



CANADA

# AIR CANADA INQUIRY REPORT



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# AIR CANADA INQUIRY REPORT

OCTOBER

1975

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*By*

The Honourable Willard Z. Estey

Commissioner

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TO HIS EXCELLENCY  
THE GOVERNOR GENERAL IN COUNCIL

MAY IT PLEASE YOUR EXCELLENCY

I, the Commissioner, appointed in accordance with the terms of Order in Council P.C. 1975-963 of 25th April, 1975, to inquire into and report upon certain matters related to the system of financial controls, accounting procedures, and other matters relating to fiscal management and control of Air Canada:

BEG TO SUBMIT TO YOUR EXCELLENCY THE FOLLOWING REPORT.



# AIR CANADA INQUIRY

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# Foreword

In the investigation of the matters directed to this Inquiry and in the preparation of this Report, I am gratefully indebted to the very small Inquiry staff. The expedition with which it was necessary to hold the hearings and to produce this Report combined with the summer season made the task of the Commission unusually difficult. The staff are listed in Appendix A. It is very difficult to find persons of high professional calibre at the best of times and to impose on such persons at short notice these investigative tasks is difficult enough let alone in the summer period. On both counts I have been most fortunate for the opportunity to work with this staff.

Beginning in early May the accounting staff, headed by Stephen B. Lowden and his assistants, Paul O. Gratias and Rudy R. Okker, of the Toronto and Montreal offices of Clarkson, Gordon & Co., undertook the complex accounting examination of Air Canada's accounting and control disbursement systems. The accounting analysis of all the information and material collected was then carried out by this Clarkson, Gordon team under the direction of William A. Farlinger, Administrative Partner.

The specialized nature of the airline industry as well as the magnitude of the Air Canada undertaking required the perspective and guidance of an auditor specialized in airline accounting and corporate organization. Such a person we found in Thomas E. Sinton of Arthur Young & Co., New York. His insight into the problems facing this Inquiry saved a great deal of time, expense and energy, particularly at the outset.

The legal investigations were shared by L. Yves Fortier of Montreal and R. M. Sedgewick, Q.C., of Toronto, the former assisted by Bernard A. Roy and the latter by Arthur M. Gans. The conduct of the examination of witnesses in the almost three months of hearings in Montreal fell principally on Messrs. Fortier and Roy and it is a tribute to their abilities that, in all, fifty-five witnesses testified through some 9,000 pages of evidence without adjournments or loss of time throughout the spring and early summer. Upon Messrs. Sedgewick and Gans fell the burden of examining the great volume of corporate by-laws, minutes, contracts and an almost limitless supply of files on the many transactions and aspects of Air Canada. Without Mr. Sedgewick's skill in assembling this formidable array of documents and his willingness to forego any vacation throughout the entire summer, this Inquiry would not have been completed and the Report would not have been produced on the present schedule.

To Gordon F. Henderson, Q.C. and Robert Nelson, of Ottawa who represented Air Canada, and A. J. Campbell, Q.C. of Montreal who represented the Vice-President Finance and the Controller, I am particularly

grateful for their willingness to sit long hours, on holidays and throughout the summer schedule. The Commission is indebted to them for the skill and industry with which they attacked the questions raised in this Inquiry. Mr. Richard Holden, Q.C. of Montreal represented Robert McGregor and McGregor Travel Co. Ltd. His attendance from the first to the last day was of very great assistance to the Inquiry and the manner in which he assembled the requested material and witnesses in the McGregor aspect of this Inquiry enabled the Commission to start only a few days after its appointment.

No Inquiry can assemble and organize the evidence of so many witnesses and take in over 600 documents without a Registrar of unusual organizing ability and energy. Such a person we most fortunately found in Beverley J. Oram of the Ministry of Transport, Montreal. She and her assistant, Suzanne Lavigne, also of the Ministry of Transport, Montreal, collected, catalogued and produced sets of the complete record during the course of these hearings and then set up those records in Toronto for the laborious process of preparing the Commission Report. For undertaking this hectic task without notice and without prior experience, we are very grateful to Miss Oram.

I was very fortunate in having at my righthand throughout this Inquiry, from the examination of the first witness to the writing of the last page, the assistance of Mr. H. Jory Kesten, B.A.Sc., M.Sc., LL.B., presently Law Clerk to the Court of Appeal of Ontario. Besides his unusual legal skills Mr. Kesten brought to this Inquiry his training and experience from post-graduate studies in airline regulation at the Massachusetts Institute of Technology. His guidance and organizing ability were invaluable.

Last of all, may I record the appreciation of myself and our small band to the ranks in Air Canada's Headquarters in Place Ville Marie, Montreal, and the Winnipeg Accounting Centre who put up with the chaos and confusion created by our searches for files, documents, records and accounting material through the summer. The accounting analysis of their operations by an outsider is necessarily disruptive and particular appreciation is extended to the Air Canada accounting and legal personnel, who frequently, and on very short notice, furnished a considerable volume of detailed information which this study required.

We were indeed fortunate in being able to conduct these hearings on the premises of the Law School of McGill University and for this privilege we thank Dean John E. C. Brierley.

To Mr. John-David Lyon of the Ministry of Transport, Ottawa, for making all the administrative arrangements necessary for this Inquiry, we are most appreciative.

My absence from the Court of Appeal in the early stages of the Commission necessarily placed a burden on my former colleagues of that Court and in the later stages on my brother Judges in the High Court who carried the judicial load in my absence. May I express my gratitude to The Honourable G. A. Gale, Chief Justice of Ontario, and my colleagues in the Supreme Court of Ontario, for their many generousities in this hectic period.

# Chapter 1

## SUMMARY

This Inquiry was directed to investigate, and this Report is concerned with, financial controls, accounting procedures and fiscal management. We were not authorized to, and did not, examine any other areas of this large airline. Nothing contained in this report should be taken to indicate that Air Canada is not as regards its actual airline operations a sound business-like operation. What follows is a chronology of some unusual transactions either conceived or executed contrary to the company's written and unwritten rules, or both. The corporation, as a result, encountered business losses which would have been largely avoidable. The executive response to these transactions as they were revealed was inadequate and in some cases slow, but there is no sign that anyone in the company's employ profited in any way as a result of these transactions.

