

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

Court File 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**

**AND**

**IN THE MATTER OF THE BANKRUPTCY OF AERO INVENTORY (UK) LIMITED**

**DEBTOR**

**AND**

**KPMG INC.**

**TRUSTEE**

**AND**

**IN THE MATTER OF THE BANKRUPTCY OF AERO INVENTORY PLC**

**DEBTOR**

**AND**

**KPMG INC.**

**TRUSTEE**

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

**JUNE 30, 2010**

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## INTRODUCTION

1. On November 11, 2009, James Robert Tucker, Richard Heis and Allan Watson Graham of KPMG LLP were appointed Joint Administrators of Aero Inventory (UK) Limited (“Aero UK”) and Aero Inventory plc (“Aero Plc” and collectively with Aero UK, the “**Foreign Debtors**”) pursuant to an order of the High Court of Justice of England and Wales (Chancery Division, Companies Court) (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 United Kingdom administration proceedings of the Foreign Debtors (the “**Administration Proceedings**”) as “foreign main proceedings” for the purposes of section 47 of the *Companies’ Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the “**CCAA**”), recognizing the Foreign Representatives (as defined below) as “foreign representatives” as defined in section 45 of the CCAA and recognizing and enforcing the Administration Order pursuant to Section 49 of the CCAA. The Recognition Order also imposed a stay of proceedings over the Foreign Debtors.
3. Pursuant to the Recognition Order, KPMG Inc. was appointed as information officer (in such capacity, the “**Information Officer**”). As described in more details below, KPMG Inc. is also the trustee in bankruptcy (in such capacity, the “**Trustee**”) of the Foreign Debtors. As well, pursuant to an order made by the Court on December 1, 2009, KPMG Inc. was appointed receiver and manager (in such capacity, the “**Receiver**”) of the Foreign Debtors’ Canadian affiliate, Aero Inventory Canada Inc./Aero Inventaire (Canada) Inc. (“**Aero Canada**”).
4. On January 22, 2010, James Robert Tucker, Richard Heis and Allan Watson Graham of KPMG LLP (collectively, the “**Foreign Representatives**”) brought a motion before this Honourable Court seeking an order temporarily lifting the stay imposed by the Recognition Order to permit an assignment into bankruptcy of the Foreign Debtors under the *Bankruptcy and Insolvency Act* (“**BIA**”). The primary purpose of the bankruptcy filing was to preserve the rights of the Trustee to pursue any reviewable transactions, preferences or transfers at under value which may have taken place during the statutory time period prescribed by the BIA.
5. On January 22, 2010, the Honourable Justice Morawetz issued an Order (the “**Lift Order**”) temporarily lifting the stay granted in the Recognition Order and authorizing the Foreign Representatives to assign the Foreign Debtors into bankruptcy. The assignment documents were filed with the office of the Superintendent of Bankruptcy on January 22, 2010 and the Certificates of Appointment were issued naming KPMG Inc. as Trustee-

6. On February 10, 2010, the Honourable Justice Morawetz issued an Order (the “February 10 Order”) to, among other things:
  - (i) extend the time periods, *nunc pro tunc*, for the Trustee to perform its statutory obligations as prescribed by sections 16, 21, 22, 24, 27 and 102 of the BIA and for the Foreign Debtors to perform their obligations under section 158 of the BIA until further Order of this Court;
  - (ii) approve the form of notice of the bankruptcy to be issued to the Foreign Debtors’ known creditors (the “Trustee’s Letter”); and
  - (iii) authorize the Foreign Representatives to provide direction to the Trustee as required, including the authority to direct and supervise the Trustee to pursue claims under sections 95 and/or 96 of the BIA, subject to the review of this Honourable Court.
7. Pursuant to the Endorsement of the Honourable Justice Morawetz issued on February 10, 2010, the Trustee is directed to provide periodic reports to the Court on the Foreign Debtors.
8. This report contains the first quarterly report by the Trustee and will provide an update to this Honourable Court in respect of the estate administration, as follows:
  - (a) Confirmation that the Trustee’s Letter was issued to the known creditors of the Foreign Debtors;
  - (b) Confirmation that the Trustee has set up a website for the purpose of providing creditors with information about the bankruptcies of the Foreign Debtors as they proceed;
  - (c) Confirmation that proof of insurance for the Foreign Debtors’ assets was provided to their Canadian customers pursuant to their request;
  - (d) An update on retention of title (“ROT”) claims and claims of unpaid suppliers in Canada;
  - (e) An update on-litigation with Air Canada; and
  - (f) An update on the independent review of the security against the Foreign Debtors’ Canadian assets.

