

Tab 2

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

**SIXTH REPORT OF KPMG INC.
IN ITS CAPACITY AS TRUSTEE IN BANKRUPTCY
AND INFORMATION OFFICER**

MARCH 27, 2013

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Tab:	Appendices:
A	Administration Sale of Assets Agreement (Canadian Assets), dated as of March 26, 2013 between the Foreign Debtors, the Joint Administrators and Diversified Aero Inventory I, LLC (redacted)
B	Administration Sale of Assets Agreement (Canadian Assets), dated as of March 26, 2013 between the Foreign Debtors, the Joint Administrators and Diversified Aero Inventory I, LLC (unredacted) and disc containing Canadian Aero Parts information. (Confidential)

INTRODUCTION

1. On November 11, 2009 (the "**Administration Date**"), James Robert Tucker, Richard Heis and Allan Watson Graham, partners of KPMG LLP, 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 Joint Administrators as "foreign representatives" as defined in section 45 of the CCAA (in such capacities, the "**Foreign Representatives**") 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 information officer (in such capacity, the "**Information Officer**").
4. On January 22, 2010, the Court issued an order temporarily lifting the stay granted in the Recognition Order and authorizing the assignment of 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 of each of the Foreign Debtors (in such capacity, the "**Trustee**").
5. This is the sixth report by the Information Officer (the "**Sixth Report**"). The Information Officer is filing this Sixth Report to provide information regarding the Foreign Representatives' motion seeking approval of the sale of assets of the Foreign Debtors located in Canada pursuant to an Administration Sale of Assets Agreement (Canadian Assets) the

"**Canadian Sale Agreement**"), dated as of March 26, 2013 between the Foreign Debtors, the Joint Administrators and Diversified Aero Inventory I, LLC.

FACTUAL BACKGROUND

6. Aero is the main operating company of the group of companies controlled by Aero plc. This group of companies, which comprises the Foreign Debtors and their international affiliates, supplies parts to the airline industry.

7. Aero’s customers are airlines, aerospace maintenance and repair companies and intermediary suppliers that operate in various locations globally.

8. Aero’s assets are primarily composed of category 3 consumable and expendable spare aircraft parts ("**CAT 3 Parts**").

REALIZATION STRATEGY

9. In order to maximize realizations for the benefit of creditors, the Foreign Debtors implemented a global inventory realization strategy under which the current business of the Foreign Debtors would be sold including the CAT 3 Parts.

10. The core realisation strategy could not be based around a going concern sale of the business in its pre-administration form; nor could the assets readily be parcelled out and sold in the open market in a traditional liquidation. The Joint Administrators therefore concluded (in consultation with creditors) that the best way to achieve their statutory objectives would be to develop and sell a new business model using Aero’s marketable inventory.

11. With the exception of the Canadian inventory, Aero’s global inventory (the "**Singapore Inventory**") has been consolidated at one central hub located in Singapore (the "**Singapore Hub**") that is operated by DHL Supply Chain PTE LTD., a worldwide logistics services provider. The Singapore Inventory 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**"). As discussed in greater detail below, the assets of the Foreign

Debtors that were located in Canada at the Administration Date are a part of the inventory of the New Aero Business, but have not been moved to the Singapore Hub.

FOREIGN DEBTORS' ASSETS IN CANADA

12. The Canadian inventory represents a very significant portion of Aero's overall global inventory. Aero-owned CAT 3 Parts, including the "Swapped Back Parts" described below, located in Canada will be referred to herein as the "**Canadian Aero Parts**".

13. At the Administration Date, Aero was the owner of tens of millions of dollars of CAT 3 Parts (at list price).

14. All of the inventory owned by Aero in Canada, save for a minimal amount of slow moving inventory located in warehouse space rented by Aero's Canadian subsidiary, was, at the commencement of these proceedings, located at various facilities across Canada that were under the control of Aveos Fleet Performance Inc. ("**Aveos**") and Air Canada.¹ These facilities were located in Montréal, Toronto, Winnipeg and Vancouver. The inventory owned by Aero at these facilities was largely commingled with Aveos and Air Canada inventory in tens of thousands of bins.

15. In order to extract Aero's Canadian inventory, Air Canada, Aveos and Aero had to agree on a method to identify and allocate ownership of CAT 3 Parts held in Air Canada and Aveos facilities across Canada. A sophisticated set of computer programs were required to provide Aero with the information it needed to untangle its inventory from the Aveos and Air Canada stock.

16. By April 2011, the Foreign Debtors, Aveos and Air Canada had agreed upon computer programs that could accurately divide ownership of the aggregate balance of CAT 3 Parts held at Air Canada and Aveos facilities in Canada and track quantities of consumption of those parts (the "**Algorithm**"). In the following months Aero, Aveos and Air

¹ Aveos had also deposited certain portions of Aero's inventory at third party warehouses. In the case of those arrangements, Aveos was the contracting party with the warehouse services provider and effectively controlled access to that inventory.

