ATTACHMENT 9

VEDDERPRICE

Memorandum

To: Jonathan Solursh **Date:** March 4, 2002

From: Geoffrey Kass, Esq.
Michael M. Eidelman, Esq.

cc: Neil Saxe, Esq.
Anthony Castanares, Esq.

Re: Canada 3000 Airlines Limited (*"C3000"*)

As set forth in our Memorandum dated January 22, 2002, we are continuing our analysis concerning the ability of PriceWaterhouse Coopers, in its capacity as Trustee (***"Trustee"***), to compel the repayment of airframe, engine or similar types of maintenance reserves (collectively, the ***"Reserves"***) paid by C3000 to numerous equipment lessors. The purpose of this Memorandum is to provide the Trustee with (i) a general overview of US bankruptcy laws regarding discovery from C3000's equipment lessors; (ii) a detailed review and analysis of C3000's leases, as they specifically relate to the treatment of the Reserves; (iii) a status report on the foreign proceeding pending in California; and (iv) a strategic plan regarding the return of the Reserves.

Overview/Summary

Under US bankruptcy law, C3000's ability to recover the Reserves depends on a factual analysis of the relevant provisions of each lease to determine whether the parties to the lease intended the Reserves to be payments of additional rent, and thus not recoverable, or payments of a security deposit, and thus subject to potential recovery. Even under the leases that treat Reserves as security deposits, C3000's ability to recover the Reserves may be limited by the lessors' rights to setoff the Reserves against damages suffered by said lessors. In order to effectively analyze the Trustee's position and potential strategies, the legal rights available to the Trustee must be considered in light of the actual amounts available for recovery. In order to determine the amounts potentially available for recovery, we need to ascertain, for each lessor, the amount of the Reserves in question and the lessors' potential claims for damages, which the lessors can set off against their obligations to refund the Reserves and consider same against the characterization of the Reserves in the applicable leases. There are a variety of facts we need in order to make these calculations. Finally, there are a variety of strategies that should be considered in light of the foregoing facts and analyses.

The Purpose, Characterization and Differing Perspectives of the Maintenance Reserves

Maintenance reserves are payments periodically (typically monthly) made by a lessee to a lessor based on the lessee's hours and/or cycles of use of the aircraft during the preceding period. The reserves so paid are then available to the lessee to reimburse the lessee for the lessee's costs

of maintaining the aircraft (or paying such costs on behalf of the lessee directly to the maintenance provider). Because reserves are both paid by a lessee and then recoverable by the lessee, they have a dual nature and are regarded very differently by the lessor and the lessee.

From the lessor's perspective, maintenance reserves are payments made by its lessee to compensate the lessor for the lessee's use of the lessor's aircraft. Although this is an over-simplification, the lessor's view can be summarized as follows:

If a new aircraft is worth $100 and a maintenance visit costs $5, then the same aircraft, when it is due for a maintenance visit, is worth $95. Once the aircraft undergoes the maintenance visit, it will be worth $100 again. If the aircraft flies 100 hours between maintenance visits, then the aircraft loses $.05 for each hour of flight. The lessor therefore requires the lessee to pay $.05 per hour of use of the aircraft to compensate the lessor for the ongoing devaluation of the aircraft. Under the lease, the lessee is responsible for causing the aircraft to undergo the maintenance visit and paying for the same. Because the maintenance visit costs $5 and increases the value of the aircraft by $5, the lessor is willing to pay to the lessee $5 for increasing the value of the aircraft by $5, the amount the lessee has paid to the lessor for the temporary devaluation of the aircraft.

From the lessee's perspective, on the other hand, maintenance reserves are just what they are named: reserves paid (or deposited) over time by the lessee, to be held by the lessor as a reserve to pay for upcoming maintenance. Under the same factual scenario set forth above, the lessee knows that it is going to incur a maintenance expense of $5 for each 100 hours of operation of the aircraft. By "paying" $.05 to the lessor for each hour of the lessee's operation of the aircraft, the lessee is creating a reserve that will pay for the maintenance visit at the end of the 100 hours of operation. The lessee views the maintenance reserves as nothing more than cash management - the lessee is setting aside its own money so that it has sufficient cash available to pay for the significant periodic maintenance.

In negotiating and drafting leases, there is constant tension between the lessor's and the lessee's views of maintenance reserves. Negotiated leases can vary widely in how reserves are treated, from leases where reserves are treated purely as additional rent payments to leases where reserves are treated virtually identically to security deposits. Under US law, as discussed below, C3000's ability to recover the reserves depends, on a lease by lease basis, on whether the lease in question treats the reserves as rent, in which case a recovery is less likely, or like a security deposit, in which case a recovery is more likely.