The following is a summary of the succeeding thirteen Chapters. In a supplement to this report will be found confidential segments which have been removed from their respective Chapters.

Air Canada is a corporation all the shares of which are held by the Canadian National Railway Company under the provisions of the *Air Canada Act*. The corporation is described in the schedule to the *Financial Administration Act* as a "proprietary corporation" and is organized generally along the lines of a commercial organization of like size and undertaking. The Board is appointed by the Canadian National Railways and the Governor General in Council and reports to Parliament annually through the Minister of Transport. The auditors of the corporation are those of the CNR who are appointed by Parliament, currently for a five year term.

The Chairman of the Board of Directors is the Chief Executive of the corporation. There is a President and seventeen Vice Presidents all of whom are located in the corporate head office in Montreal except the five Regional Vice Presidents. The By-laws of the corporation provide for an Audit Committee and a Subsidiary and Associated Companies Committee. There is a management committee known as the Executive Committee comprised of twelve of the senior officers of the company. The financial and accounting regulations of the company are found in the By-laws and many policy directives issued by management. The main control is the requirement that the expenditure of funds (except those made in the

ordinary course of business and certain other special exceptions) require an Authorization for Expenditure (AFE). Where the amount in question exceeds \$150,000 the Board of Directors must approve the expenditures; below that level the Chairman may designate the appropriate officers who may approve the expenditure and this has been done according to levels of expenditures and levels of general authority within the corporate executive. Where the amount of the AFE exceeds \$50,000 the comments of the Finance Branch on the expenditure in question are required. There are budget procedures for the corporation and subprocedures for adjusting the budgetary allotment inside each branch and region of the corporation throughout the course of the fiscal year.

The corporation has only one subsidiary established by the Governor in Council under the *Air Canada Act*, AirTransit, which is operated on behalf and for the account of the Ministry of Transport. There are affiliated companies which are subsidiaries of the Canadian National Railway Company and which are used by Air Canada to conduct operations related to the airline's principal business. Through one of these companies, Venturex Limited, Air Canada operates its air charter business and its ground services business. Through another such company, CN Realities Limited, Air Canada holds, among other things, a one-third interest in several Holiday Inns in the Caribbean area.

The investigations conducted in this Inquiry centred on four main areas of transactions:

- (a) The payment of \$100,000 to Robert McGregor of McGregor Travel Co. Limited.
- (b) The leasing of substantial accommodation in Barbados from Sunset Crest Rentals Limited.
- (c) Problems surrounding an affiliated company, Venturex Limited.
- (d) Conflicts of interest and related conduct by a former Vice President Marketing.

(a) *McGregor Travel Transaction*

Beginning in early 1973 Yves Menard, then Vice President Marketing, apparently set out to investigate or to involve Air Canada in the travel agency business. Mr. Menard initiated negotiations with Mr. McGregor whom he met through Mr. McGill, then Vice President Eastern Region, for the participation of Air Canada in a new corporate organization being assembled by McGregor and Burke, the head of a travel agency in Vancouver. The plan was that McGregor's company in Montreal and Burke's company in Vancouver would acquire a third company operating in Toronto and somehow combine these organizations into a national network of travel agencies. The Board of Directors of Air Canada in 1973 approved a "general diversification" concept which contemplated Air Canada's involvement in some areas of the travel industry, but the Board was never asked to approve any transaction involving McGregor Travel.



By June 1974 the proposal had apparently died. Somehow the McGregor aspect of the original idea revived and Menard asked Lindsay of Venturex to ascertain the amount required to keep the McGregor transaction afloat. Lindsay ascertained that \$100,000 would be needed to keep the McGregor deal alive. Later, Menard directed that the Marketing Branch funds would be used for this transaction. Some understanding appears to have been reached whereby McGregor would perform certain services, including the representation of Air Canada's interests in discussion with the Province of Quebec concerning forthcoming travel agency legislation, in return for \$100,000. There was, according to Smith and McGregor, some unwritten gentleman's agreement whereby Air Canada would have an option on some percentage of the McGregor Travel shares exercisable for a nominal consideration. Three letters of agreement and three supporting AFE's were drawn in the Marketing Branch. On November 29 cheques to McGregor personally, totalling \$100,000, and charged to a budget item in the Marketing Branch budget, were delivered to McGregor by Lindsay of Venturex and Smith, who, although he was a member of the staff of the President, Mr. Vaughan, was working at the time under Menard.

Some time in the following two weeks, Bagg, the Controller of another Branch of Air Canada, Purchasing and Facilities, picked the three AFE's out of a group of AFE's forwarded to him from the Winnipeg Accounting Centre in connection with a checking procedure on capital expenditure. Bagg recognized the possibility that these AFE's might have been split and sent them to the Finance Branch with a note to that effect. When notice of these AFE's percolated up through the Finance Branch to the Vice President Finance, Cochrane, an investigation was ordered. This was some time in mid-December to the first week in January 1975. Nothing much was learned of this transaction by March 7, 1975, when Cochrane mentioned the matter to the Chairman, Mr. Pratte, in the course of a discussion concerning other matters. The investigation thereafter proceeded slowly and by late March it was scheduled for reporting to the Audit Committee of the Board at the end of April. In the meantime, on April 17, a question was raised in the House of Commons about these three AFE's, the agreements and the \$100,000 payment.

After about twenty days of hearings and the examination of hundreds of documents, many questions about the McGregor transaction remained unanswered. One of these questions relates to the unwritten option. Menard's first explanation to Mr. Pratte on April 16 mentioned both the 'services' and the 'option' aspect. In testimony at the opening of this Inquiry, Menard stated that he was not aware of the services contracts until he saw them on television on the night of April 17, some four and a half months after the moneys were paid to McGregor. On April 19 Menard informed Messrs. Vaughan, the President of Air Canada, and Taylor, Vice President Public Affairs, by long distance telephone from Barbados that the option feature was something of value obtained in addition to the services upon payment of the \$100,000. Menard, in speaking to McGregor on the night of April 17, advised

him that he should stay with the services contracts and continue to honour them. Other witnesses asserted that both the option and the services were obtained in return for the \$100,000.