Canada also developed a program that could pinpoint the locations of Canadian Aero Parts in specific locations across Canada (the "**Bin Allocation Program**"). As a result, allocations had been determined at a theoretical level² under the Algorithm and the Bin Allocation Program, such that Aero could determine how many units of a particular CAT 3 Part it should own in a particular bin at a particular facility.

SWAPPED BACK INVENTORY

17. Certain of the Canadian Aero Parts are described as "**Swapped Back Parts**". This sub-class of parts arises from a claim that Air Canada may assert in the future, the details of which 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 Canadian Aero Parts currently, but asserts a potential interest in the portion of those parts that are Swapped Back Parts that may crystallize in the future. Aero does not concede that this contingent interest is valid and Aero continues to believe that the Swapped Back Parts are validly owned by Aero in all circumstances. However, the contingent interest of Air Canada may not be fully and finally determined until a claim by the Trustee against Air Canada under Section 95 of the BIA is resolved.

18. Aero has agreed not to deal with the Swapped Back Parts at this time and will place those parts into storage in Montréal, pending resolution of Air Canada's potential contingent claim, or further order of the Ontario Court.

19. The Swapped Back Parts account for, at most, 26% of the Canadian Aero Parts based on inventory values incorporated into the Bin Allocation Program and Algorithm. The process of physically isolating the Swapped Back Parts has been a time consuming and costly exercise, as described in more detail below.

² The theoretical quantities of CAT 3 Parts that Aero should be able to retrieve from a particular bin at a particular facility could deviate from the quantities of parts actually physically found in a particular bin since the algorithm was based upon the electronic records of inventory purchases, sales and transfers, and not upon a physical count of inventory.

PARTS RECEIPT AND INITIAL SEGREGATION PROCESS

20. While computer programs to determine ownership at a theoretical level were finalized during 2011, it was not until the late summer of 2012 that Air Canada, Aero and Aveos developed a mutual understanding of the method by which the Canadian Aero Parts would be physically separated and removed from the Aveos and Air Canada facilities. Aero entered into two agreements in 2012 that prescribed certain procedures for the uplift and removal of the Canadian Aero Parts from various facilities across Canada controlled by Aveos, Air Canada or third party warehouse service providers contracted by Aveos.

21. Aero understood that it was unlikely that the parts physically located at each Aveos, Air Canada or third party warehouse facility would completely match the records produced by the Bin Allocation Program and the Algorithm. A variety of factors could lead to discrepancies between the computer program outputs and the physical quantity of Canadian Aero Parts, since it was virtually impossible to take physical inventory counts to verify the accuracy of the computerized inventory records at any point in time. Since Aero understood that there could be situations in which the physical number of CAT 3 Parts at a particular location would be less than the quantity of parts shown by the Algorithm and the Bin Allocation Program as being situated at that location and being owned by each of Aveos, Air Canada and Aero, a protocol to respond to such shortages was beneficial.³

22. While no protocol was established in respect of the Aveos facilities, a detailed protocol was established for the Air Canada controlled facilities. At all but one of the Air Canada facilities, Air Canada was to physically remove and deliver the Canadian Aero Parts into Aero's possession. At one particular Air Canada controlled facility, Aero's contractors were permitted to attend pursuant to a short term license arrangement and remove the Canadian Aero Parts. In all cases, the arrangements with Air Canada provided that parts located at an Air Canada controlled facility and physically delivered to Aero would be allocated first to satisfy the full quantum of Swapped Back Parts before any CAT 3 Parts

³ Air Canada and Aero agreed that, as between themselves, they would each reserve any rights that they may have to assert claims in respect of shortfalls in the quantity of physically delivered CAT 3 Parts as compared to the quantity of CAT 3 Parts shown to exist in the Algorithm and the Bin Allocation Program.

could be considered non-Swapped Back Parts. No similar arrangement was mandated in respect of CAT 3 Parts located at the Aveos-controlled sites and third party warehouses, but as described below, Aero allocated Canadian Aero Parts to first satisfy the Swapped Back Parts at these facilities as well. This process was intended to provide the greatest possible comfort that Aero would not record any recovery of non-Swapped Back Parts of a particular type at a particular facility before all Swapped Back Parts of that type at that facility were fully accounted for up to the quantities physically available.

23. The initial phase of Aero’s segregation process in Canada involved the centralizing, receiving and processing of the Canadian Aero Parts at a leased facility in Montréal (the "**Canadian Validation Centre**"). It was a large scale, protracted and complex exercise that required Aero to physically handle some 3.46 million individual parts. It was necessary to hire a workforce of more than one hundred skilled individuals to handle this volume of parts in a timeframe acceptable to Aero and its stakeholders.

