

Appendix D

Court File No. 09-8456-00CL

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

NOTICE OF MOTION

AIR CANADA will make a motion before a Judge of the Ontario Superior Court of Justice on a date to be determined through the Commercial List Office, at 330 University Avenue, Toronto, Ontario.

THE PROPOSED METHOD OF HEARING: This motion is to be heard orally.

THIS MOTION IS FOR orders:

- (a) striking out paragraph 10 of the order dated November 11, 2009 (the "Recognition Order"), whereby this Honourable Court gave effect to and recognized in Canada pursuant to the *Companies' Creditors Arrangement Act* (Canada) ("CCAA") the administration order (the "English Order"), granted by the High Court of Justice (Chancery Division, Companies Court) of England and Wales, as against the Respondents;

- (b) in the alternative to (a), leave for Air Canada to set-off amounts owing to it by the Respondents subsequent to the date of the Recognition Order, as against any amounts that Air Canada may owe the Respondents;
- (c) directing that any issues related to the exercise of Air Canada's set-off rights be heard before the Superior Court of Quebec sitting in Montreal; and
- (d) such other relief as Air Canada may advise and this Honourable Court shall permit.

THE GROUNDS FOR THE MOTION ARE:

With respect to the relief sought in paragraph (a):

1. Paragraph 10 of the Recognition Order provides that determination and enforcement of any Person's rights of set-off from and after the effective time of the Recognition Order shall be stayed pending further order of this Court and any new purchases of goods from the Respondents under existing supply contracts or otherwise from and after the effective time of the Recognition Order shall be paid by the customers on the terms acceptable to the UK Administrators without counterclaim or deduction.
2. The English Order refers to a set of rules, the EC regulation on Insolvency Proceedings 2000 ("EC Regulation") and the Insolvency Act 1986, Schedule B1 ("Schedule B1").
3. Article 6(1) of the EC Regulation provides that "the opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim". Neither Schedule B1 nor the English Order provides any limitation with respect to set-off rights following an Administration Order.
4. Section 21 of the CCAA is to similar effect and Section 50 of the CCAA prohibits a court in granting a recognition order for a foreign proceeding if the making of such an order would not otherwise be available to a debtor company had the proceeding been initiated in Canada.

5. Aero Inventory (UK) Limited (“Aero”) assigned itself into bankruptcy on January 22, 2010. Section 97(3) of the *Bankruptcy and Insolvency Act* (“BIA”) provides that the law of set-off applies to all claims made against the estate of a bankrupt.

With respect to the relief sought in paragraph (b):

6. The principal activity of the Aero Group was to provide a comprehensive procurement and inventory management service to companies in the aerospace industry. Specifically, Aero sourced, distributed and sold consumable and expendable parts (e.g., bearings, fasteners and gaskets) required in the maintenance of aircraft, its customers being airlines and aerospace maintenance and repair companies around the world.

7. As between Air Canada and Aero, the consumable and expendable spare parts that Aero sold are known as Category 3 Inventory (“CAT 3 Inventory”). Spare parts are classified as CAT 3 Inventory because they are either single-use items that are not capable of repair or items which, after the performance of certain procedures, are re-certifiable for limited periods. Air Canada requires tens of thousands of different types of CAT 3 Inventory to maintain its aircraft. Expandable spare parts must be traceable, warranted and certifiable tracking systems record the entire life cycle of the part. The efficient procurement and management of CAT 3 Inventory is a crucial and complex task, indispensable to Air Canada’s operations and the delivery of its services to customers.

8. In December, 2008, Air Canada and Aero entered into an Agreement for the Supply and Management of Consumable and Expandable Spares (the “Line Maintenance Agreement”). Under the Line Maintenance Agreement, Aero became Air Canada's exclusive supplier for approximately 98% of CAT 3 Inventory used by Air Canada for line maintenance on its mainframe aircraft. Aero also assumed responsibility for managing all aspects of the procurement and delivery of CAT 3 Inventory for line maintenance, including monitoring and planning for Air Canada’s consumption and use of the inventory.

9. Having concluded the Line Maintenance Agreement and outsourced most of procurement and maintenance functions to Aveos, Air Canada did not intend and, until the default of the Aero Companies following the Recognition Order, was not required to take on any responsibility for the logistics, procurement or management of CAT 3 Inventory.

