

TAB 2

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

**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**

**FOURTH REPORT OF KPMG INC.
IN ITS CAPACITY AS INFORMATION OFFICER**

APRIL 26, 2012

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INTRODUCTION

1. On November 11, 2009 (the "**Administration Date**"), 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**") and Aero Inventory plc ("**Aero plc**" and, collectively with Aero, the "**Foreign Debtors**") pursuant to an order of the High Court of Justice of England and Wales (Chancery Division, Companies Court) (as later extended, 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 UK 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. A copy of the Recognition Order is attached hereto as Appendix "A".
3. Pursuant to the Recognition Order, KPMG Inc. ("**KPMG**") was appointed information officer (in such capacity, the "**Information Officer**").
4. On December 1, 2009, the Court granted an order appointing KPMG Inc. receiver and manager of all of the assets, properties and undertakings of Aero Inventory (Canada) Inc./Aero Inventaire (Canada) Inc. ("**Aero Canada**").
5. On January 22, 2010, Justice Morawetz issued an order temporarily lifting the stay granted in the Recognition Order and authorizing the Foreign Representatives to assign the Foreign Debtors into bankruptcy under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (the "**BIA**"). 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 in bankruptcy (in such capacity, the "**Trustee**").

6. This is the fourth report by the Information Officer (the "**Fourth Report**"). The Information Officer is filing the Fourth Report in respect of inventory owned by Aero that is currently located at facilities controlled by Air Canada (the "**Facilities**") including, without limitation, those facilities listed on Appendix "B" hereto.

7. The Information Officer files this Fourth Report in support of a motion for an Order, inter alia:

- (a) that Air Canada and Aero are bound by the terms of the Uplift Agreement (as defined below);
- (b) that Air Canada shall forthwith provide Aero, or its affiliates, agents or contractors, with access to the Facilities for the purposes of repossessing the Aero Parts (as defined below);
- (c) that Air Canada shall preserve all Airworthiness Certifications (as defined below) in its possession and relating to the Aero Parts, and deliver such documents, whether in electronic or hard copy form, to Aero upon request, and Air Canada shall cooperate with Aero to assist in obtaining Airworthiness Certifications relating to Aero Parts in Air Canada's possession if Aero does not currently possess those Airworthiness Certifications, all with reimbursement by Aero for Air Canada's reasonable out-of-pocket costs;
- (d) that Air Canada shall provide Material Transfer Forms (as defined below) in fully executed form to Aero for all Aero Parts currently in Air Canada's possession; and
- (e) authorizing Aero, or its affiliates, agents or contractors, to take possession of the Swapped Back CAT 3 Parts (as defined below), for the purposes of storing those Swapped Back CAT 3 Parts at Aero-controlled facilities in Montreal until resolution of Air Canada's potential claim to the Swapped Back CAT 3 Parts or further order of the Ontario Court, provided that Air

Canada is given rights to inspect the Swapped Back CAT 3 Parts on reasonable notice to Aero.

SCOPE

8. In preparing this report, KPMG has relied on information supplied by the Foreign Debtors. KPMG has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of such information.

FACTUAL BACKGROUND

9. Aero is the main operating company of the group of companies controlled by Aero plc. This group of companies, comprised of the Foreign Debtors, Aero Canada and their international affiliates, supplied parts to the airline industry.

10. Aero's customers are airlines and aerospace maintenance and repair companies that operate in various locations globally.

11. Aero's assets in Canada are primarily composed of category 3 consumable and expendable spare aircraft parts ("CAT 3 Parts"). Aero-owned CAT 3 Parts, including the "Swapped Back CAT 3 Parts" described below, located in Canada will be referred to herein as the "Aero Parts".

12. Aero has two primary Canadian customers: Air Canada and Aveos Fleet Performance Inc. ("Aveos"). The primary contractual document entered into in connection with Air Canada's business arrangements with Aero was the Agreement for the Supply and Management of Consumable and Expendable Spares between Air Canada and Aero, dated as of December 10, 2008 (the "AC LMA"). A copy of this agreement is attached hereto as Appendix "C".

13. All of the inventory owned by Aero in Canada, save for a minimal amount of slow moving inventory located in third party owned warehouse space rented by Aero Canada, is located at various facilities across Canada that are under the control of Aveos and Air Canada. These facilities are located in Montréal, Toronto, Winnipeg and Vancouver.

14. At the Administration Date, Aero was the owner of tens of millions of dollars of CAT 3 Parts in the possession of Aveos and Air Canada.

