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

FACTUM OF THE APPLICANTS
(Motion Returnable July 24, 2014)

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PART I - OVERVIEW

1. The administration proceedings of Aero Inventory (UK) Limited and its parent Aero Inventory PLC (collectively, "Aero") commenced over four years ago in November of 2009.[1]

2. At the date of Aero's administration, tens of millions of dollars of Aero's airline parts inventory was located at facilities across Canada controlled by its customers, Air Canada and Aveos Fleet Performance Inc. ("Aveos").[2] Any steps to immediately repossess Aero's inventory or to prevent further consumption by Air Canada or Aveos were impractical given the volume of inventory involved, the location of this inventory at secure facilities controlled by Aveos and Air

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[1] Third Report of KPMG Inc., in its capacity as Information Officer, dated April 26, 2012 **[Third Report]**, para. 1, Applicants' Motion Record **[Motion Record]**, Tab 2, p. 9

[2] Third Report, paras. 11-13, Motion Record, Tab 2, p. 11.

Canada and the fact that Aero's inventory was fungible and commingled with the property of Air Canada and Aveos.[3]

3. The fact that Aero could not exercise control over its inventory exposed it to the risk that Air Canada and Aveos would consume Aero's inventory following the commencement of the insolvency proceedings, accruing large accounts payable to Aero, and then purport to set off those accounts payable against damages that Air Canada and Aveos would allege.

4. The Applicants took proactive steps to mitigate this risk. The Order of this Court recognizing the administration proceedings of Aero on November 11, 2009 (the **Recognition Order**) stated:

> **THIS COURT ORDERS** that the determination and enforcement of any Person's rights of set-off from and after the effective time of this Order shall be stayed pending further order of this Court and any new purchases of goods from the Foreign Debtors under existing supply contracts or otherwise from and after the effective time of this Order shall be paid by the customers on terms acceptable to the Foreign Representatives without counterclaim or deduction. [Emphasis added][4]

5. The intention of this provision was clear: if Aveos or Air Canada continued to consume Aero's inventory after November 11, 2009, they would have to pay for that consumption on terms acceptable to the Applicants. Air Canada could not simply consume inventory and avoid payment for this post-filing consumption with claims of set-off.

6. Air Canada was promptly advised of the terms of the Recognition Order[5] and represented that it was not continuing to draw on Aero's inventory and, most notably, that if it did, it would be "prepared to pay for any such parts used during the post-filing period".[6]

7. Despite the Recognition Order and Air Canada's representations, there is no question that Air Canada has since November 11, 2009 consumed millions of dollars of Aero's inventory without payment.[7]

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[3] Affidavit of Nicholas Brearton, sworn May 28, 2014 **[Brearton Affidavit]**,paras. 4, 9 and 10, Applicants' Second Supplementary Motion Record **[Second Supplement]**, Tab 1, pp. 2-4.

[4] Third Report, Appendix A, Motion Record, Tab 2-A, p. 29.

[5] Third Report, para. 59(a), Motion Record, Tab 2, p. 22; Third Report, Appendix I, Motion Record, Tab 2-I, p. 222-223;

[6] Third Report, Appendices J and W, Motion Record, Tabs 2-J and 2-W, pp. 226, 309; Affidavit of Gilles Neron, sworn May 15, 2014 **[Neron Affidavit]**, Exhibit A, Air Canada Responding Motion Record **[Responding Motion Record]**, Tab 1-A, p. 80.

8. The Applicants seek to enforce the terms of the Recognition Order to obtain payment from Air Canada for this consumption.

PART II - THE FACTS

A. Aero's Business

9. Aero supplied airplane parts to the airline industry.[8] Its customers were airlines and aerospace maintenance and repair companies. Aero's two main Canadian customers were Aveos and Air Canada.[9]

10. Aero's assets in Canada consisted primarily of category 3 consumable and expendable spare aircraft parts (**CAT 3 Parts**), which were the products Aero supplied to Aveos and Air Canada.[10]

B. The Insolvency Proceedings

11. On November 11, 2009 (the **Administration Date**), Aero commenced insolvency proceedings in the United Kingdom in the High Court of Justice of England and Wales (the **Administration Proceedings**).[11] James Robert Tucker, Richard Heis and Allan Watson Graham of KPMG LLP were appointed Joint Administrators (the **Applicants** or the **Joint Administrators**) by the UK Court's order (the **Administration Order**).[12]

12. On the same day, this Court granted the Recognition Order that:

(a) recognized the Administration Proceedings as "foreign main proceedings" under section 47 of the *Companies Creditors' Arrangement Act* (the **CCAA**);

(b) recognized the Joint Administrators as "foreign representatives" under section 45 of the CCAA; and

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[7] Supplement to the Third Report of KPMG Inc., in its capacity as Information Officer, dated December 6, 2013, **[Supplement to Third Report]**, para. 12, Applicants' Supplemental Motion Record **[Supplement]**, Tab 2, page 16.

[8] Third Report, para. 9, Motion Record, Tab 2, p. 11.

[9] Third Report, para. 11, Motion Record, Tab 2, p. 11.

[10] Third Report, para. 11, Motion Record, Tab 2, p. 11.

[11] Third Report, para. 1, Motion Record, Tab 2, p. 9.

[12] Third Report, para. 1, Motion Record, Tab 2, p. 9.