10. It was beneficial for the Aero Companies and Air Canada that Air Canada bear a portion of the capital cost of the CAT 3 Inventory required by Aero to perform its services for Air Canada. Air Canada financed a portion of the capital cost of the CAT 3 Inventory required by Aero under two principal agreements. In February, 2009, Air Canada purchased US\$100,000,000 of Aero's then current stock of CAT 3 Inventory under a Bulk Inventory Purchase Agreement, dated January 28, 2009, between Air Canada and the Aero Companies (the "January Purchase Agreement"). In October, 2009, Air Canada agreed to purchase from Aero additional CAT 3 Inventory from Aero's then current stock but in three equal instalments, each valued at US\$8,500,000, deliverable on October 23, 2009, November 1, 2009, and December 1, 2009, and each payable approximately 60 days after delivery (the "October Purchase Agreement").

11. More specifically, the January Purchase Agreement provided three advantages to Air Canada. First, Air Canada would acquire CAT 3 Inventory necessary to meet its forecast consumption for a year but would pay for that inventory only at the end of the year. Second, because Aero would be buying back the inventory in order to supply Air Canada under the Line Maintenance Agreement and to supply Aveos under its exclusive supply agreement with Aveos, Air Canada would receive monthly payments from Aero before making any cash outlay itself on account of the Purchase Price. Third, Air Canada could obtain certain discounts and volume rebates under the Line Maintenance Agreement. For the Aero Companies, the January Purchase Agreement held out the prospect of raising new capital under then prevailing market conditions that limited the Aero Companies' access to the capital markets.

12. Under the January Purchase Agreement, Aero sold to Air Canada the CAT 3 Inventory described in Schedule 2.1(c) to the agreement (the "January Inventory Pool"). Air Canada paid a purchase price of US\$100,000,000 plus applicable goods and services tax and provincial sales taxes, representing an aggregate purchase price of US\$110,740,027 (the "January Purchase Price"). The January Purchase Price, less a holdback (as provided for in the January Purchase Agreement) in the amount of US\$10,000,000 (the "Holdback"), was paid in full at the time the transaction closed on February 9, 2009, by the delivery of 10 bills of exchange (the "Bills of Exchange") drawn by Aero on Air Canada and payable on February 8, 2010.

13. As further consideration for the purchase of the CAT 3 Inventory under the January Purchase Agreement, the Line Maintenance Agreement was amended in order to guarantee Air Canada a monthly rebate of US\$100,000. This amendment also provided for three additional rebates to Air Canada of US\$833,333.33 each, payable on July 1, 2009, and on July 1 of each year thereafter until July 1, 2011.

14. Air Canada insisted on receiving extensive representations and warranties under the January Purchase Agreement. Part of the benefit to it under the transaction accrued because Air Canada would use the spare parts from the January Inventory Pool before being required to make any payments under the Bills of Exchange. For this to occur, it was essential that the CAT 3 Inventory in the January Inventory Pool be of a nature and kind, and purchased in quantities, that would meet Air Canada's requirements over the ensuing twelve (12) months.

15. In planning for the purchase and sale transaction under the January Purchase Agreement, Air Canada took the steps necessary to verify and protect its interests in the January Inventory Pool, including obtaining the consent of the Aero Companies' senior lenders and the discharge of their security interests in the January Inventory Pool, taking its own security in the January Inventory Pool, obtaining confirmation from Air Canada's auditors and the Aero Companies' auditors that the transaction would be recorded as a sale and insisting on receiving extensive representations and warranties.

16. Aero PLC made these representations and warranties jointly and severally (solidarily) with Aero and agreed to indemnify Air Canada in connection with Aero's obligations under the January Purchase Agreement.

17. Only weeks after the closing of the transaction under the January Purchase Agreement, Aero sought to sell a number of Bills of Exchange to Air Canada. Because Air Canada was concerned when it learned of the difficulty in selling the Bills of Exchange and had concluded the January Purchase Agreement to conserve cash, it was reluctant to buy any Bills of Exchange. Instead, it proposed that the parties take the steps necessary to reverse the transaction. The Aero Companies refused to consider unwinding the purchase and sale. Air Canada agreed to purchase two Bills of Exchange but subject to a discount of 50%. Bills of Exchange Nos. 1 and 2 were

thus acquired by Air Canada. Air Canada understands that the proceeds from the transaction were used to make an interest payment to the Aero Companies' senior lenders.

18. The Line Maintenance Agreement, as amended by the LMA First Amending Agreement, was in full force and effect as of the date of the Recognition Order. As at that date, Air Canada was indebted to Aero in the amount of US\$11,050,541.01, representing the difference between the sales under the Line Maintenance Agreement and the cumulative rebates owing as at that date. These balances do not include expenses which Air Canada is entitled to deduct from the amount payable to Aero nor the damages caused by Aero's breach and disclaimer of the Line Maintenance Agreement.

