOR**

**AND**

**KPMG INC.**

**TRUSTEE**

**AND**

**IN THE MATTER OF THE BANKRUPTCY OF AERO INVENTORY PLC**

**DEBTOR**

**AND**

**KPMG INC.**

**TRUSTEE**

**SECOND REPORT OF KPMG INC. IN ITS CAPACITIES AS INFORMATION  
 OFFICER AND AS TRUSTEE IN BANKRUPTCY, AND FIRST REPORT OF KPMG  
 INC. IN ITS CAPACITY AS RECEIVER AND MANAGER**

**JANUARY 17, 2011**

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## INTRODUCTION

1. On November 11, 2009, James Robert Tucker, Richard Heis and Allan Watson Graham of KPMG LLP (collectively, the “**Foreign Representatives**”) were appointed Joint Administrators (in such capacity, the “**Joint Administrators**”) of Aero Inventory (UK) Limited (“**Aero UK**”) and Aero Inventory plc (“**Aero Plc**” and, collectively with Aero UK, the “**Foreign Debtors**”) pursuant to an order of the High Court of Justice of England and Wales (Chancery Division, Companies Court) (the “**Administration Order**”).
2. On the same date, the Ontario Superior Court of Justice (Commercial List) (the “**Court**”) granted an Order (the “**Recognition Order**”), *inter alia*, recognizing the United Kingdom administration proceedings of the Foreign Debtors (the “**Administration Proceedings**”) as “foreign main proceedings” for the purposes of section 47 of the *Companies’ Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the “**CCAA**”), recognizing the Foreign Representatives as “foreign representatives” as defined in section 45 of the CCAA and recognizing and enforcing the Administration Order pursuant to section 49 of the CCAA. The Recognition Order also imposed a stay of proceedings in respect of the Foreign Debtors.
3. Pursuant to the Recognition Order, KPMG Inc. (“**KPMG**”) was appointed as information officer (in such capacity, the “**Information Officer**”). As described in more details below, KPMG is also the trustee in bankruptcy (in such capacity, the “**Trustee**”) of the estates of the Foreign Debtors. As well, pursuant to an Order made by the Court on December 1, 2009, KPMG was appointed receiver and manager (in such capacity, the “**Receiver**”) of the Foreign Debtors’ Canadian affiliate: Aero Inventory (Canada) Inc./Aero Inventaire (Canada) Inc. (“**Aero Canada**”).
4. On January 22, 2010, the Foreign Representatives brought a motion before the Court seeking an order temporarily lifting the stay imposed by the Recognition Order to permit the filing of assignments in bankruptcy in respect of the Foreign Debtors under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (“**BIA**”).
5. On January 22, 2010, the Honourable Justice Morawetz issued an Order (the “**Lift Order**”) temporarily lifting the stay granted in the Recognition Order and authorizing the

Foreign Representatives to assign the Foreign Debtors into bankruptcy. The assignment documents were filed with the Office of the Superintendent of Bankruptcy on January 22, 2010 and Certificates of Appointment were issued naming KPMG as Trustee.<sup>1</sup>

6. On February 10, 2010, the Honourable Justice Morawetz issued an Order (the “**February 10 Order**”) to, among other things:
  - (i) extend the time periods, *nunc pro tunc*, for the Trustee and the Foreign Debtors to perform certain of their statutory obligations pursuant to the BIA;
  - (ii) approve the form of the notice of bankruptcy to be issued to the Foreign Debtors’ known creditors (the “**Trustee’s Letter**”); and
  - (iii) authorize the Foreign Representatives to provide directions to the Trustee, as required, including the authority to direct and supervise the Trustee to pursue claims under sections 95 and/or 96 of the BIA, subject to the review of the Court.
7. KPMG, in its capacity as Trustee and Information Officer, issued its first report to the Court on June 30, 2010 (the “**First Report**”), a copy of which (without appendices) is attached hereto as **Appendix A**.
8. This report constitutes the second report by the Trustee and the Information Officer (the “**Trustee’s and Information Officer’s Second Report**”). The purpose of the Trustee’s and Information Officer’s Second Report is to provide an update to this Honourable Court in respect of the administration of the bankrupt estate and the Administration Proceedings, including:
  - (i) An update on the Trustee’s litigation with Air Canada;

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<sup>1</sup> The Trustee is of the view that the “date of the initial bankruptcy event”, as defined in the BIA, in respect of each of the Foreign Debtors was November 11, 2009 (the date of the Recognition Order). The assignment in bankruptcy was undertaken only as a precautionary measure for greater certainty.

- (ii) An update with respect to the Foreign Representatives' inventory realization strategy and the ongoing negotiations with Aero UK's Canadian customers;
- (iii) The Trustee also requests this Court's approval of:
  - (1) the Settlement and Labour Supply Agreement (the "**Aveos Settlement Agreement**"), entered into on December 31, 2010 between, amongst others, Aero UK, Aero Plc, Aero Canada, Aveos Fleet Performance Inc. ("**Aveos**") Aeromantenimiento S.A. ("**Aeroman**") the Trustee and the Joint Administrators;
  - (2) the vesting in Aveos of the Foreign Debtors' right, title and interest in the Aveos Purchased Assets (as defined in the Aveos Settlement Agreement);
  - (3) direction of the net proceeds of the Aveos Settlement Agreement to be paid to Aero UK to be dealt with in accordance with the Administration Proceedings;
  - (4) the sealing of the Confidential Schedules (as defined below) to the Aveos Settlement Agreement, pending further order of the Court;
  - (5) the sealing of the Supplemental Report (as defined below) in its entirety, pending further order of the Court;
  - (6) the releases contemplated by Section 2 of the Aveos Settlement Agreement and provided by the Trustee, the Information Officer, the Foreign Representatives and the Receiver; and
  - (7) the First Report, the Trustee's and Information Officer's Second Report, the Supplemental Report and the Trustee's and the Information Officer's activities described therein.