Lease Analysis

The tension between the lessee's and the lessor's view of maintenance reserves manifests itself through a variety of provisions in a typical lease. The analysis of these provisions creates the arguments for whether the lessee and lessor intended the reserves to be treated as additional rent or as a security deposit. The relevant provisions are as follows:

1. Description. A lease can explicitly refer to payments of maintenance reserves as payments of rent. This (obviously) evidences an intent to treat reserves as rent. This is fairly common; however, this relatively simple statement is often contradicted by the more mechanical provisions of a lease, which may still evidence an intent to treat maintenance reserves as a security deposit.

2. Refund of payments to lessee, other than for maintenance. A lease can provide for maintenance reserves to be refunded to the lessee in circumstances other than for the payment of maintenance expenses. Provisions that require a refund of the reserves contradict the lessor's argument that reserves are additional rent and thus not recoverable. The typical refund scenarios are as follows:

(a) Event of Loss. A lease can require the lessor to refund maintenance reserves after the lessor has been paid the required termination payment (this is a payment calculated to make the lessor whole in respect of the loss of its aircraft). The Trustee could argue that this type of provision evidences the intent of the parties that the lessor is entitled only to a fixed value for the aircraft – reserves are available to ensure that the lessor receives such value but otherwise should be returned to the lessee. The Trustee then can extrapolate this argument to a general rule – as long as the lessors are made whole, C3000 should be entitled to a refund of the excess reserves.

(b) Excess payment by lessee. A lease can require the lessor to refund maintenance reserves to the lessee to the extent the reserves paid are in excess of the cost of the maintenance covered by the reserves. The Trustee could argue that this type of provision evidences a general intent of the parties that the reserves are funds held by the lessor to pay for maintenance – the lessor must return to the lessee maintenance reserves paid by the lessee to the extent unnecessary to pay for maintenance.

3. Specificity of reserve payments and maintenance covered. As a general rule, significant maintenance events are predictable in terms of (a) items of equipment that will require maintenance, (b) the cost of such maintenance and (c) the frequency of such maintenance. Thus, a lease can be very specific in identifying separate reserve payments for separate items of equipment and separate maintenance activities. This specificity is consistent with the lessor's view of maintenance reserves as rent and compensation for devaluation through use – identifying with specificity devaluation of the aircraft caused by the actual use of specific items of equipment demonstrates the parties' detailed knowledge of devaluation and their intent to compensate the lessor therefore. When a lease fails to be specific, especially in the activities for which reserves are available for reimbursement or the types of reserve payments from which the lessor pays reimbursement, on the other hand, the Trustee could argue that the lease evidences the parties intent that the reserves are the lessee's money, because this demonstrates that the parties are not connecting the reserve payments to specific devaluation.

This can be illustrated with the following example:

An aircraft has two engines, each of which requires $100 of maintenance for every 1,000 flight hours. Under the lessor's view of reserves, the lessor loses $.10 for each hour of operation of each engine and the lessor should be willing to reimburse the lessee only on a per engine basis based only on a $.10 per hour per engine re-creation of value through maintenance. If a lease allows the lessee to apply the full amount of reserves paid for both engines against a single engine maintenance event, then the lessor is paying more in reimbursement than it was "compensated" for loss in value (and the lessor no longer has been "compensated" for the engine which did not undergo maintenance). This contradicts the lessor's efforts to tie reserves to rent payments as compensation for lost value.

4. Treatment of reserves while held by the lessor. A lease can require the lessor to treat reserves as other than general funds of the lessor. Such treatment can include (a) holding reserves in a separate account (or even an escrow account with a third-party), (b) allowing the lessee to determine how the reserves are invested and (c) accruing interest on the reserves and allowing the lessee to use the accrued interest to pay for maintenance. These types of provisions give the lessee control of the reserves, which evidence the parties' intent to treat the maintenance reserves as property of the lessee and thus as a security deposit.

5. Refund to lessee at return. A lease can require the lessor to refund maintenance reserves to the lessee if the lessee returns the aircraft to the lessor in compliance with the required return conditions. As with the requirement that reserves be refunded to the lessee when the reserve amounts are greater than the cost of the relevant maintenance, the requirement to refund reserves at the end of the lease is evidence of the parties' intent to treat the reserves as the property of the lessee, held by the lessor until the lessor is "made whole," in this case by receiving back its aircraft in the agreed upon condition, and then returned to the lessee.

Under separate cover we will provide you with a detailed chart, setting forth, among other things, (i) each lease to which C3000 is a party; (ii) the provisions in each such lease which evidence the intent of C3000 and the relevant lessor to treat reserves as rent or security deposits; and (iii) our preliminary estimation as to the probability of success of any litigation compelling the return of the Reserves against each lessor.