24. Set out below is a summary of the CAT 3 Parts expected to be received based on the records produced by the Bin Allocation Program and the Algorithm, compared to the CAT 3 Parts physically received at the Canadian Validation Centre. Inventory located in a warehouse rented by Aero Canada at the Administration Date has been incorporated into the analysis.⁴

	Expected Parts			Received Parts			Part Shortages		
	Non-Swapped Back	Swapped Back	Total	Non-Swapped Back	Swapped Back	Total	Non-Swapped Back	Swapped Back	Total
Number of parts	3,710,795	553,990	4,264,785	3,006,462	460,203	3,466,665	(704,333)	(93,787)	(798,120)
AIP value*	\$53.9m	\$17.3m	\$71.2m	\$45.3m	\$14.5m	\$59.8m	(\$8.6m)	(\$2.8m)	(\$11.4m)

* Note: AIP, or Average Invoice Price, is an inventory valuation per unit calculated by Air Canada which is integrated into Algorithm and Bin Allocation Program. The figures in the table exclude any parts defined as overages, as described below.

⁴ The value of inventory located in a warehouse rented by Aero Inventory (Canada) Inc. at the Administration Date amounted to \$4.4 million based on AIP valuation. This parcel of inventory does not contain any Swapped Back Parts.

25. The table above shows that Aero expected to receive parts valued at \$71.2 million and physically received parts valued at \$59.8 million, resulting in an inventory shortfall of \$11.4 million (or 16% of total expected inventory) at AIP value. This excludes overages, as discussed below, valued at approximately \$7.7 million at AIP value.

26. In addition to validating the Canadian Aero Parts, a key activity of the first phase of operations involved the matching of parts with the appropriate trace certification documents.

FINAL SEGREGATION PROCESS AND ISOLATING THE CANADIAN INVENTORY THAT IS THE SUBJECT OF THE INITIAL SALE

27. Once all available Canadian Aero Parts from all locations across Canada had been consolidated at the Canadian Validation Centre by late November 2012, Aero worked for three months to complete the process of identifying and segregating those Canadian Aero Parts that could not be subject to Air Canada's Swapped Back Parts claim by dividing the parts into the following categories based upon the Algorithm output.

(a) Canadian Aero Parts that could not be Swapped Back Parts:

These Canadian Aero Parts could not be Swapped Back Parts because they are of types not included on the Swapped Back Parts list agreed to with Air Canada, as at March 1, 2012, with adjustments made for parts consumed from this date up to June 1, 2012.

(b) Canadian Aero Parts that were definitely Swapped Back Parts:

These Canadian Aero Parts can only be Swapped Back Parts because they are of types and quantities included on the Swapped Back Parts list agreed to with Air Canada and not otherwise included on the list of non-Swapped Back Parts (at a bin level), as at March 1, 2012, with adjustments made for parts consumed from this date up to June 1, 2012.

- (c) Canadian Aero Parts that could be either Swapped Back Parts or non-Swapped Back Parts:

These Canadian Aero Parts could be either Swapped Back Parts or non-Swapped Back Parts because parts of this type appear on both the list of Swapped Back Parts and the list of non-Swapped Back Parts agreed to with Air Canada, as at March 1, 2012, with adjustments made for parts consumed from this date up to June 1, 2012.

- (d) Overages:

In certain cases, Aero obtained quantities of a particular type of CAT 3 Part over and above the quantities that Aero was to receive in accordance with the Algorithm and the Bin Allocation Program as at March 1, 2012, with adjustments made for parts consumed from this date up to June 1, 2012.

28. At the initial stage, Aero seeks to sell the parts described in category (a) above and the parts described in category (c) above to the extent of any excess over and above the quantity necessary to satisfy the Swapped Back Parts balance. Parts described in (b) and (d) are described in the Canadian Sale Agreement as "Unresolved Parts", some of which may become the subject of a sale in the future, as described below.

29. Any Canadian Aero Parts not currently being sold because they are, or may be, Swapped Back Parts will be stored by Aero pending further order of the Court or other resolution among interested parties.

30. In respect to any CAT 3 Parts that appear to constitute overages as described in item (d) above, Aero will be commencing a dialogue with Air Canada and Aveos to determine how the overages should be appropriately treated.

MARKETING PROCESS

31. The sale process for the Aero business has been ongoing for approximately two years.

32. The Joint Administrators retained KPMG Corporate Finance (UK) and UBS Limited as financial advisors to assist with this sale process.

33. The sale process in a UK administration proceeding is not court approved. Rather, the Joint Administrators have a statutory duty to maximise realisations for the benefit of all creditors while pursuing the statutory purpose approved by creditors in the Joint Administrators' proposals. The Joint Administrators perform these functions as agent of the Foreign Debtors with duties to all creditors as an officer of the court (albeit not under its direct supervision as is the case in Canada).

34. The Joint Administrators have fulfilled this mandate and these duties as described below. In working with their advisors to establish a marketing process for the New Aero Business, the Joint Administrators were mindful of the fact that the New Aero Business and assets were highly specialized and that an approach that provided flexible and tailored attention to the needs of potential acquirers would be beneficial. Whereas more traditional business assets could be adequately marketed through a straight-forward multi-stage marketing process with fixed and firm deadlines, the New Aero Business required a more fluid approach.