9. This report also constitutes the first report of the Receiver (the "**Receiver's First Report**") to the Court in this matter and is filed to:

- (i) report on the Receiver's activities since its appointment and to seek the Court's approval of the Receiver's First Report and its activities described therein; and
  - (ii) obtain approval of the Receiver's Statement of Receipts and Disbursements for the period December 1, 2009 to January 7, 2011.
10. In preparing this report, KPMG has relied on information supplied by the Joint Administrators. KPMG has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of any of this information.

## **BACKGROUND**

11. The Foreign Debtors, Aero Canada and their international affiliates form an integrated and inter-dependent group of companies that supply parts to the airline industry.
12. The Foreign Debtors have assets in Canada, and their Canadian operations were administered by Aero Canada. The Foreign Debtors have two key Canadian customers: Air Canada and Aveos.
13. The Canadian assets of the Foreign Debtors are subject to a security interest in favour of a lending syndicate (the "**Lending Syndicate**"), the security trustee of which is Lloyds TSB Commercial Finance Limited ("**Lloyds**"). As discussed in the First Report, KPMG retained independent counsels to review the Lending Syndicate's security, their conclusion being that the Lending Syndicate holds valid security over the Foreign Debtors' assets located in British Columbia, Manitoba, Ontario and Quebec, which is enforceable against the Trustee. The Foreign Representatives have advised of their belief the Lending Syndicate will suffer a significant shortfall on its loans to the Foreign Debtors.

## **TRUSTEE'S ACTIVITIES**

### **Reports**

14. The Trustee posted its First Report and attachments on the Trustee's website at [www.kpmg.ca/en/ms/cl/aeroinventory](http://www.kpmg.ca/en/ms/cl/aeroinventory).

## Litigation

15. As previously reported, Air Canada's counsel served Ogilvy Renault LLP ("**Ogilvy**"), Canadian counsel for the Trustee and the Foreign Representatives, with a motion seeking leave to appeal the Lift Order (the "**Lift Order Appeal**"). Air Canada did not pursue this appeal.
16. Additionally, Air Canada advised the Information Officer that it would apply to this Court seeking the ability to set-off amounts owing to it by the Foreign Debtors as against amounts, both pre and post filing, that Air Canada may owe the Foreign Debtors (the "**Set-off Claim**"). This motion is expected to be heard in conjunction with the Preference Action defined below.
17. As previously reported, on or about April 27, 2010, the Trustee served Air Canada with the notice of and materials for a motion seeking a declaration, amongst other things, that certain transactions between Air Canada and Aero UK are preferences within the meaning of section 95(1) of the BIA (the "**Preference Action**"). The Trustee has since received responding materials from Air Canada, and served further reply materials upon Air Canada.
18. On August 9, 2010, Air Canada served the Trustee with notice of a motion seeking, amongst other things, variations to the February 10 Order and a dismissal of the Preference Action in the present proceedings under the CCAA. This motion is without prejudice to the Trustee pursuing the Preference Action in proceedings commenced under the BIA.
19. On September 30, 2010, Lloyds through its solicitors, sent a letter to all parties on the Service List in the existing matter advising them that, among other things, it considered the transactions that are the subject of the Preference Action to be a breach by Air Canada of its obligations to the Lending Syndicate pursuant to an inter-creditor agreement entered into on February 6, 2009 by Aero UK, Aero plc, Air Canada and the Lending Syndicate (the "**Inter-creditor Agreement**"). The Lending Syndicate also advised that it intends to pursue its remedies against Air Canada in the event that its claims for breach of the Inter-creditor Agreement are not fully satisfied by the recoveries from the Preference Action.



20. In late October, Lloyds retained Canadian counsel in this matter.
21. This Court subsequently ordered that prior to hearing the Preference Action, it would first address entitlement to the preference proceeds. This hearing was heard on January 6, 2011.
22. The Trustee and the Information Officer respectfully submit that their activities, as set out in this Second Report and the First Report including in respect of the Aveos Settlement Agreement described below, are within the scope of the Trustee's and the Information Officer's mandate and are reasonable in the circumstances.

### **ADMINISTRATION PROCEEDINGS UPDATE**

#### **Foreign Representatives' Reporting**

23. The Joint Administrators attended court in the U.K. in October 2010 to, among other things, seek an order extending the Administration Proceedings to November 10, 2012, for each of Aero UK and Aero Plc, these orders were granted and are attached hereto as **Appendix B**.
24. The Joint Administrators issued a progress report to the unsecured creditors of the Foreign Debtors on December 7, 2010, which report is attached hereto as **Appendix C**.