The option cost Air Canada \$100,000, less the value of the services to be performed, and was laid out in order to acquire a ten per cent or some other amount of shares in McGregor Travel, a company whose shares in the opinion of all witnesses had virtually no value in November 1974. McGregor himself has testified that he did not intend to perform the services in question and furthermore was not qualified to perform them. Many explanations for this transaction were proffered. None can be accepted as sensible.

While the object of the exercise remains shrouded in mystery, several weaknesses are exposed by the negotiations, the closing of the transaction and the subsequent investigation thereof by the Finance Branch. The Marketing Vice President had been raised to the level of Group Vice Presidents reporting directly to the Chairman. He was given the run of the range with inadequate supervision. The Marketing Branch Budget was sufficiently elastic to fund the venture with no reference to sources outside the Branch. The President, to whom Smith the chief negotiator reported, did not follow Smith's work although he had the opportunity and the means to do so. Seath, then the Treasurer of Air Canada, knew the basis and much of the details before the payment was made to McGregor on November 29 and he knew all the essential facts by December 2. He says, however, he did not communicate these matters to Cochrane, the Vice President Finance. A capital expenditure control procedure operating in the P & F Branch detected the transaction, not the AFE scrutiny procedure in the Finance Branch. However there is no reason to believe that the latter would not have done so. What has been described as the functional reporting system of branch controllers failed to operate when Garratt, the Controller of the Marketing Branch, failed to alert the Finance Branch to the imminent expenditure. Garratt also said he failed to recognize that the AFE had been artificially split into three AFE's so as to avoid or defeat the control system.

The investigation by the Finance Branch was lethargic and accomplished very little until shortly before public disclosure of the deal. Indeed, it may well have dwindled to nothing had Menard's unexpected resignation on February 28 not restarted the process. The Marketing Branch might still have buried the transaction by "an AFE closing procedure" in March 1975, had not the Finance Branch by that time taken the matter more firmly in hand.

It appears that Air Canada did not get value for its \$100,000 payment either in the form of an option to acquire shares, or in the form of services from McGregor. The former right was valueless and the latter services have never been performed and indeed McGregor has stated that he never agreed and never intended to perform such services. Air Canada has decided to pursue McGregor for the recovery of the money and McGregor has testified that he will defend any such claim.

McGregor negotiated over a period of eighteen months with very senior officers of Air Canada. He had no reason to believe that the Air Canada

representatives were not acting within their proper authority. He signed the documents put before him by Air Canada. Apart from this act, the evidence reveals no untrue or improper representations by him. Indeed he and many other witnesses said that they believed the McGregor proposal was a good and beneficial arrangement for Air Canada. He has been the focal point of publicity, much of which cannot have assisted him and his company in the travel business, and nothing in the record of this Inquiry demonstrates it was deserved.

(b) *Barbados—Sunset Crest Leases*

By a series of leases, Venturex and later Air Canada became the lessee of a group of villas, condominiums and apartments in a development in Barbados known as Sunset Crest. The total rent payable under these leases through the years 1973, 1974 and 1975 amounts to about \$1,500,000. The obligations were undertaken by Venturex or Air Canada in the period from July to September 1973 but were not approved by the Board of Directors of Air Canada until April 30, 1974, at which time Air Canada elected to renew the leases through the calendar year 1975.

In the marketing of the accommodation Air Canada lost approximately \$1,000,000 which was charged to "promotion" in the Marketing Branch budget. The forecasts available by April 30, 1974 showed a loss in 1974 of about \$500,000 and a similar loss was forecast for the year 1975. Much smaller amounts were included in the Marketing Branch budget for the Sunset Crest venture in these years and in any case the gross rental obligations of Air Canada under these leases were not reported in any budget. The accounting for this adventure was done by way of a "suspense" account so that only at year end were the losses carried into the general operating accounts of the airline.

The Sales and Service Branch was apparently never consulted, through the Executive Committee or otherwise, even when the Marketing Branch was faced with mounting losses in connection with marketing this accommodation. In fact, this project is never mentioned in any of the minutes of the weekly Executive Committee meetings. When the transaction was started in Venturex Limited, discussed in paragraph (c) below, the Sales and Services Branch was represented on the Board of Venturex by Messrs. d'Amours and Callen, respectively Group Vice President Group Sales and Services and Vice President Central Region, but they apparently took no part in marketing discussions concerning this project thereafter. When the Board of Air Canada finally decided in April 1975 not to exercise the right of renewal the decision was not included in the minutes of the meeting. The Marketing Branch sought to justify the losses on the accommodations as being promotion expenses in connection with the scheduled airline operations into the Barbados. However, the losses on accommodations exceeded the gross revenue from scheduled seat sales to users of the accommodation.

The Barbados project was not prospectively approved by the Board of Directors and could hardly be said to be in the ordinary course of business. It lost money as forecast in each of the years 1974 and 1975. The losses did not alert any personnel in the budget sectors of Air Canada, and no mention was made either of the launching of the venture or the recurring losses at any meeting of the Executive Committee. In the whole of the transaction, no AFE was ever issued and the gross rental of \$1,500,000 was paid out on the basis of a memo from a relatively junior person in the Finance Branch at Montreal.

The Chairman apparently was unaware of this transaction until at least January 1974 when Mr. Allen, a member of the Board of Air Canada, advised him of a rumour which he had heard while in the Barbados about the ownership by Air Canada of some kind of accommodation on that Island. This seems to have led, indirectly, to the matter being brought to the Board in April 1974 for the approval of a one year renewal of these leases. No corrective action appears to have been taken by the Chairman to prevent a recurrence in Venturex or the Marketing Branch or to clarify and enforce the AFE rules in respect of such transactions.

(c) *Venturex Limited*

This Company was incorporated by the CNR at the request of Air Canada for the purpose of conducting the airline's air charter business. Later, with a minimum of forethought as to the taxation, accounting, regulatory and corporate authority implications, a ground reception services business known as Canaplan was added to the company's operations. At times the company is treated as a division of Air Canada; at other times it is regarded as an independent entity. Neither the By-laws nor the AFE regulations of Air Canada were made applicable to Venturex. The Board of Venturex consisted entirely of Air Canada personnel plus one CNR employee and has unlimited authority to approve undertakings, contracts and obligations.