35. In total, throughout the course of marketing the business, 103 potentially interested parties in various countries around the world engaged with the Joint Administrators or their financial advisors to some degree. 27 of these were strategic parties (including lessors, airframers, major MRO providers, aerospace parts distributors and surplus parts traders). The remaining 76 potential purchasers could be characterised as financial purchasers.

36. The Joint Administrators initially publicly signalled their plans to put the New Aero Business up for sale on March 3, 2011 in a Financial Times news article.

37. In November 2011, a list of potential buyers from across the world, encompassing strategic parties and financial purchasers, was developed in consultation with senior members of the business management team and the financial advisors to the Joint Administrators.

38. Parties that, based upon market research, would have the greatest strategic appetite were approached in late 2011 with a 2 page teaser. In addition, these parties were also offered

the opportunity to receive a pre-marketing presentation through the course of January/February 2012 (5 parties received a pre-marketing presentation).

39. In May 2012, 81 parties were approached (including those that had been approached previously and remained interested) with a view to providing an Information Memorandum ("IM") and a profile of the assets. Of the parties approached, 41 executed a Non-Disclosure Agreement and received an IM and the profile of the assets. These documents were dispatched through the course of May/June 2012. The IM provided a detailed summary of the business, the market in which it operates and financial projections. The written profile of the assets provided a summary of the inventory owned by the business detailing the inventory portfolio cross-referenced by, among other things, aircraft platform, type, and usage. Interested parties were further provided with a process letter that set out the timetable, key steps in the intended sale process and guidance around what information should be included within any bid submission.

40. By August 2, 2012, three (3) indicative bids had been received. While the process remained open to further bids from other interested parties⁵, the Joint Administrators believed that sufficient time had been provided to potential bidders to make their interest known and submit an indicative bid within the scope of the formal process.

41. In late August 2012 the indicative bidders were provided with access to a more detailed inventory summary, which provided granular detail of Aero's inventory and assisted bidders in refining their bids. Indicative bidders were then asked to reconfirm their bids and provided with detailed guidance on information their reconfirmation should contain.

42. Throughout the sale process, the New Aero Business continued to maintain a profile within the industry consistent with trying to build sales momentum. This included attending trade shows, utilising public relations tools and maintaining a dialogue with industry participants. As highlighted above, the process remained open to approaches from parties who had not been identified and approached as part of the formal bid process. Where an indication

⁵ Further bids were in fact received and considered as described below.

of interest was received, even informally, the Joint Administrators or their advisors would proactively respond to enquiries. Through this approach, four (4) further parties who had not been previously involved in the formal process engaged with the Joint Administrators or their advisors with a view to acquiring the New Aero Business through the second half of 2012. These parties were provided with further information so that they could also formally submit an indicative bid. Of these four (4) parties, three (3) submitted an indicative bid.

43. By January 21, 2013, two (2) bidders remained highly active in the process. Both of these parties have received the benefit of access to a dataroom (including an updated inventory summary to reflect the latest inventory position), the opportunity to ask detailed questions on the inventory summary, the option of physical inspection of the New Aero Business' stock and Q&A sessions with management.

44. The Joint Administrators believe that the marketing process has been comprehensive. The Joint Administrators have maintained a flexible approach throughout the sales process and have sought to reasonably explore all *bona fide* interest, either directly or through their advisors. Overall, the Joint Administrators believe that the transaction selected is the most beneficial transaction available for stakeholders having a view to purchase price, timing, execution risk and other closing conditions.

SUCCESSFUL PURCHASER

45. The Purchaser is a special purpose entity formed to undertake this acquisition by the principal of Diversified Aero Services Inc.

46. According to its website, Diversified Aero Services Inc. is a privately held full-service aftermarket commercial aircraft parts supplier based in Miami, Florida with additional facilities in Phoenix, Arizona and Madrid, Spain that has been in operation for at least 20 years. The Purchaser is uniquely positioned to make full use of the platform established by the New Aero Business, which is complementary to the business already carried on by Diversified Aero Services Inc.

TERMS OF CANADIAN ASSET SALE⁶

47. The Canadian Sale Agreement is one part of a larger global asset sale transaction undertaken by the Foreign Debtors and the Purchaser. The Purchaser is not entitled to complete the global asset sale transaction without also completing the transaction contemplated by the Canadian Sale Agreement.

48. The Canadian Sale Agreement is governed by the laws of the United Kingdom and is drafted to be consistent to the extent possible with the documents governing the global sale transaction. Whereas the assets in all other jurisdictions are being sold pursuant to a global asset sale agreement, the Canadian Sale Agreement has been drafted as a separate local sale agreement to facilitate court approval in Canada.

49. A redacted copy of the Canadian Sale Agreement is attached as Appendix "A" hereto. An unredacted copy of the Canadian Sale Agreement is attached as confidential Appendix "B" hereto. For the reasons discussed below, the Foreign Representatives are requesting that confidential Appendix "B" be sealed by this Court.