19. Contrary to the evidence presented in the report of the proposed Information Officer presented to this Court at the time of the Recognition Order, Air Canada was entitled to in excess of US\$1,500,000 in rebates under the Line Maintenance Agreement. More importantly, the Information Officer's report omitted any reference to the obligations of Aero to Air Canada under the January Purchase Agreement, the October Purchase Agreement and the other transactions that occurred in the period until the end of October, 2009. The net effect of these transactions is that Aero was indebted to Air Canada, not the other way around.

20. In order to supply CAT 3 Inventory to Air Canada under the Line Maintenance Agreement and to supply CAT 3 Inventory to Aveos, Aero was buying CAT 3 Inventory from the January Inventory Pool throughout the period preceding the Recognition Order. In fact, Aero purchased CAT 3 Inventory from Air Canada daily until the Administrators ceased making any such purchases.

21. The Aero Companies had breached the representation and warranty made in section 3.6(c) of the January Purchase Agreement to the effect that all the CAT 3 Inventory from the January Inventory Pool would be used or consumed by Air Canada within twelve months. Compliance with this representation and warranty would require average monthly purchases by Aero of US\$8,500,000 plus applicable taxes.

22. Around April 7, 2009, to induce Air Canada to refrain from exercising its remedies, Aero delivered two Bills of Exchange to Air Canada but in escrow and subject to a right of

redemption. Aero also granted Air Canada the right to set off the Bills of Exchange against Aero payables if Aero failed to remedy its defaults.

23. On May 8, 2009, with Aero's consent, two Bills of Exchange were released from escrow and delivered to Air Canada to enable Air Canada to set-off the amounts payable under the Bills of Exchange against Air Canada's outstanding receivables from Aero.

24. In June of 2009, based on the declining volumes of consumption from the January Inventory Pool, Air Canada undertook an audit of the CAT 3 Inventory in the January Inventory Pool. Based on the results of the audit, Air Canada estimated that as much as US \$40,000,000 of the CAT 3 Inventory in the January Purchase Pool would not be used by Air Canada within the period agreed to between the parties under the January Purchase Agreement and that the remaining January Inventory Pool was comprised of many spare parts that could not be used by Air Canada at all or would not be used for 24 months or so. Air Canada notified Aero of Aero's breach and demanded that the breach of warranty be remedied.

25. Aero acknowledged the breach and agreed to remedy the breach by replacing the non-conforming inventory with conforming inventory that Aero said it had on site in Canada. Aero agreed to pay Air Canada the difference between actual consumption and the average monthly consumption that would be necessary to meet the warranty requirements, namely US\$8,500,000, if the new inventory was not delivered.

26. This became the basis for a Warranty Performance Agreement executed between the parties in October, 2009 (the "Warranty Performance Agreement"). Procedures were implemented immediately to begin to correct the composition of the January Inventory Pool.

27. As Aero's indebtedness to Air Canada increased throughout the summer of 2009, including indebtedness arising from its warranty performance obligations, Aero agreed, in August of 2009, to deliver three more Bills of Exchange into escrow and authorized Air Canada to set off the Bills of Exchange against its outstanding receivables from Aero.

28. Throughout the summer of 2009, negotiations continued between Air Canada and Aero with a view to settling their disputes and, in particular, agreeing on the terms and conditions

under which Aero would exchange the Bills of Exchange that it held for the CAT 3 Inventory it was purchasing from Air Canada or in payment of its warranty obligations.

29. Air Canada learned during this period that Aero PLC was showing a markedly improving share price and, in October 2009, Aero PLC advised Air Canada that it was negotiating a major equity issue and had applied for a listing on the senior board at the London Stock Exchange.

30. On October 9, 2009, a term sheet is agreed to between Air Canada and Aero providing for the settlement of their disputes.

31. The settlement of the dispute between Air Canada and the Aero Companies involved several key concessions by each of the parties:

- (a) Air Canada would be bound to buy two Bills of Exchange and, except for US\$2,000,000 which would be used to set-off against Aero payables, the purchase price would be paid to Aero; the discount rate in respect of the Bills of Exchange to be purchased was fixed at 15%, generating proceeds of US\$17,000,000 for Aero;
- (b) Aero would deliver to Air Canada the remaining Bills of Exchange in its possession, except Bill of Exchange No. 10 which Aero would sell in a private placement, generating additional cash proceeds;
- (c) the discount rate for the five Bills of Exchange that had previously been delivered to Air Canada, and which Air Canada had the right to set off against outstanding Aero payables, would be fixed at 5%;
- (d) to compensate Air Canada for the cost of capital relating to the foregone cash payments under the January Purchase Agreement, the Holdback would be reduced by US\$4,000,000;
- (e) Air Canada agreed to purchase new CAT 3 Inventory from Aero, representing new receivables for Aero in an aggregate amount of US\$25,500,000 plus applicable taxes, provided that the sales would be in instalments and that Air

Canada would have no obligation to pay for any instalment for at least 60 days;
and

- (f) the parties would memorialize and give effect to their agreement relating to warranty performance in the Warranty Purchase Agreement.

