

**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**

**SECOND SUPPLEMENTARY MOTION RECORD
(Returnable July 24, 2014)**

May 29, 2014

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Tab 1

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**AFFIDAVIT OF NICHOLAS BREARTON
(sworn May 28, 2014)**

I, **Nicholas Brearton**, of the City of Toronto, in the Province of Ontario, **MAKE OATH
AND SAY:**

1. I am the President of KPMG Inc. KPMG Inc. has been appointed the Information Officer of Aero Inventory (UK) Limited (in administration) ("**Aero**") and Aero Inventory plc (in administration) ("**Aero plc**" and collectively with Aero, the "**Foreign Debtors**"). I am the individual at KPMG Inc. with primary carriage of this matter. As such, I have knowledge of the matters to which I hereinafter depose. To the extent that I rely upon the information of others, I have stated the source of that information, and believe it to be true.

2. I have reviewed the affidavit of Gilles Néron, sworn May 15, 2014 (the “**Néron Affidavit**”) and swear this affidavit in response. I adopt the terms defined the Néron Affidavit.

3. This affidavit is sworn in connection with a motion as outlined in the Applicants’ Amended Notice Of Motion dated December 6, 2013 in these proceedings. This Affidavit will respond only to matters raised in the Néron Affidavit that are relevant to the Applicants’ motion.

Context In Which CAT 3 Parts Were Stored And Used

4. At the commencement of Aero’s insolvency proceedings, its Canadian inventory was stored in many thousands of bins located across the floors of various facilities controlled by Aveos and Air Canada and commingled with other fungible CAT 3 Parts owned by Aveos and Air Canada. An Aveos or Air Canada employee seeking to obtain a part from storage for maintenance purposes would obtain the particular type of CAT 3 Part needed for a particular task from the commingled inventory pool without knowledge of the ownership of that part. Ownership of such CAT 3 Parts as between Aero, Aveos or Air Canada was irrelevant for the purposes of completion of the maintenance task.

5. At any particular time available books and records would show the number of CAT 3 Parts in the inventory pool by part type, split by facility location, and the aggregate number of CAT 3 Parts consumed by part type, again split by facility location, based upon entries made by Air Canada and Aveos employees each time they retrieved such CAT 3 Parts from, or returned such CAT 3 Parts to, the inventory pool at such facility location. However, this on its own would not provide sufficient information to determine ownership of CAT 3 Parts within the inventory pool between Aveos, Air Canada and Aero or, at the time of any particular consumption, whether the part consumed belonged to Aveos, Air Canada or Aero. Further, the accounting system in place could only identify the location of any particular CAT 3 Part at the facility level and could not locate a particular CAT 3 Part within a particular bin in that facility.

6. As a result of the above arrangement, ownership of CAT 3 Parts as between Aveos, Air Canada and Aero, and consumption of those parts could not be determined without a theoretical reconciliation based upon rules that would use:

- (a) assumed ownership distributions of CAT 3 Parts between the three parties as at a particular identified start date.
- (b) an agreed upon order in which fungible CAT 3 Parts of a particular type owned by each of Aveos, Air Canada and Aero would be consumed from the commingled inventory pool after that start date.
- (c) an agreed upon order in which ownership of expired parts that had to be written off would be attributed to each of Aveos, Air Canada and Aero.
- (d) an agreed upon procedure to determine ownership of parts returned to the commingled inventory pool if removed from the inventory pool for use but not ultimately used in a maintenance task by Aveos or Air Canada employees.
- (e) an agreed upon procedure to allocate ownership of newly purchased CAT 3 Parts that were introduced to the commingled inventory pool after the particular identified start date.

CAT 3 Parts Segregation and Removal Process

7. At paragraph 24 of the Néron Affidavit, Mr. Néron states that as of November 11, 2009, Aero had never taken steps to segregate its inventory. I do not believe that Aero would have had any practical means to do so.

8. As noted above, detailed business rules needed to be developed collectively by Aveos, Air Canada and Aero to facilitate any segregation process at a theoretical level.

