

**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 KPMG INC., IN ITS CAPACITY AS TRUSTEE
IN BANKRUPTCY OF AERO INVENTORY (UK) LIMITED AND AERO INVENTORY
PLC (THE "TRUSTEE")**

(MOTION RETURNABLE JANUARY 6, 2011)

December 30, 2010

Ogilvy Renault LLP
Suite 3800
Royal Bank Plaza, South Tower
200 Bay Street, P.O. Box 84
Toronto, Ontario M5J 2Z4

Orestes Pasparakis LSUC#: 36851T
Tel: (416) 216-4815
Evan Cobb LSUC#: 55787N
Tel: (416) 216-1929
Vasuda Sinha LSUC# 55005B
Tel: (416) 216-3921
Fax: (416) 216-3930

Lawyers for the Trustee

**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 TRUSTEE

PART I - OVERVIEW

1. The central issue before the Court is a question of law: are the proceeds of a preference action under section 95 of the *Bankruptcy and Insolvency Act* (the "BIA") subject to the rights of secured creditors?
2. The Trustee has brought a motion to have certain transactions (the "**October Transactions**") between Aero Inventory (UK) Limited ("**Aero**") and Air Canada declared void pursuant to section 95 of the BIA. In connection with its preference motion, the Trustee seeks the return of value in the amount of US \$75 million from Air Canada (the "**Preference Proceeds**").

3. In the Trustee's view, the Preference Proceeds, once recovered, would be subject to the rights of Aero's secured creditors. Air Canada argues that the proceeds of a preference action benefit only a bankrupt's unsecured creditors.

4. From the outset, the Trustee advised all stakeholders that it would seek directions with respect to the priority of the Preference Proceeds from the Court prior to any distributions. The parties have now agreed to resolve this question as a preliminary matter.

PART II - THE FACTS

5. In its factum, Air Canada has provided an account of the events leading up to the October Transactions. Given that the issue now before the Court is a question of law, the Trustee will not respond on this motion to Air Canada's detailed allegations relating to the October Transactions.

(a) The Proceedings to Date

6. On November 11, 2009, Aero and Aero Inventory plc (collectively the "Aero Companies") filed for protection from their creditors in England. Aero reported that its secured creditors would face a shortfall of approximately £150 million while Aero's unsecured creditors, who were owed approximately £60 million, would likely receive virtually nothing at all.

7. On the same day, this Court recognized the appointment of the Applicants as foreign representatives of the Aero Companies (the "Foreign Representatives") under Part IV of the *Companies' Creditors Arrangement Act* ("CCAA").

8. Following the November 11, 2009 filings, the Foreign Representatives met with Air Canada and discussed, *inter alia*, the October Transactions. During this period, a concern arose that the October Transaction might constitute an unlawful preference.

Report of the Proposed Trustee in Bankruptcy dated January 19, 2010.
Responding Record of the Trustee ("**Responding Record**"), Tab 1.

9. On January 4, 2010, pursuant to 49(4)(b) of Schedule B1 to the UK *Insolvency Act, 1986*, the Foreign Representatives prepared and sent Form 2.17B to all of the Aero Companies' more than 650 worldwide creditors, advising that the secured creditors will suffer significant shortfall

and there will be no funds available for distribution to unsecured creditors with the exception of UK statutory priority claims.

Report of the Information Officer and Trustee in Bankruptcy dated February 4, 2010, Responding Record, Tab 4.

10. In January 2010, the Foreign Representatives brought a motion to assign the Aero Companies into bankruptcy expressly “for the purpose of pursuing a preference action under Section 95(1) or 96(1) of that Act.”

Notice of Motion dated January 19, 2010, Responding Record, Tab 2.

11. On January 22, 2010, over the objection of Air Canada, an order was granted allowing the assignment of the Aero Companies into bankruptcy and authorizing KPMG Inc. to act as trustee in bankruptcy over the Aero Companies.

Endorsement dated February 24, 2010, Responding Record, Tab 3.

12. On February 4, 2010, the Trustee filed a motion seeking to dispense with certain obligations of the Trustee under the BIA. In its report, the Trustee made clear that, among other things:

3. The express purpose of the proposed bankruptcy filing was to preserve the rights of the trustee in bankruptcy to pursue any reviewable transactions, settlements and preferences or conveyances under value which may have taken place during the statutory time period prescribed by the BIA.

...

9. The assets of the Foreign Debtors are subject to a security interest in favour of a lending syndicate. At this time, it appears that the secured lenders will suffer a significant shortfall.

...

11. The Trustee’s role is expected to be limited, given the existence of creditors with security over the property and undertakings of the Foreign Debtors and the expectation that such security will extend to any funds generated from an action under section 95 or 96 of the BIA.

Report of the Information Officer and Trustee in Bankruptcy dated February 4, 2010, Responding Record, Tab 4.

13. This Court granted the order sought by the Trustee (the “February 10 Order”). Air Canada did not oppose the relief sought.

Order dated February 10, 2010, Responding Record, Tab 5.

14. In the February 10 Order, the Court further directed the Trustee to send a notice to all known creditors of the Aero Companies (the “Trustee’s Notice”). The Trustee’s Notice, which was also served upon the Superintendent in Bankruptcy, advised that:

- (a) the secured Creditors of the Aero Companies will suffer a significant shortfall and there will be no funds available for general distribution to unsecured creditors;
- (b) the purpose of the bankruptcy in Canada was to preserve the rights of the Trustee to pursue any preference action or similar transaction;
- (c) the security of the secured creditors was being reviewed and a legal opinion on it was being sought; and
- (d) future information relating to the proceedings would be provided on the Trustee’s website.

Order dated February 10, 2010 at para. 4, Responding Record, Tab 5
Affidavit of Service of Mansoor Khalifa sworn January 19, 2010, Responding Record, Tab 6.

15. On April 27, 2010, the Trustee served its motion materials seeking a declaration that the October Transactions between Air Canada and Aero constitute a preference within the meaning of Section 95(1) of the BIA.