The accounts of Venturex are not consolidated with Air Canada and no mention is made of Venturex in the Annual Reports by the Air Canada or the CNR Board of Directors, or by the outside auditors to the Minister of Transport and Parliament. The accounting problems entailed in transferring the charter loss to Air Canada, where they must in the final analysis be borne, are considerable and were not seriously investigated at the outset although such losses were forecast from the inception of the charter business. The use of this affiliate in the conduct of charter operations was discussed with the Air Transport Committee of the Canadian Transportation Commission, but, there is no clear record of high level planning and liaison, particularly with reference to the need to establish an affiliate rather than a subsidiary, and the need to avoid a direct assumption of the charter losses by Air Canada.

By placing the Canaplan business in Venturex the problems were aggravated further. The dangers of autonomy and operations outside the parent

company are illustrated by the acquisition of another ground reception company by Venturex without any notice to or approval by the Air Canada Board and without utilizing the services of the Law Department of Air Canada. The CN Law Department in fact provided the legal services in this acquisition.

The transfer of the losses of Canaplan to Air Canada required further accounting consideration. This was done by a "services" agreement between the two companies, the cost of which was charged to the Marketing Branch budget as in the case of the McGregor and the Barbados transactions. An AFE was initiated by Menard in December 1974 and was authorized by Pratte. Contrary to the AFE regulations the Finance Branch was not asked for comments on the "expenditure" and there is no evidence that the Finance Branch scrutiny picked up the AFE in any of their financial controls.

#### (d) *Conflicts of Interest*

Menard was the senior officer in Air Canada responsible for the negotiations of the Sunset Crest leases in Barbados and their renewals. During the period when these leases were being negotiated and executed, Menard purchased a small cottage or villa at the Sunset Crest development from the Sunset Crest group. Many of the senior executives of Air Canada knew of the purchase by Menard of this villa.

The Chairman stayed in it in early January 1974 during the currency of the Air Canada Sunset Crest leases. He asked no questions about either the villa or the leases and he says that he believed Menard had paid for it in the ordinary way by a combination of cash and mortgage. Mr. Vaughan knew about the villa and simply asked Menard "if it was clean". On March 1, 1975, the Montreal Gazette published the facts of the Menard villa and the conflict of interest arising out of Menard's purchase of it from Air Canada's lessors, Sunset Crest. As it turned out, Menard paid the same price as other buyers of like villas at the same time. The vendor, Sunset Crest, failed in its obligation to arrange a first mortgage in the case of Menard and several other buyers so that, through no fault of Menard, the purchase could not be closed for one and a half years after the contract was signed. Other purchasers were treated in precisely the same manner.

In the result, Menard did not use his position in Air Canada for his benefit in the Sunset Crest dealings and his superiors were aware of his purchase of the villa well ahead of the approval of the Board of Directors of the Sunset Crest leases in April 1974. Nevertheless, one year later when faced with the prospect of a discussion of the Menard villa in a Montreal newspaper, Menard, with the approval of the Chairman, most of the senior officers of the airline and at least four of the Board of Directors of the airline, resigned because of his "conflict of interest". As it turned out, his resignation could have been accepted at that time for other reasons. Actions in the McGregor transaction, when exposed, displayed a complete disregard for corporate

procedures and financial regulations in the company. Yet neither the Vice President Finance nor the Vice President Public Affairs mentioned the McGregor investigations at any Executive Committee sessions when Menard's Barbados dealings were under investigation. Menard's use of an automobile of a former employer while he was at Air Canada also did not come to light until during this Inquiry nor did his practice of introducing his former employers, who were in the business of importing wines, to more junior executives in Air Canada responsible for purchasing wine for the airline. There is no evidence of any personal profit to Menard (or indeed to his former employers) as a result of these actions on his part, however improper they may be in business affairs. These matters concern only Menard and there is no evidence before this Inquiry of any similar conduct on the part of any other employee.

Many parts of this Report deal with the actions of Yves Menard and the Marketing Branch when it was under his direction. These segments should be read in the light of the fact that he was a very cooperative witness, appearing on three separate occasions when requested by the Commission. He cooperated fully throughout with the investigation staff and answered all questions put to him in a forthright manner.

### *General Investigation*

The evidence amounting to about 8900 pages of transcript and about 600 exhibits reveals no criminal action on the part of any employees and no attempt by any employee to deprive the airline of any of its assets or revenue; nor is there any evidence of any conspiracy between any employee and anyone outside the airline to do anything which might be contrary to the interests of Air Canada.

The Marketing Branch was the situs of such transactions as appear to have exposed the airline to risks and losses, but all such transactions appear to have been entered into by well-intentioned executives bent on advancing the interests of their employer, Air Canada, as they saw those interests. The other branches of the airline which became involved, principally the Finance Branch, the Public Affairs Branch and the President's staff, were implicated by Marketing Branch personnel in the course of staging the transactions in question or by reason of detection procedures and subsequent investigations.

The general review of financial controls and corporate controls relating to authority to expend money revealed the advisability of some adjustments and relatively minor amendments. Corporate controls, the use of subsidiaries, the levels of signing authorities and like matters are the subject of extensive comments in Chapter 13 and of Recommendations in Chapter 14.

The Board of Directors of the company considering the lack of articulation of its role in the *Air Canada Act*, the size of the undertaking, the geographical spread of its membership, and the fact that this Board has no Executive Committee, performed its appointed role in the corporation's affairs as an element of financial and corporate control. The evidence reveals

that in some circumstances the Board has been asked to respond to inadequate information; in other cases matters such as the Barbados leases were not brought to the Board at the proper time; and on other occasions the Board received more information than would be the case in comparable non-government owned public companies.

Throughout this Report reference is made to certain difficulties in the airline's administration which arise because of the restrictive provision of the corporation's parent statute, the Air Canada Act. To the extent these provisions relate to matters of financial control and executive response to accounting and finance problems, certain conclusions are drawn in Chapter 13 and recommendations made in Chapter 14.

The one common element linking all the problems revealed in this investigation relating to financial and corporate control and accounting and other regulations relating thereto is a serious lack of communications in the top levels of the corporation's management. Likewise there are many restrictions revealed in the investigation of a similar lack of inter-branch communications. The communication syndrome is also observed in connection with the operations of the Board of Directors and particularly in connection with the adequacy of the information put before the Board of Directors when authorizations or confirmations are sought by management. A discussion of this problem is to be found in Chapter 13.