(c) recognized and enforced the Administration Order under section 49 of the CCAA.[13]

C. Storage of CAT 3 Parts

13. Aero purchased its initial Canadian inventory of parts in bulk at a time when they were already situated at facilities controlled by Air Canada and Aveos in Montreal, Toronto, Winnipeg and Vancouver and that is where those parts remained.[14] All Canadian parts that Aero subsequently purchased were also stored at the Aveos and Air Canada facilities.

14. This arrangement was essential to ensure that parts were accessible to Air Canada and Aveos maintenance personnel as needed.[15]

15. Aero's CAT 3 Parts were stored in thousands of bins located on the floors of the Aveos and Air Canada facilities, and were commingled with other CAT 3 Parts owned by Aveos and Air Canada.[16] The CAT 3 Parts owned by Aero, Air Canada and Aveos were fungible and did not bear any marks identifying ownership.[17]

16. The ownership of the CAT 3 Parts was unknown to the Aveos and Air Canada employees using the parts. Ownership was irrelevant to completing the maintenance task that required the parts; the parts were drawn and used as needed.[18]

17. At the date of the Recognition Order, Aero had minimal independent inventory ownership and consumption records. Aero relied on computerized reconciliations in the ARTOS computer system to determine ownership and consumption of CAT 3 Parts.[19] The ARTOS system was controlled by Air Canada and Aveos, and had significant limitations[20]:

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[13] Third Report, para. 2, Motion Record, Tab 2, p. 9.

[14] Affidavit of Gilles Neron, sworn May 15, 2014 **[Neron Affidavit]**, Exhibit A, Air Canada Responding Motion Record **[Responding Motion Record]**, Tab 1-A, p. 44.

[15] Third Report, para. 12, Motion Record, Tab 2, p. 11.

[16] Brearton Affidavit, para. 4, Second Supplement, Tab 1, p. 2.

[17] Brearton Affidavit, para. 4, Second Supplement, Tab 1, p. 2.

[18] Brearton Affidavit, para. 4, Second Supplement, Tab 1, p. 2, Third Report, para. 12, Motion Record, p. 11.

[19] Third Report, para. 14, Motion Record, Tab 2, pp. 11-12.

[20] Third Report, para. 14, Motion Record, Tab 2, pp. 11-12 and Neron Affidavit, para. 27, Responding Motion Record, Tab 1, p. 13.

(a) it was dependent on data to be entered by Air Canada and Aveos employees each time they withdrew a CAT 3 Part, but there was no mechanism to ensure that the data was entered correctly or at all;[21]

(b) it could not identify the location of a particular CAT 3 Part within a particular bin; and[22]

(c) it did not differentiate between ownership by Air Canada, Aveos and Aero for certain CAT 3 Parts.[23]

D. Protection of Aero's Inventory

18. Given the manner in which the CAT 3 Parts were stored, at the time of the Administration Order the Applicants were concerned that Aero's Canadian customers could continue their consumption of Aero's inventory without the intention of ever paying cash for that fresh inventory consumption based upon pre-existing set off claims.[24]

19. The Applicants considered and rejected several options for protecting Aero's inventory:

(a) imposing "cash on delivery" for each transaction was impossible given that Aero did not have control over the delivery of CAT 3 Parts, and the number of individual transactions occurring on any given day was in the range of 4,000 to 5,000;[25]

(b) contrary to the assertions of Air Canada, removing or segregating Aero's inventory was not a realistic option:

(i) the Aveos and Air Canada facilities had to remain secure facilities free from outside interference (including interference from Aero) to ensure regulatory compliance;

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[21] Neron Affidavit, para. 28, Responding Motion Record, Tab 1, pp. 13-14.

[22] Brearton Affidavit, para. 5, Second Supplement, Tab 1, p. 2.

[23] Third Report, para. 14, Motion Record, Tab 2, pp. 11-12 and Neron Affidavit, para. 27, Responding Motion Record, Tab 1, p. 13.

[24] Third Report, para. 18, Motion Record, Tab 2, pp. 12-13.

[25] Third Report, para. 18, Motion Record, Tab 2, pp. 12-13.

(ii) the Aveos and Air Canada facilities were unionized, which created additional barriers to physical entry;

(iii) the Aveos and Air Canada facilities were subject to enhanced security measures given their proximity and potential access to critical airport systems;

(iv) it was not clear that physical segregation of Aero's inventory was possible given space constraints at the Aveos and Air Canada facilities;

(v) segregation may have resulted in the removal of parts from where they were needed, causing a serious threat to Aveos' and Air Canada's operations; and[26]

(vi) Aero was not in a position to determine precisely which specific parts it owned or where those parts were located: either the facility or the bin.[27]

20. Accordingly, the best protective measure available in the circumstances was a court order requiring payment for any new purchases without set-off. The Applicants requested and obtained as part of the Recognition Order the following provision, appearing at paragraph 10:

> 10. THIS COURT ORDERS that the determination and enforcement of any Person's rights of set-off from and after the effective time of this Order shall be stayed pending further order of this Court and any new purchases of goods from the Foreign Debtors under existing supply contracts or otherwise from and after the effective time of this Order shall be paid by the customers on terms acceptable to the Foreign Representatives without counterclaim or deduction.
>
> [Emphasis added]

21. In its endorsement in connection with the Recognition Order, the Court acknowledged the Applicants' concerns and the need for the no set-off provision:

> The applicants submit that no party is unreasonably prejudiced by the proposed set-off relief which is intended to operate only to

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[26] Brearton Affidavit, para. 10, Second Supplement, Tab 1, p. 4.