Notice of Motion dated April 27, 2010, Responding Record, Tab 7.

16. On June 30, 2010, the Trustee filed a report with the Court, which included the opinions from independent counsel on the validity and enforceability of the security held by the syndicate of secured lenders (the “Lenders”) over Aero’s assets. Copies of the opinions were posted on the Trustee’s website in accordance with the Trustee’s Notice.

Report of KPMG Inc. in its capacities as Information Officer and as Trustee in Bankruptcy dated June 30, 2010 at para. 22, Responding Record, Tab 8.

(b) The Lenders

17. Aero financed its business with a US \$500 million revolving facility which it obtained from the Lenders led by Lloyds TSB Commercial Finance Ltd. The Lenders have a general security interest over the assets of the Aero Companies worldwide, including, in particular, over Aero's assets in Canada. This is confirmed by independent legal opinions obtained by the Trustee.

Appendix D, Report of KPMG Inc., in its capacities as Information Officer and as Trustee in Bankruptcy dated June 30, 2010, Responding Record, Tab 9.

18. Specifically, the Lenders hold:

- (a) a general security interest and fixed mortgage over all of the personal property of Aero in Canada, which has been duly registered; and
- (b) a Deed of Hypothec also duly registered in the Province of Quebec.

Exhibits "A" and "B", Affidavit of Ron Podolny sworn December 9, 2010, Tabs A and B.

PART III - ISSUES TO BE DETERMINED

19. This Court is being asked to determine, as a preliminary question, the entitlement to the Preference Proceeds. Specifically, the legal question to be decided is whether secured creditors are entitled to assert priority over the proceeds of a preference action.

20. In its factum, Air Canada also raises certain ancillary issues relating to:

- (a) the appropriate role of the trustee;
- (b) the availability of a BIA preference claim within the context of a CCAA proceeding; and
- (c) the February 10 Order relieving the Trustee from complying with certain obligations under the BIA.

PART IV - THE LAW

(a) Proceeds of a Preference Action

21. On several occasions, Canadian courts have had to consider whether a secured creditor has the right to assert its priority claim over the proceeds of a preference action. The body of jurisprudence appears unclear, inconsistent and conflicting.

22. The Trustee has attempted to put before this Court all of the Canadian jurisprudence on point and to present a coherent analysis of the case law.

23. In the Trustee's opinion, the jurisprudence and policy considerations underlying the BIA lead to the conclusion that the Preference Proceeds should be paid over to the Lenders by the Trustee.

(i) The Jurisprudence

24. The appropriate starting point of an analysis of the Canadian jurisprudence is, in fact, the English decision of *In Re Yagerphone Limited*. *Re Yagerphone* has been cited by some Canadian courts to stand for the proposition that secured creditors have no claim to the proceeds of a preference action. However, read properly, the holding in *Re Yagerphone* is in fact narrower.

In Re Yagerphone Limited, [1935] Ch. 392 [*Re Yagerphone*], Air Canada's Authorities, Tab 11.

25. In *Re Yagerphone*, the Court considered a priority dispute between a liquidator and a debentureholder over the proceeds of a preference action. In reaching its conclusion, the Court focussed on the nature of the debentureholder's security. The Court observed that at the time the preference was given, the debentureholder's charge was still floating and therefore had not attached to the assets of Yagerphone. As the Court reasoned:

On January 17, 1933, the creditor to whom the money was paid and from whom the money was recovered was a creditor of Yagerphone, Ld. When Yagerphone, Ld. paid to the creditor the 240*l.* 11*s.* 2*d.*, that sum, in my judgment, ceased to be the property of Yagerphone, Ld. The payment to that creditor could not have been attacked or impeached, unless within three months from the date of payment the liquidation of Yagerphone, Ld., had begun,

and, in my judgment, at the date when the security contained in the debenture crystallised, the sum of 240l. 11s. 2d. was not the property of Yagerphone, Ltd...

Re Yagerphone, supra at 395-396, Air Canada's Authorities at Tab 11 [emphasis added].

26. In other words, at the time the preference was given by the debtor, the assets transferred were not subject to the debentureholder's security. When the debentureholder's security was crystallized, the debtor's estate did not extend to the assets that had already been transferred on account of the preference. On this basis, the Court found that the debentureholder's security did not attach to those assets when they were eventually returned to the estate.

27. From a policy perspective, the holding in *Re Yagerphone* is not unreasonable. When the assets were transferred out of the hands of the debtor, the "fraud" was perpetrated against all the creditors of the debtor since no single creditor held any greater claim to the assets transferred. In particular, because the debentureholder's security was floating it had no claim to the assets. When these assets were brought back into the estate, the Court's decision that all creditors share rateably is consistent with the fact that the "fraud" occurred against all of the debtor's creditors.

28. In *Mohawk Sports Equipment*, Justice Houlden applied the holding in *Re Yagerphone* in analogous circumstances which involved a floating charge that had not crystallized. The Court held that the proceeds "cannot be claimed by the debenture holder as it was not part of the property of the debtor company at the time the security crystallized."

Mohawk Sports Equipment, [1972] O.J. No. 707 at para. 16, 17 C.B.R. (N.S.) 115 (H.C.J.), Brief of Authorities of KPMG Inc. ("Trustee's Authorities") at Tab 1. See also *Re Quebec Trucks & Trailers Inc.* (1967), 11 C.B.R. (N.S.) 115 (S.C.), Trustee's Authorities at Tab 2.

29. In subsequent cases, however, the holding in *Re Yagerphone* has been summarized more broadly to apply to secured creditors generally.¹ In *Re Maybank Foods Inc.*, the Court stated:

¹ In *J.K. Campbell & Associates Ltd.*, [1989] A.J. No. 464 [*J.K. Campbell*] (Q.B.), the Court distinguished *Re Yagerphone* and determined that the floating debenture held by TD Bank did attach to the assets and that the secured creditor had first right to the proceeds of the proposed preference action. Trustee's Authorities at Tab 3.