9. Even if such a set of business rules was developed, given the thousands of physical retrieval and return transactions involving CAT 3 Parts that were undertaken by numerous individual Aveos and Air Canada personnel each day, as well as the fungible

nature of CAT 3 Parts that could not be identified on their face as owned by either Air Canada, Aveos or Aero, it would have been unrealistic to think that any physical segregation would be maintained over the long term.

10. Moreover:

- (a) Aveos and Air Canada facilities had to remain a secure system free from outside interference, including interference by Aero, to ensure that all parts remained traceable and certifiable for regulatory reasons.
- (b) these facilities were unionized and any access by non-union Aero workers to segregate Aero's parts would likely have been problematic. This concern arose again when Aero ultimately sought to remove its CAT 3 Parts from these facilities.
- (c) these facilities were also subject to additional security concerns given proximity to, and potential access to, airport runways and other critical airport systems.
- (d) any segregation of Aero-owned inventory would have led to multiplication of the number of individual bins on the floor of the Air Canada and Aveos facilities. It is not clear that any such multiplicity of bins would have been physically feasible given space constraints.
- (e) segregation may have resulted in a CAT 3 Part being removed from the particular location where it was required for use by Air Canada and Aveos.

11. I disagree with the assumption at paragraph 5 of the Néron Affidavit that Aero could have immediately categorized and removed its inventory at the commencement of its insolvency proceedings. For the same reasons outlined above with respect to physical segregation, physical retrieval would have also been problematic. Additionally, CAT 3 Parts must be traceable, warrantied and certified. Tracking systems must record the entire life-cycle of every expendable part. If an expendable part's history cannot be

tracked, it will have no material value. Aero needed assistance from Aveos to provide necessary documentation and information to evidence compliance with all traceability, warranty and certification requirements when parts were retrieved. Traceability, warranty and certification documentation was in many cases stored by Aveos offsite in boxes separate from the parts to which the documentation related and only in physical paper form. Arrangements needed to be made with Aveos to locate and scan these records into electronic form and match these records to the relevant CAT 3 Parts. The act of locating and physically removing Aero's parts on their own, without certification, traceability and warranty information, would not have been sufficient for Aero's purposes.

Algorithm

12. The Algorithm described in paragraph 2 of the Néron Affidavit was developed to track consumption and allocate ownership of CAT 3 Parts among Aveos, Aero and Air Canada using business rules to resolve some of the issues described above.

13. The Algorithm provided ownership information at a facility level but would not on its own pinpoint the location of a particular part in a particular bin within an Air Canada or Aveos facility. A separate bin allocation program was needed for this purpose (the "Bin Allocation Program").

14. The Néron Affidavit states at paragraph 49 that KPMG was unwilling to participate in an algorithmic solution to the problem of establishing consumption when approached by Air Canada to do so. KPMG, as Information Officer, was willing to participate in an algorithmic solution, but Air Canada did not initially propose an algorithmic solution that would serve Aero's needs. The initial algorithmic solutions that Air Canada proposed would not have provided sufficient data for Aero to locate its inventory within the bins in a particular facility and have its inventory physically removed from those bins.

15. Subsequently, during late 2010 and early 2011, representatives of the Information Officer and employees of Aero Inventory (Canada) Inc. did participate in, and dedicate

significant time and effort to, development of the rules that created the business structure for the Algorithm. Upon completion of the Algorithm, the Bin Allocation Program was developed using separate business rules negotiated with Aveos and Air Canada.

16. The Néron Affidavit explains at paragraph 43 that Air Canada did not purposefully consume Aero's inventory. The business rules underlying the Algorithm were developed in a manner consistent with this concept and incorporated an implicit assumption that Air Canada would not consume an Aero-owned CAT 3 Part unless absolutely necessary. If Air Canada consumed a particular type of part, the Algorithm would first attempt to treat that transaction as a use by Air Canada of its own inventory at the time of consumption. If the part could not have been sourced from Air Canada's then existing owned inventory, the Algorithm would deem Air Canada to have consumed that part from Aveos-owned inventory, if any. Only if the part was not available from either the Air Canada or Aveos owned inventory would the part be deemed consumed from the Aero-owned inventory.