[27] Brearton Affidavit, para. 5, Second Supplement, Tab 1, p. 2.

> prevent fresh inventory of the foreign debtors from being appropriated by third parties without an ensuing payment. The proposed relief does not affect the position of the parties on the date of the recognition order but ensures that no further prejudice is caused to the foreign debtors' estate. If the foreign debtors' inventory were in their possession rather than in the possession of third parties, they could control and minimize such potential prejudice by obtaining assurances of payment ahead of providing new supplies.
>
> The applicants are concerned that as Aveos has physical control of the foreign debtors' inventory, any refusal to supply their inventory without assurances of payment might lead to the grounding of several airplanes, thereby causing prejudice to the foreign debtors' customers. They submit that in the circumstances, the better option to ensure continued supply to customers and payment for fresh inventory is by the granting of a temporal stay of any right of set-off.[28]

22. The Recognition Order also included a "comeback" clause at paragraph 18, which gave any interested person the right to apply to vary or rescind the order or seek other relief in respect of the order.[29]

E. Air Canada's Representations of Compliance with the Recognition Order

23. On November 11, 2009, immediately following the issuance of the Recognition Order, the Joint Administrators advised Air Canada of the order's key terms, with particular emphasis on the no set-off provision:

> I wish to reiterate that the Companies consent to your continued draw down of AI Stock (referred to below), but on the following terms:
>
> 1. all parts (as defined in the Contract), stock and other property of Aero (collectively, the "AI Stock") removed, utilized or consumed by you following the effective date of the Orders will be paid for by you at the pricing specified in Section 21 of the Contract without set-off (legal or equitable), deduction, lien, reduction, rebate, charge, fee, damages (whether or not liquidated), dispute, counterclaim or contest whatsoever (a "Set-off"), whether or not otherwise permitted in the Contract, with [*sic*]

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[28] *Tucker v. Aero Inventory (UK) Ltd.*, [2009] O.J. No. 4797 at para. 29-30 (Ont. S.C.J.), Aero's Brief of Authorities [**Aero's Authorities**], Tab 1.

[29] Third Report, Appendix A, Motion Record, Tab 2-A, p. 31.

five (5) business days of the end of the month during which the AI Stock is so removed, utilized or consumed.

2. for the avoidance of doubt, no Set-offs, whether or not otherwise permitted under Sections 16, 17.1, 20.9, 20.11 or 20.12 or otherwise under the Contract, will reduce any amounts payable as provided in items 1 and 6. Any liquidated or other damages, other Set-offs or other amounts that you consider due to you shall rank as unsecured creditor claims;

...

Please confirm by return to the sender... your agreement to items 1 to 10 set out above. For the avoidance of doubt, without your immediate express agreement to item 1 above, payment in full for stock consumed by you, you should cease to access any AI Stock in accordance with the terms hereof and the [Administration Order and the Recognition Order].[30]

24. Air Canada responded that same day and advised the Joint Administrators that it would "comply with the administration and other court orders applicable to [Air Canada]".[31]

25. Air Canada subsequently confirmed to the Applicants that it had not consumed any Aero CAT 3 Parts since the Recognition Order, and had no intention of consuming any Aero CAT 3 Parts going forward:

(a) on November 27, 2009, Air Canada's counsel advised the Joint Administrators that:

(i) "[Air Canada] would not be willing to resume transacting any business with [Aero] except on a very limited basis and would not do so as long as [Aero] is in default of its obligations to [Air Canada]"; and

(ii) "Arrangements will have to be made to remove [Aero's] goods" from Air Canada's premises;[32] and

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[30] Third Report, Appendix I, Motion Record, Tab 2-I, p. 222-223.

[31] Third Report, Appendix J, Motion Record, Tab 2-J, p. 226.

[32] Third Report, Appendix W, Motion Record, Tab 2-W, p. 309.

(b) on December 1, 2009, in the context of KPMG's appointment as receiver of Aero Inventory (Canada) Inc., Air Canada's counsel represented to the Court that Air Canada was "not continuing to draw on Aero inventory";[33] and

(c) in an affidavit sworn January 27, 2010 in support of a motion to strike paragraph 10 of the Recognition Order that was never pursued, Air Canada stated that it did not need to purchase any CAT 3 Parts from Aero after the date of the Recognition Order, except certain parts in limited quantities.[34]

26. By letter dated April 9, 2010, the Information Officer expressly confirmed Air Canada's previous representation that it had ceased drawing upon Aero's inventory since the date of the Recognition Order.[35]

F. Air Canada's Post-Filing Consumption of Aero-owned CAT 3 Parts

27. In July 2010, Aero discovered, contrary to Air Canada's previous representations, that Air Canada had in fact consumed Aero-owned CAT 3 Parts following the date of the Recognition Order. Aero responded to this discovery as follows:

(a) on July 9, 2010, the Information Officer requested that Air Canada immediately stop consuming Aero-owned CAT 3 parts;[36]

(b) On August 5, 2010, the Foreign Representatives' counsel advised Air Canada's counsel that it was concerned with the possibility of Air Canada consuming Aero-owned inventory without payment and requested full particulars of Air Canada's inventory usage since the Administration Date.[37]

28. Aero invoiced Air Canada in 2010 for its consumption based upon the best data available at that time. The Foreign Representatives subsequently replaced those invoices with new invoices based upon improved consumption data as described below.[38]

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[33] Third Report, Appendix X, Motion Record, Tab 2-X, p. 310-311.

