CANADA
PROVINCE OF QUEBEC
DISTRICT OF MONTRÉAL

No: 500-11-042345-120

SUPERIOR COURT
(Commercial Division)
(Sitting as a court designated pursuant to the *Companies'Creditors Arrangement Act*, R.S.C. 1985, c. C-36)

IN THE MATTER OF THE PROPOSED PLAN OF COMPROMISE AND ARRANGEMENT OF:

AVEOS FLEET PERFORMANCE INC. / AVEOS PERFORMANCE AÉRONAUTIQUE INC.
and
AERO TECHNICAL US, INC.

Insolvent Debtors/Petitioners

AVEOS FLEET PERFORMANCE INC. / AVEOS PERFORMANCE AÉRONAUTIQUE INC.

Insolvent Debtor/Plantiff

vs

CANADIAN NORTH INC.

Respondent/Cross-Plaintiff

and

FTI CONSULTING CANADA INC.

Mis en cause/Monitor

CONTESTATION AND CROSS-CLAIM OF THE RESPONDENT, CANADIAN NORTH INC., ON PLAINTIFF'S MOTION TO RECOVER AMOUNTS FOR GOODS SUPPLIED AND SERVICES RENDERED AND FOR OTHER ORDERS
(Section 9 and 11 of the Companies' Creditors Arrangement Act, R.C.S. 1985 c. C-36)

TO THE HONOURABLE JUSTICE MARC SCHRAGER OR TO ONE OF THE HONOURABLE JUDGES OF THE SUPERIOR COURT, SITTING IN COMMERCIAL DIVISION, IN AND FOR THE JUDICIAL DISTRICT OF MONTRÉAL, RESPONDENT AND CROSS-PLAINTIFF RESPECTFULLY SUBMITS THE FOLLOWING:

1. The Respondent and Cross-Plaintiff, Canadian North Inc. (**"Canadian North"),** admits paragraph 1 of Aveos' "Motion to recover amounts for goods supplied and services rendered and for other orders" (the "Motion");

2. Canadian North admits paragraph 2 of the Motion;

3. Canadian North admits paragraph 3 of the Motion;

4. Canadian North admits paragraph 4 of the Motion;

5. Canadian North denies as drafted paragraph 5 of the Motion because there were exclusions other than just Heavy Maintenance Services (known as "C-Checks and HMV's") that were invoiced on a Time and Material basis or on a fixed rate basis, the whole as more fully detailed in further contestation hereafter;

6. Canadian North denies as drafted paragraph 6 of the Motion and adds that the payment was linked to a specific volume of maintenance by Aveos as it was an underlying principal consideration of the B737 Agreement (as defined in the Motion) for the reasons mentioned in further contestation hereafter;

7. Canadian North denies as drafted paragraph 7 of the Motion but acknowledges that:

   a) Not forecasted activity levels on an aircraft would fluctuate, sometimes considerably, both to the upside and the downside for each party, over the course of the B737 Agreement;

   b) Forecasted events (driven by manufacturer's or regulatory mandated cycles (*i.e.* landings or hours) could also fluctuate depending on the activity level of each aircraft, either escalating or delaying the time at which certain scheduled events would have to occur;

   c) Accordingly, the total PBH (as defined in the Motion) aggregate payment would fluctuate each month depending on each aircraft's flying hours (subject to a minimum hour commitment). Regardless of the amount of the PBH payment, the maintenance (particularly Line Maintenance and Component Services) had to be done without delay to keep Canadian North's aircrafts operational;

8. Canadian North denies paragraph 8 of the Motion and adds that while there was some predictability in the PBH part of the contract, it was still subject to fluctuation depending on the effective flying hours and, also, many items were covered by the B737 Agreement were of a time and materials or fixed rate nature for the reasons mentioned in further contestation hereafter;

9. Canadian North denies paragraph 9 of the Motion and adds that Aveos' characterization of the B737 Agreement is incorrect for the reasons mentioned in further contestation hereafter;

10. Canadian North admits paragraph 10 of the Motion;

11. Canadian North admits paragraph 11 of the Motion;

12. Canadian North admits paragraph 12 of the Motion;

13. Canadian North admits paragraph 13 of the Motion;

14. Canadian North denies as drafted paragraph 14 of the Motion and adds that the Termination Notice was served as agreed with Aveos for the reasons mentioned in further contestation hereafter;