ALGORITHM

15. The task of identifying Aero Parts and distinguishing them from Air Canada's and Aveos' own inventory has been challenging. Because Aero was never in physical possession of its Canadian inventory it had no means, even prior to the Administration Date, to ensure that its parts were segregated from Air Canada's and Aveos' parts. Further complicating this matter was the fact that the ARTOS inventory tracking computer system operated by Aveos and Air Canada did not differentiate between ownership by Air Canada and Aero for certain CAT 3 Parts.

16. The Aero Parts located in Canada are not physically segregated from inventory owned by Aveos or Air Canada.

17. The Aero Parts, Air Canada parts and Aveos parts are largely fungible and generally do not bear any marks identifying ownership.

18. Significant efforts were made by Aero to reconstruct Aero's independent inventory data during the year following the Administration Date. However, this process achieved limited success in the absence of integral information from Aveos and Air Canada, including in respect of parts for which ARTOS did not distinguish Air Canada's and Aero's ownership.

19. A sophisticated set of computer programs was required to provide Aero with the information it needed to untangle its inventory from the Aveos and Air Canada stock and to determine how much of Aero's inventory had been consumed by Aveos and Air Canada. Aero required the cooperation of Aveos and Air Canada to develop these programs as Aero did not have sufficient information and resources to undertake this process independently.

20. On November 10, 2010, the Information Officer and Air Canada, along with their respective legal counsel, met at Air Canada's facilities in Montreal to discuss a process to determine ownership and consumption of Aero Parts, as well as identification of Air Canada's inventory and Aveos' inventory. At that meeting, Air Canada first introduced the

concept of a computer algorithm to determine ownership and consumption of CAT 3 Parts as between Aveos, Air Canada and Aero (the "**Algorithm**"). The Algorithm would rely upon ARTOS daily data feeds.

21. Aveos, Air Canada and Aero spent several months finalizing the Algorithm, which has been completed. The final version of the business principles applicable to the Algorithm were substantially completed by April of 2011 on a without prejudice basis. The final version of the business principles document is attached hereto as Confidential Appendix "D".

AGREEMENT ON THE ALGORITHM

22. On March 9, 2012, an agreement was reached between Air Canada and Aero (the "**March 9 Agreement**") on, among other things, ownership of the Aero Parts, which is evidenced by an endorsement of Justice Morawetz of the Ontario Court. A copy of the endorsement of Justice Morawetz is attached hereto as Appendix "E".

23. On April 13, 2012, Aveos and Aero executed an agreement the terms of which substantially mirror the terms of the March 9 Agreement (the "**Aveos Agreement**"). A copy of the Aveos Agreement is attached hereto as Appendix "F".

24. Based upon the March 9 Agreement and the Aveos Agreement, Air Canada and Aero now have full confirmation on the ownership of Aero Parts from all relevant parties.

SWAPPED BACK CAT 3 PARTS

25. The March 9 Agreement with Air Canada states, in part, that:

The balance of Swapped Back CAT 3 Parts as at November 11, 2009 and as at March 1, 2012 are as reflected in the files delivered to Air Canada in connection with the March 1 Letter and the March 7 email from Francois Gagnon to Anton Vidgen and Norma Carey, respectively.

26. The issue regarding "**Swapped Back CAT 3 Parts**" arises from a claim that Air Canada may assert which is complex and its details are not relevant for the purposes of the current matter. For the purposes of the current matter, it is sufficient to understand that Air

Canada acknowledges that Aero owns the Aero Parts currently but asserts a potential interest in certain of those parts that were the subject of pre-Administration Date swap arrangements between Aero and Air Canada, which interest could only crystallize if the Trustee is successful in its claim against Air Canada under Section 95 of the BIA. Aero does not concede that this contingent interest is valid even if the Trustee is successful in its claim under Section 95 of the BIA. However, the contingent interest of Air Canada may not be fully and finally determined until the claim of the Trustee against Air Canada under Section 95 of the BIA is decided.

27. Aero has elected not to deal with the Aero Parts that constitute "Swapped Back CAT 3 Parts" at this time and intends to place those parts into storage in Montreal pending resolution of Air Canada's potential contingent claim, or further order of the Ontario Court.

28. Aero continues to believe that the Swapped Back CAT 3 Parts are validly owned by Aero and that the Algorithm is determinative of this issue.