17. The Néron Affidavit states, at paragraph 47, that new CAT 3 Parts procurement was expected to "re-fill" consumed inventory such that sufficient CAT 3 Parts would be available to satisfy quantities claimed to be owned by Aero. In other words, if an Aero-owned CAT 3 Part was consumed by Air Canada from the inventory pool, Air Canada planned to effectively return a newly purchased identical CAT 3 Part to Aero. To my knowledge, this "re-fill" concept was not included in the business rules applicable to the Algorithm. Rather, if Air Canada purchased a new CAT 3 Part, that part would be recorded in the Algorithm as owned by Air Canada in all cases. The purchased part would not be treated as a replacement of Aero's CAT 3 Part.

18. The Néron Affidavit states that it does not address the effectiveness of the Algorithm. I am unaware of any basis upon which the use of the Algorithm to track consumption and allocate ownership is, or can be, questioned at this stage. The Algorithm was the subject of an endorsement of the Court that stated in part that the Algorithm "is the agreed upon means by which Air Canada and [Aero] will track consumption and ownership of Category 3 Consumable and Expendable Spare Parts

(“CAT 3 Parts”) at any particular date on or after October 1, 2009”. A copy of that endorsement is attached as Exhibit “K” to the Néron Affidavit. The recitals to the agreement attached as Exhibit “P” to the Néron Affidavit also state that the Algorithm, and an accompanying Bin Allocation Program, have been developed as an acceptable means by which to track consumption, allocate ownership, and identify bin location of CAT 3 Parts.

Purpose Of Paragraph 10 Of The Recognition Order

19. Paragraph 36 of the Néron Affidavit states that the Applicants’ major concern in November 2009 with respect to temporarily staying set-off rights related to Aero’s relationship with Aveos. This is not correct. Aero’s major concerns were evident from the Applicants’ factum, found at Exhibit “E” to the Néron Affidavit. Aero’s major concerns were:

- (a) “Purchase” by Aero’s customers of large quantities of inventory and assertion that no payment is necessary on account of set-off.
- (b) Appropriation of fresh inventory belonging to the Foreign Debtors without ensuing payment.

20. Based upon limited information at November 11, 2009, the Applicants and the Information Officer believed that Aveos was the only customer to which the above concerns would apply, but the concerns would certainly apply equally to any other similarly situated customers of Aero, such as Air Canada.

Aero’s Response To Post-Filing Consumption By Air Canada

21. The Applicants and the Information Officer received indications from Air Canada on a number of occasions that Air Canada would comply with Paragraph 10 of the Recognition Order and either (i) not consume Aero’s inventory on or after November 11, 2009; or (ii) pay for any consumption of Aero’s inventory on or after November 11, 2009. The Affidavit of Alan Butterfield, sworn August 13, 2010, stated that:

it is possible that Air Canada has used some of Aero's parts inadvertently after the bankruptcy filing (although the amount, if any, has not yet been finally determined). Air Canada is reviewing whether any such use occurred and is prepared to pay for any such parts used during the post-filing period.

22. In March of 2010, Aero personnel reviewed available data indicating that Aero's inventory was the subject of continued consumption by Air Canada and Aveos without payment. As noted in the Néron Affidavit at paragraph 46, Aero issued invoices to Air Canada for that consumption beginning in July 2010. Those invoices were issued based upon the best data available to Aero at the time of those invoices. Aero has not sought to collect payment on those invoices as more accurate consumption data has now become available using the Algorithm.

Physical Inventory Discrepancies

23. As Mr. Néron states at paragraph 2 of the Néron Affidavit, one cannot know whether the physical count of inventory at any particular time would perfectly match the inventory ownership determinations of the Algorithm. This issue is also referred to as "vapour" at page 14 of the Néron Affidavit. Vapour could arise, for example, by (i) an Aveos or Air Canada employee physically retrieving parts from the commingled inventory pool without electronically recording that retrieval; or (ii) incorrect inventory records at the time of Aero's purchase of inventory in bulk from Aveos or Air Canada's purchase of inventory in bulk from Aero. Given the past dealings among Aveos, Aero and Air Canada with respect to bulk sale transactions as well as the thousands of individual consumption transactions on any given day, some amount of vapour is to be expected. The parties did not attempt to allocate responsibility among Aveos, Air Canada and Aero for vapour: the discrepancies between physical quantities and the Algorithm's recorded quantities of inventory.