15. Canadian North admits paragraph 15 of the Motion and adds that: (i) on the day following the issuance of the Initial Order, all Aveos' maintenance engineers and support staff assigned to the service of Canadian North were terminated permanently, thus Aveos was no longer in a position to honour its obligations under the B737 Agreement and (ii) Aveos did not contest Canadian North's Termination notice whether verbally or in writing and furthermore (iii) Aveos acted as if the B737 Agreement was effectively terminated;

16. Canadian North denies as drafted paragraph 16 of the Motion and adds that it was normal practice throughout the entirety of the contract for Canadian North to dispute invoices presented by Aveos. The normal procedure would be to advise Aveos of the dispute and the related reasons. This would normally come from the director of maintenance at Canadian North. The dispute and details would be reviewed by Aveos and Aveos would either agree or disagree. It was sometimes necessary to resolve long-standing disagreements with a special meeting involving the respective management (*i.e.* the parties' vice-presidents). At the end of the discussions referred to in paragraph 16 of the Motion, Canadian North agreed that the sum of $1,109,746.79 was owed for the payment of the invoices mentioned in the Statement of account Exhibit P-4 and not as a settlement of all obligations under the B737 Agreement;

17. Canadian North denies paragraph 17 of the Motion and adds that during the last round of discussions between Stephan Côté (Aveos) and Don Maclellan (Canadian North) at no time was there an indication that Aveos agreed to adjust an invoice in return for an undertaking by Canadian North to make immediate payment of the final total. The exchange was a routine account reconciliation rather than a negotiation, as more fully appears from the emails communicated herewith as **Exhibit D-1**, *en liasse*;

18. Canadian North denies paragraph 18 of the Motion and adds that once it had agreed on the amount owing pursuant to the account reconciliation, it had discussions with Aveos regarding its contention that, although it acknowledged the amount owing of $1,109,746.19, it viewed it as inequitable and unwarranted to have to pay this amount in light of the fact that Canadian North made payments in the past under the B737 Agreement for services which would never be provided by Aveos' due to the termination its activities. Further, Canadian North, as a show of good faith and contrary to the allegations in paragraph 18 of the Motion, deposited without any admission the full amount agreed into the trust of its lawyers while it tried to reach a settlement with Aveos;

19. With respect to paragraph 19 of the Motion, the Canadian North admits having received the demand letter Exhibit P-5 but denies having to pay the amount claimed by Aveos after compensation of its cross-claim detailed in further contestation hereinafter;

20. With respect to paragraph 20 of the Motion, Canadian North already admitted the receipt of said letter which content speaks for itself;

21. With respect to paragraph 21 of the Motion, Canadian North relies on the letter Exhibit P-7 and denies anything contrary to its wording. Furthermore, Canadian North adds that there is nothing in said letter that compromises its cross-claim and set-off rights against Aveos;

22. With respect to paragraph 22 of the Motion, Canadian North relies on the email and bid Exhibit P-8 and denies anything contrary to its wording. Furthermore, Canadian North adds that there is nothing in the said email and bid that compromises its cross-claim and set-off rights against Aveos. In any event, said bid was rejected and, accordingly, the offer contained therein is no longer binding;

23. Canadian North admits paragraph 23 of the Motion and adds that it proposed to Aveos' Monitor (Heather Brodie) on June 7th that it would make immediate payment for past usage together with an arrangement for ongoing access to the Smart System until the end of the year. However, such agreement could not be reached because Aveos requested the full payment of its claim in order to allow ongoing access to the Smart System;

24. Canadian North admits most of the allegations in paragraph 24 of the Motion, with the exception of the existence of a "continuing default", which is denied for the reasons mentioned in further contestation hereafter;

25. Canadian North denies paragraph 25 of the Motion and adds that it has a valid cross-claim and set-off right against the Plaintiff, as detailed in further contestation hereafter;