It is conceded by the respondent that the moneys recoverable by a trustee from a creditor who has been preferred do not become part of the general assets of the bankrupt estate subject to the claims of secured creditors, but rather are received by the trustee subject to a trust in favour of the creditors represented by the trustee: *Re Yagerphone, Ltd.*, [1935] 1 Ch. 392 (Ch. D.)

Maybank Foods Inc. (Re), [1990] O.J. No. 3262 [*Maybank Foods*] at para. 2 (H.C.J.), *Air Canada's Authorities* at Tab 13.

30. In the Trustee's submission, the concession made in *Maybank Foods* goes beyond the *ratio* in *Re Yagerphone*. The reasoning in *Re Yagerphone* does not necessarily follow in circumstances in which a secured creditor holds a fixed charge over the assets of the debtor.²

31. Where the secured creditor holds a fixed charge, the policy considerations are very different. Unlike a floating charge, a fixed charge gives the secured creditor a property interest in the debtor's collateral that attaches at the time the charge is granted. As the Supreme Court of Canada recently reaffirmed:

The critical significance of the characterization of an interest as being fixed or floating, of course, is that it describes the extent to which a creditor can be said to have a proprietary interest in the collateral. In particular, during the period in which a charge over inventory is floating, the creditor possesses no legal title to that collateral. ... However, if a security interest can be characterized as a fixed and specific charge, it will take priority over a subsequent statutory lien or charge; in such a case, all that the lien can attach to is the debtor's equity of redemption in the collateral....

Bank of Montreal v. Innovation Credit Union, 2010 SCC 47 at para. 46, *Trustee's Authorities* at Tab 5.

32. Thus, where a secured creditor has a fixed charge, the giving of a preference by the debtor is a "fraud" on the secured creditor's proprietary interest in the debtor's collateral. When

² At the time of the October Transactions, the Lenders held by virtue of their security a fixed charge over all of the assets of the Aero Companies. *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] S.C.J. No. 25, at paras. 55 and 56, *Trustee's Authorities* at Tab 4.

the property is returned to the estate, it follows that the asset should go back into the hands from which it was taken – the hands of the secured creditor.³

33. There is very little case law to support the general proposition that secured creditors do not have a claim to the proceeds of a preference action. Air Canada relies on⁴ the 1998 decision of *S-Marque Inc. v. Homburg Industries Ltd.* in which the Nova Scotia Supreme Court found that the proceeds of a preference action would enure to the benefit of the unsecured creditors for two reasons:

- (a) first, the Court relied on the decision in *Re Yagerphone*; and
- (b) second, the Court cited a number of decisions to the effect that only a trustee can void a preference action.⁵

³ There is also authority for this principle in English law. In commenting on a series of English cases in which preference claims are said to be for the benefit of unsecured creditors, Roy Goode states: “All these cases assume that what is recovered by the liquidator either was never the property of the chargee or ceased to be so prior to the winding up as the result of the fact that the transfer in question overrode the charge. In such a case the chargee is not entitled to use the avoidance provisions to recover what he had lost or had never had. Where however, the charge was not overridden by the transfer and the property transferred is recovered, the charge continues to attach to the recovered property.” *Principles of Corporate Insolvency Law*, 3rd ed. (London: Sweet & Maxwell, 2005) at s. 11-140, Trustee’s Authorities at Tab 19. Similarly, *Halsbury’s Laws of England*, v. 7(4) (2004) on this issue states at para. 847 n 4: “Recoveries from successful proceedings under s239 enure for the benefit of the general unsecured creditors and not a charge....The position may be different where specific property which was formerly subject to the charge is recovered through the proceedings”. Trustee’s Authorities at Tab 20. The Australian case of *NA Kratzmann Pty Ltd v Tucker* (No 2) (1968) 123 CLR 295, which provides *obiter* comments on 19th century English cases on this issue is also instructive. It states at paragraph 6: “if specific property, to which a charge, validly created by the bankrupt prior to his bankruptcy, has attached prior to the time of its disposition, is subsequently recovered as a preference the trustee’s title will be no higher or better than that of the bankrupt to which he has succeeded.” Trustee’s Authorities at Tab 6.

⁴ Air Canada also cites two English cases: In *Re M.C. Bacon Ltd.* (1990), [1991] Ch. D. 127 at 137 the Court is again dealing with a floating charge. In its factum, Air Canada quotes the ratio of the Court “... any sum recovered from a creditor who has been wrongly preferred enures for the benefit of the general body of creditors, not for the benefit of the company or the holder of the floating charge.” [emphasis added]. Air Canada’s Authorities at Tab 16. In *Re Oasis Merchandising Services Ltd.*, [1997] 2 W.L.R. 764 (C.A.) the Court’s analysis stems from a careful reading of the U.K. statutory regime for personal bankruptcies versus corporate bankruptcies and the interplay of various definitions and applicable provisions. Air Canada’s Authorities at Tab 15, p. 772-773.

⁵ In particular, at paragraph 144, the Court cites the Supreme Court of Canada’s decision in *Royal Bank of Canada v. North American Life Assurance*, [1996] S.C.J. No. 17 as follows: “If a settlement is declared void against the trustee, then the settled property reverts back to the bankrupt’s estate, and falls into the possession of the trustee in bankruptcy.” This does not appear to answer the priority question. However, later in the Supreme Court’s decision, at paragraph 49, is a passage that is instructive and that is not noted

S-Marque Inc. v. Homburg Industries Ltd., [1998] N.S.J. No. 550 at paras. 142-147 (S.C.) [*S-Marque*], Air Canada's Authorities at Tab 17.

34. The decision was affirmed on appeal but the Court of Appeal decided the priority issue "for different reasons". The Court of Appeal focused on the fact that the secured creditor held a floating charge and that the preference occurred "before the debenture crystallized". As in *Mohawk Sports Equipment*, the Court determined the matter on the basis that the secured creditor "never had a fixed charge on these assets when the Debenture crystallized".