50. The following paragraphs provide a summary overview of the material terms of the Canadian Sale Agreement.

Purchased Assets

- a) Aero shall transfer its right, title and interest in the Canadian Aero Parts (subject to certain exceptions discussed below) and all trace documentation and certification currently in Aero's possession and relating to the Canadian Aero Parts (subject to certain exceptions discussed below) to the Purchaser.

⁶ This summary is not intended to be a comprehensive description of the terms of the Canadian Sale Agreement. In the event of any inconsistency between this summary and sale agreement, the Canadian Sale Agreement shall control.

Retained Assets

- a) Aero will not, at this time, transfer its right, title and interest in the Canadian Aero Parts that constitute "Unresolved Parts" or "Canadian Restricted Parts", which are described in greater detail below. Aero will also not, at this time, transfer its right, title or interest in any trace documentation or certification relating to the Unresolved Parts or the Canadian Restricted Parts. Unlike certain of the Unresolved Parts, Aero has no intention of selling the Canadian Restricted Parts at any time in the future.
- b) Aero will also retain, among other things, any cash or near cash assets, the benefit of all insurance policies, the benefit of any claims or potential claims that the Foreign Debtors may hold against third parties including claims for book debts owing, any rights under contracts entered into in Canada by the Foreign Debtors, and certain business records.
- c) The Trustee and Joint Administrators will also retain any claims that they may have against third parties.

Put Option

- a) Certain of the Canadian Aero Parts may be subject to contingent competing ownership claims. Those parts are the Swapped Back Parts described above. Aero is provided with a "put option" under the Canadian Sale Agreement, whereby it may sell these Unresolved Parts to the Purchaser at a prescribed price once ownership questions are resolved, to the extent that those ownership questions are resolved in Aero's favour

Purchase Price

- a) The purchase price is divided into three tranches (i) the initial purchase price; (ii) any purchase price paid upon exercise of Aero's put option in respect of the Unresolved Parts; and (iii) certain contingent "Additional Consideration".

- b) The Additional Consideration is determined by reference to the proceeds received by the Purchaser from its eventual sale of the Canadian Aero Parts in the market, as well as from the sale of all other CAT 3 Parts purchased from Aero globally.
- c) The initial purchase price is subject to adjustment following a physical inventory verification process that will be undertaken by the Purchaser prior to closing.

Representations and Warranties/Covenants of the Parties

- a) The Canadian Sale Agreement contains representations and warranties on the part of the Purchaser that are standard in the context of a sale transaction undertaken with a Joint Administrator under English insolvency laws, with respect to corporate power and authorization and binding effect.
- b) The Canadian Sale Agreement also contains certain representations specific to the aerospace industry relating to the Purchaser's export compliance program and the status of the Purchaser under the US *International Traffic in Arms Regulation*, or equivalent legislation in other jurisdictions.
- c) The Purchaser also agrees to indemnify certain persons including Aero, the Joint Administrators, the Trustee and the Information Officer against, among other things, all demands, claims and liabilities asserted by any third party and relating to manufacture, distribution, sale, supply or use of the Canadian Aero Parts by or on behalf of the Purchaser or subsequently by any third party. This indemnity is unsecured.
- d) The assets that are the subject of the Canadian Sale Agreement are being sold on an "as is, where is" basis.

Closing Conditions

Closing of the sale transaction shall be conditional upon:

- (a) issuance by the Court of an approval and vesting order substantially in the form provided in the Foreign Representatives' motion record (the "Vesting Order") and an order described in paragraph 52 below;
- (b) delivery of an acknowledgement by the Purchaser that provides the Trustee with a release and indemnity in form previously agreed between the Purchaser and the Trustee;
- (c) delivery of a certificate of the Information Officer in the form attached to the Vesting Order confirming that the conditions for closing have been met;
- (d) the orders sought in the Foreign Representatives' motion becoming "Final Orders" as defined in the Canadian Sale Agreement; and
- (e) the delivery of certain deeds of release from the Lending Syndicate (as defined below).

Closing of the sale transaction in respect of the Unresolved Parts shall be conditional upon:

- (a) a determination by this Court or by agreement of all interested parties that Aero's claim to the Unresolved Parts has been resolved;
- (b) the provision of notice by Aero to the Purchaser requiring the Purchaser to complete the acquisition of Aero's right, title and interest in such parts; and
- (c) the payment by the Purchaser of the price specified in Aero's put option on the Unresolved Parts.

Canadian Restricted Parts

Certain Canadian Aero Parts defined in the Canadian Sale Agreement as "Canadian Restricted Parts" are not being transferred as part of the transaction at any time due to regulatory restrictions.

Deposits

A security deposit is not available under the terms of the Canadian Sale Agreement.

Escrow

The initial purchase price payable under the Canadian Sale Agreement will be placed into escrow with the Joint Administrators' solicitors upon granting of the orders sought on the Foreign Representatives' motion. That initial purchase price will be released from escrow and dealt with in accordance with the Canadian Sale Agreement upon those orders becoming "Final Orders".