9. This report will also serve as the first report of the Information Officer to this Honourable Court and will provide an update to this Honourable Court in respect of the Administration Proceedings of the Foreign Debtors in the United Kingdom.
10. In preparing this report, KPMG Inc. has relied on information supplied by the Foreign Representatives. KPMG Inc. has not audited, reviewed or otherwise attempted to verify the accuracy or completeness of all of this information.

## **BACKGROUND**

11. The Foreign Debtors and their international affiliates, including Aero Canada, form an integrated and inter-dependent group of companies that supply parts to the airline industry.
12. The Foreign Debtors have assets in Canada, and their Canadian operations are administered by Aero Canada. The Foreign Debtors have two key Canadian customers: Air Canada and Aveos Fleet Performance Inc. (“Aveos”).
13. The Canadian assets of the Foreign Debtors are subject to a security interest in favour of a lending syndicate, the security trustee being Lloyds TSB Commercial Finance Limited (the “Lending Syndicate”). We are advised by the Foreign Representatives that they believe the Lending Syndicate will suffer a significant shortfall on their loans to the Foreign Debtors.

## **TRUSTEE’S ACTIVITIES**

### **Notice**

14. On February 16, 2010, the Trustee caused to be mailed the Trustee’s Letter, a copy of which is attached hereto at **Appendix A**, by ordinary mail to all known creditors of the Foreign Debtors advising as follows:
  - (a) Aero Inventory (UK) Limited and Aero Inventory Plc have been assigned into bankruptcy in Canada;
  - (b) The Trustee has created a website where any further updates on these proceedings will be available, and where a copy of the assignments into bankruptcy, the statement of affairs and the creditors list may be found;
  - (c) No creditors’ meeting or claims process will be conducted by the Trustee until further Order of this Honourable Court; and
  - (d) The security of the Lending Syndicate will be reviewed.

15. The Trustee's website regarding the estates' administration can be found at [www.kpmg.ca/en/ms/cl/aeroinventory](http://www.kpmg.ca/en/ms/cl/aeroinventory).

### **Insurance**

16. The Trustee's February 9, 2010 Supplemental Report listed various insurance policies the Foreign Debtors had in place to comply with their customer contract requirements. Air Canada's and Aveos' legal counsels subsequently requested that the Trustee assist in having the Foreign Debtors' insurance broker confirm in writing, through the issuance of a Certificate of Insurance, that they were an Additional Named Insured under the referenced policies for the current policy period.
17. Attached hereto at **Appendix B**, is a letter from the Foreign Debtors' broker, Jardine Lloyd Thompson (the "**Broker**"), confirming certain of the insurance coverage the Foreign Debtors had in place until May 31, 2010, a copy of the letter having been provided to Air Canada's and Aveos' legal counsels. We were advised by the Broker that, while Air Canada and Aveos were not specifically endorsed onto the policy as additional named insured, the policy structure included within the definition of Assured anyone: "for whom the Assured have or assume a responsibility to arrange insurance, whether contractually or otherwise, as their respective rights and interests may appear". This information was also conveyed to Air Canada's and Aveos' counsel.
18. In addition, the Broker has provided written confirmation that the above referenced insurance has been extended through to June 14, 2011. Copies of which have been sent to counsel for Air Canada and Aveos and are attached hereto at **Appendix C**.

### **Unpaid Suppliers' Claims**

19. Given the input from the Trustee's Canadian legal counsel; Ogilvy Renault LLP ("Ogilvy") that Canadian law should apply to claims in respect of goods supplied that are located in Canada, the Trustee reviewed potential claims under section 81.1 of the BIA with Ogilvy. Given that there were no goods supplied in the time period prescribed by the BIA because the Foreign Debtors ceased accepting new stock upon filing for Administration on November 11, 2009, it was determined that section 81.1 of the BIA did not apply to this case. Further, the Trustee has not received any 30 day goods claims from any suppliers as of the date of this report.