24. As noted in correspondence attached as Exhibit "R" to the Néron Affidavit, Aero has calculated that it has physically received parts from Air Canada and Aveos facilities having a value \$11.4 million lower than expected based upon the Algorithm output.

25. I am not aware of any evidence to suggest that Air Canada faced greater physical parts deficiencies than Aero. The uplift of Aero's inventory from the Air Canada and Aveos facilities was to be undertaken in accordance with certain rules that ensured that if a fungible collection of CAT 3 Parts existed that could have been owned in part by Air Canada and either of Aveos or Aero, those CAT 3 Parts were allocated to Air Canada first. This reduced the likelihood that Air Canada would bear the burden of any physical parts deficiencies that may exist in that fungible collection of CAT 3 Parts as such physical parts deficiencies would be allocated to Aero and Aveos first.

Aveos Settlement and Labour Supply Agreement ("SALSA")

26. On December 31, 2010, Aero entered into an agreement with Aveos to perform the retrieval of Aero's inventory, a copy of which is found at Exhibit "L" to the Néron Affidavit (the "SALSA"). The agreement would have been quite useful as Aveos would be able to deliver Aero's parts from the secure closed systems operated by Aveos and Air Canada in certified and traceable form. Aveos also had a unionized labour force qualified to undertake the task. Aveos' work under this agreement could only commence upon resolution of inventory ownership issues between Aveos, Aero and Air Canada. Aero's efforts were hindered by the subsequent commencement of CCAA proceedings by Aveos and the resulting refusal of Aveos to perform under the SALSA.

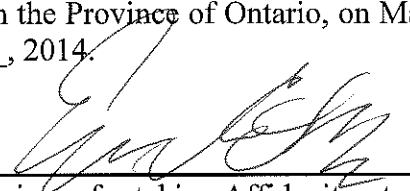
27. At paragraph 65 of the Néron Affidavit, Mr. Néron states that Aveos and Aero agreed in the SALSA that Aveos would have certain set off rights. Any such set off was part of a larger comprehensive agreement that settled issues between Aveos and Aero, provided a mechanism for the uplift of Aero's CAT 3 Parts from Air Canada and Aveos facilities in certified form using Aveos labour, and provided for the payment by Aveos to Aero for both pre and post-November 11, 2009 consumption of CAT 3 Parts. Aveos and its affiliates paid Aero over \$6 million dollars under the SALSA on account of consumption of Aero's inventory.

Corrections to the Néron Affidavit

28. At paragraph 1 of the Néron Affidavit, Mr. Néron describes the Third Report of the Information Officer in this matter dated April 6, 2013. The Third Report of the Information Officer, which described factual matters that are the subject of this motion, was in fact dated April 26, 2012.

29. Exhibit "A" of the Néron Affidavit attaches an affidavit of Alan Butterfield, sworn August 13, 2010 in these proceedings (without exhibits). That affidavit states at paragraph 111 that Aero appears to have effectively abandoned its remaining CAT 3 Parts housed at Aveos' and Air Canada's facilities. Aero did not at any time abandon its CAT 3 Parts housed at Aveos' and Air Canada's facilities. This is evident from correspondence included in the Information Officer's Third Report, dated April 26, 2012 in these proceedings, including at Appendix I thereto.

SWORN BEFORE ME at the City of
Toronto, in the Province of Ontario, on May
28, 2014.



A Commissioner for taking Affidavits, etc.



NICHOLAS BREARTON

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

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Proceeding commenced at Toronto

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Proceeding commenced at Toronto

SECOND SUPPLEMENTARY MOTION RECORD

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