Status of the Foreign Proceeding

On February 20, 2002, Tony Castanares of Stutman, Treister & Glatt Professional Corporation, counsel for the Trustee in its capacity as foreign representative, appeared before the Bankruptcy Court for the Central District of California with respect to the ancillary proceeding pending there. At that hearing, the Court ordered the foreign representative to file a motion with the Court if it wished to extend the effectiveness of the preliminary injunction entered on November 16, 2001. Accordingly, on February 25, 2002, the foreign representative filed a Motion to Extend the Effectiveness of the Preliminary Injunction ("Motion to Extend") through the conclusion of the ancillary proceeding.

At the urging of certain of the lessors, the foreign representative is also seeking to modify the preliminary injunction to clarify that such injunction is not intended to prohibit certain conduct permissible under Canadian law. The motion is set for hearing on March 20, 2002, at 11 a.m. (PST).

If such Motion is granted the following language will be included in the preliminary injunction:

> "and provided further that nothing contained in the Preliminary Injunction (including, without limitation, the provisions of Section 1(3), (4), (6) and (8) thereof) shall be construed to restrict or prevent an owner or lessor, that has leased any aircraft or engines (or both) to any of the Debtors (including Canada 3000 Airlines Limited or Royal Aviation, Inc.) from (i) retrieving possession of such aircraft and engines, terminating the relevant leases and otherwise exercising all rights and remedies available to them in connection with such leases, as agreed to between the Petitioner and such owners or lessors, or as otherwise permitted by the Canadian Court; or (ii) exercising remedies, if any, available to the lessors or owners under the leases permitted by the Canadian court or pursuant to the *Bankruptcy and Insolvency Act* or as agreed to between the Petitioner and such owners or lessors, including without limitation, applying (whether by security remedies, set-off or otherwise) security deposits, maintenance reserves and similar amounts held by or for such lessors or owners against amounts owing to such lessors or owners pursuant to such leases provided that the purported exercise of such remedies is without prejudice to the Petitioner taking the position that any or all of such remedies are not available to the lessors or owners."

US Bankruptcy Law Regarding Discovery

As indicated in our prior Memorandum and as we discussed in our meeting, the Trustee may find that initiating discovery from the US Bankruptcy Court provides a more streamlined and effective method of obtaining documents and information from the lessors. Rule 2004 of the Federal Rules of Bankruptcy Procedure (***"Rule 2004"***) is a valuable discovery tool that is used only in the context of bankruptcy cases. Rule 2004 permits a party in interest to examine any "entity," including, without limitation creditors of the debtor. Pursuant to 11 U.S.C. §304(b)(3)[1], US Bankruptcy Courts have required entities to submit to discovery initiated by the foreign

[1] 11 U.S.C. §304(b)(3) provides:

(b) Subject to the provisions of subsection (c) of this section, if a party in interest does not timely controvert the petition, or after trial, the court may

(3) order other appropriate relief.

representative. *Angulo v. Kedzep, Ltd.* 29 B.R. 417, 419 (S.D. Tex. 1983) (District Court affirmed Bankruptcy Court's decision authorizing foreign representative to take depositions in aid of Canadian bankruptcy proceeding); *In re Brierly*, 145 B.R. 151, 160 (Bankr. S.D.N.Y. 1992); *In re* Gee, 53 B.R. 891 (Bankr. S.D.N.Y. 1985).

The purpose of a Rule 2004 examination is to allow inquiry into the debtor's acts, conduct or financial affairs. The scope of a Rule 2004 examination is broad and unfettered. *In re Dinubilo*, 177 B.R. 932 (E.D. Cal. 1993). In fact, Rule 2004 examinations allow for a "fishing expedition" to obtain information relevant to the administration of the bankruptcy case, including attempts to discover assets. *In re Hyde*, 222 B.R. 214 (Bankr. S.D.N.Y. 1998); *In re Bakalis,* 199 B.R. 443 (Bankr. E.D.N.Y. 1996); *In re Szadkowski*, 198 BR. 140 (Bankr. D. Md. 1996). It offers few of the procedural safeguards, such as relevance, that are part of Rule 26 of the Federal Rules of Civil Procedure.

The Rule 2004 examination would be initiated by the filing of a Motion, seeking leave of the Court to issue a subpoena on each lessor. Motions of this type are typically granted as a matter of course, especially in cases (such as this) where the entity to be examined (the lessor) has previously agreed to supply documents to the Trustee concerning the Reserves. Based upon our conversations with Mr. Castanares, we do not believe that, assuming the Court grants the Motion to Extend, Judge March would be adverse to granting a Motion of the foreign representative to issue such subpoenas.