29. The Swapped Back CAT 3 Parts account for, at most, 24% of the Aero Parts.

UPLIFT AGREEMENT

30. Upon completion of the Algorithm, Aero sought Air Canada's agreement on the removal of Aero Parts from the Facilities. Negotiations on these matters were extensive and took place over the period from April of 2011 until March of 2012.

31. In April 2011, Aero sought to formalize the understanding of Aveos, Air Canada and Aero regarding the validity of the output of the Algorithm and to establish a framework for the removal of the Aero Parts. A draft agreement was circulated by counsel to the Joint Administrators to counsel for each of Aveos and Air Canada on April 21, 2011. A copy of the email circulating this draft agreement is attached hereto as Appendix "G".

32. On May 25, 2011, representatives of Air Canada, Aveos and Aero met. The meeting was called to discuss the development of a bin allocation program that would pin-point the specific bin locations of CAT 3 Parts owned by each party within a given facility (the "**Bin Allocation Program**").

33. The Joint Administrators have resolved to accept the Bin Allocation Program in an effort to move forward with the uplift.

34. After a further meeting on August 11, 2011 attended by Air Canada, the Information Officer and the Joint Administrators and their respective counsel, and several months of negotiation, correspondence, and exchanges of draft agreements, Air Canada and Aero substantially agreed on a form of ownership and uplift agreement in March of 2012, with the only outstanding issue being the suitability of Aveos as a possible party to undertake the physical removal of Aero's Parts from the Facilities. Correspondence received from Air Canada's counsel on March 15, 2012 indicated that this issue was resolved. A copy of that correspondence is attached hereto as Appendix "H".

35. On March 19, 2012 Air Canada's counsel and the Joint Administrators' counsel attended before the Ontario Court and advised that they had resolved all issues relating to the form of ownership and uplift agreement (the "**Uplift Agreement**"). A copy of the Court's record of this attendance is attached hereto as Appendix "I".

36. Also on March 19, 2012, the final version of the Uplift Agreement was circulated by the Joint Administrators' counsel to Air Canada's counsel for execution. A copy of this agreement and counsel's covering email are attached hereto as Appendix "J".

37. A key term of the Uplift Agreement was the following:

Subject to the preservation of the claimed storage lien claim, Air Canada shall permit, following reasonable written notice to, and under the supervision of, Air Canada, the uplifting and removal (or scrapping or disposition) of such Schedule A Parts by [Aero], or by such parties as may be approved by Air Canada acting reasonably, in a manner agreed to by the parties acting reasonably (the costs of doing so to be borne solely by [Aero]) so as not to materially disrupt the normal operations of Air Canada. For the avoidance of doubt, Air Canada may refuse to approve the uplifting or removal by parties other than [Aero] if, amongst other things, they fail to demonstrate continuing insurance coverage satisfactory to Air Canada and/or in order to ensure compliance with collective bargaining agreements or other similar arrangements. Aveos is, as at the date of this Agreement, approved by Air Canada as a party that may

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undertake the uplifting and removal (or scrapping or disposition) of Schedule A Parts at Air Canada Facilities.

38. To date the Uplift Agreement has not been executed by Air Canada.

39. While the Uplift Agreement refers to the uplift and removal of Aero Parts by Aero itself, Aero always contemplated that it could hire independent contractors, either directly or through Aero Canada, to perform the uplift and removal. During the negotiation of the Uplift Agreement, Aero provided Air Canada with confirmations regarding its insurance coverage in respect of the uplift activities, which Air Canada appears to have been satisfied with. Aero has advised that its insurance coverage would be equally applicable to performance of the uplift by Aero Canada, as well as any agents or contractors of Aero or Aero Canada.

PERFORMANCE OF UPLIFT

40. As originally contemplated in late 2010, Aveos would have performed the physical removal of the Aero Parts from the Facilities. For this purpose, among others, a Settlement and Labour Supply Agreement was entered into between, *inter alia*, Aveos and Aero on December 31, 2010 (the "**Settlement Agreement**") and was approved by the Ontario Court on January 21, 2011. A copy of the Settlement Agreement is attached hereto as Appendix "K". Copies of the order of the Ontario Court approving the Settlement Agreement, and the endorsement of the Ontario Court are attached hereto as Appendices "L" and "M", respectively.

41. On March 19, 2012, Aveos commenced CCAA proceedings. A copy of the Initial Order in the Aveos CCAA proceedings, and amendments thereto, are attached hereto as Appendix "N".