#### **Joint Administrators' Sales Process**

25. Prior to entering Administration Proceedings, the Foreign Debtors' business consisted of operations and customers throughout Europe, Asia, Australia and North America. The inventory stocks associated with the business, which represent the overwhelming bulk of the Foreign Debtors' assets, comprise approximately 40 million parts across 500,000 parts lines located in 30 physical locations in 12 separate countries. The Joint Administrators' mandate as Administrators covers all of the Foreign Debtors' worldwide operations and assets.
26. As disclosed in the First Report, on January 26, 2010, the Joint Administrators initiated a sale process for the assets and operations of the Foreign Debtors' business on an enbloc basis or otherwise, sending out confidentiality undertakings to all those interested parties who contacted them. More than sixty parties executed confidentiality undertakings.

Each of these parties was provided with an information memorandum containing high level inventory information from the rebuilt inventory records.

27. Given the inherent complexity of a transaction at the current time caused by the inventory being distributed with third parties throughout the world and the need to uplift all inventory in compliance with all applicable legislation, the Joint Administrators have determined that it is not possible to conclude a sale of the business at the current time. Therefore, the Joint Administrators continue to implement their inventory realization strategy, which is discussed below, while regularly re-assessing the options available to market and sell the business.

#### **Joint Administrators' Inventory Realization Strategy**

28. The Joint Administrators are currently implementing their inventory realization strategy, which is comprised of the following:
- (a) Negotiating the sale of certain inventory to the Foreign Debtors' former customers. These blocks of inventory are likely to involve only those parts that are expected to be consumed over the next three years by these customers. Following many months of negotiations, sales to three principal customers have taken place. Discussions remain ongoing with a number of other customers.
  - (b) As it is not possible to immediately liquidate the balance of the inventory, even at low values for the reasons described in paragraph 27 above, the Joint Administrators' realization plan is first to remove from former customers' facilities all inventory that they do not purchase. To the extent that inventory has a realizable value in excess of its removal and holding costs (the "**Uplifted Inventory**") it will be consolidated at one central hub located in Singapore that will be operated by a worldwide logistics provider. The Uplifted Inventory will then be sold on the open market via a number of different sale channels (inventory that does not have a realizable value in excess of its removal and holding costs will be disposed of, or value realised locally, by the Joint Administrators in accordance with all relevant regulations). The uplift is expected to take approximately 8 months before sufficient inventory will

accumulate at the hub to start fulfilling orders in reasonable volumes. The sales channels include:

- (i) Competing directly in the secondary parts market by having a wider range of inventory than competitors and offering rapid availability and fulfilment; and
  - (ii) Selectively targeting the existing primary market as a highly credible alternative to established suppliers.
- (c) It is expected that the Uplifted Inventory will be sold over approximately three years.
29. To date, the Joint Administrators have concluded sale agreements with three of the Foreign Debtors' former customers, and the uplift process at a number of sites has commenced. The uplift process is designed to ensure that all inventory meets industry quality standards and is moved to the new central hub in Singapore in compliance with all relevant regulations for inventory of this type.

#### **Canadian Customers and Uplift Plan**

30. Aero UK's Canadian customers consist of Air Canada and Aveos. The estimated quantity and value of Aero UK's inventory located at these customers' Canadian facilities as at November 11, 2009 totalled approximately 6.9 million parts and \$84.2 million.
31. Due to inadequacies associated with Aero UK's inventory records, it was not until July 2010 that Aero Canada's management completed a detailed Canadian inventory analysis and was in a position to determine what inventory was owned by Aero UK and what consumption should be invoiced to Air Canada and Aveos from October 1, 2009 onward.
32. Although Air Canada stated it was not drawing on Aero UK inventory from the date of the Recognition Order, it was later determined that Air Canada had done so, and continues to do so. Accordingly, a letter was issued to Air Canada by the Joint Administrators on July 9, 2010 requesting that it cease consuming Aero UK inventory effective immediately, and requesting Air Canada to provide written confirmation

thereof. Air Canada has neither provided a substantive response to this letter nor paid for inventory consumed since the date of the Recognition Order.

33. On July 9, 2010, letters were sent to Air Canada and Aveos providing them with a list of parts the Joint Administrators believe were owned by Aero UK as at January 31, 2010 and giving them a deadline of July 20, 2010 to advise if they were asserting any ownership interest in these parts.
34. Based on the detailed inventory consumption analysis, Aero UK prepared and issued invoices covering the period October 1, 2009 to June 30, 2010 inclusive for Air Canada and Aveos. The Joint Administrators have also demanded that Air Canada and Aveos pay their respective receivable balances outstanding as at the date of the Recognition Order. Aveos subsequently advised that it was disputing the invoices issued to it.
35. In October, the Information Officer and Aveos started to work together in an effort to identify transaction errors and resolve pricing disputes associated with the invoices rendered to Aveos for the period October 1 to November 10, 2009, inclusive. Over the ensuing two months, largely due to new information made available to Aero UK, it was determined that some of the transactions invoiced to Aveos were invoiced in error. It also became apparent that Aveos was disputing pricing used by Aero UK.
36. On November 10, 2010, the Information Officer and Air Canada, along with their respective legal counsels, met to discuss a process to resolve the inventory ownership issue. A follow-up meeting was subsequently held on December 16, 2010, which included Aveos and its legal counsel, and related discussions are ongoing.