32. The purpose of converting the Bills of Exchange maturing on February 8, 2010, into obligations payable on demand was to accelerate Air Canada's indebtedness and to evidence the discount rate negotiated and fixed by mutual agreement.

33. As part of the settlement transactions, the January Purchase Agreement, as amended, was further amended by a Second Amending Agreement (the "Second January Agreement Amendment"). The Second January Agreement Amendment reduced the Holdback under the January 2009 Agreement from US\$10,000,000 to US\$6,000,000. This transaction compensated Air Canada for the damages it suffered due to the loss of the cash flows that should have been generated under the January Purchase Agreement.

34. The settlement transactions were concluded on October 23, 2009. Air Canada paid to or to the order of Aero US\$17,000,000 under the Demand Promissory Notes exchanged for Bills of Exchange Nos. 8 and 9. Air Canada then set off the amounts owing under the Demand Promissory Notes exchanged for Bills of Exchange Nos. 3-7 against amounts due and owing to Air Canada as at September 30, 2009. After the conclusion of these transactions, the Aero Companies continued to be net debtors to Air Canada for ongoing purchases of CAT 3 Inventory from the January Purchase Pool and for warranty performance under the January Purchase Agreement.

35. On October 23, 2009, the parties also entered into the Warranty Performance Agreement. This agreement confirmed and extended the agreement already made and in force for the purpose of remedying Aero's breach of warranty under the January Purchase Agreement.

36. Aero has defaulted in the performance of its obligations under the Line Maintenance Agreement, the Warranty Performance Agreement and the October Purchase Agreement. Air Canada has informed the Administrators that no payment would be made under the Line Maintenance Agreement, the October Purchase Agreement or any other agreement between the

parties until the obligations owed by the Aero Companies to Air Canada have been discharged. The Administrators have dismissed Aero's employees in Canada and refused to perform their obligations, disrupting Air Canada's operations and causing it extensive damages.

37. Following the Recognition Order, the Administrators wrote to Air Canada, to inform Air Canada that Aero did not consider itself to be bound by the Line Maintenance Agreement and dictating new commercial terms for all transactions. Since the date of the Recognition Order, Aero has failed to provide any of the services or support required under the Line Maintenance Agreement, disrupting Air Canada's operations and causing it extensive damages.

38. Because Air Canada holds CAT 3 Inventory purchased under the January Purchase Agreement and the October Purchase Agreement, it has not needed to and has not purchased any CAT 3 Inventory from Aero under the Line Maintenance Agreement since the date of the Recognition Order. Air Canada has taken over the inventory procurement and management functions that it had outsourced to Aero. The disruption of Air Canada's operations and the increased costs are substantial, including a profound change in the implementation of Air Canada's long-term strategic objectives to outsource the procurement and management of CAT 3 Inventory.

With respect to the relief sought in paragraph (c):

39. All material agreements between Air Canada and the Respondents are governed by the law of Quebec. The January 2009 Purchase Agreement and the October 2009 Purchase Agreement contain the following provisions:

"This Agreement shall be governed by and construed in accordance with the laws of the Province of Quebec and the laws of Canada applicable therein. The parties consent to the exclusive jurisdiction of the courts of the Province of Quebec in connection with any civil action concerning any controversy, dispute or claim arising out of or relating to this Agreement or the Transaction Documents."

40. Section 40.19 of the Line Maintenance Agreement provides the parties choice regarding both the law governing their relationship and the appropriate forum for resolving disputes:

“Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the Province of Quebec and the federal laws of Canada applicable therein, without regard to its choice of law principles. Subject to the provisions for arbitration in Section 32.3, the courts of the province of Quebec, judicial district of Montreal shall have exclusive jurisdiction in relation to all Disputes.”

General Provisions

41. Sections 9, 11, 21, 48 and 50 of the CCAA;
42. Section 97(3) of the BIA;
43. Rules 2.03 and 37 of the *Rules of Civil Procedure*, R.R.O. 1990, Reg. 194; and
44. Such further and other grounds as counsel may advise and this Honourable Court may permit.

THE FOLLOWING DOCUMENTARY EVIDENCE will be used at the hearing of this motion:

1. The Affidavit of Alan Butterfield, solemnly declared and affirmed January 27 , 2010, and the exhibits thereto ; and
2. Such further and other materials as counsel may advise and this Honourable Court may permit.

January 27, 2010

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