[34] Affidavit of Alan Butterfield , sworn January 27, 2010, para. 52, Air Canada Motion Record dated January 27, 2010, Tab 2, p. 35.

[35] Third Report, Appendix S, Motion Record, Tab 2-S, p. 303.

[36] Third Report, Appendix T, Motion Record, Tab 2-T, p. 304.

[37] Third Report, Appendix V, Motion Record, Tab 2-V, p. 305

[38] Bearton Affidavit, para. 22, Second Supplement, Tab 1, p. 8.

29. By August 2010, Air Canada was prepared to concede that it may have consumed some of Aero's inventory following the Recognition Order. In an affidavit sworn August 23, 2010 in these proceedings, a representative of Air Canada stated:

> 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).[39]

30. Based upon the following statement in the August 23, 2010 affidavit, the Applicants believed Air Canada would pay for its post-filing consumption:

> Air Canada is reviewing whether any such use occurred and is prepared to pay for any such parts used during the post-filing period.[40] [emphasis added]

G. The Algorithm

31. The inadequacy of the then existing inventory information led to the development of a new computer program to track consumption and ownership of CAT 3 Parts. Aveos and Air Canada had been working on such a program for some time prior to the commencement of Aero's insolvency proceeding.[41] This program was necessary for Air Canada and Aveos to operate their businesses going forward irrespective of Aero's role in those businesses.[42]

32. Aveos took the lead role in developing this computer program and in fact is acknowledged to have "created" the computer program.[43]

33. In late 2010, Aero joined in the development of this computer program.[44]

34. In March 2012, Aveos, Air Canada and Aero finalized the new computer algorithm to track consumption and ownership of CAT 3 Parts (the **Algorithm**). The Algorithm was based on a set of agreed-upon business rules (the **Business Rules**) developed cooperatively by Aveos, Air Canada and Aero.

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[39] Neron Affidavit, Exhibit A, Responding Motion Record, Tab 1-A, p. 80.

[40] Neron Affidavit, Exhibit A, Responding Motion Record, Tab 1-A, p. 80.

[41] Neron Affidavit, para. 31, Responding Motion Record, Tab 1, p. 14.

[42] Neron Affidavit, para. 27, Responding Motion Record, Tab 1, p. 13.

[43] Neron Affidavit, Exhibit I, Responding Motion Record, Tab 1-I, p. 142.

[44] Brearton Affidavit, paras. 14 and 15, Second Supplement, Tab 1, pp. 5-6.

35. The Business Rules used the following principles:[45]

(a) assumed ownership allocations of CAT 3 Parts between the three parties as at a specified 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 the 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 unused parts returned to the commingled inventory pool; and

(e) an agreed upon procedure to allocate ownership of newly purchased CAT 3 Parts that were introduced to the commingled inventory pool after the start date.

36. The Business Rules specifically included assumptions that would prevent a determination that Air Canada consumed Aero's parts unless absolutely necessary. For example, the Algorithm would only attribute consumption to an Aero part if the part could not have been sourced from Air Canada's or Aveos' inventories, either because Aveos and Air Canada did not own such type of part at all or did not own enough of such type of part to meet consumption needs.[46]

37. Following the finalization of the Algorithm, Aero and Air Canada reached an agreement to use the Algorithm to determine ownership and consumption of Aero's CAT 3 Parts from October 1, 2009 onwards. Their agreement was memorialized in a March 9, 2012 endorsement of this Court, which states, in part, as follows:

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[45] Brearton Affidavit, para. 6, Second Supplement, Tab 1, p. 3.

[46] Brearton Affidavit, para. 16, Second Supplement, Tab 1, p. 6.

> [the Algorithm], based upon Business Rules Document version 2.1, is the agreed upon means by which Air Canada and Aero UK 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. [emphasis added][47]

38. There can be no dispute over the quantity of Aero-owned CAT 3 Parts consumed by Air Canada after October 1, 2009. The parties agreed to use the Algorithm to determine that issue.

H. Payments Owed by Air Canada to Aero

39. According to the Algorithm, total post-filing consumption by Air Canada is now approximately US $9.6 million.[48] At the time Air Canada agreed to use the Algorithm to determine consumption of Aero's CAT 3 Parts, a significant majority of that consumption had already occurred and had already been reflected in the Algorithm's output.[49]

40. Air Canada has failed to pay for any of its post-filing consumption of Aero-owned CAT 3 Parts, in breach of the Recognition Order.[50]

PART III - ISSUES AND THE LAW

41. The sole issue for determination on this motion is whether paragraph 10 of the Recognition Order remains valid and enforceable. More specifically, the issue for this Court is whether Air Canada is obligated to pay for its consumption of Aero's CAT 3 Parts from November 11, 2009 onward, without set-off.[51]

42. The Applicants are not requesting any determination with respect to the quantification or the pricing of Air Canada's consumption of Aero's CAT 3 Parts at this time.

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[47] Third Report, Appendix F, Motion Record, Tab 2-F, p. 192.

[48] Supplement to Third Report, para. 12., Supplement, Tab 2, p. 16.

[49] Third Report, para. 49, Motion Record, Tab 2, p. 20.

[50] Supplement to Third Report, para. 12., Supplement, Tab 2, p. 16.