S-Marque Inc. v. Homburg Industries Ltd., [1999] N.S.J. No. 94 at paras. 76, 82, 90 (C.A.), Air Canada's Authorities at Tab 18

35. The fact that only the trustee can bring a preference action (as noted by the Court of first instance in *S-Marque*) does not necessarily mean that secured creditors have no claim to the proceeds. That is a leap in logic. While section 95 of the BIA empowers the trustee to recover a preference, it does not speak to the priority of any claims to those proceeds.

36. In 2000, the British Columbia Supreme Court considered the priority rights of secured creditors to proceeds from a preference action in *Re ASI Acoustical Supplies Inc.* In that case, the Court squarely addressed the fact that only a trustee can make a claim for a fraudulent preference under the BIA. The Court noted that while the BIA gave that right to the trustee, it did not change the priority rights of creditors to the proceeds:

In any event the fact that only a Trustee can make a claim alleging a fraudulent preference does not change the priority position of a secured creditor.

ASI Acoustical Supplies Inc. (Re), 2000 BCSC 1838 [*Re ASI Acoustical*] at para. 20, Trustee's Authorities at Tab 8. See also *J.K. Campbell, supra*.

37. The conclusion of the Court in *Re ASI Acoustical* is consistent with a long line of jurisprudence that holds that monies recovered by the trustee are subject to the rights of secured

by the court in *S-Marque*: "Where a settlement is void against the trustee under s. 91, then in normal circumstances, the trustee is empowered to administer the settled asset, and use it to satisfy the claims of creditors." (para. 49) Thus, like all assets, proceeds of a preference are to be used to satisfy the claims against the estate. They do not simply go into a newly found "common pool." Trustee's Authorities at Tab 7.

creditors. In *Agricultural Credit Corp. of Saskatchewan v. Featherstone*, the Saskatchewan Court noted:

Monies owing to a bankrupt, when collected by the trustee continue to be the property of the bankrupt and continue to be subject to the existing security interests. This includes monies realized through the efforts of the trustee. (*Holy Rosary Parish (Thorold) Credit Union Limited v. The Premier Trust Company*, 1965, S.C.R. 503; *Re Stadnick (Bankrupt)* (1991), 90 Sask. R. 12 (Q.B.); *Re Moore (Bankrupt)* (1989), 79 Sask. R. 63 (C.A.))

Agricultural Credit Corp. of Saskatchewan v. Featherstone (Trustee of), [1996] S.J. No. 319 at para. 31 (Q.B.), Trustee's Authorities at Tab 9; *Moore (Trustee Of) v. Regina (City) (Sask. C.A.)*, [1989] S.J. No. 509 (C.A.), Trustee's Authorities at Tab 10.

38. The holding in *Re ASI Acoustical* is also consistent with the structure of the BIA. The preference provisions are contained within Part IV of the BIA dealing with "Property of the Bankrupt" and are used to marshal the property of the bankrupt vesting in the trustee pursuant to sections 67 and 71 of the BIA. In terms of the statutory mechanics:

- (a) per section 95, a preference is "void". As a result of the transaction being "void", the subject-matter of the preference is returned to the estate; and
- (b) per sections 67 and 71, the property vests in the trustee.

BIA, supra ss. 67, 71 and 95

39. Section 71 of the BIA specifically provides that the trustee takes the bankrupt's property subject to the rights of secured creditors:

On a bankruptcy order being made or an assignment being filed with an official receiver, a bankrupt ceases to have any capacity to dispose of or otherwise deal with their property, which shall, subject to this Act and the rights of secured creditors, immediately pass to and vest in the trustee named in the bankruptcy order or assignment...

BIA, supra s. 71 [emphasis added].

40. This approach is also consistent with the principle of *nemo dat non habet*, which requires that the trustee take the collateral subject to the equities, including any security that was attached

to it. The Supreme Court of Canada has repeatedly held that a trustee cannot obtain a greater interest to the goods than was held by the bankrupt.

Giffen (Re), [1998] S.C.J. No. 11 at para. 50, Trustee's Authorities at Tab 11;
Lefebvre (Trustee of), 2004 SCC 63 at para. 37, Trustee's Authorities at Tab 12.

41. Similarly, the distributions of the bankrupt's estate pursuant to section 136 of the BIA are prefaced with the proviso: "subject to the rights of secured creditors".

BIA, supra s. 136.

42. The British Columbia Court of Appeal's decision in *Re Thorne, Ernst & Whinney Inc. and Gazzola et al.* explained the interplay of the preference provisions and priority distributions. In that case, the Court observed that the preference provisions assist the trustee in its obligation to marshal the assets of the estate – which are then distributed pursuant to section 136(1):

Under the *Bankruptcy Act* the trustee is charged with gathering the assets of the bankrupt for the benefit of creditors and then distributing those assets pursuant to the scheme of distribution set out in s. 136 of the Act. Section 95 is in that part of the Act that deals with schemes and preferences. Pursuant to s. 95 the trustee is entitled to consider any transaction involving a creditor of the bankrupt and if that transaction occurred within three months prior to the bankruptcy, the trustee can take steps to seek to establish that the transaction be deemed fraudulent and void as against the trustee.

Re Thorne, Ernst & Whinney Inc. and Gazzola et al. (1989), 60 D.L.R. (4th) 590 [*Gazzola*] at 593-594 (C.A.), Trustee's Authorities at Tab 13.

43. The Court then went on to consider how the proceeds of a preference action against a landlord would be distributed:

In such event, the trustee may bring an application under s. 95 and if he is successful the landlord will be required to pay over the proceeds of the transaction to the trustee. In due course, depending on the claims of secured creditors and those standing in priority to the landlord under the scheme of distribution established by s. 136 of the Act, if there are sufficient assets in the estate the landlord will then receive payment pursuant to the provisions of that section.

Gazzola, supra at 594 [emphasis added].