APPROVAL AND VESTING ORDER

51. The draft Vesting Order provides for the transfer of Aero's right, title and interest in the purchased assets to the Purchaser free and clear of all claims. The form of Vesting Order proposed by the Foreign Representatives in this case is in standard form for transactions of this nature, subject to the following material amendments:

- a) The proposed Vesting Order would provide that the net proceeds from the Canadian Sale Agreement shall be delivered into the possession of Aero to be dealt with in accordance with the Administration Proceedings. To the extent that any party has a claim to the Canadian Aero Parts that is expunged or discharged by the Vesting Order, that claim would be asserted to the extent legally permissible against the sale proceeds in the Administration Proceedings.
- b) The proposed Vesting Order provides for the Holdback, which will be held by the Trustee until further order of the Court.
- c) The proposed Vesting Order provides for a mechanism to transfer Aero's right, title and interest in any portion of the Unresolved Parts that are ultimately transferred to the Purchaser through an exercise by Aero of its put option. The funds paid by the Purchaser upon Aero's exercise of this put option would also be delivered into the possession of Aero to be dealt with in accordance with the Administration Proceedings.

TRUSTEE ORDER

52. As the Trustee has not taken an active role in the marketing and sale process, and in recognition of the fact that this process has been undertaken by the Joint Administrators in the Administration Proceedings, which are the foreign main proceedings, the Foreign Representatives seek an order confirming that:

- a) the effects of the bankruptcy proceedings in respect of the Foreign Debtors will not apply to the Foreign Debtors' assets, property and undertaking currently located outside of Canada; and
- b) the Trustee shall have no liability or duty in respect of any dealings by any party, including the Foreign Debtors and the Purchaser, with the assets, property or undertaking of the Foreign Debtors located outside of Canada.

SALE PROCEEDS

53. The Foreign Representatives propose that the net proceeds from the Canadian Sale Agreement shall be paid through the escrow arrangement contemplated in the Canadian Sale Agreement by the Purchaser to Aero, to be dealt with in accordance with the Administration Proceedings and any party asserting an interest in such proceeds shall only be entitled to do so in the Administration Proceedings. The sole exception to this rule is the Holdback (as defined below) for certain potential unpaid tax amounts described in greater detail below.

54. In the circumstances of this particular transaction, the Information Officer believes that this provision is reasonable. The only party that the Information Officer and the Foreign Representatives are aware of that will obtain any material economic benefit from the proceeds of the Canadian Sale Agreement is the syndicate of secured lenders to the Foreign Debtors (the **Lending Syndicate**"), by virtue of its security interest in the Canadian Aero Parts. The Lending Syndicate, which is owed in excess of US\$500 million will experience a significant shortfall. Further, it is respectfully submitted by the Foreign Debtors that the Administration Proceedings, as foreign main proceedings, are the appropriate forum in which to deal with any claims to these sale proceeds, with the exception of any amounts that may be necessary to satisfy Canadian tax liabilities.

HOLDBACK/TAX MATTERS

55. Aero is currently attempting to resolve certain outstanding issues that relate to excise taxes in Canada.

56. Aero has filed GST/HST returns and QST returns for the periods from October 1, 2009 until January 22, 2010 (being the date of Aero's bankruptcy). Canada Revenue Agency ("CRA") has filed an unsecured proof of claim for unpaid GST/HST up to January 22, 2010 in the amount of \$638,730.⁷

57. Until 2012 Aero had not filed GST/HST or QST returns for the post-bankruptcy period as there were numerous conflicting analyses and positions on: (a) the level of consumption by Aero's customers; (b) the prices that should be charged for that consumption; (c) set-off claims; and (d) ownership of parts.

58. To the degree practicable, relevant tax authorities in Canada have been kept informed of this matter. In April of 2011 the Information Officer submitted a letter to various Canadian tax authorities, including CRA and Revenu Quebec highlighting certain of the above issues. Aero has not received a response from Revenu Quebec. The Information Officer has attempted to contact Revenu Quebec on a number of occasions.⁸ Various discussions and in person meetings have taken place between the Information Officer, CRA and Department of Justice.

59. Once invoices were issued by Aero to its Canadian customers for the post-bankruptcy period following agreement between Aero, Air Canada and Aveos on ownership of parts,

⁷ For clarity, no formal claims process has been commenced at this time in the bankruptcies of the Foreign Debtors.