26. Canadian North denies paragraph 26 of the Motion;

27. Canadian North denies paragraph 27 of the Motion;

28. Canadian North denies paragraph 28 of the Motion for the reasons mentioned in further contestation hereafter;

29. Canadian North denies paragraph 29 of the Motion and adds that in fact, the Termination Notice (Exhibit P-7) was successfully transmitted by email to Paul Lochab and by fax at the number 514-856-7427 as provided in section 29 of the B737 Agreement, on Sunday March 18, as it appears from the email and fax transmission confirmations communicated herewith as **Exhibit D-2**, *en liasse*;

30. Canadian North denies paragraph 30 of the Motion and adds that the termination of the Agreement was mutually agreed on Saturday March 17, 2012, and confirmed by the fax transmission of the Termination Notice on Sunday March 18, 2012, before the Effective Time of the Initial Order;

31. Canadian North denies paragraph 31 of the Motion and adds that said inventory is not in its legal possession and that it has apparently been acquired by Discovery Air Technical Services Inc. ("DATS") in the course of Aveos divestiture process;

32. Canadian North denies paragraph 32 of the Motion and adds that these engines were removed by Aveos as part of the B737 Agreement: engine 674234 was removed January 24, 2011; engine 696751 was removed February 4, 2012, engine 688588 was removed April 15, 2011, engine 709511 was removed March 7, 2011 and engine 709491

was removed November 15, 2011. Aveos would be the only one to have records relating to these engines, just as in the ordinary course of the B737 Agreement they had records for other engines they removed and reinstalled or exchanged. These engines are all currently at Timco with outstanding repair/overhaul bills pending against them and, presumably, liens attached by Timco, the whole, as it appears from the emails communicated herewith as **Exhibit D-3**, *en liasse*. Also, Aveos sold these engines to DATS in the course of the Divestiture Process;

33. Canadian North denies paragraph 33 and reiterates the allegations of paragraph 32 above;

34. Canadian North denies paragraph 34 of the Motion;

AND IN FURTHER CONTESTATION OF THE MOTION, BUT WITHOUT PREJUDICE TO THE FOREGOING, THE CANADIAN NORTH ADDS THAT:

The PBH component of the B737 agreement:

35. Over the course of the agreement the parties made adjustments to the PBH rate and the minimum flight hours depending on the level of flying activity which would, in turn, require corresponding maintenance activity adjustments;

36. In 2009, both PBH rates and monthly minimum hours were adjusted because Canadian North's fleet was not flying very much and Canadian North was paying for maintenance it was not getting because the activity level of its aircraft did not warrant it. Canadian North had several discussions with Aveos during the course of their contractual relationship about better matching manpower and rates to activity levels which notably led to either increases of the manpower or reduction of the rates;

37. Hence, the link of the PBH rate to the volume of maintenance was an important underlying consideration of the B737 Agreement. For example, the B737 Agreement provides that 14 engine overhauls and 7 paint jobs are to be performed over the course of the contract. As at March 19, 2011 Canadian North had received only six engine overhauls and three paint jobs;

38. The PBH payment obligations under B737 Agreement cover both foreseeable scheduled and unscheduled maintenance services to be rendered by Aveos. Commercial airplanes are subject to mandatory maintenance schedules imposed by Transport Canada or by the manufacturer and are based generally on cycles (*i.e.* landings) or the number of flying hours or are calendar driven. Aircraft also encounter maintenance events (i.e. referred to in the industry as "snags") which must be rectified generally on a daily basis in order for the aircraft to be airworthy and operate legally. Together these services are called "line maintenance" and were provided by Aveos to Canadian North as part of the PBH payment commitment;

39. Because it is unknown exactly when the requirement for a scheduled maintenance event will arise (because the number of cycles or flight hours can vary monthly) and because it is unknown how many snags will be encountered on any particular aircraft (and because the labour and parts to fix it are unknown) the best way to "match" PBH payments to the

services required to be rendered by Aveos was to make the payments based on monthly estimated flight hours, with adjustments for actual flight hours at agreed intervals;

40. Under the B737 Agreement, the parties' PBH obligations were fundamentally intended to be relatively neutral or balanced between the parties at the natural end of the seven (7) year contract.