[51] The Foreign Representatives acknowledge that during these proceedings they have agreed to certain limited potential set offs in favour of Air Canada. In particular (i) Section 2.2.8 of an Agreement as of June 15, 2012 preserves certain set off rights with respect to an alleged storage lien claim asserted by Air Canada; and (ii) Clause 1 of a letter agreement dated January 27, 2011 preserves certain set off rights with respect to certain parts which may have been owned by Air Canada and sold by Aero to Aveos. Aero did not concede that any such claims were valid. No such claims have been advanced by Air Canada to date.

A. Paragraph 10 of the Recognition Order Captures Air Canada's Post Filing Consumption

43. The effect of paragraph 10 of the Recognition Order is clear and unambiguous: Air Canada is required to pay for all purchases of Aero's CAT 3 Parts made from November 11, 2009 onward, without counterclaim or deduction (i.e., without set-off).

44. Paragraph 10 reads as follows:

> THIS COURT ORDERS that the determination and enforcement of any Person's rights of set-off from and after the effective time of this Order shall be stayed pending further order of this Court and any new purchases of goods from the Foreign Debtors under existing supply contracts or otherwise from and after the effective time of this Order shall be paid by the customers on terms acceptable to the Foreign Representatives without counterclaim or deduction.[52]

45. The provision consists of two key elements:

(a) a stay of the determination and enforcement of any set off rights arising after November 11, 2009, pending further order of the Court; and

(b) a mandatory requirement that any new purchases from Aero from November 11, 2009 onward be paid without counterclaim or deduction.

46. The payment requirement is not subject to any restrictions. It creates a clear and unambiguous obligation to make payment without set-off where the criteria established by the provision are satisfied.

47. Air Canada's post-filing consumption of Aero's CAT 3 Parts is indisputably captured by paragraph 10. Air Canada's consumption was:

(a) a new purchase of goods;

(b) from the "Foreign Debtor" (Aero); and

(c) made from November 11, 2009 and afterwards.

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[52] Third Report, Appendix A, Motion Record, Tab 2-A, p. 29.

48. Accordingly, paragraph 10 mandates Air Canada to pay for its post-filing consumption of Aero's CAT 3 Parts without set off.

49. The Applicants acknowledge that Section 21 of the CCAA preserves creditors' set off rights in certain circumstances. However, paragraph 10 of the Recognition Order is not inconsistent with Section 21 of the CCAA. Paragraph 10 did not determine any party's rights of set off or modify any rights of set off that any party may have had as of November 11, 2009. Paragraph 10 only regulated the manner in which the Applicant's property would be consumed or disposed of following the commencement of insolvency proceedings.

50. In any event, it is not necessary for orders granted in a Part IV proceeding under the CCAA to strictly comply with all other provisions of the CCAA unless a plenary proceeding has been commenced under the CCAA.[53]

B. Permitting Air Canada to Avoid Payment Would Frustrate the Purpose of the Paragraph 10 and Section 49(1) of the CCAA

51. Paragraph 10 is consistent with Section 49 of the CCAA, which allows the Court make "any order that it considers appropriate" to protect a debtor company's property:

> If an order recognizing a foreign proceeding is made, the court may, on application by the foreign representative who applied for the order, if the court is satisfied that it is necessary for the protection of the debtor company's property or the interests of a creditor or creditors, make any order that it considers appropriate.[54]

52. If Air Canada is permitted to avoid payment for its post-filing consumption of Aero's CAT 3 Parts, the purpose of Section 49 of the CCAA would be frustrated and Air Canada would effectively be given preferred creditor status.

53. The purpose of paragraph 10 of the Recognition Order was to protect Aero's property and creditors' interests in that property in accordance with Section 49 of the CCAA. Paragraph 10 clarifies that customers of Aero, who may also be creditors, are not permitted to help themselves to Aero's inventory as a means of collecting an *in specie* distribution on their debts

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[53] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, s. 49(2) [***CCAA***] and *Hartford Computer Hardware, Inc. (Re)*, 2012 ONSC 964, [2012] O.J. No. 715 (Ont. S.C.J.), Aero's Authorities, Tab 2.

[54] *CCAA*, *supra*, s. 49(1).

ahead of other creditors. The provision prohibited Air Canada and Aveos from taking advantage of their control over Aero's inventory to the detriment of other creditors.

54. In his endorsement in connection with the Recognition Order, Justice Newbould expressly acknowledged that Paragraph 10 was intended to protect Aero's assets for other creditors:

> In this case, because of the fact that the foreign debtors do not have physical control of their inventory in Canada as the inventory is in warehouses operated by Aveos, a concern has been raised that set-off could adversely impact the foreign proceeding and impact recoveries available to creditors.
>
> [...]
>
> The applicants submit that no party is unreasonably prejudiced by the proposed set-off relief which is intended to operate only to prevent fresh inventory of the foreign debtors from being appropriated by third parties without an ensuing payment. The proposed relief does not affect the position of the parties on the date of the recognition order but ensures that no further prejudice is caused to the foreign debtors' estate. If the foreign debtors' inventory were in their possession rather than in the possession of third parties, they could control and minimize such potential prejudice by obtaining assurances of payment ahead of providing new supplies.
>
> [...]
>
> It seems to me that at this stage the relief sought should be granted. [emphasis added]