⁸ On October 1, 2012, the Information Officer sent via courier all of the outstanding QST returns for the period November 11, 2009 to August 2012 which were being filed on behalf of the Joint Administrators, together with a cheque for the net taxes (i.e. after consideration of offsetting input tax credits) of approximately \$80,000 for the period.

which invoicing first occurred in April of 2012, an obligation to file sales tax returns and remit taxes may have arisen.⁹

60. Aero may currently have an outstanding tax liability on account of invoices rendered to Air Canada in an amount in excess of \$990,000. To date, Aero has not collected any of the amounts invoiced to Air Canada and, as such, has not received the funds necessary to pay the taxes. Aero understands that Air Canada may seek to assert certain set off claims in order to avoid paying these invoices.¹⁰ Aero does not currently have any other funds to draw on in order to pay these taxes. To date, Aero has taken the position that Section 231 of the *Excise Tax Act*, R.S.C. 1985, C. E-15 which relates to the ability to deduct the amount of tax applicable to accounts that are determined to be bad debts, is applicable in the current circumstances to at least temporarily relieve Aero of any tax liability for sales taxes on Air Canada invoices.

61. If funds are collected from Air Canada on account of the above described invoices, the Information Officer understands that Aero fully intends to pay the portion of outstanding sales taxes applicable to the invoices paid by Air Canada. If amounts are not ultimately received from Air Canada in payment of certain invoices, Aero believes that any obligation to pay taxes on account of those invoices would be eliminated.

62. This position is responsive to the Canadian tax authorities' concern that they will be paid for the sales taxes owing by Aero, but not to potential concerns that: (i) Aero does not ultimately collect on the invoices rendered to Air Canada; (ii) Aero seeks to permanently reverse its tax liability in respect of those invoices that are not paid; and (iii) the applicable tax authorities accept the reversal of taxes but refuse to reverse the penalties and interest that accrued during the period from the date when Aero was first obligated to pay the reversed

⁹ Invoices were issued as early as 2010. However, these invoices included consumption prior to ownership being resolved. In Aero's view a remittance obligation would not have been triggered by these invoices.

¹⁰ In early 2010, Air Canada served materials for a motion seeking to vary the provisions of the Recognition Order that would have prevented the exercise of such set off rights. Air Canada's motion has not yet been determined by the Court.

sales taxes (being the date when invoices were first rendered) and the date that those sales taxes were finally reversed. Aero estimates the dollar value of the potential liability described in (iii) above at \$224,000.¹¹

63. Aero believes that sales taxes were validly reversed in the case of invoices delivered to Aveos. However, Aero cannot rule out the possibility that relevant tax authorities will claim the interest and late payment penalties applicable to those taxes that accrued during the period prior to reversal despite the fact that those taxes were subsequently reversed. While Aero does not believe that any such claim would be successful, it estimates the potential quantum of such claim at \$54,000.

64. Aero proposes to hold back sale proceeds in the amount of \$300,000 (the "**Holdback**") to pay the above potential liabilities.¹² The Holdback shall be held in trust by the Trustee until such time as all matters in respect of Aero's Canadian sales taxes are resolved and until further order is received from this Court. The provision of this Holdback is not intended by Aero to be an acceptance of the proposition that any such penalties or interest would be payable in the circumstances described in Paragraphs 62 and 63 above.

REMAINING CANADIAN ASSETS

65. As previously mentioned, any Canadian Aero Parts not currently being sold because they are Unresolved Parts will be stored by Aero pending further order of the Court or other resolution among parties with a potential interest in those Unresolved Parts.

66. Aero has located a cost effective warehouse facility in Montréal where the Swapped Back Parts will be relocated once the Canadian Validation Centre is vacated, which is expected to occur in or around April 2013.

¹¹ This calculation assumes that invoicing matters remain outstanding until January of 2015. Aero believes that this is a highly conservative estimate.

¹² The Holdback is allocated as follows: \$125,000 to amounts potentially collectible by Canada Revenue Agency and \$175,000 to amounts potentially collectible by Revenu Quebec

TRUSTEE'S ROLE/TRUSTEE ORDER

67. In a traditional bankruptcy scenario, the trustee in bankruptcy would take possession of the bankrupt's property, wherever located, and would have certain duties to deal with that property. Due to the current circumstances where the bankruptcy is interposed upon the Administration Proceedings, which are the foreign main proceedings, the Trustee has not taken on an active role in the sale process and has not become a party to the Canadian Sale Agreement or a global asset sale agreement. For the reasons set out below, the Trustee believes that its very limited role, and the provisions of the Trustee Order authorizing that limited role, are appropriate in the circumstances.

68. The Recognition Order established that the Administration Proceedings are "foreign main proceedings". As a result, the Court has recognized the Administration Proceedings as the primary proceedings in which the assets of the Foreign Debtors will be dealt with. The Trustee does not believe that it would be appropriate to take steps inconsistent with that recognition and would expect that the Joint Administrators would strongly oppose any attempt to do so.

69. Even in absence of the above overriding policy consideration, the Trustee believes that it is highly unlikely that any material assets belonging to the Foreign Debtors as at the date of the bankruptcy could have vested in the Trustee. Further, any steps to assert that such assets vested in the Trustee would be both costly, uncertain in outcome, and likely value destructive for Aero.