The accomplishments of the Air Canada management team over the past decade must be kept in mind when assessing the cluster of problems which sprang up initially in the Marketing Branch and the executive response thereto in several branches. Despite these adversities and the attendant publicity, it must be said, to maintain one's perspective, that this large national undertaking still ranks amongst the world's leading airlines operating across Europe as far east as Moscow and throughout the Caribbean. Its revenues have risen from \$387,000,000 in 1968 to about \$850,000,000 in 1974 when it carried about 12 million passengers and employed about 23,000 people. This very detailed review of its disbursement procedures, accounting and corporate controls and management reaction to exposing irregularities revealed no loss of corporate assets due to the unlawful conduct on the part of any of its employees. Nor was there any evidence of any pecuniary gain by any employee either at the expense of the airline or by an improper use of his position in the airline.





## Chapter 2

### SCOPE OF ORDER IN COUNCIL

#### A. *The Hearings*

This Inquiry was convened by Order-in-Council PC 1975-963 on 25th April, 1975 under the *Inquiries Act* of Canada. Pursuant thereto, the Inquiry assembled a small staff consisting of lawyers, accountants and a registrar as listed in Appendix A to this report. The hearings commenced on 30th April, 1975 in Montreal and continued with short interruptions to accommodate witness and staff schedules until 24th July, 1975. In the course of these hearings evidence was taken in public (and in some instances in camera) from some 55 witnesses, and in all 8900 pages of testimony and 304 exhibits (together with sub-exhibits) were collated.

The following counsel appeared before this Inquiry:

- (a) G. F. Henderson, Q.C. and R. Nelson, together with the General Counsel of Air Canada, Mr. Ian E. MacPherson, representing Air Canada.
- (b) Richard Holden, Q.C., representing Robert Y. McGregor and McGregor Travel Co. Ltd.
- (c) A. J. Campbell, Q.C., representing M. Cochrane, Vice-President, Finance, Air Canada and H. Seath, Controller of Air Canada.

While the proceedings were underway the Commission accountants, Messrs. Clarkson, Gordon and Co., examined the relevant accounting records of the airline at Montreal and Winnipeg, and of McGregor Travel Co. Ltd. at Montreal and Burke's World Wide Travel Co. Ltd. at Vancouver; Commission Counsel R. M. Sedgewick, Q.C., and L. Yves Fortier, or their staff, examined the appropriate files and corporate records of Air Canada, its subsidiaries and affiliates. Other examinations were undertaken by the staff of the Inquiry to ascertain what information and what sources of information should be brought forth in the Inquiry proceedings.

In order to reduce the amount of hearing time required to fully investigate these matters and to limit, so far as possible, the dislocation to the operations of Air Canada necessarily occasioned by such an investigation, we interviewed a number of persons to determine whether their information was relevant to the purposes of the Inquiry. In the course of these interviews and investigations

it was determined that the competitive position of the airline and the personal position of some potential witnesses would be seriously prejudiced if their evidence were taken in public hearing. Therefore, we examined several witnesses in camera on notice to all counsel representing persons who had appeared or were appearing before the Commission. Certain evidence taken in camera was determined by the Commissioner to be of such a character as to require that it be kept confidential in the Public Archives of Canada at the end of the Inquiry and not be released to the public. This evidence was considered by the Commission to be of such a nature that its publication might jeopardise present and future operations of Air Canada in the competitive airline business or in some instances might damage or embarrass the witnesses by reason of their particular avocation or position in the Canadian community. For the same reason some comments by the Commission on these confidential matters are forwarded in a confidential supplement to this report.

#### **B. *The Terms of the Order in Council, P.C. 1975-963***

The primary directive to the Inquiry is "... to inquire into and report upon the system of financial controls, accounting procedures and other matters related to the fiscal management and control of the corporation...". This general directive is made more specific by way of illustration, made "without limiting the generality" of the primary mandate, "... to determine whether

- (a) Air Canada follows a system of financial controls that is appropriate for a corporation of its size and undertaking having regard to the fact that it is a Crown corporation ultimately accountable through the Minister of Transport to Parliament for the conduct of its affairs;
- (b) there has been any misapplication, improper handling or misuse of the funds of Air Canada in contravention of its existing financial control policies and procedures as approved by the Board of Directors, or in violation of any applicable legislation; and
- (c) if such incidents did occur to determine whether they were brought to the attention of the senior management and in such event were they handled effectively and promptly and, in particular, did senior management take appropriate action within a reasonable time to secure redress."

The operative portion of the Order-in-Council follows recitals wherein reference is made to a specific situation wherein the airline paid a substantial sum of money to McGregor Travel Co. Ltd. and wherein reference is made to "other matters necessarily related to the financial administration of the Corporation". Elsewhere in the preliminary recitals mention is also made of "... the public indication of inadequate financial administration ... of the Corporation". These recitals are a preface to the operative part of the

Order-in-Council, and have not been construed as in any way delimiting. Consequently, the Commission has not interpreted the operative mandate as being limited to the illustrations contained in the recitals, nor have the terminology and phrases employed in the directive been construed in any narrow sense by reason of language adopted in the recitals. Had the basic instruction to the Commission been capable of two conflicting interpretations, the recital terminology might have been put to a different use but we have not found such to be the case with this Order-in-Council.

The primary mandate refers to fiscal management and control of Air Canada, and the system of financial controls, accounting procedures and other matters adopted with reference to such fiscal management and control.

To begin with, this all important portion of the Order-in-Council is interpreted as if the word 'fiscal' were repeated before the word 'control' so that we are here concerned with matters relating to both fiscal management and fiscal control. In the same way, the 'other matters' mentioned above have been interpreted *ejusdem generis* with "financial controls and accounting procedures" and not as introducing matters not related to financial controls and accounting procedures. At the same time, be it understood that the Inquiry has given a broad interpretation in its Report to the terms of fiscal management and fiscal control so that the Inquiry has concerned itself not only with the narrow financial controls in the company, but also with those elements of management located in the various levels of the Corporation which are concerned with financial and accounting matters. To interpret the directive otherwise would be to defeat the plain intention of the Privy Council as manifested by the terms of the Order-in-Council and this Inquiry therefore now reports upon the fiscal management and fiscal control of the Corporation and the financial and accounting procedures related thereto or adopted for that purpose.