55. The policy purpose of this type of order was affirmed by the BC Supreme Court and the BC Court of Appeal in *Quintette Coal Ltd. v. Nippon Steel Corp.*[55] Like the current case, *Quintette* involved an order under the CCAA aimed at prohibiting creditors from taking a distribution of the debtor's property post-filing in order to satisfy their outstanding claims in reliance upon a purported set off. The plaintiff had an ongoing business relationship with the defendant and sought to avoid payment for post-filing consumption on the basis of purported set off rights contrary to the order previously granted in the CCAA proceedings. The Court denied

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[55] *Quintette Coal Ltd. v. Nippon Steel Corp.*, 1990 CarswellBC 382, 2 C.B.R. (3d) 291 (B.C.S.C.) [***Quintette BCSC***], Aero's Authorities, Tab 3.

the plaintiff's application, holding that the court "must not carve out one portion of the order and give an advantage to one creditor over the other."[56] The BC Court of Appeal agreed with this decision, finding that the exercise of set off in that case would be inappropriate as no customer should have recourse to set-off "in the colloquial sense, as a sword to achieve a species of extra judicial execution."[57]

56. Leading authorities have also recognized, in the proposal context, the appropriateness of protections from set off rights:

> It is customary in a proposal to provide that creditors shall have no right of set-off for goods or services purchased by them from the debtor after the date of the filing of the notice of intention or the proposal if no notice of intention was filed. This provision [prevents] creditors from purchasing goods from the debtor after the date of the proposal and claiming a right of set-off. Even if such a provision is not contained in the proposal, it would appear that there is no right of set-off in these circumstances.[58]

57. Permitting Air Canada to avoid the requirements of paragraph 10 would undermine the important policy objectives underlying the Recognition Order. Air Canada would be permitted to, effectively, convert itself into preferred creditor, and the primary purpose of paragraph 10 – to protect Aero's inventory for the benefit of all creditors – would be completely frustrated.

C. Air Canada cannot seek to vary, modify or strike paragraph 10

58. Air Canada is estopped from seeking a variance of paragraph 10 of the Recognition Order as a consequence of its (a) representations and omissions, and (b) delay.

59. Aero always maintained its right to be paid, and reasonably expected to be paid, in accordance with paragraph 10 of the Recognition Order. Notably, Aero's other significant Canadian customer, Aveos, agreed to pay for both its pre-filing and post-filing consumption.[59] Aero had the same expectation of Air Canada.

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[56] *Quintette BCSC*, *supra* at para. 21.

[57] *Quintette Coal Ltd. v. Nippon Steel Corp.*, 1990 CarswellBC 384 at para. 22, 2 C.B.R. (3d) 303 (B.C.C.A.), Aero's Authorities, Tab 4.

[58] L. W. Houlden, G. B. Morawetz and J. Sarra, Bankruptcy and Insolvency Law of Canada (4th ed. (looseleaf)), vol. 2, at F237(7), Aero's Authorities, Tab 10.

[59] Brearton Affidavit, para. 27, Second Supplement, Tab 1, p. 9.

i. Air Canada is estopped by its representations

60. Estoppel by representation operates to prevent a party from denying the truth of a representation once another party has relied on that representation to their detriment. The essential elements giving rise to an estoppel have been described as:

(a) a representation by words or conduct;

(b) that the representation is made with the intention that it be acted on by the party to whom the representation is made; and

(c) the party to whom the representation is made acts upon it so as to make it inequitable that the party making the representation should be permitted to dispute its truth or do anything inconsistent with it.[60]

61. These elements are all satisfied in this case. Air Canada made the following representations, expressly or by omission:

(a) on November 11, 2009, Air Canada advised Aero that it would adhere to the terms of the Recognition Order; and

(b) Air Canada advised Aero that it had not consumed any Aero-owned CAT 3 Parts after the Administration Date and did not need to consume any Aero-owned CAT 3 Parts, and also subsequently that it would be "prepared to pay for any such parts used during the post-filing period".

62. In short, Air Canada represented to Aero that (1) it would comply with the terms of the Recognition Order, (2) there was no concern over possible non-compliance because Air Canada had not consumed Aero-owned CAT 3 Parts and had no intention of consuming Aero-owned CAT 3 Parts; and (3) if Air Canada did consume any Aero-owned CAT 3 Parts, it would pay for those parts.

63. The intention element is judged objectively. The test is whether "a reasonable person would interpret the purpose of the statement as having been made with the intention that it be relied on".[61]

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[60] *Bank of Montreal v. Loyens*, 2014 ONSC 2524 at para. 50, [2014] O.J. No. 2129, Aero's Authorities, Tab 5.

64. It is certainly reasonable to interpret Air Canada's representations as being made with the intention that they be relied on by Aero. These representations were made in certain cases in direct response to Aero's request for confirmation on these points and in other cases in evidence before the Court.

65. Aero relied on Air Canada's representations, to its detriment. As a result of Air Canada's representations, Aero believed that Air Canada would either not consume Aero's inventory or pay for any inventory that it consumed without set off. Accordingly, Aero did not seek any further relief from the Court to protect or secure its inventory from being appropriated by Air Canada.

66. Air Canada is estopped from seeking any variance of the Recognition Order that would permit it to escape payment for its consumption in accordance with paragraph 10 of the Recognition Order and leave Aero without any avenue to remedy its prejudice. Paragraph 10 of the Recognition Order must be enforced.

ii. Air Canada is precluded from seeking to vary the Recognition Order on account of its unreasonable delay

67. For over four years, Air Canada failed to exercise any procedural rights to seek to vary the Recognition Order. In fact, Air Canada has yet to take any such steps – this motion was brought by Aero as a means to secure payment for goods appropriated by Air Canada without proper payment.