44. In a similar case involving a preference action against a landlord, the Ontario Court of Appeal considered and followed the *Gazzola* case. Citing the concurring reasons in *Gazzola*, the Court noted that the preference proceeds are to be distributed in accordance with the scheme in section 136, which is subject to the rights of secured creditors:

However, Locke J.A. is undoubtedly correct in stating that one must answer the question of whether there are any other persons entitled to priority over the landlord under s. 136, and whether there are sufficient funds in the estate to pay prior claims before the landlord may retain the funds.

Canadian Imperial Bank of Commerce v. Canotek Development Corp., [1997] O.J. No. 3735 at para. 25 (C.A.), *Air Canada's Authorities* at Tab 14.

(ii) **Policy Considerations under the BIA**

45. Moreover, the proposition that unsecured creditors have priority to the proceeds of a preference action may lead to anomalous results. An insolvent person could defeat the rights of a secured creditor by simply granting a preference immediately prior to assigning itself into bankruptcy. Once the preference is reversed, the proceeds would benefit unsecured creditors. It cannot be correct that by dealing with collateral in a preferential fashion, an insolvent person can alter bankruptcy priorities and nullify a secured creditor's exclusive claim to that collateral.

46. As a commercial statute, the BIA needs to be interpreted in a manner that makes business sense.

Port Alice Specialty Cellulose Inc. (Trustee of) v. ConocoPhillips Co., 2005 BCCA 299 at para. 27, *Trustee's Authorities* at Tab 14.

47. This policy concern was raised in *Anron Mechanical Ltd. v. L'Abbe Construction* in the context of a priority dispute between a trustee and a construction lien claimant. The Court observed that the trustee must respect the priorities:

If this were not so, a general contractor could then easily divert monies, defeat the rights of the unpaid subcontractors and thwart the whole purpose of the trust section of the Construction Lien Act. If he cannot divert the monies lawfully, as by assignment, then surely he cannot do so unlawfully, as by a fraudulent preference.

Anron Mechanical Ltd. v. L'Abbe Construction, [1991] O.J. No. 399 at 4 (Gen. Div.), Air Canada's Authorities at Tab 12.

48. This leads to a final observation: the argument that secured creditors have no claim to the proceeds of a preference action is based on the notion that all creditors ought to share equally in the trustee's recovery. Air Canada cites section 141 of the BIA and case law affirming the principle that all creditors ought to be treated rateably.

49. However, the general principle found in Section 141 of the BIA is expressly subject to the other provisions of the act:

Subject to this Act, all claims proved in a bankruptcy shall be paid rateably.

BIA, supra, s. 141 [emphasis added]; see also *Hudson v. Benallack*, [1976] 2 S.C.R. 168, Air Canada's Authorities at Tab 9.

50. Notably, section 136 sets out a distribution scheme which provides priority to secured creditors and preferred creditors. In particular, secured creditors are permitted to realize on their security ahead of any distributions to unsecured creditors and as if there were no bankruptcy.

Husky Oil Operations Ltd. v. Minister of National Revenue, [1995] S.C.J. No. 77 at para. 18, Air Canada's Authorities at Tab 7.

51. It follows that Air Canada's premise in its factum that section 95 of the BIA ensures "equal treatment of unsecured creditors" is fundamentally incorrect.

Factum of Air Canada dated December 10, 2010 at p. 18

52. By any account, unsecured creditors do not "share" in the proceeds of a preference action. Those proceeds are distributed pursuant to the hierarchy established in section 136 of the BIA. Thus, preferred creditors retain priority over simple unsecured creditors. It is incongruous to suggest that the priority of preferred creditors in section 136 is preserved but the priority given to secured creditors in the opening words of section 136 is lost.

BIA, supra s. 136.

53. A proper reading of the legislations indicates that the priority under the BIA ought to be respected.⁶

(b) Ancillary Issues

(i) The Role of the Trustee

54. Air Canada's case for returning the proceeds of a preference to the unsecured creditors appears also to be based on the idea that the trustee must act for the unsecured creditors. This is not necessarily the case.

55. Section 13.4 of the BIA explicitly contemplates that a trustee may act for or assist a secured creditor in certain circumstances. The header to Section 13.4 of the BIA reads: "Trustee May Act for Secured Creditor".

Ruth Sullivan, *Sullivan on the Construction of Statutes*, 5th ed., (Markham: Butterworths, 2008) at 392-397, *Trustee's Authorities* at Tab 21

56. Sections 13.4(1) and (1.1) of the BIA set out the circumstances in which a trustee can act for a secured creditor. Section 13.4(1) provides:

(1) No trustee may, while acting as the trustee of an estate, act for or assist a secured creditor to assert a claim against the estate or to realize or otherwise deal with a security that the secured creditor holds, unless the trustee has obtained a written opinion from independent legal counsel that the security is valid and enforceable against the estate.

Such opinions were obtained and contained in the Trustee's June 30th Report.

BIA, supra s. 13.4(1) [emphasis added].

57. Section 13.4(1.1) provides:

⁶ It should further be recognized that *Re Yagerphone* is not an exception to this rule since a creditor with a floating charge has no interest in the debtor's property prior to the crystallization of the charge. However, while not the issue directly before the Court, see *J.K. Campbell, supra*.

(1.1) Forthwith on commencing to act for or assist a secured creditor of the estate in the manner set out in subsection (1), a trustee shall notify the Superintendent and the creditors or the inspectors

- (a) that the trustee is acting for the secured creditor;
- (b) of the basis of any remuneration from the secured creditor; and
- (c) of the opinion referred to in subsection (1).

BIA, supra s. 13.4(1.1). See also *Dynatek Automation Systems Inc. (Re)*, [1998] O.J. No. 2097 (Ont. Gen. Div.), Trustee's Authorities at Tab 15; *Pratchler Agro Services Inc. v. Cargill Ltd.* (1999), 11 C.B.R. (4th) 104, Air Canada's Authorities at Tab 1.