A definition of "internal control" adopted by The American Institute of Certified Public Accounts illustrates the wide-ranging limits of an investigation into such matters:

"Internal control comprises the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."

As will be seen in Chapter 13 and elsewhere, it was found practical and effective to concentrate any accounting recommendations in the disbursement area. In the airline industry this has been found to be the area of the greatest sensitivity to controls or their absence.

Turning to more specific questions of interpretation, attention is directed to subparagraph (a) set out above, wherein the Inquiry is directed to determine whether the financial controls adopted by Air Canada are appropriate for "a Corporation of its size and undertaking". In making such an assessment and determination the Inquiry is directed to take into account the fact that the airline is a Crown corporation ultimately accountable for the conduct of

its affairs to Parliament through the Minister of Transport. The Inquiry has interpreted this specific directive as requiring a study and a report on the financial systems of Air Canada in the setting of a corporation of considerable magnitude owned and directed in the broad sense by the Parliament of Canada through the Executive Branch of government, represented by the Minister of Transport.

Paragraph (b) from the Order-in-Council, as quoted above, poses the question as to whether or not the expressions "misapplication, improper handling or misuse" include innocent or unintentional misapplication of funds of the airline only; or whether these expressions, when read in the context of the entire Order-in-Council, connote a deliberate or intentional state of mind, sometimes referred to in the law as *mens rea*. Paragraph (b) goes on to require a determination as to whether the misapplication, etc. is in contravention of (i) Air Canada's existing financial control policies and procedures, as approved by the Board of Directors, or (ii) is in violation of any applicable legislation.

This question is academic when one reverts for the moment to a consideration of the phraseology of the primary directive in the Order, namely, the system of financial controls related to the fiscal management of the Corporation. Fiscal or financial controls include both prospective and retrospective operations at the accounting and managerial levels for the purpose of disciplining the use of the funds and other assets of the airline, and at the same time for the detection of any departure from a proper use or application of those properties. The system of detection is not concerned with the presence or absence of any motive on the part of the offending employee or corporate organism. The Inquiry therefore, in applying paragraph (b) has included in its investigations deliberate as well as unintentional or accidental application of the funds of the Corporation, where such is in contravention of either (i) or (ii) above.

It is important to observe, however, and we point this out again later, that such an interpretation does not include a consideration of regulations or guidelines adopted by voluntary associations to which the airline has affiliated itself except to the extent that those policies or regulations have been adopted by the Corporation as "financial control policies and procedures".

In interpreting and applying paragraph (a) of the Order-in-Council, as set out above, we have considered that paragraph (c) operates only in the event of a determination that there has been a misapplication, etc., as defined in paragraph (b). A more difficult question arises in considering paragraph (c), namely whether we are concerned with a situation where the incident in question occurred but was not brought to the attention of senior management by reason of culpable failure on the part of other members of senior management.

The Inquiry has adopted, in determining whether "appropriate action within a reasonable time" was taken by senior management, a broad view of the meaning of the term "senior management" as it occurs in the third line of paragraph (c) quoted above. That is to say, senior management in para-

graph (c) has been taken to mean not only the officers of the highest rank in the Corporation but all those persons filling positions which in our general commercial community would be regarded as positions forming a part of senior management. Certainly for these purposes personnel of the rank of vice-president would be included and the Inquiry has proceeded on the basis that senior management embraces echelons of management somewhat lower in scale, including the Corporation Controller and the senior Directors of divisions or sections within the major branches and divisions of the Corporation. This interpretation has the consequence of requiring a determination as to whether or not the response of those persons so considered to be within senior management, who had actual knowledge of these incidents, was adequate.

Finally, and in the same area of interpretation, we have taken the view that a reading of the primary directive of the Order-in-Council and the three illustrative paragraphs requires a determination as to whether the incidents described in paragraph (b) were "brought to the attention of the senior management" and not merely whether that senior management took proper, or any, cognizance thereof. We have not gone so far as to interpret paragraph (c) as requiring a determination as to whether these incidents "ought to have been brought to the attention of the senior management". We will, however, be making comment upon the inner responses amongst senior management to incidents known to major segments of that management.

So much for matters interpreted by the Commission as being within its purview. It is much easier to be precise with reference to matters outside the purview of the Inquiry. This Commission has, from the outset, interpreted and applied the Order-in-Council as not requiring the Commission to assess and pass upon decisions of management of Air Canada from the substantive point of view; that is, as to whether or not those decisions were from a business or corporate viewpoint, good or bad, wise or unwise, or provident or improvident. Matters of business judgment or business assessment have been scrutinized only with reference to "financial controls" or "fiscal management". For example, whether or not the airline should or should not have entered the hotel and resort accommodation business generally or in specific geographical locations, has in no way concerned this Commission. Neither, as a further example, has the Commission concerned itself with whether or not the \$100,000 advanced by the airline to Robert Y. McGregor, as described in Chapter 6 below, is recoverable by legal proceedings. The Commission has, of course, concerned itself at some length with the financial controls which were applicable or which should have been applicable throughout any such transactions, and whether or not the controls were adequate but their implementation was inadequate, or whether managerial response to the discovery of the disbursement was appropriate.



## APPLICABLE STATUTES

The following is a summary of the statutes and provisions thereof which appeared to be relevant to the purposes of the Inquiry. The list is not an exhaustive one, but is set out here to provide a fuller picture of the context of the Inquiry. The full text of these provisions is set out in Appendix "C" of this report.

s. 5 Management—Board of Directors.

s. 12 Audit—by auditor appointed by Parliament for C.N.R.

s. 13(1) *Powers of the Corporation*

(a) to establish, operate and maintain airlines or regular services of aircraft of all kinds, to carry on the business of transporting mails, passengers and goods by air, and to enter into contracts for the transport of mails, passengers and goods by any means, and either by the Corporation's own aircraft and conveyances or by means of the aircraft and conveyances of others, and to enter into contracts with any person or company for the interchange of traffic and, in connection with any of the objects aforesaid, to carry on the business of warehousing goods, wares and merchandise of any kind and description whatever;

(b) to buy, sell, lease, erect, construct and acquire hangers, aerodromes, seaplane bases, landing fields and beacons and to maintain and operate the same;

(c) to borrow money for any of the purposes of the Corporation and, without limiting the generality