42. On March 21, 2012, counsel to the Joint Administrators wrote to Air Canada's counsel to explore the possibility of Aero undertaking the parts removal task itself, using its own labour. This inquiry was initiated in view of the Aveos CCAA proceedings and potential labour supply issues that may be associated therewith. A copy of that letter is attached hereto as Appendix "O".

43. Throughout late March and early April of 2012, multiple conversations and email correspondence took place between Air Canada and the Information Officer in which the Information Officer discussed the removal of Aero Parts from Air Canada's facilities. Notably, on April 5, 2012 a list of operational matters surrounding the uplift was provided to Air Canada and on April 16, 2012 a meeting was held between Air Canada and the Information Officer at Air Canada's facilities to discuss the uplift. Finally, on April 20, 2012 an email was sent by the Information Officer to Air Canada to outline a proposed action plan for the uplift. A copy of the April 20, 2012 email is attached hereto as Appendix "P".

44. Aero and Air Canada have been unable to agree on a process for Aero to undertake the uplift of the Aero Parts.

45. During a meeting between Aveos and the Information Officer on April 16, 2012, Aveos indicated that it was no longer willing to undertake the uplift of the Aero Parts.

46. While not an ideal scenario, Aero has no option other than to contract for its own labour directly or through its affiliates to undertake the uplift process. Aero seeks to enforce the terms of the Uplift Agreement in order to allow Aero to remove its parts from the Facilities.

47. Aero has completed a document summarizing the framework for the completion of the uplift (the "**Repossession Procedures**") . A copy of the Repossession Procedures is attached hereto as Appendix "Q".

48. The Uplift Agreement makes reference to a proposed rental arrangement at the "Montreal Main Stores", which is a Facility in which a substantial majority of the Aero Parts are located. While Aero does not concede that any rent is payable at any other Facilities, the immediate entry into a rental arrangement at the Montreal Main Stores in connection with the proposed uplift is essential. Aero understands that Air Canada asserts certain storage liens in respect of alleged rent payable by Aero to Air Canada in connection with occupancy of the Facilities. These storage lien claims would be preserved in accordance with the terms of the Uplift Agreement.

MATERIAL TRANSFER FORMS AND AIRWORTHINESS CERTIFICATION

49. In order to market the Aero Parts in a manner that achieves near optimum value, Aero must be able to provide such parts in an appropriately certified form. Appendix A to the Airworthiness Agreement that Aero and Air Canada entered into on or about May 29, 2008. (a predecessor of Aveos and former subsidiary of Air Canada) (the “**Airworthiness Agreement**”) outlines the material certification requirements that existed as at May 29, 2008. The Joint Administrators believe that such requirements remain substantially the same at this time.¹ A copy of the Airworthiness Agreement is attached hereto as Appendix “R”.

50. In recognition of these airworthiness requirements, a critical term of the Settlement Agreement was the delivery of parts to Aero in an “Uplift Ready” form. According to the Settlement Agreement, a part would be “Uplift Ready” if, among other things:

- (a) it is packed in accordance with International Air Transport Association standards and/or ATA specification 300,
- (b) it is accompanied by a valid material transfer form, and
- (c) it is accompanied by sufficient documentation to satisfy the relevant authorities that the part conforms to applicable standards of airworthiness, as per applicable Transport Canada requirements.²

51. Certain of the Aero Parts were originally purchased from Air Canada and/or Aveos, which was at one time the heavy maintenance division of Air Canada. The Joint Administrators must assume that when these parts were originally in the possession of Aveos and/or Air Canada they had the benefit of all relevant certifications. If this were not the case, Air Canada would not have been able to utilize these parts in its operations.

¹ While a fully executed copy of the Airworthiness Agreement was not available from Aero’s records, the Information Officer is informed by Aero that the attached version represents the final agreed version of this document.

² Such documentation would include, without limitation, forms such as Transport Canada 24-0078 or Form One, FAA 8130-3, EASA Form One.

52. The Joint Administrators would expect that Air Canada would be in possession of certification documents in electronic and/or hard copy form related to Aero Parts originally acquired from Air Canada or Aveos (to the extent that these parts were originally acquired when the Aveos business was a division of Air Canada). The Joint Administrators would expect that such certification documents would be responsive to the requirements of relevant authorities that a particular Aero Part conforms to applicable standards of airworthiness (the **“Airworthiness Certifications”**), which would include, at a minimum, (i) the certification documentation contemplated in Appendix A to the Airworthiness Agreement and, (ii) given past corporate structure changes involving Air Canada’s maintenance operations, documentation confirming a continuous chain of possession of the Aero Parts and the applicability of Airworthiness Certifications.