#### **SETTLEMENT AND LABOUR SUPPLY AGREEMENT**

37. The Information Officer, Aero Canada and Aveos personnel have met, either in person or via conference calls, numerous times since the First Report, including meetings in mid-August, mid-September, October, November and throughout December. The purpose of the meetings was to negotiate the terms of an agreement to: i) coordinate the “**Inventory Uplift Plan**” (i.e. to remove the Aero UK owned inventory located at Aveos and Air Canada facilities in Canada, together with the Aero UK owned inventory located at Aeroman and Transportes Aéros Del Continente Americano (“TACA”) facilities in El

Salvador and match such inventory to the related certification documents); and ii) to settle the pre-filing accounts receivable and post-filing inventory consumption by Aveos, Aeroman and TACA. The negotiations involved numerous complex issues including the timeframe and responsibilities in respect of the Inventory Uplift Plan processes, the appropriate pricing for pre-filing and post-filing consumption, formulating a dispute resolution process, uncertainty over inventory ownership, and determination of the nature and extent of releases. As a result of these negotiations, on December 31, 2010, Aero UK, Aero Plc, Aero Canada, Aveos, Aeroman, the Joint Administrators, the Receiver and the Trustee (collectively; the “**Parties**”), entered into the Aveos Settlement Agreement, which agreement is subject to approval of the Court. A copy of the Aveos Settlement Agreement which has had Schedules 3.1, 4.4, 5 and 6.9 (the “**Confidential Schedules**”) redacted, is attached as **Appendix D** to this report.

38. The key terms of the Aveos Settlement Agreement include, but are not limited to, the following (capitalized terms used in this paragraph but not otherwise defined herein shall have the meanings ascribed to them in the Aveos Settlement Agreement):
- (a) mutual releases provided by and to Aveos, Aeroman and other specified parties (Section 2);

The Trustee, the Foreign Representatives, the Receiver, the Information Officer, the Joint Administrators, the Aero Inventory Group and various associated parties (the “**Aero Releasers**”) have provided releases to Aveos and Aeroman and various associated parties (the “**Aveos Releasers**”). The Aveos Releasers have provided similar releases to the Aero Releasers. All such releases are subject to customary carve outs for gross negligence, wilful misconduct, fraud, or intentional or gross fault.

- (b) the payment for pre-November 11, 2009 consumption by Aveos and Aeroman (Section 3);

In respect of amounts owing by the Aveos Parties to the Aero Inventory Group for the period prior to November 11, 2009, the Aveos Parties shall pay to Aero an agreed upon sum that equals the value of the Aveos Parties consumption of C&E during the period October 1 to November 10, 2009 inclusive less amounts owing to Aveos for various

items including, without limitation, returns and purchases made on behalf of Aero UK. Certain payments by Aveos may be in respect of C&E owned by Air Canada. Each of Air Canada, Aveos and Aero UK acknowledge this possibility, which may need to be remedied at some point in the future, but such remedies will not include Aero UK seeking any additional amounts from Aveos directly. Air Canada, Aveos and Aero UK are currently working toward a solution to this issue. While the Foreign Representatives are confident that this issue will be resolved before the hearing of the motion to approve the Aveos Settlement Agreement, in the absence of such resolution the transaction, particularly as contemplated in Section 3, cannot be concluded as currently structured.

- (c) the pricing of Aveos' and Aeroman's post-November 11, 2009 consumption and payment terms associated with same (Section 4/Schedule 4.4);

Aveos, Aeroman and Aero UK have agreed to the pricing terms that will be applicable to consumption of parts on and after November 11, 2009.

- (d) provisions on the Inventory Uplift Plan (Section 6);

The Inventory Uplift Plan contains a very detailed set of provisions. These provisions include obligations surrounding the planning and commencement of the Inventory Uplift Plan, certification of parts being uplifted, transfers of parts as between Aveos Prime Locations, the provision by Aveos of labour and non-labour inputs for the Inventory Uplift Plan, reimbursement of Aveos for costs incurred, provisions requiring the renegotiation of cost structures in certain circumstances, a method for calculation of compensation payable to Aero UK for parts shrinkage and the provision of a security deposit by Aero UK.

If the agreement is terminated under certain specific circumstances (see Sections 6.11, 6.12 and 6.18), Aveos shall be deemed to have purchased all remaining Parts at its facilities on such Termination Date without further payment or liability to Aero UK and Aero UK shall forfeit the balance of the Security Deposit discussed below.

The parties will establish a timeline for the Inventory Uplift Plan, which will be extendable upon the occurrence of certain events including, without limitation, work stoppages at the Aveos facilities. If Aero UK terminates the Aveos Settlement

Agreement due to a Force Majeure Event, it will forfeit any remaining balance of the Security Deposit.

- (e) security deposit for Aveos' out-of-pocket costs associated with parts abandoned by Aero UK or the termination of the Aveos Settlement Agreement in certain circumstances (Section 6.16);

This Security Deposit is being provided in the amount of \$2,000,000 which is subject to periodic reduction. The Security Deposit will be held in trust and will be funded by Aero directing payment of the first Post-November 11 Payables for Aveos consumption into trust.