41. However, in the event of an early termination, important discrepancies in the parties' contributions may occur, as is the case in the present instance. This was, by Aveos' own admission, the reason for a portion of the PBH payments being diverted into a Deferred Revenue Account in order to match the services provided with the amount of earned revenue in Aveos' monthly financial statements, the whole as detailed in further contestation hereafter;

42. The B737 Agreement does not prohibit compensation, even at the end of the agreement. To the contrary, section 5.6 provides specifically the right of set-off at termination of the agreement;

43. Also, there are other end-of-contract adjustments stipulated in the B737 Agreement. Notably, Annex B-2, Engine and APU Maintenance Services section 2(b), indicates that: "*Aveos will Repair, Overhaul or replace Engines, including LLPs, in such a manner that the remaining life of the Engine at the end of the term of this Agreement would be equivalent to the remaining life of the Engines as if the Engine Schedule had been executed*";

44. This means there was a requirement not only to provide the maintenance services but also to ensure that the value of Canadian North's engines at the end of the contract were equal to the value contemplated at the outset of the contract despite the fact that engines may have been changed out during the course of the contract;

45. Furthermore, the process of allocating part of the PBH payments to various components of the Services was a long-standing practice going back to at least 2001, as it more fully appears from the fax headed by "Re: Air Norterra Rate Change" outlines the breakdown of the PBH payments at the time, around November 13, 2001 and the document entitled "Canadian North Aircraft Maintenance Proposal" dated 9/3/2003 communicated hereto as **Exhibit D-4**, *en liasse.* These documents show the breakdown of the proposed PBH payments at that time, when Air Canada was providing maintenance services;

46. Also, if the B737 Agreement was in the nature of an "insurance policy", as alleged by Plaintiff in paragraph 8 c) of the Motion, it would not have been necessary for Aveos to allocate certain amounts from each PBH payment to a specific element of the contracted services nor would it have been necessary to have the PBH payments in a Deferred Revenue Account to ensure the monies were not taken into revenue until the services were provided;

47. In any event, even if the agreement was in the nature of an "insurance policy", which is specifically denied, the PBH payments made in advance for maintenance services not yet rendered, like insurance premiums, would be subject to adjustment or compensation in case of an early termination;

The termination of the B737 Agreement:

48. When it became aware, on March 14, 2012, that Aveos was in financial hardship, Canadian North realized that it would encounter serious operational problems if Aveos discontinued services (particularly Line Maintenance and Component Services). Canadian North needed an immediate solution to avoid such an outcome;

49. On Saturday, March 17, 2012, Mrs Tracy Medve, President for Canadian North, offered to bring her team to Montreal to discuss an orderly withdrawal from the contract in a telephone conversation with, notably, Paul Lochab, Chief Commercial Officer, Peter Timotheatos, Chief Financial Officer and Tim Canavan, Chief Operating Officer for Aveos;

50. During that conversation, Mr. Lochab advised Mrs. Medve that if Canadian North submitted a termination notice immediately, Aveos would not object to it;

51. At that point, Canadian North was being led to believe that Aveos was trying to work things out but if a CCAA filing was made, Aveos airframe business would be abandoned;

52. On March 18, 2012, Tracy Medve had a call with, notably, Paul Lochab, Tim Canavan, and Jean-Pierre Bastien (Customer Service Director for Aveos) where they agreed that upon termination, Aveos would work with Canadian North to make an alternate plan for its required services;

53. At that point, it was obvious that a CCAA filing was imminent: Paul Lochab mentioned that they were doing everything possible to be ready for a filing and that with the termination of the B737 Agreement, Canadian North would be able to manage its own destiny;

54. Furthermore, Paul Lochab offered to Tracy Medve on this call to give her the contact of a party willing to help Canadian North only after receipt of the Termination Notice;

55. Also, as above mentioned, Aveos did not contest the termination in any way pursuant to the receipt of the Termination Notice. To the contrary, it acted as if said termination was accepted;

56. In the circumstances, a mutual agreement to terminate the B737 Agreement was clearly reached at that time;

57. It is rather awkward and surprising that Aveos now takes the position that the Termination Notice was not served with sufficient notice;

58. In any event, the termination was acknowledged by the parties whether on a legal or de facto basis;

59. With respect to the additional amounts claimed for the alleged use of the inventory mentioned in the inventory statement Exhibit P-6, Canadian North adds that (i) it had the permission to use said inventory as it appears from a letter dated March 19, 2012, communicated herewith as **Exhibit D-5** and (ii) all (or most) of the items on this list have either been purchased or consigned to DATS in the course of Aveos divestiture process the whole, in connection with its service contract with Canadian North;