If the Trustee were to proceed in this manner, we suggest that the subpoena require each lessor to provide the Trustee with copies of all documents (broadly defined), including, without limitation, documents relating to (i) the amount of the Reserves (and security deposits) held by such lessor; (ii) application (actual or intended) of the Reserves and inspection reports (and security deposits); (iii) payments/credits paid to such lessor from third parties (letters of credit, funds from new lessees, etc.); (iv) mitigation efforts undertaken by such lessor; and (v) the current location of the aircraft. This request should include copies of all documents needed to substantiate the lessors' calculations, including all new leases of the aircraft, copies of maintenance invoices and inspection reports, etc. After the foregoing documents have been reviewed, the Trustee should then take the oral testimony (done in the presence of a court reporter) of a knowledgeable representative of each lessor.

Use of the US Bankruptcy Court to Compel Turnover of the Reserves

The Bankruptcy Court, pursuant to 11 U.S.C. §304(b)(2), may, under certain circumstances, "order turnover of the property of such estate, or the proceeds of such property, to such foreign representative." The scope of the Canadian bankruptcy "estate" is governed by Canadian law; applicable state law (as set forth in the particular leases) will define whether the estate has an interest in the Reserves.

While the foreign representative may not, in a 304 proceeding, assert claims for the turnover of money or property under various sections of the US Bankruptcy Code, the foreign representative may use the US Bankruptcy Court to assert avoiding powers and similar causes of action available to him under applicable law (i.e. under Canadian law).

Suggested Initial Course of Action

As detailed in the final section of this Memorandum, there are a number of open issues and strategic considerations that must be analyzed prior to commencing litigation against the lessors. Since entitlement to the Reserves is an issue on the minds of both the Trustee and the lessors, we believe it prudent to promptly request, in writing, that each lessor provide the Trustee with the detailed information concerning the Reserves set forth above, as contemplated by the Reservations of Rights provisions in each of the Aircraft Acceptance Agreements. Each letter should request, with specificity, the same documents described above concerning the subpoenas issued pursuant to Rule 2004. Further, each letter should require that the requested documents be provided to the Trustee within 30-45 days. In the event the lessors do not provide the necessary information, the Trustee will proceed under either the U.S. or Canadian proceedings to compel disclosure, as discussed above and below.

Pursuant to your request, we will prepare a draft letter, which can be modified for each lessor, seeking this information. We anticipate that each letter will be sent to the lessors by the Trustee's Canadian bankruptcy counsel (Neil Saxe). As each letter is only seeking information to which the Trustee is entitled (pursuant to the Aircraft Acceptance Agreements or otherwise), it will not impair the Trustee's ability to obtain this information through formal discovery or to initiate litigation against the lessors.

Additional Legal and Factual Considerations

Although discovery can be served with minimal cost to the estate, document review and conducting the examinations can be costly. In order to ascertain the cost/benefit analysis of pursuing this matter in greater detail, we suggest that, immediately after the above-described letters are sent to each lessor, the Trustee and his counsel (McMillan Binch, Vedder Price and Stutman Triester) meet to discuss the following issues:

- Appropriate jurisdictions to commence litigation against the lessors (US/ Canada) and the potential theories for recovery. We should also confirm that if we have to issue subpoenas from the US Bankruptcy Court, it will not prejudice the Trustee's rights to commence suit in Canada (if that is the decision that is ultimately made). Finally, if Canadian law avoidance actions are being applied, are we better off with a Canadian judge who has familiarity with such laws or in the US? Conversely, if US state law is being applied to determine the rights of the parties under the leases, are we better off with a US judge? Given the high profile of C3000, is Canada a friendlier forum?

- What setoff and/or recoupment rights are available to the lessors? If the lessors prove to be the largest creditors in the case, is any attempt to collect the Reserves an exercise in futility if they can setoff same against their claim? How many of the lessors hold sufficient funds, including both Reserves and security deposits, that you may be able to reach a substantial financial settlement because it will be easier for such a lessor to pay you a significant sum than to litigate fairly complex issues? If you have marginal legal arguments for obtaining a refund of Reserves, but have a reasonable chance of reaching a financial settlement because a lessor holds sufficient funds, do you have a duty as Trustee to pursue such a refund?

- Are there any applicable statutes of limitation? Do we need to ask the lessors for tolling agreements?

With the assistance of its legal team and a better understanding of these issues, the Trustee should be able to ascertain the next course of action during the 30-45 days that each lessor has to respond to the informal discovery requests.