53. The Joint Administrators expect that Air Canada would be in a position to provide valid material transfer forms, substantially in the form attached hereto as Appendix “S”, to Aero for all Aero Parts that are removed from the Facilities controlled by Air Canada (the **“Material Transfer Forms”**).

54. The Joint Administrators require Air Canada’s assistance and cooperation in preserving and obtaining Airworthiness Certifications and executing Material Transfer Forms for the Aero Parts. Aero is willing to pay Air Canada’s reasonable out-of-pocket costs in this regard.

55. In order to facilitate the matching of Aero Parts with applicable Airworthiness Certifications, Aero has already arranged for a third party to digitally scan certificates in the possession of either Air Canada or Aveos for parts received between January 1, 2000 and January 1, 2005 (certificates were digitally scanned by Aveos and Air Canada following this date pursuant to their regular warehouse receiving processes). The cost of this process, which was undertaken in 2011 in contemplation of the uplift described in the Settlement Agreement, was borne entirely by Aero and amounts to approximately \$350,000.

URGENCY

56. In order to maximize realisations for the benefit of creditors, Aero is currently implementing a global inventory realization strategy.

57. A substantial amount of Aero's global inventory is being consolidated at one central hub located in Singapore (the "**Singapore Hub**") that is operated by DHL International GmbH, a worldwide logistics services provider (the "**Uplifted Inventory**"). The Uplifted Inventory at the Singapore Hub is then sold on the open market, via a number of different global sale channels based around the Americas, EMEA and APAC regions (the "**New Aero Business**").

58. Inventory from other jurisdictions is ready to be monetized through the New Aero Business and a marketing effort is underway to sell the New Aero Business as a going concern.

59. The Joint Administrators have finalized and issued an information memorandum for the purposes of marketing the New Aero Business. However, one obvious gap in that information memorandum is the method by which the Canadian inventory will be accessed. Whereas this issue has been resolved in all other jurisdictions, it remains a problem in Canada. The problem is intensified by the fact that (i) the Canadian inventory mix is by far the most attractive to the New Aero Business; and (ii) the duration of the Administration Proceedings has already been extensive and the Joint Administrators are seeking to conclude a sale of the New Aero Business in the next few months. In order to complete a sale on the proposed timeline, the inventory access issues in Canada must be resolved immediately.

60. The Joint Administrators understand that Aveos is currently undertaking a court-approved expedited sales process for its business, as shown in the order of the Quebec Superior Court attached hereto as Appendix "T". This process contemplates the receipt of offers from potential purchasers by May 29, 2012. As a result, Aero is seeking to move quickly to remove the Aero Parts from Aveos-controlled facilities. From an economic cost perspective, Aero wishes to remove its parts from Air Canada's facilities on a timeline that corresponds to the removal from the Aveos-controlled facilities in order to avoid process

inefficiencies and limit the time period of fixed costs, such as warehouse rentals and supervisory personnel costs, which fixed costs will be significant.

PROPOSED RESOLUTION

61. The Joint Administrators propose that Aero or its affiliates, agents or contractors should be permitted to obtain access to the Facilities for the purposes of re-possessing its property, in marketable form, and that Air Canada shall provide cooperation in that regard. This was the purpose of the Uplift Agreement.

62. The Joint Administrators propose that Air Canada should be bound by the terms of the Uplift Agreement to which it previously indicated its agreement.

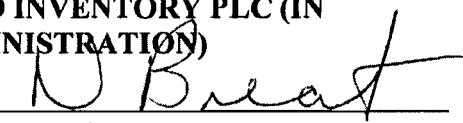
63. The Joint Administrators propose that Swapped Back CAT 3 Parts would be stored by Aero in a Montreal facility once removed from the Facilities until resolution of Air Canada's potential claim to the Swapped Back CAT 3 Parts or further order of the Ontario Court

64. Finally, the Joint Administrators request that this Honourable Court direct Air Canada to preserve all existing Airworthiness Certifications for Aero Parts and to provide executed Material Transfer Forms and Airworthiness Certifications, all with reimbursement from Aero.

All of which is respectfully submitted this 26th day of April, 2012.

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

Per:



Nicholas Brearton
President

IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT ACT,
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Proceeding commenced at Toronto

FOURTH REPORT OF KPMG INC.
IN ITS CAPACITY AS
INFORMATION OFFICER

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