68. Air Canada could have pursued a variance under either paragraph 18 of the Recognition Order (the "comeback clause") or Rule 37.14, but did neither. Air Canada has failed to act in a timely manner – and in fact has failed to act at all – and as a result should not at this stage be given any procedural relief in respect of the Recognition Order.

69. While Air Canada served materials for a motion to strike paragraph 10 of the Recognition Order on January 27, 2010, that motion was not pursued.

70. Air Canada states that the parties expected this motion to be heard at a later date:

> As the Trustee and Information Officer reported in its Second Report dated January 17, 2011 (the "Second Report") at

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[61] *Halsbury's Laws of Canada*, vol. 76, 1st ed., (Markham: LexisNexis, 2012) at §123, p 404, Aero's Authorities, Tab 11.

paragraph 16, the motion was 'expected to be heard in conjunction with the Preference Action.'[62]

71. The context in which the above statement was made is important:

(a) Based upon Air Canada's representations, it was reasonable to expect that the Algorithm would not show material consumption of Aero's inventory.

(b) Air Canada expected to "re-fill" bins 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 the expectation was that Air Canada would return a newly purchased identical CAT 3 Part to Aero. Once the Algorithm was completed, it was clear that this never occurred.[63]

(c) As stated in the Third Report of the Information Officer, dated April 26, 2012, delay in scheduling Air Canada's motion was not problematic for Aero on the assumption that Air Canada did not consume Aero's inventory,[64] or any material amounts of Aero's inventory. Once the Algorithm was agreed to, providing clear evidence of the precise amounts of Aero's inventory that Air Canada had consumed, the matter became problematic, particularly given the quantum of the inventory consumed.

72. Air Canada did not bring, and still has not brought its motion. In the interim, Aero relied upon Air Canada's representations that it was not consuming Aero's inventory and that it would pay for any of Aero's inventory that it did consume. Aero also relied upon the clear terms of the Recognition Order that remained in effect.

(1) Comeback relief would be inappropriate and unfair

73. In the over four and half years since the Administration Date, Air Canada has failed to pursue relief under the comeback clause in the Recognition Order. Air Canada has failed to act in a timely manner, and any attempt by Air Canada to seek relief under the comeback clause should be rejected for unreasonable delay.

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[62] Neron Affidavit, Para. 39, Responding Motion Record, Tab 1-A, p. 18.

[63] Brearton Affidavit, Para. 17, Second Supplement, Tab 1, p. 6.

74. In *Millard v North George Capital Management Ltd.,* Justice Farley observed that "the comeback clause in matters generally should be utilized forthwith", and further that comeback motions should be brought "on a timely basis after reflection has provided the opportunity for a sober second thought and appreciation of the basis and the implications of the order."[65]

75. Similarly, *Cavell Insurance Co. (Re)*, Justice Farley commented that it would be inappropriate to use a comeback provision "to sit in the weeds to gain a tactical advantage."[66]

76. This case clearly demonstrates the need for timely use of a comeback clause. If Air Canada had brought its motion to strike paragraph 10 in a timely manner and had been successful, Aero could have responded accordingly: Aero could have sought an order prohibiting further consumption by Air Canada, or drawn the court's attention to the prejudice Aero faced in order gain access to its inventory within Air Canada's and Aveos' secured closed facilities. Aero is now, at this late stage, unable to take any alternative steps to protect itself from the risks targeted by paragraph 10 of the Recognition Order.

77. In short, Air Canada's delay has given it a tactical advantage: it used the inventory without payment. Aero's only response to a successful comeback motion by Air Canada would have been to control further access to its inventory. At this point, all business dealings between Air Canada and Aero have ceased and Air Canada has already utilized Aero's inventory to the extent it needed to. Air Canada could not now, at a time when Aero can no longer protect itself or its inventory, seek retroactive relief on a comeback motion. Comeback relief would be inappropriate and unfair in the circumstances.

(2) Air Canada's failure to act precludes reliance on Rule 37.14

78. Similarly, Air Canada is precluded from relying on Rule 37.14. Rule 37.14 states, in relevant part:

> (1) A party or other person who,
>
> (a) is affected by an order obtained on motion without notice;
>
> [...]

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[65] *Millard v North George Capital Management Ltd.*,[1999] O.J. No. 3957 at para. 4, 1 B.L.R. (3d) 106 (Ont. S.C.J.), Aero's Authorities, Tab 6.

[66] *Cavell Insurance Co. (Re)*, [2005] O.J. No. 645 at para. 3, 25 C.C.L.I. (4th) 230 (Ont S.C.J.), Aero's Authorities, Tab 7.

> may move to set aside or vary the order, by a notice of motion that is served forthwith after the order comes to the person's attention and names the first available hearing date that is at least three days after service of the notice of motion.[67]

79. On the face of the rule, Air Canada cannot rely on Rule 37.14. First, Air Canada does not have a motion seeking relief under Rule 37.14 before this Court. There is no procedural basis to give Air Canada relief under Rule 37.14, because it has not sought such relief.