58. Pursuant to the February 10 Order and the Trustee's Notice approved by the Court, the Trustee notified the creditors and the Superintendent of Bankruptcy before any action was taken on behalf of the Lenders. The Trustee's Notice explained that further notice would be given on the Trustee's website.

59. Since that time, the public notice has included:

- (a) notice that the Trustee obtained an independent security opinion, the contents of which were posted; and
- (b) notice that the Trustee was bringing a preference action and that it expected the proceeds to go to the Lenders.

60. No notice has been provided regarding "remuneration from the secured creditor" since the Trustee is receiving no remuneration from any secured creditors. The Trustee is being paid by the Foreign Representatives who have been funded to date by monies in the estate.

(ii) Concurrent CCAA and BIA Proceedings

61. In paragraphs 51 to 52 of its factum, Air Canada seems to argue that this Court does not have jurisdiction to allow a trustee to pursue a BIA preference action within the context of a CCAA proceeding. Air Canada does not directly address the fact that this proceeding is under Part IV of the CCAA.

62. In any event, these issues have been canvassed by this Court already. In its February 24, 2010 endorsement, this Court held:

29. Counsel to Air Canada also raised the question as to how a bankruptcy is consistent with the Part IV application. It seems to me that Part IV contemplates the possibility of concurrent proceedings involving the BIA. Further, the possibility of concurrent BIA proceedings was contemplated by the parties as it is reflected in the orders of both Newbould J. and Cumming J.

30. In the circumstances of this case, the use of the BIA in concurrent proceedings to Part IV is consistent with Canadian public policy. The proposed actions of the UK Court Administrators in seeking to invoke Canadian bankruptcy proceedings to take advantage of Canadian preference provisions are for the purpose of maximizing the Debtors' Companies' assets. The proposed actions of the UK Administrators are consistent with what a creditor representative would undertake in Canada.

31. If counsel to Air Canada were to be successful in opposing the relief sought, the effect may very well be that a transaction that may be preferential in nature may escape review by a creditor representative. Such an outcome would be inconsistent with Canadian public policy. It seems to me that, in the circumstances of this case, the foreign representative should have the ability to challenge the transaction under Canadian bankruptcy law.

32. In my view, the interpretation urged by counsel to Air Canada is unduly restrictive in the circumstances. The language of the CCAA is permissive. There is no going concern operation. The stated purpose of the assignment is to engage in a review of a potential preference transaction and the only objection is being raised by the party that is likely the subject of the review.

33. I am in agreement with all submissions made by counsel to the Foreign Representatives.

Endorsement dated February 24, 2010, p. 5, paras. 29-33, Responding Record, Tab 3.

Factum dated January 19, 2010 and Supplemental Factum dated January 21, 2010 of the Foreign Representatives, Responding Record, Tab 10.

63. Air Canada initially brought a motion for leave to appeal this decision which it subsequently abandoned. Air Canada is therefore barred from raising these allegations again.

Air Canada's Notice of Motion for Leave to Appeal dated February 12, 2010, Responding Record, Tab 11.

Order of the Ontario Court of Appeal dated September 2, 2010, Responding

Record, Tab 12.

EnerNorth Industries Inc. (Re), 2009 ONCA 536 at para. 53, Trustee's Authorities at Tab 16.

64. The Court's order coordinating CCAA and BIA proceedings was correct in any case. As recently noted by the Supreme Court of Canada regarding section 20 of the CCAA:

That section provides that the CCAA "may be applied together with the provisions of any Act of Parliament . . . that authorizes or makes provision for the sanction of compromises or arrangements between a company and its shareholders or any class of them", such as the BIA. Section 20 clearly indicates the intention of Parliament for the CCAA to operate in tandem with other insolvency legislation, such as the BIA.

Century Services Inc. v. Canada (Attorney General), 2010 SCC 60 at para. 76 [emphasis added], Trustee's Authorities at Tab 17.

(iii) The February 10 Order

65. Air Canada suggests that if it is correct and the Preference Proceeds will in fact benefit the unsecured creditors, the provisions of the February 10 Order ought to be revisited.

66. The Trustee proposes to address these submissions in the event that this Court determines that the Preference Proceeds will benefit the unsecured creditors. It may be that certain provisions of the February 10 Order are nonetheless appropriate:

- (a) given that the proceedings are brought under Part IV of the CCAA; and
- (b) to avoid unnecessary duplication.

The Trustee believes that these issues can be dealt with expeditiously as the need arises.

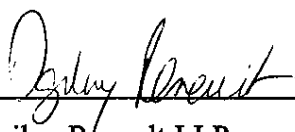
PART V - CONCLUSION

67. The Trustee is cognizant of its obligations as a court officer. It has attempted to present the issues to the Court in a manner that is even-handed and fair. It seeks to gather in and realize on the assets of the bankrupt and to distribute the proceeds in accordance with the scheme of the BIA.

See *Beetown Honey Products Inc., Re* (2003), 46 C.B.R. (4th) 195 (Ont. S.C.J.) at para. 22, aff'd (2004), 3 C.B.R. (5th) 204 (Ont. C.A.), citing *P.E.I. v. Bank of Nova Scotia* (1988), 70 C.B.R. (N.S.) 209. *Air Canada's Authorities* at Tabs 2, 5.

68. In the Trustee's view, there has been a preference and, for the reasons herein, any recoveries are subject to the rights of the secured creditors. The Trustee asks that a date be set for the hearing of the motion on the preference as soon as possible.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 30th day of December, 2010.