## **Litigation**

20. On or about February 12, 2010, Air Canada's counsel served Ogilvy with notice of a motion seeking leave to appeal the granting of the Lift Order (the "**Lift Order Appeal**"). Air Canada has not yet determined whether it wishes to proceed with that motion. Additionally, Air Canada advised the Information Officer that it will be making an application to this Honourable Court seeking the ability to set-off amounts owing to it by the Foreign Debtors as against amounts that Air Canada may owe the Foreign Debtors (the "**Set-off Claim**"). On January 29, 2010, Air Canada served on the Information Officer and the Foreign Debtors its materials related to the Set-off Claim but has not yet filed such materials with this Court.
21. On April 27, 2010, the Trustee served on Air Canada its materials related to its Court motion seeking a declaration that certain transactions between Air Canada and Aero Inventory (UK) Limited are preferences within the meaning of Section 95(1) of the BIA, and are therefore void *as against* the Trustee (the "**Preference Action**"). These materials were filed with the Court.

## **Independent Security Review**

22. The Foreign Representatives retained the law firms of Thompson Dorfman Sweatman LLP, Macleod Dixon LLP, and BCF LLP as independent counsels (the "**Independent Counsels**"), to advise as to the validity, and enforceability, of the Lending Syndicate's security over the assets of the Foreign Debtors located in the Provinces of Manitoba, Ontario, British Columbia and Quebec. The Independent Counsels have concluded that the Lending-Syndicate holds valid security over the Foreign Debtors' assets located in Manitoba, Ontario, British Columbia and Quebec, enforceable against the Trustee. Copies of the Independent Counsels' opinions are attached as **Appendix D** to this report and have also been posted on the Trustee's website).

## **FOREIGN PROCEEDINGS UPDATE**

### **Foreign Representatives Reporting**

23. In accordance with paragraph 49(4)(b) of Schedule B1 of the Insolvency Act 1986 (UK), the Foreign Representatives issued Form 2.17B on January 4, 2010 (the "**Form 2.17B Report**"), a report to all known creditors of the Foreign Debtors which sets out the Foreign Representatives' proposals in respect of the administration of the Foreign Debtors (the "**Proposals**"). A copy of the Form 2.17B Report can be found at the Information Officer's website being

www.kpmg.ca/en/ms/cl/aeroinventory and copies of the Proposals are attached hereto as **Appendix E**. The Proposals included the following provisions:

- (a) Continue to do all such things as are reasonably expedient and generally exercise all powers as Administrators as they, in their discretion, consider desirable in order to maximize realisations from the assets; and
  - (b) Investigate and, if appropriate, pursue any claims of the Foreign Debtors.
24. The Proposals also included provisions associated with the transitioning to other proceedings if deemed appropriate and the payment of KPMG LLP's and KPMG overseas firms' fees.
25. The Form 2.17B Report included the Directors' Statement of Affairs Aero UK as of November 11, 2009, which indicated that its liabilities significantly exceeded the estimated realizable value of its assets. Additional Aero UK information contained in the statement included the following:
- (i) All of its assets, which had a book value of £384,248,929, were estimated to realize £150,880,096;
  - (ii) Its indebtedness to the Lending Syndicate totalled approximately £296,660,000, resulting in an expected shortfall on their loans, after consideration of the items in sub-paragraph (iii) and paragraph 26 below, of approximately £146,646,000;
  - (iii) Former employees of Aero UK were owed £267,000 relating to wages and/or pension contributions; and
  - (iv) Indebtedness to non-preferential unsecured creditors totalled £58,572,000.
26. The United Kingdom's Insolvency Act 1986 provides that unsecured creditors have a priority claim against the prescribed part of the assets which are secured by a floating charge, to a maximum of £600,000. The prescribed part is paid pro-rata to all proven unsecured creditors, and can be paid by the administrator with consent of the UK Court or a liquidator if the proceedings convert to a liquidation. In an administration, all creditors are given 28 days notice of the intention to pay a dividend ("NID") in accordance with rule 2.95 of the Insolvency Act 1986, once it is determined that a dividend can be paid. In the case of Aero UK, the Foreign Representatives estimate on the basis of current information, that a distribution of approximately 1.1p on the pound may be available to priority claims of unsecured creditors.
27. The Directors' Statement of Affairs for Aero Plc as of November 11, 2009, indicated that the estimated realizable value of its assets were nil (book value of the assets being £26,000) and that its liabilities were also nil. We note, however, that Aero plc is a guarantor of Aero UK's

indebtedness to the Lending Syndicate, and the Directors' Statement of Affairs for Aero UK indicate an expected shortfall to the Lending Syndicate of approximately £146,646,000.