- (f) costs to be incurred by the Administrator for rent and sub-vented costs (including parts handling charges) (Section 5);
- (g) the bulk sale of Aero UK owned inventory located in El Salvador to Aeroman (Section 12);

This inventory is being sold for an aggregate purchase price of US\$542,000, which sale is conditional upon the Joint Administrators satisfying themselves that the sale would not result in a violation of the International Traffic in Arms Regulations of the United States or any other export control legislation.

The foregoing represents a very general summary of the terms of the Aveos Settlement Agreement, a copy of which is attached hereto as Appendix D. The foregoing does not provide any interpretive guidance in respect of the Aveos Settlement Agreement and reference should be made to the agreement itself for that purpose.

39. The Trustee and the Foreign Representatives as well as their counsel, Ogilvy Renault LLP and CMS Cameron McKenna LLP, have undertaken a review of the history of the relationship between Aveos and Aero UK in order to determine whether the releases granted as part of the Aveos Settlement Agreement are reasonable in the circumstances. Two particular transactions that could be subject to challenge by the Trustee have been considered in detail:

- (a) a settlement of amounts claimed to be receivable by Aero UK for a fraction of the purported balance of these receivables, and
- (b) an agreement that significantly reduced the scope of parts that Aero UK was responsible for supplying to Aveos, reduced the prospective pricing to be charged by Aero UK for certain parts being supplied, and settled various pricing and other disputes between the parties.

Upon completion of this review, the Trustee is satisfied that the releases granted are reasonable and the Joint Administrators are satisfied that their actions in providing the releases are in the interests of creditors as a whole in accordance with their statutory duties. The Trustee has been provided with a memorandum from its counsel, Ogilvy Renault LLP, on these releases and has compiled a written report (the “**Supplemental Report**”), which report will be provided to the Court and will be subject to a request for a sealing order.

- 40. The Joint Administrators, with the assistance of the Trustee, believe that they have received adequate assurances from Aveos and Aeroman, and have conducted sufficient due diligence, to be satisfied that any transactions contemplated by the Aveos Settlement Agreement comply with applicable export control laws, including the International Traffic in Arms Regulations of the United States.
- 41. The Information Officer, the Trustee and the Foreign Representatives believe that the Aveos Settlement Agreement is beneficial to all stakeholders of the Foreign Debtors. It settles outstanding disputes between Aero UK and Aveos, providing a mechanism by which outstanding accounts will be paid and a process for the removal of Aero UK owned inventory from Aveos’ control, all in a commercially reasonable fashion. The Information Officer, on behalf of the Foreign Representatives, hereby requests approval of the Aveos Settlement Agreement.
- 42. The Information Officer, on behalf of the Foreign Representatives, hereby further requests that the Confidential Schedules be sealed pending further order of the Court so as to protect certain confidential commercial information regarding pricing and operations that is critical to the Aveos operations and the disclosure of which would be



highly prejudicial to Aveos' commercial interests. The Joint Administrators also believe the disclosure of the pricing information would be detrimental to its efforts to realize on Aero UK's inventory. The Foreign Representatives, the Information Officer and the Trustee believe that the salutary effects of sealing the Confidential Schedules outweigh any deleterious effects and that no third party would be materially prejudiced by such sealing.

43. In the event that the Trustee and the Foreign Representatives have appeared before this Court for the purposes of seeking approval of the Aveos Settlement Agreement and the Court Approval Date (as defined in the Aveos Settlement Agreement) has not occurred within 70 days from the date such approval is sought, any party to the agreement shall have the option to terminate the agreement.

#### **VESTING ORDER AND POTENTIAL CLAIMS AGAINST THE PARTS**

44. Pursuant to section 14.1 of the Aveos Settlement Agreement, the obligations of the parties are subject to, amongst other things, an order of this Court approving the agreement and providing for the vesting of all parts consumed or purchased by the Aveos Parties in Canada free and clear of all liens and encumbrances.
45. The Foreign Representatives' proposed order (the "Proposed Court Order"), contemplates title to inventory initially owned by Aero UK and subsequently i) consumed by Aveos; or ii) transferred without proceeds in certain circumstances on termination of the Aveos Settlement Agreement, being vested in Aveos in three tranches; the Initial Aveos Purchased Assets; the Interim Aveos Purchased Assets; and the Termination Date Aveos Purchased Assets (collectively the "Aveos Purchased Assets").
46. Air Canada, Aveos and Aero UK are currently working to resolve the ownership dispute in respect of the inventory. The proposed vesting relates only to inventory that is ultimately determined to be owned by Aero UK.

#### **Vesting Upon Installation on Customers' Property**

47. The Proposed Court Order contemplates that upon installation of any Initial Aveos Purchased Assets or Interim Aveos Purchased Assets (each as defined in the Aveos Settlement Agreement) on a customer's property, all of the Foreign Debtors' right, title

and interest in those Aveos Purchased Assets shall vest absolutely in Aveos free and clear of and from any and all Claims (as defined in the Proposed Court Order). This occurs irrespective of whether payment for such assets has been received by Aero UK. Aveos has advised that this is a commercial necessity in the aviation maintenance and repair industry and accordingly has required this provision.