70. Based upon the Trustee's review of:

- (a) the balances owing to the Lending Syndicate, which are in excess of \$500 million;
- (b) jurisdictions where the Joint Administrators' status has been recognized;¹³

¹³ The Trustee is informed by the Joint Administrators that their proceedings have been recognized either formally or automatically by operation of law in the following jurisdictions: Canada, Ireland, Switzerland, Hong Kong, Japan, Australia and the United States.

- (c) the security position of the secured lenders to the Foreign Debtors, as shown in legal opinions from certain jurisdictions where the Foreign Debtors' assets are located;¹⁴
- (d) the steps that the Trustee would have to take to confirm the enforceability of any security interests (or the lack of any enforceable security interests) in the jurisdictions where (i) no legal opinions attesting to the enforceability of the secured lenders' security have been obtained and (ii) the Joint Administrators are not recognized;¹⁵
- (e) the values (net of realization costs) of any of the Foreign Debtors' assets in each global jurisdiction where (i) security opinions are not available and (ii) the Joint Administrators have not been recognized¹⁶; and
- (f) the extensive steps required to attempt (likely unsuccessfully) to enforce any interest that the Trustee may have in the assets in a foreign jurisdiction where (i) no security opinions were available, (ii) the Joint Administrators are not recognized, and (iii) the value of the assets in that jurisdiction are not negligible¹⁷,

¹⁴ Opinions from counsel to the secured lenders provided in February of 2008 have been reviewed by the Trustee's counsel for the following jurisdictions: England, Australia, Ireland, Hong Kong and the United States. Security opinions from independent counsel were obtained in all Canadian jurisdictions where assets of the Foreign Debtors were located at the commencement of these proceedings.

¹⁵ The following is a list of relevant jurisdictions where (a) assets were under the Foreign Debtors' control at the Administration Date; (b) the Joint Administrators have not been recognized; and (c) no security opinions have been obtained: Indonesia, Bahrain, Abu Dhabi and El Salvador (the Foreign Debtors' assets in El Salvador were sold through a transaction previously approved by this Court).

¹⁶ With the exception of Indonesia, where the OEM value of inventory was approximately US\$23 million (before provision for obsolescence, damage or inadequate trace paperwork), OEM values of assets located in these jurisdictions at January 22, 2010 did not exceed, US\$1 million. Note that OEM value provides no indication of the realizable value of these assets in the circumstances.

¹⁷ The only jurisdiction that meets these criteria is Indonesia. However, the costs of enforcing any interest in assets that were located in Indonesia as at January 22, 2010 would have been extensive and would have involved the commencement of local enforcement proceedings. The Trustee also has no independent platform to monetize the assets in Indonesia, the marketing of which is inherently complex. Further, the Joint Administrators have taken steps to recover the assets in Indonesia. Any attempt by the Trustee to enforce an interest in these assets would be in direct conflict with the goals of the Joint Administrators and would likely be

the Trustee is of the view that any steps to assert an interest in any of the Foreign Debtors' assets are unwarranted. Further, the Trustee has no funding to pursue any interest in these assets. In respect of the Canadian assets, the Trustee notes that it has obtained independent security opinions stating that the Foreign Debtors assets in Canada are subject to an enforceable and perfected security interest.

71. Whereas a trustee in bankruptcy would typically be obligated to take steps to collect and realize upon a bankrupt's worldwide assets, those steps are not warranted in this case for the reasons set forth above.

SEALING

72. This Sixth Report includes one confidential appendix containing, among other things, an un-redacted copy of the Canadian Sale Agreement showing the sale price and certain bank account information and a disc containing certain information on the Canadian Aero Parts that are being sold pursuant to the Canadian Sale Agreement. These documents contain sensitive competitive information for the Purchaser of the New Aero Business. Further, in the event that the proposed sale transaction does not close, any disclosure of an un-redacted copy of the Canadian Sale Agreement at this time may prejudice future marketing efforts. It is not apparent that any party is prejudiced by such a sealing order.

CONCLUSIONS

73. The Joint Administrators believe that now is the appropriate time to complete a sale of the New Aero Business not only because of the comprehensive sale process that has been undertaken but also because of the importance of placing the New Aero Business in the hands of a purchaser with the capacity to invest in and grow the New Aero Business. The Joint Administrators have always intended to sell, rather than actively re-build, the New Aero Business. The Joint Administrators have neither the resources nor the mandate to undertake a comprehensive rehabilitation process. More than 3 years into these insolvency proceedings,

strongly opposed by the Joint Administrators, which opposition would likely be successful in defeating the Trustee's claim.

the Joint Administrators believe that they have achieved an appropriate balance of maximizing the purchase price for the New Aero Business and at the same time ensuring that the New Aero Business can be transferred to an interested third party with the potential for future growth.

All of which is respectfully submitted this March 27, 2013.

**KPMG INC. AS
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,
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

Court File No. 09-CL-8456-00CL
Estate No. 31-456351
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ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

Proceeding commenced at Toronto

SIXTH REPORT OF KPMG INC.
IN ITS CAPACITY AS TRUSTEE IN BANKRUPTCY
AND INFORMATION OFFICER

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