Ogilvy Renault LLP

SCHEDULE “A”

LIST OF AUTHORITIES

Cases

1. *Mohawk Sports Equipment*, [1972] O.J. No. 707 (H.C.J.)
2. *Re Quebec Trucks & Trailers Inc.* (1967), 11 C.B.R. (N.S.) 115 (S.C.)
3. *J.K. Campbell & Associates Ltd.*, [1989] A.J. No. 464 (Q.B.)
4. *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] S.C.J. No. 25
5. *Bank of Montreal v. Innovation Credit Union*, 2010 SCC 47
6. *NA Kratzmann Pty Ltd v Tucker* (No 2) (1968) 123 CLR 295
7. *Royal Bank of Canada v. North American Life Assurance*, [1996] S.C.J. No. 17
8. *ASI Acoustical Supplies Inc. (Re)*, 2000 BCSC 1838
9. *Agricultural Credit Corp. of Saskatchewan v. Featherstone (Trustee of)*, [1996] S.J. No. 319 (Q.B.)
10. *Moore (Trustee Of) v. Regina (City) (Sask. C.A.)*, [1989] S.J. No. 509 (C.A.)
11. *Giffen (Re)*, [1998] S.C.J. No. 11
12. *Lefebvre (Trustee of)*, 2004 SCC 63
13. *Re Thorne, Ernst & Whinney Inc. and Gazzola et al.* (1989), 60 D.L.R. (4th) 590 (C.A.)
14. *Port Alice Specialty Cellulose Inc. (Trustee of) v. ConocoPhillips Co.*, 2005 BCCA 299
15. *Dynatek Automation Systems Inc. (Re)*, [1998] O.J. No. 2097(Gen. Div.)
16. *EnerNorth Industries (Re)*, 2009 ONCA 536
17. *Century Services Inc. v. Canada (Attorney General)*, 2010 SCC 60

Commentary

1. Roy Goode, *Principles of Corporate Insolvency Law*, 3rd ed. (London: Sweet & Maxwell, 2005)
2. *Halsbury's Laws of England*, v. 7(4) (2004) at para. 847, n 4.
3. Ruth Sullivan, *Sullivan on the Construction of Statutes*, 5th ed. (Markham: Butterworths, 2008)

SCHEDULE "B"

LEGISLATION

Bankruptcy and Insolvency Act, (R.S., 1985, c. B-3)

Trustee may act for secured creditor

13.4 (1) No trustee may, while acting as the trustee of an estate, act for or assist a secured creditor to assert a claim against the estate or to realize or otherwise deal with a security that the secured creditor holds, unless the trustee has obtained a written opinion from independent legal counsel that the security is valid and enforceable against the estate.

Notification by trustee

(1.1) Forthwith on commencing to act for or assist a secured creditor of the estate in the manner set out in subsection (1), a trustee shall notify the Superintendent and the creditors or the inspectors

- (a) that the trustee is acting for the secured creditor;
- (b) of the basis of any remuneration from the secured creditor; and
- (c) of the opinion referred to in subsection (1).

Property of bankrupt

67. (1) The property of a bankrupt divisible among his creditors shall not comprise

- (a) property held by the bankrupt in trust for any other person;
- (b) any property that as against the bankrupt is exempt from execution or seizure under any laws applicable in the province within which the property is situated and within which the bankrupt resides;
 - (b.1) goods and services tax credit payments that are made in prescribed circumstances to the bankrupt and that are not property referred to in paragraph (a) or (b);
 - (b.2) prescribed payments relating to the essential needs of an individual that are made in prescribed circumstances to the bankrupt and that are not property referred to in paragraph (a) or (b); or
 - (b.3) without restricting the generality of paragraph (b), property in a registered retirement savings plan or a registered retirement income fund, as those expressions are defined in the Income Tax Act, or in any prescribed plan, other than property contributed to any such plan or fund in the 12 months before the date of bankruptcy,

but it shall comprise

(c) all property wherever situated of the bankrupt at the date of the bankruptcy or that may be acquired by or devolve on the bankrupt before their discharge, including any refund owing to the bankrupt under the Income Tax Act in respect of the calendar year — or the fiscal year of the bankrupt if it is different from the calendar year — in which the bankrupt became a bankrupt, except the portion that

(i) is not subject to the operation of this Act, or

(ii) in the case of a bankrupt who is the judgment debtor named in a garnishee summons served on Her Majesty under the Family Orders and Agreements Enforcement Assistance Act, is garnishable money that is payable to the bankrupt and is to be paid under the garnishee summons, and

(d) such powers in or over or in respect of the property as might have been exercised by the bankrupt for his own benefit.

Deemed trusts

(2) Subject to subsection (3), notwithstanding any provision in federal or provincial legislation that has the effect of deeming property to be held in trust for Her Majesty, property of a bankrupt shall not be regarded as held in trust for Her Majesty for the purpose of paragraph (1)(a) unless it would be so regarded in the absence of that statutory provision.

Exceptions

(3) Subsection (2) does not apply in respect of amounts deemed to be held in trust under subsection 227(4) or (4.1) of the Income Tax Act, subsection 23(3) or (4) of the Canada Pension Plan or subsection 86(2) or (2.1) of the Employment Insurance Act (each of which is in this subsection referred to as a “federal provision”) nor in respect of amounts deemed to be held in trust under any law of a province that creates a deemed trust the sole purpose of which is to ensure remittance to Her Majesty in right of the province of amounts deducted or withheld under a law of the province where

(a) that law of the province imposes a tax similar in nature to the tax imposed under the Income Tax Act and the amounts deducted or withheld under that law of the province are of the same nature as the amounts referred to in subsection 227(4) or (4.1) of the Income Tax Act, or

(b) the province is a “province providing a comprehensive pension plan” as defined in subsection 3(1) of the Canada Pension Plan, that law of the province establishes a “provincial pension plan” as defined in that subsection and the amounts deducted or withheld under that law of the province are of the same nature as amounts referred to in subsection 23(3) or (4) of the Canada Pension Plan,

and for the purpose of this subsection, any provision of a law of a province that creates a deemed trust is, notwithstanding any Act of Canada or of a province or any other law, deemed to have the same effect and scope against any creditor, however secured, as the corresponding federal provision.