60. Therefore, Aveos' demand for the return of these parts when they are either in the possession of DATS or out for overhaul/repair and being returned to DATS upon completion is unfounded. If the parts were in Canadian North's possession at the time of the sale to DATS, DATS now has possession of those parts;

61. Canadian North also disagrees with the amount indicated for "usage". The fair market value for these parts is not the correct measure. For example, if Aveos takes a new or freshly overhauled part from the inventory and puts it on the aircraft and subsequently removes it there are a few choices of what can happen to that part to best manage it from a cost and operational perspective. A part may come off and be beyond economic repair. In such case, the part would be scrapped and a replacement (new or used) would be acquired. For Canadian North's fleet (*i.e.* eight 737-200's and four 737-300's aircraft) the parts are generally never new given the age of the aircraft so an overhauled replacement part would be acquired. If a part can be repaired or overhauled then instead of getting a replacement, the overhaul or repair would be affected;

The records issue:

62. On or about June 29, 2012, Canadian North's attorney informed Aveos' attorney that Canadian North was concerned that Aveos may not have the complete life limited parts record ("LLP Records") and supporting engineering documents for its aircraft and that before entertaining into further discussions, Canadian North wanted to verify their availability;

a) Life limited parts

63. Life limited parts ("LLP") are any parts for which a mandatory replacement limit is specified by the manufacturer and/or Transport Canada/Federal Aviation Authority. The life status of an LLP mean the accumulated cycles (*i.e* landings), hours or any other mandatory replacement limits of the LLP (can also be a calendar limit). An LLP is controlled using a record keeping system that substantiates the part number, serial number and current life status. Each time an LLP is removed from an aircraft the record must be updated with the current life status. Overhaul vendors like Aveos must have the history back to birth for LLP authentication and life status tracking;

64. Without the records the LLP's become worthless because there is no means of verifying their life status. Typically, jet engine internal rotating parts, all landing gear piece parts that make a nose or main landing gear assembly, and a few various airframe components are defined as LLP. As the operator of commercial transport category aircraft in Canada, Canadian North is responsible for ensuring that LLP's are tracked and removed/replaced as required. The regulations permit the operator (i.e Canadian North) to contract this responsibility to a third party, and this was done with Aveos in the context of the B737 Agreement;

65. The B737 Agreement, Annex B-2, section 4 "Records and Inspection" provides that Canadian North shall keep operation and maintenance records for "Airworthiness Authority standards" requirements;

66. Annex B-3, paragraph 2.1 a) viii states that Aveos will provide records for installed Components (including LLP's) including "serviceable" tags which include the part number, the serial number and the total cycles/hours since new, the back to birth history and total cycles/hours since last repair or overhaul;

b) Supporting engineering documents

67. Canadian North's B737-200 aircraft maintenance program which Transport Canada approves as part of an air operator of transport category aircraft has thousands of work tasks contained within the maintenance program. Hundreds of these tasks have additional engineering requirements which were engineered by Canadian Airlines and Air Canada and are needed to maintain support of the current maintenance program;

68. Without these documents, the validity of its maintenance program is in jeopardy, and all the past engineering becomes unusable, which would nullify Canadian North's maintenance program. Without a valid maintenance program, Canadian North's fleet would be grounded;

69. The records asked by Aveos in paragraphs 32 and 33 of the Motion with respect to these engines are precisely the records Canadian North is demanding, among others, for the engines/gear and its aircraft;

70. Canadian North has been working with Aveos representative Michael Gaetano in order to track these records, as it appears from an email exchange regarding this issue communicated herewith as **Exhibit D-6,** *en liasse*;

71. Although Canadian North obtained Mr. Gaetano's assistance in the attempt to track the requested records, he has apparently not been able to locate all of them to this date;

72. Furthermore, Aveos made it clear that it would not release said records before their claim was paid or that an agreement was reached between the parties;

73. Without these records, Canadian North's aircraft are subject to be grounded and indefinitely made useless until the parts with the missing records are replaced and in such event would inevitably cause considerable damage to Canadian North's business;