28. A creditors meeting was not called in the Foreign Proceedings to approve the Foreign Representatives' Proposals as no distribution (other than the prescribed part) is expected to be made to unsecured creditors. Pursuant to UK law, 10% (by value) of creditors can request a meeting within the prescribed time, however, this did not occur and the Foreign Representatives' Proposals were deemed approved without a creditors' meeting being called.
29. In accordance with Rule 2.47(4) of the Insolvency Rules 1986 (as amended), the Foreign Representatives have prepared and issued a progress report for the period November 11, 2009 to May 2010 which was distributed to the Foreign Debtors creditors on or around June 7, 2010. A copy is attached hereto as **Appendix F**.

### **Foreign Representatives' Sales Process**

30. The Foreign Debtors' business, prior to its insolvency filing, consisted of operations and customers throughout Europe, Asia, Australia and North America. The inventory stocks associated with the business, which represent the overwhelming bulk of the Foreign Debtors' assets, comprise approximately 40 million parts across 500,000 parts lines located in 30 physical locations. The Foreign Representatives' mandate covers all of the Foreign Debtors' worldwide operations and assets.
31. In the weeks leading up to its insolvency filing, the Foreign Debtors disclosed that an issue had arisen regarding the valuation of its inventory stock (both from an accounting book value and physical quantity perspective) that could have a material impact on the 2008 audited accounts and the 2009 accounts, although the precise impact was still being evaluated. The consequence of this stock valuation issue to the Foreign Representatives was that the historical financial performance of the Foreign Debtors, for certain periods, along with the recorded book value and physical quantities of inventory stock as at November 11, 2009, could not be relied upon. Thus, a credible sales process covering the Foreign Debtors' business and/or its assets could not be initiated by the Foreign Representatives until the inventory stock position was better understood.
32. The Foreign Representatives spent several months, and considerable effort attempting to quantify the Foreign Debtors' inventory stock position as at November 11, 2009. During this time, the Foreign Representatives were contacted by over seventy five parties expressing an interest in the Foreign Debtors' business or its inventory.

33. On January 26, 2010, the Foreign Representatives initiated an “Indicative Sale Process”, sending out Confidentiality Undertakings to all those parties that had contacted them. In excess of sixty executed Confidentiality Undertakings were returned and each of these parties was provided with an Information Memorandum with high level inventory information from the rebuilt inventory records.
34. The Foreign Representatives received seven expressions of interest by their requested deadline of February 12, 2010, and subsequently engaged with each of these parties to clarify their sources of funding and provide them with additional information.
35. As a result of these discussions, a smaller number of parties progressed through to the detailed due diligence stage where they had access to a data room and Aero UK employees.
36. To date, no formal offers capable of acceptance have been received.
37. The working assumption of the Foreign Representatives is that there is unlikely to be an agreed sale of the business or a sale of the entire inventory to a single party and, as a result, the Foreign Representatives continue to implement their inventory realization strategy, which is discussed below.

### **Foreign Representatives’ Inventory Realization Strategy**

38. In the absence of a sale of the business or the entire inventory holding to a single party, the Foreign Representatives intend to implement an inventory realization strategy that consists of the following components:
  - Attempting to immediately sell blocks of inventory to the Foreign Debtors’ former customers. These blocks of inventory are likely to involve only those parts that are expected to be consumed over the next three years.
  - Removing from former customers’ facilities all inventory that they do not purchase and has a realizable value in excess of its removal and holding costs (the “Uplifted Inventory”), with the inventory being uplifted to a few warehouses around the world. These warehouses would be either leased by the Foreign Representatives, or operated by third party providers for the account of the Foreign Representatives.
  - Selling the Uplifted Inventory over an approximate three year time frame.
  - The Foreign Representatives are currently in discussions with many of the Foreign Debtors’ former customers to determine if they wish to buy certain of the Foreign Debtors’ inventory, in which case the sale terms will be negotiated. To the extent the customers do not acquire all of the inventory, material uplift arrangements will be negotiated.