- of the foregoing, to borrow money for capital expenditures from time to time from the Canadian National Railway Company;
- (d) to carry on its business throughout Canada and outside of Canada;
  - (e) to purchase, hold and, subject to this Act, sell and dispose of shares in any company incorporated under section 18 *or* in any company or corporation incorporated for the operation and maintenance of airlines or services of aircraft of any kind;
  - (f) to lend money to any corporation incorporated under section 18 on such security as the Minister may determine;
  - (g) to deposit money with or lend money to the Canadian National Railway Company at such rate of interest as may be agreed upon between the Corporation and the Canadian National Railway Company;
  - (h) to issue such bonds, notes or other securities of the Corporation as are necessary to carry out the provisions of this Act;
  - (i) to buy, sell, lease or operate motor vehicles of all kinds for the purpose of transporting mails, passengers and goods in connection with the Corporation's air services and the air services of other air carriers and to enter into contracts with any other person respecting the provision of motor vehicle services of all kinds;
  - (j) to purchase, lease or to otherwise acquire or provide, hold, use, enjoy and operate such hotels in Canada as are deemed expedient for the purposes of the Corporation.
- s. 17 Pt. IV of Canada Corporations Act applies, except sections 161, 174, 175, 179, 196 and 197.
- s. 18 Governor in Council may create corporations.
- s. 25 Provisions of this Act, except sections 3, 4, 6, 11, 14 and 15, applied to every section 18 corporation.
- s. 27 Annual report to Parliament by Board of Directors.
- s. 28 Annual reports of Board and Auditors submitted to Parliament through the Minister of Transport.

FINANCIAL ADMINISTRATION ACT, R.S.C. 1970, c. F-10

Part VIII—*Crown Corporations*

- s. 66(1) "proprietary corporation"—includes Air Canada
- s. 70(2) capital budget to be put before Parliament annually.



- s. 74            a corporation may make provision for reserves for depreciation, uncollectable accounts and other purposes.
- s. 75            Books, records and statements of account.
- s. 75(3)        Annual report to be submitted to Minister and to Parliament.
- s. 76            Auditor to have access to books, records, etc., and is entitled to require from directors and officers such information and explanation as he deems necessary.
- s. 77            Auditor's report to Minister—to be made annually and included in the annual report of the Corporation.
- s. 78            In any case where the Auditor is of the opinion that *any matter* in respect of the corporation *should be brought to the attention* of the Governor in Council, the Treasury Board or the Minister of Finance, such report *shall* be made forthwith through the appropriate Minister.

CANADA CORPORATIONS ACT, R.S.C. 1970, c. C-32

Part IV

- s. 163(1)      Every company incorporated under any Special Act shall be a body corporate under the name declared in the Special Act, and may acquire, hold, alienate and convey any real property necessary or requisite for the carrying on of the undertaking of such company, and shall be invested with all the powers, privileges and immunities necessary to carry into effect the intention and objects of this part and of the Special Act, and which are incident to such corporation, or are expressed or included in the *Interpretation Act*.
- s. 171          Powers of Directors—the directors of the company may, in all things, administer the affairs of the company, and may make or cause to be made for the company, any description of contract which the company may by law enter into.
- s. 172          Directors may make by-laws in certain specified matters.
- s. 173          Directors may repeal, amend or re-enact any by-law.
- s. 198          Contracts, agreements, etc., by any agent, officer or servant of the company within the apparent scope of his authority as such agent, officer or servant, are binding upon the company.
- s. 206          No company shall use any of its funds in the purchase of shares in any other corporation except to the extent that such purchase is specially authorized by the Special Act.

Part IV— International Charters

- s. 21 Definitions—"inclusive tour" "inclusive tour charter" "tour operator"
- s. 25 Every Air Carrier to file tariff covering international air charter service before applying for a permit or licence for such service.

Division E—Inclusive Tour Charters

- s. 39 No air carrier shall operate an inclusive tour charter without first obtaining a permit from the Air Transport Committee.
- s. 40 The issue of a permit to operate an inclusive tour charter shall be subject to certain conditions as follows:—
- (j) the air carrier shall not pay directly or indirectly any commission to, or confer any benefit upon, a tour operator or any other person;
  - (q) the air carrier shall not act directly or indirectly as a tour operator and shall not advertise or participate in any way in the promotion of any inclusive tour.

Division F—Advance Booking Charters (A. B. C.)

- s. 43.31 No air carrier shall
- (a) pay or offer to pay any commission, gratuity or other benefit to any person in respect of any ABC; or
  - (b) advertise or cause to be advertised any ABC.
- s. 43.15(1) Every air carrier that is to perform the outgoing portion of an ABC shall, upon executing the contract for that ABC,
- (d) provide the Committee with a statement by each charterer, verified by his statutory declaration or, where the charterer is a company, by the statutory declaration of a duly authorized officer of the company setting out . . .
  - (iv) evidence of the financial responsibility of the charterer, consisting of
  - (A) audited statements including the auditor's report, and a balance sheet prepared as of a date not more than three months prior to the date of the receipt by the Committee pursuant to paragraph (b) of the executed copy of the contract.

Part V— Tariffs and Tolls

- s. 44(10) No air carrier or any officer or agent thereof shall offer, grant, give, solicit, accept or receive any rebate, concession or discrimination in re-

spect of the transportation of any traffic by the air carrier whereby such traffic is, by any device whatever, transported at a toll that differs from that named in the tariffs then in force or under terms or conditions of carriage other than those set out in such tariffs, unless with the prior approval of the Committee.

- s. 45(1) All tolls and terms or conditions of carriage established by an air carrier shall be just and reasonable and shall always, under substantially similar circumstances and conditions, with respect to all traffic of the same description, be charged equally to all persons at the same rate.
- s. 45(2) No air carrier shall in respect of tolls
- (a) make any unjust discrimination against any person or other air carrier;
  - (b) make or give any undue or unreasonable preference or advantage to or in favour of any person or other air carrier in any respect of whatever; or
  - (c) subject any person or other air carrier or any description of traffic to any undue or unreasonable prejudice or disadvantage in any respect whatever.