48. In the cases of Interim Aveos Purchased Assets not vested as described in the above paragraph, vesting will occur upon delivery of an acknowledgement of the Foreign Representative attesting to full payment for particular Interim Aveos Purchased Assets, with full payment to occur upon resolution of parts ownership disputes with Air Canada. In the case of the Initial Aveos Purchased Assets not vested as described in the above paragraph, vesting will occur upon payment in full of the Pre-filing Settlement Amount (as defined in the Aveos Settlement Agreement).

#### **Vesting of Termination Date Aveos Purchased Assets**

49. The Termination Date Aveos Purchased Assets are parts located in the Aveos Parties Facilities (as defined in the Aveos Settlement Agreement) in Canada that are abandoned by Aero UK pursuant to certain terms of the Aveos Settlement Agreement. There will be no proceeds paid by Aveos for the Termination Date Aveos Purchased Assets and such assets will vest in Aveos free and clear of all claims upon termination of the Aveos Settlement Agreement in certain circumstances.

#### **Potential Claims Against The Inventory**

50. The Aveos Purchased Assets to be vested in Aveos will include only the Foreign Debtors' parts situated in Canada. The Trustee and the Information Officer have considered the various potential prior ranking claims to the inventory. The Foreign Debtors' have no Canadian based employees and accordingly, there should be no prior ranking claims in respect of source deductions, or any other employee related liabilities that would be subject to sections 81.3 or 81.5 of the BIA or otherwise. As outlined in the First Report, it was determined that section 81.1 of the BIA should not result in any claims in this case. The Trustee has not received any 30 day goods claims from any parties as of the date of this report.

51. As outlined in the First Report, the Foreign Representatives retained independent counsel to advise as to the validity and enforceability of the Lending Syndicate's security over the assets of the Foreign Debtors located in the Provinces of Manitoba, Ontario, British Columbia and Quebec, which opinions concluded the security is valid and enforceable against the Trustee. The Joint Administrators are currently seeking the Lending Syndicate's consent to the transactions contained in the Aveos Settlement Agreement. Canadian counsel to the Lending Syndicate will be served with notice of the motion to approve the Aveos Settlement Agreement.
52. The Proposed Court Order contains a provision that the net proceeds from the Aveos Settlement Agreement shall be delivered into the possession of Aero UK to be dealt with in accordance with the Administration Proceedings. In the circumstances of this particular transaction, the Trustee believes that this provision is reasonable. The only party that the Trustee and the Foreign Representatives are aware of that will obtain an economic benefit from the proceeds of the Aveos Settlement Agreement is the Lending Syndicate, by virtue of its security interest in the Aveos Purchased Assets (as defined in the Aveos Settlement Agreement).

## **RECEIVER'S ACTIVITIES**

### **Background**

53. KPMG Inc. was appointed Receiver of Aero Canada pursuant to an order of the Court dated December 1, 2009 (the "**Receivership Order**"). A copy of the Receivership Order is attached hereto at **Appendix E** to this report. The receivership of Aero Canada is a direct result of the Administration Proceedings of its parent company.
54. Aero Canada's sole activity was to provide management services to Aero UK primarily in respect of Aero UK's contracts with its Canadian based customers (Aero Canada also provides management services to Aero UK in respect of Aero UK's contracts with certain El Salvador based customers). Given the interdependence of the Foreign Debtors and Aero Canada, the appointment of the Receiver over Aero Canada was sought to assist the Joint Administrators in their efforts to realize on the Canadian based assets.

**Premises**

55. Aero Canada operated its head office and a warehouse from leased premises located at 394 Rue Isabey, Suites 150 and 250, St. Laurent, QC H4T 1V3 (the “**Isabey Premises**”). Immediately upon its appointment the Receiver notified the landlord, Olymbec Investments Ltd. (“**Olymbec**”), of the Receiver’s appointment and the intention of the Receiver to continue to pay occupation rent for the leased premises during its occupation period.
56. Aero Canada maintained offices at several of the Aero UK customer locations in Montreal, Toronto, Winnipeg and Vancouver. These sites are operated either by Air Canada or Aveos. Immediately prior to the receivership, Aero Canada had a monthly rental agreement with Air Canada for office space at its Vancouver location. The Receiver notified Air Canada of the Receiver’s appointment and of the intention of the Receiver to continue to pay occupation rent for the rented Vancouver premises during the occupation period and the Receiver has maintained the monthly payment. Subsequent to the Receivership Order, Air Canada advised the Receiver that it was unwilling to provide Aero Canada personnel with access to its Toronto premises. Aero Canada personnel have not since accessed these premises.
57. The Receiver has made arrangements to transition the Aero Canada office and warehouse operations at the Isabey Premises to a new office and a warehouse space. The transition occurred in January 2011, and will result in a monthly savings of approximately \$17,500.

**Banking**

58. Upon its appointment on December 1, 2009, the Receiver notified Aero Canada’s banking institution of its appointment and requested that Aero Canada’s accounts be for deposit only.
59. The Receiver immediately made arrangements to open a separate Receiver’s trust account to facilitate future receipts and disbursements with respect to the receivership administration. The funds on hand in Aero Canada’s accounts as at December 1, 2009, totalling \$3,726.66, were transferred to the Receiver’s trust account.