74. Therefore, Aveos' claim is unfounded and inadmissible on this ground alone and until Aveos will be in a position to provide the requested records to Canadian North;

AND IN CROSS CLAIM, THE CANADIAN NORTH CONSTITUTING ITSELF CROSS-PLAINTIFF, ADDS THE FOLLOWING:

75. At the time of issuance of the Initial Order, the value of PBH maintenance services paid by Canadian North under the B737 Agreement before said services were actually rendered exceeds the amount claimed by Plaintiff in the Motion (the "Plaintiff's Claim");

76. Without prejudice to the foregoing, notwithstanding if the B737 Agreement was terminated or not, the circumstances of the present case justify the application of the rules of compensation because Canadian North was, at the time of issuance of the Initial Order, the creditor of a significant value of maintenance services paid in advance to Aveos;

77. According to Aveos, its deferred revue account ("DRA") with respect to the B737 Agreement was in the positive amount of $471,796.41 at the time of the issuance of the Initial Order;

78. According to the Canadian generally accepted accounting practices ("GAAP") of the Canadian Institute of Chartered Accountants, which applies to Aveos' accounting, a DRA must be used by a company when it receives un-earned revenues, notably pre-paid remuneration, contractual advances and essentially any money received for goods and services which have not been delivered or rendered. This is the exact characterization of the PBH payments and the DRA as acknowledged by Aveos during Mr. Timotheatos' examination;

79. When the services are actually performed the associated monies from the DRA are booked into Aveos' income statement as revenue;

80. The purpose of the Aveos DRA was to ensure that any amounts from the PBH payments which were unearned would remain as a liability to Aveos on their balance sheet until the contracted services were provided;

81. Canadian North respectfully submits that Aveos DRA balance at the time of the issuance of the Initial Order is one of the best valuation methods to determine the value of the services paid in advance under the B737 Agreement for the PBH, the whole subject to the verifications and re-statement mentioned hereafter;

82. After an examination of Mr. Peter Timotheatos and analysis of the financial information provided in this context, Canadian North found certain irregularities in Aveos accounting (*i.e* certain charges or book entries debited from the DRA that are questionable), that would have a significant impact on Aveos DRA after a re-statement of same, the whole as it will be demonstrated at trial;

83. According to Canadian North's estimate at this stage, based on its experience and contractual knowledge and information provided by Aveos representative Peter Timotheatos during his examination and by further undertakings, Aveos' DRA with respect to the B737 Agreement should be in the amount of $1,592,558.91 at the time of issuance of the Initial Order, the whole as it appears from the re-calculation of the DRA communicated herewith as **Exhibit D-7**;

84. Canadian North reserves its rights to review and demonstrate through forensic accounting expertise the effective impact of such irregularities and re-statement of Aveos DRA and/or to establish at trial the exact amount of its cross-claim by another method if need be;

85. Therefore, Canadian North constitutes itself Cross-Plaintiff and claims that Plaintiff was indebted in its favour at the time of the issuance of the Initial Order to an amount equal to Aveos'claim in capital, interest and fees;

86. Canadian North reserves its rights to claim from Aveos the sum of $459,187.72 representing the balance between its cross-claim ($1,592,558.91) and Aveos claim ($1,133,371.19) in due course of the Plan of Arrangement;

87. The present Contestation and Cross-Claim are well founded in fact and in law;

FOR THESE REASONS, MAY IT PLEASE THIS HONOURABLE COURT TO:

DISMISS Plaintiff's Motion to recover amounts for goods supplied and services rendered and for other orders;

GRANT Respondent and Cross-Plaintiff's claim for an amount of $1,133,371.19 plus interest at the legal rate, as well as the additional indemnity provided for by Article 1619 of the Civil Code of Quebec since June 1st 2012;

ORDER AND DECLARE the compensation of Respondent and Cross-Plaintiff's claim on Plaintiff's claim;

RESERVE Respondent's rights to claim from the Plaintiff the sum of $459,187.72 in due course of the Plan of Arrangement;

THE WHOLE with costs.

MONTRÉAL, November 23, 2012

MILLER THOMSON POULIOT LLP
Attorneys for the Respondent/Cross Plaintiff