80. Second, even if Air Canada attempted to revive its previous motion served in January 2010 or brought a fresh motion, it would clearly fail to satisfy the rule's threshold criterion. The motion would not have been be served "forthwith" after the Recognition Order came to Air Canada's attention, which was on November 11, 2009. Whether two and half months in the case of the January 2010 motion or four and half years for a fresh motion, Air Canada would not have acted "forthwith".[68]

81. Case law applying Rule 37.14 provides that the rule is to be applied using a contextual approach, with reference to the following factors:

(a) an explanation of the litigation delay;

(b) whether deadlines were missed through inadvertence;

(c) whether the motion to vary has been brought promptly; and

(d) whether prejudice results to the counterparty.[69]

82. These factors are of no assistance to Air Canada. Air Canada has failed to provide any explanation for failing to pursue relief under the Rules, nor any basis for justifying its failure to act on the basis of inadvertence. There can be no dispute that a four and half year delay in pursuing relief is not "prompt". Finally, for the numerous reasons discussed above, allowing Air Canada to vary the Recognition Order by striking paragraph 10 would cause serious prejudice to Aero.

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[67] *Rules of Civil Procedure*, R.R.O. 1990, Reg. 194, s. 37.14.

[68] *Coopers & Lybrand Ltd v. Richter & Associates Inc.*, [2000] O.J. No. 2073 at paras. 29-31, 2000 CarswellOnt 1965 (Ont S.C.J.), Aero's Authorities, Tab 8.

[69] *Scaini v. Prochnicki*, [2007] O.J. No. 299 at para. 12, 85 O.R. (3d) 179 (Ont. C.A.), Aero's Authorities, Tab 9.

PART IV - ORDER SOUGHT

83. The Applicants request an order that Air Canada pay for its consumption in accordance with the terms of the Recognition Order.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

June 20, 2014

Norton Rose Fulbright Canada LLP

NORTON ROSE FULBRIGHT CANADA LLP

Lawyers for Applicants

SCHEDULE "A"
LIST OF AUTHORITIES

1. *Tucker v. Aero Inventory (UK) Ltd.*, [2009] O.J. No. 4797 (Ont. S.C.J.).

2. *Hartford Computer Hardware, Inc. (Re)*, 2012 ONSC 964, [2012] O.J. No. 715 (Ont. S.C.J.).

3. *Quintette Coal Ltd. v. Nippon Steel Corp.*, 1990 CarswellBC 382, 2 C.B.R. (3d) 291 (B.C.S.C.).

4. *Quintette Coal Ltd. v. Nippon Steel Corp.*, 1990 CarswellBC 384, 2 C.B.R. (3d) 303 (B.C.C.A.).

5. *Bank of Montreal v. Loyens*, 2014 ONSC 2524, [2014] O.J. No. 2129.

6. *Millard v. North George Capital Management Ltd.*, [1999] O.J. No. 2957, 1 B.L.R. (3d) 106 (Ont. S.C.J.).

7. *Cavell Insurance Co. (Re)*, [2005] O.J. No. 645, 25 C.C.L.I. (4th) 230 (Ont. S.C.J.).

8. *Coopers & Lybrand Ltd v. Richter & Associates Inc.*, [2000] O.J. No. 2073, 2000 CarswellOnt 1965 (Ont S.C.J.)

9. *Scaini v. Prochnicki*, [2007] O.J. No. 299, 85 O.R. (3d) 179 (Ont. C.A.)

10. L. W. Houlden, G. B. Morawetz and J. Sarra, Bankruptcy and Insolvency Law of Canada (4th ed. (looseleaf))

11. Halsbury's Laws of Canada, vol. 76, 1st ed., (Markham: LexisNexis, 2012)

SCHEDULE "B"
RELEVANT STATUTES

1. ***Companies' Creditors Arrangements Act*, R.S.C. 1985, c. C-36**

Law of set-off or compensation to apply

21. The law of set-off or compensation applies to all claims made against a debtor company and to all actions instituted by it for the recovery of debts due to the company in the same manner and to the same extent as if the company were plaintiff or defendant, as the case may be.

Other orders

49. (1) If an order recognizing a foreign proceeding is made, the court may, on application by the foreign representative who applied for the order, if the court is satisfied that it is necessary for the protection of the debtor company's property or the interests of a creditor or creditors, make any order that it considers appropriate, including an order

(a) if the foreign proceeding is a foreign non-main proceeding, referred to in subsection 48(1);

(b) respecting the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor company's property, business and financial affairs, debts, liabilities and obligations; and

(c) authorizing the foreign representative to monitor the debtor company's business and financial affairs in Canada for the purpose of reorganization.

Restriction

(2) If any proceedings under this Act have been commenced in respect of the debtor company at the time an order recognizing the foreign proceeding is made, an order made under subsection (1) must be consistent with any order that may be made in any proceedings under this Act.

2. ***Rules of Civil Procedure*, R.R.O. 1990, Reg. 194,**

Motion to Set Aside or Vary

37.14 (1) A party or other person who,

(a) is affected by an order obtained on motion without notice;

(b) fails to appear on a motion through accident, mistake or insufficient notice; or

(c) is affected by an order of a registrar,

may move to set aside or vary the order, by a notice of motion that is served forthwith after the order comes to the person's attention and names the first available hearing date that is at least three days after service of the notice of motion.

(2) On a motion under subrule (1), the court may set aside or vary the order on such terms as are just.

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

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

AND IN THE MATTER OF JAMES ROBERT TUCKER, RICHARD HEIS AND ALLAN WATSON GRAHAM OF KPMG AS JOINT ADMINISTRATORS

AND IN THE MATTER OF AERO INVENTORY (UK) LIMITED AND AERO INVENTORY PLC

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

Proceeding commenced at Toronto

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