## Notices

60. The Receiver prepared and issued its notice dated December 10, 2009 pursuant to Section 245(1) and 246(1) of the BIA to the Office of the Superintendent of Bankruptcy and to all known Aero Canada creditors. Additionally, the Receiver prepared and issued notices pursuant to Section 246(2) dated August 6, 2010 and December 10, 2010. Copies of the Receiver's notices are attached hereto at **Appendix F** to this report. The Receiver also posted the Receivership Order on its website address [www.kpmg.ca/en/ms/cl/aeroinventory](http://www.kpmg.ca/en/ms/cl/aeroinventory).

## Employees

61. As at the date of the appointment of the Receiver, Aero Canada employed nineteen employees (the "**Aero Canada Employees**"): 16 in Quebec; and 1 in each of Ontario, Manitoba and B.C.
62. Pursuant to the Receivership Order, the Aero Canada Employees continued to remain employees of Aero Canada. The Receiver prepared and issued letters to the Aero Canada Employees advising that their employment would continue with Aero Canada on the same terms and conditions as existed prior to the date of the receivership, with the exception of certain changes as outlined in the letter. A sample copy of the letter issued to the Aero Canada Employees is attached as **Appendix G** to this report.
63. Prior to the Receiver's appointment, there were approximately thirty five employees terminated by Aero Canada on or around November 18, 2009 (the "**Aero Canada Terminated Employees**"). The Receiver issued letters to the Aero Canada Terminated Employees notifying them of the Receiver's appointment and to advise that the Joint Administrators would be funding their unpaid wages and outstanding accrued vacation pay. A sample copy of the letter to the Aero Canada Terminated Employees is attached as **Appendix H** to this report.
64. Pursuant to section 81.4 of the BIA, Aero Canada Terminated Employees have claims against Aero Canada's current assets of up to \$2,000 each in priority to all other creditors, excluding claims for source deductions, for unpaid wages and vacation pay owing for the period six months prior to the Receivership Order.

65. Aero Canada management prepared a list detailing the outstanding wages and vacation pay arrears owed to each of the Aero Canada Terminated Employees together with the calculation of termination pay they would be entitled to pursuant to Quebec law. The Joint Administrators funded the outstanding wages and vacation pay owing to the Aero Canada Terminated Employees, with the exception of one individual (the “Missing VP”) as per the listing provided by Aero Canada management, in the amount of \$92,878.53. It is the position of the Joint Administrators that they have assumed the rights of the Aero Canada Terminated Employees as against the estate of Aero Canada for the \$92,878.53 of outstanding wages and vacation pay that they funded.
66. Pursuant to statutory requirements the Human Resource and Social Development Canada (“HRSDC”) funded amounts to certain of the Aero Canada Terminated Employees in respect of termination and will have a claim against Aero Canada for the termination amounts they funded, which total \$33,569.03.
67. The Joint Administrators also funded wages outstanding as at December 1, 2009, and unpaid vacation pay owing as at December 1, 2009, for the Aero Canada Employees. The Joint Administrators have funded \$68,854.75 associated with same. It is the position of the Joint Administrators that they have assumed the rights of the Aero Canada Employees as against the estate of Aero Canada for these payments.

### **Worker’s Compensation**

68. After its appointment, the Receiver made enquiries as to the extent of worker’s compensation coverage for Aero Canada’s employees. The Receiver was advised that Aero Canada had worker’s compensation coverage in place in Quebec, but not in any other province where it had employees. The Receiver contacted the Commission de la Santé et de la Sécurité du Travail (“CSST”) in Quebec to arrange for ongoing coverage. Additionally, the Receiver contacted the Ontario Workplace Safety and Insurance Board, the Worker’s Compensation Board of Manitoba and WorkSafe BC to make arrangements for workers compensation coverage for the Aero Canada Employees in these respective provinces.

**Insurance**

69. The Receiver notified Aero Canada's insurance broker of its appointment and made arrangements to be added as an additional named insured on Aero Canada's continuing insurance coverage.

**Government Accounts**

70. The Receiver notified the various government agencies of its appointment and requested new accounts for the Receiver in respect of Aero Canada's federal and Quebec sales tax.
71. The Receiver is preparing and will submit corporate income tax returns for Aero Canada's fiscal year ended June 30, 2010.

**Sales of Fixed Assets**

72. Aero Canada's fixed assets are primarily office furniture and computer equipment (the "Fixed Assets") with a book value of approximately \$518,000. The Receiver commissioned an appraisal of the office furniture and equipment, which indicated a forced liquidation value of approximately \$78,000 as at February 1, 2010.
73. Pursuant to the Receivership Order, the Receiver has the authority to dispose of the property of Aero Canada out of the ordinary course of business, without the approval of this Court in respect of any transaction not exceeding \$100,000, provided that the aggregate consideration for all such transactions does not exceed \$250,000.
74. As a result of the transition from the Isabey Premises, the Receiver marketed the excess furniture and computer equipment.
75. Aero UK identified certain Aero Canada computer equipment that it would require to proceed with the Inventory Uplift Plan. The Receiver entered into a bill of sale to sell certain server and computer equipment to Aero UK (in administration), the proceeds of which were \$11,575.00. A copy of the bill of sale is attached hereto as **Appendix I** to this report. The proceeds will be held by the Receiver pending further order of this Court.
76. Additionally, the Receiver compiled a listing of the remaining Aero Canada assets that (i) would not be required for the Inventory Uplift Plan or (ii) would not be transitioned to the

new office operations, together with the terms and conditions of sale and invited eight auctioneers to submit proposals on a commission basis; a net minimum guarantee basis; and a direct purchase basis. The proposal deadline was December 20, 2010. Given the nature, quantum and anticipated realizable value based on the appraisal, the Receiver did not consider it necessary to undertake the process, and incur the costs of, advertising the assets for sale.