Vesting of property in trustee

71. On a bankruptcy order being made or an assignment being filed with an official receiver, a bankrupt ceases to have any capacity to dispose of or otherwise deal with their property, which shall, subject to this Act and to the rights of secured creditors, immediately pass to and vest in the trustee named in the bankruptcy order or assignment, and in any case of change of trustee the property shall pass from trustee to trustee without any assignment or transfer.

Preferences

95. (1) A transfer of property made, a provision of services made, a charge on property made, a payment made, an obligation incurred or a judicial proceeding taken or suffered by an insolvent person

(a) in favour of a creditor who is dealing at arm's length with the insolvent person, or a person in trust for that creditor, with a view to giving that creditor a preference over another creditor is void as against — or, in Quebec, may not be set up against — the trustee if it is made, incurred, taken or suffered, as the case may be, during the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy; and

(b) in favour of a creditor who is not dealing at arm's length with the insolvent person, or a person in trust for that creditor, that has the effect of giving that creditor a preference over another creditor is void as against — or, in Quebec, may not be set up against — the trustee if it is made, incurred, taken or suffered, as the case may be, during the period beginning on the day that is 12 months before the date of the initial bankruptcy event and ending on the date of the bankruptcy.

Preference presumed

(2) If the transfer, charge, payment, obligation or judicial proceeding referred to in paragraph (1)(a) has the effect of giving the creditor a preference, it is, in the absence of evidence to the contrary, presumed to have been made, incurred, taken or suffered with a view to giving the creditor the preference — even if it was made, incurred, taken or suffered, as the case may be, under pressure — and evidence of pressure is not admissible to support the transaction.

Exception

(2.1) Subsection (2) does not apply, and the parties are deemed to be dealing with each other at arm's length, in respect of the following:

(a) a margin deposit made by a clearing member with a clearing house; or

(b) a transfer, charge or payment made in connection with financial collateral and in accordance with the provisions of an eligible financial contract.

Definitions

(3) In this section,

“clearing house” means a body that acts as an intermediary for its clearing members in effecting securities transactions;

“clearing member” means a person engaged in the business of effecting securities transactions who uses a clearing house as intermediary;

“creditor” includes a surety or guarantor for the debt due to the creditor;

“margin deposit” means a payment, deposit or transfer to a clearing house under the rules of the clearing house to assure the performance of the obligations of a clearing member in connection with security transactions, including, without limiting the generality of the foregoing, transactions respecting futures, options or other derivatives or to fulfil any of those obligations.

Priority of claims

136. (1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:

(a) in the case of a deceased bankrupt, the reasonable funeral and testamentary expenses incurred by the legal representative or, in the Province of Quebec, the successors or heirs of the deceased bankrupt;

(b) the costs of administration, in the following order,

(i) the expenses and fees of any person acting under a direction made under paragraph 14.03(1)(a),

(ii) the expenses and fees of the trustee, and

(iii) legal costs;

(c) the levy payable under section 147;

(d) the amount of any wages, salaries, commissions, compensation or disbursements referred to in sections 81.3 and 81.4 that was not paid;

(d.01) the amount equal to the difference a secured creditor would have received but for the operation of sections 81.3 and 81.4 and the amount actually received by the secured creditor;

(d.02) the amount equal to the difference a secured creditor would have received but for the operation of sections 81.5 and 81.6 and the amount actually received by the secured creditor;

(d.1) claims in respect of debts or liabilities referred to in paragraph 178(1)(b) or (c), if provable by virtue of subsection 121(4), for periodic amounts accrued in the year before the date of the bankruptcy that are payable, plus any lump sum amount that is payable;

(e) municipal taxes assessed or levied against the bankrupt, within the two years immediately preceding the bankruptcy, that do not constitute a secured claim against the real property or immovables of the bankrupt, but not exceeding the value of the interest or, in the Province of

Quebec, the value of the right of the bankrupt in the property in respect of which the taxes were imposed as declared by the trustee;

(f) the lessor for arrears of rent for a period of three months immediately preceding the bankruptcy and accelerated rent for a period not exceeding three months following the bankruptcy if entitled to accelerated rent under the lease, but the total amount so payable shall not exceed the realization from the property on the premises under lease, and any payment made on account of accelerated rent shall be credited against the amount payable by the trustee for occupation rent;

(g) the fees and costs referred to in subsection 70(2) but only to the extent of the realization from the property exigible thereunder;

(h) in the case of a bankrupt who became bankrupt before the prescribed date, all indebtedness of the bankrupt under any Act respecting workers' compensation, under any Act respecting unemployment insurance or under any provision of the Income Tax Act creating an obligation to pay to Her Majesty amounts that have been deducted or withheld, rateably;

(i) claims resulting from injuries to employees of the bankrupt in respect of which the provisions of any Act respecting workers' compensation do not apply, but only to the extent of moneys received from persons guaranteeing the bankrupt against damages resulting from those injuries; and

(j) in the case of a bankrupt who became bankrupt before the prescribed date, claims of the Crown not mentioned in paragraphs (a) to (i), in right of Canada or any province, rateably notwithstanding any statutory preference to the contrary.

Payment as funds available

(2) Subject to the retention of such sums as may be necessary for the costs of administration or otherwise, payment in accordance with subsection (1) shall be made as soon as funds are available for the purpose.

Balance of claim

(3) A creditor whose rights are restricted by this section is entitled to rank as an unsecured creditor for any balance of claim due him.

Claims generally payable rateably

141. Subject to this Act, all claims proved in a bankruptcy shall be paid rateably.

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

**FACTUM OF THE TRUSTEE.
(MOTION RETURNABLE
JANUARY 6, 2011)**

Ogilvy Renault LLP

Suite 3800

Royal Bank Plaza, South Tower

200 Bay Street, P.O. Box 84

Toronto, Ontario M5J 2Z4

Orestes Pasparakis LSUC#: 36851T

Tel: (416) 216-4815

Evan Cobb LSUC#: 55787N

Tel: (416) 216-1929

Vasuda Sinha LSUC# 55005B

Tel: (416) 216-3921

Fax: (416) 216-3930

Lawyers for the Trustee