## **Canadian Customers and Uplift Plan**

39. Aero UK's Canadian customers consist of Air Canada and Aveos. The estimated quantity and value of Aero UK's inventory located at these customer's Canadian facilities as at November 11, 2009 totalled approximately 8.9 million parts and \$88.3 million (using the average inventory price per Aveos' inventory record keeping system, which will differ from Aero UK's book value), respectively.
40. The Information Officer and Aero Canada personnel have been holding meetings and ongoing discussions with Aveos, on a without prejudice basis, to assist the Foreign Representatives, in its development of a financial model to estimate the cost to remove the Aero UK owned inventory located at Aveos and Air Canada facilities in Canada and match such inventory to the related certification documents (the "Inventory Uplift Plan"). It was initially anticipated that the cost for Aveos personnel to perform the Inventory Uplift Plan would be significantly greater compared to Aero Canada personnel performing same, however, the Information Officer and the Foreign Representatives are working with Aveos in an attempt to develop a mutually agreeable arrangement.
41. Aveos has advised that prior to the removal of any Aero UK owned inventory from its premises pursuant to an Inventory Uplift Plan, it will require that "Aero UK prove that it is the true owner of the material either providing (i) a final unappealable order of a Canadian Court confirming Aero UK's title to such part, or (ii) a formal written confirmation from Air Canada confirming that it has no ownership claim to such part and that it waives any claim and/or damage against Aveos for providing such part to Aero UK".
42. Aero Canada management has been working on a detailed analysis of Aero UK's inventory quantities, balances, and consumption since October 1, 2009 in order to determine what was Aero UK owned inventory and what consumption should be invoiced to Air Canada and Aveos. This analysis has been complicated by the volume of transactions involved, certain bulk sales transactions entered into by Aero UK and Air Canada on October 23, 2009, and the difficulty with Aero UK's own inventory records. Aero Canada management believes it has successfully analyzed Aero UK's inventory up to January 31, 2010, such that it is able to provide a definitive list of Aero UK owned inventory up to January 31, 2010, and is close to completing its analysis of the consumption of Aveos and Air Canada during the period October 1, 2009 to January 31, 2010, including the impact of certain bulk sales transactions with Air Canada. Invoices for this

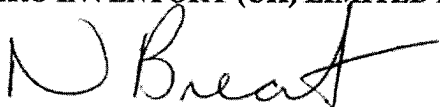
period will then be prepared. Aero Canada personnel continue to work on extending the analysis beyond January 31, 2010.

43. The Foreign Representatives and the Information Officer are also in discussions with Aveos regarding the terms, including pricing, associated with the Aero UK inventory consumed by Aveos after November 10, 2009.

KPMG Inc. has filed this Report to provide an update to the Court and in doing so understands the role of an officer of the Court and its obligation to act impartially and objectively.

All of which is respectfully submitted this 30<sup>th</sup> day of June, 2010.

**KPMG INC.  
INFORMATION OFFICER AND  
TRUSTEE OF THE ESTATES OF  
AERO INVENTORY (UK) LIMITED AND AERO INVENTORY PLC**

A handwritten signature in black ink, appearing to read "N Brearton". The signature is written in a cursive style with a large initial "N" and a long horizontal stroke extending to the right.

Per: Nicholas Brearton  
*Senior Vice President*

In the matter of the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended

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And in the matter of Aero Inventory (UK) Limited and Aero Inventory Plc

Application under Sections 46 and following of the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended - and -

In the matter of the Bankruptcy of Aero Inventory (UK) Limited - and - KPMG Inc. - and -  
In the Matter of the Bankruptcy of Aero Inventory Plc and KPMG Inc.

**ONTARIO  
SUPERIOR COURT OF JUSTICE  
COMMERCIAL LIST**

Proceeding commenced at Toronto

**Report of KPMG Inc.,  
in its capacity as Information Officer and  
as Trustee in Bankruptcy**

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