77. Three proposals were submitted for the direct purchase of the Aero Canada assets. The Receiver entered into a bill of sale with 1416088 Ontario Ltd. (“**Danbury**”) as its proposal resulted in the highest realization. A copy of the bill of sale, the purchase price being \$22,500 before taxes, is attached hereto as **Appendix J** to this report. The Receiver notes there is a discrepancy between the appraisal value and the ultimate purchase price paid by Danbury. This discrepancy is the result of: a) the time lapsed between the appraisal and the sale process; b) the lack of interest from parties for office furniture and computers; c) the assets excluded from the sales process; and d) the Receiver’s decision to accept a lower value for the assets after consideration of the holding costs associated with the various proposals. The proceeds from the sale to Danbury will be held by the Receiver pending further order of this Court.

### **Aero Canada Operations**

78. As previously noted, Aero Canada provides management services to Aero UK in respect of Aero UK’s contracts with its Canadian and El Salvador based customers.
79. Management and staff have been working with and assisting the Foreign Representatives and the Information Officer in respect of Aero UK’s Canadian and El Salvador based assets. This has included the following: a) completing detailed inventory analysis and consumption for ownership and invoicing purposes; b) evaluating options for the removal of Aero UK owned inventory located in Canada and El Salvador; and c) meeting with Aveos for the purpose of assisting in negotiation of the terms of the Aveos Settlement Agreement.



**Statement of Receipts and Disbursements**

80. **Appendix K** to this report presents a summary of the Receiver's Statement of Receipts and Disbursements for the period December 1, 2009 to January 7, 2011. As is illustrated, cash receipts relate primarily to advances from the Joint Administrators to fund operating costs.
81. The Receiver has made disbursements of approximately \$526,000, primarily relating to occupation rent and utilities. Aero Canada's payroll costs are funded directly by the Joint Administrators. Accordingly, payroll costs are not reflected in the Receiver's Statement of Receipts and Disbursements.
82. As at January 7, 2011, the Receiver had approximately \$19,000 in its trust account.
83. The Receiver respectfully submits that the activities, as set out above, are within the scope of the Receiver's mandate and are reasonable in the circumstances.

**ORDER SOUGHT**

84. This Trustee's and Information Officer's Second Report is respectfully submitted to this Court in support of the Foreign Representatives' motion for an order to approve:
- (a) the Aveos Settlement Agreement;
  - (b) the vesting in Aveos of the Foreign Debtors' right, title and interest in the Aveos Purchased Assets;
  - (c) direction of the net proceeds of the Aveos Settlement Agreement to be paid to Aero UK to be dealt with in accordance with the Administration Proceedings;
  - (d) the sealing of the Confidential Schedules to the Aveos Settlement Agreement, pending further order of the Court;
  - (e) the sealing of the Supplemental Report (as defined below) in its entirety, pending further order of the Court
  - (f) the releases contemplated by Section 2 of the Aveos Settlement Agreement and

provided by the Trustee, the Information Officer, the Foreign Representatives and the Receiver; and

(g) the First Report, the Trustee's and Information Officer's Second Report and the Trustee's and the Information Officer's activities described therein.

85. The Receiver's First Report is submitted in support of the Foreign Representatives' motion for an order to:

(a) Approve the Receiver's activities to date as outlined in this Receiver's First Report; and

(b) Approve the Receiver's Statement of Receipts and Disbursements for the period December 1, 2009 to January 7, 2011 inclusive.

86. KPMG Inc. has filed this Report to provide an update to the Court and in doing so understands the role of an officer of the Court and its obligation to act impartially and objectively.

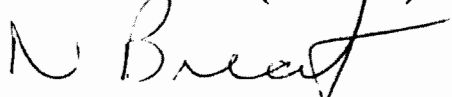
All of which is respectfully submitted this 17<sup>th</sup> day of January, 2011.

**KPMG INC.  
INFORMATION OFFICER AND  
TRUSTEE OF THE ESTATES OF  
AERO INVENTORY (UK) LIMITED (IN ADMINISTRATION) AND AERO  
INVENTORY PLC (IN ADMINISTRATION)**



Per: Nicholas Brearton  
*President*

**KPMG INC.  
RECEIVER AND MANAGER OF  
AERO INVENTORY (CANADA) LIMITED**



Per: Nicholas Brearton  
*President*

**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)**

Court File No: 09-CL-8456-OOCL

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
COMMERCIAL LIST**

Proceeding commenced at Toronto

**SECOND REPORT OF KPMG INC. IN ITS  
CAPACITIES AS INFORMATION OFFICER  
AND AS TRUSTEE IN BANKRUPTCY, AND  
FIRST REPORT OF KPMG INC. IN ITS  
CAPACITY AS RECEIVER AND  
MANAGER**

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