### *IATA Rules*

The Commission is of the opinion that the Order in Council did not require nor authorize the Commission to investigate the actions of Air Canada as they relate to the rules as set out by the International Air Transport Association (IATA). This is an international body in which the member organizations agree to abide by the rules as approved. As a breach of such rules could not be considered a violation of "legislation", a discussion of the applicability of these rules to the subject matter of the Inquiry is not considered appropriate. They are however adopted by company policy and subject the company to potential liability. Therefore the violation of the IATA rules is commented upon to that extent in various sections of this report.



## Chapter 4

### GENERAL CORPORATE ORGANIZATION

We turn now to an examination of the Corporation established and organized under the Statutes reviewed in Chapter 3. This can be done conveniently under the following headings:

- A. *Relationship Between the Corporation and the Minister of Transport*
- B. *Relationship Between the Corporation and the C.N.R.*
- C. *The Profit Motive; Advancement of Government Policies*
- D. *Corporate Structure*
- E. *Audit Services*
- F. *Objectives of the Corporation*
- G. *Magnitude of Business*

#### A. *Relationship Between the Corporation and the Minister of Transport*

The link between the Government of Canada and Air Canada is the Minister of Transport in whom the *Air Canada Act* has reposed several responsibilities relating to the Corporation. The Board of Directors of the Company consists of nine members, five of whom "shall be elected by the shareholders"—meaning the C.N.R. and four "shall be appointed by the Governor in Council". The shares of the Corporation were issued in the first instance to the C.N.R. who may, under section 6(3), dispose of them with the approval of Parliament. Somewhat in conflict therewith is section 10 of the same statute, which authorizes the Minister of Transport with the approval of the Governor-in-Council to acquire all of the shares of the Corporation from the C.N.R. at book value.

The annual report of the Board of Directors of the Corporation on the year's operations shall be tendered to Parliament through the Minister of Transport and this report shall, by reason of the *Financial Administration Act* be made within three months of the end of the Air Canada year, that is to say on or before the 31st day of March and shall include those financial statements prescribed for a corporation under the *Canada Corporations Act*.

By a further provision of the *Financial Administration Act* the auditor of the corporation shall report annually to the Minister of Transport the result of his examinations of the corporate accounts and financial statements and in so doing the auditor shall "state whether in his opinion

- (a) proper books of account have been kept by the corporation;
  - (b) the financial statements of the corporation
    - (i) were prepared on a basis consistent with that of the preceding year and are in agreement with the books of account,
    - (ii) in the case of the balance sheet, give a true and fair view of the state of the corporation's affairs as at the end of the financial year, and
    - (iii) in the case of the statement of income and expense, give a true and fair view of the income and expense of the corporation for the financial year; and
  - (c) the transactions of the corporation that have come under his notice have been within the powers of the corporation under this Act and any other Act applicable to the corporation; and the auditor shall call attention to any other matter falling within the scope of his examination that in his opinion should be brought to the attention of Parliament.
- (2) The auditor shall from time to time make to the corporation or to the appropriate Minister such other reports as he may deem necessary or as the appropriate Minister may require."

Over the years since the Corporation was established practices have grown up which have further linked the Corporation and the Minister of Transport. The Minutes of the Board of Directors' Meetings, which are generally held monthly, are transmitted by the Secretary of the Corporation to the Minister of Transport. Under the *Financial Administration Act* the budget of the Corporation must, as we will see later in this report, be submitted to the Minister of Finance through the Ministry of Transport and ultimately be approved by the Treasury Board on the recommendation of the aforementioned Ministers. This statutory procedure has no doubt contributed to a close link or a more detailed flow of information concerning financial matters between the Corporation and the Ministry of Finance.

The problems of integrating the managerial operations of a Crown corporation are old ones in our country. Where the corporation is purely a commercial operating organism the question is more difficult because it involves independence and efficiency on the one hand and control and susceptibility to communicate interest on the other hand. The Right Honourable Arthur Meighen, when Prime Minister, stated in the House of Commons on March 22, 1921:

"While there is corporate management, there remains the answerability and responsibility of the Government for the success of the system. That we cannot dispute. But there is no

immediate accountability for the day-to-day procedure of operation. If there is to be then our officers subject to our direction are not so operating. The board of directors is independent of Government control and direction; and that being so the Government from day to day cannot be answerable for details of operation, or for what takes place in the ordinary routine of operation between the operating directorate and the patrons of the road."

In the case of Air Canada, the Minister of Transport is the conduit through whom reports are made to the Parliament of Canada. Again difficult and delicate relationships arise. Parliament, being the final source of funds for the conduct of the operations of a Crown corporation, is obviously entitled to information about the corporation's operations and to control the use and application of those funds. On the other hand, the purpose for which the corporation has been established might well be defeated where legislative intervention, particularly through committees of interrogation, reaches into the operational areas of the corporation and interrupts day-to-day activities. This question of political science was considered by H. Carl Goldenberg, Q.C. when reporting on government commercial enterprises to the Province of Manitoba in 1940; at p. 44 of his report he stated:

"It does not follow from the foregoing, however, that government commercial enterprises administered by boards or commissions should be beyond control and criticism by the Legislature. While, the Legislature cannot effectively supervise the day-to-day management and ordinary matters of internal administration of the enterprises, and while legislative interference in these matters is inadvisable, nevertheless, the Legislature has a right to information and to the exercise of its power to debate and to criticize. Such discussion is effective and beneficial in relation to the broad public policies and the general condition of the enterprises and affords a valuable form of control."

## B. *Relationship Between the Corporation and the Canadian National Railways*

C.N.R. is, of course, the parent company of Air Canada and at the present time holds all the outstanding shares of the Corporation. The railway company, by reason of its capacity as shareholder, elects five directors to the Board of Air Canada, being the majority thereof. Under section 13(1)(c) of the *Air Canada Act* the airline is authorized to borrow money for capital expenditures from the C.N.R. and under subsection (g) is authorized to lend money to the C.N.R. As we have seen, the auditors of the C.N.R. are automatically the auditors of Air Canada.

In addition to these formal links there have grown up over the years several practices of sharing facilities and services including legal services which are provided to Air Canada by the C.N.R. from time to time. Until recently, the Corporate Secretary of Air Canada was the Corporate Secretary of

the C.N.R. Certain health facilities are still made available by the C.N.R. to Air Canada.

As will be dealt with in more detail later in this report, the C.N.R. has made available to Air Canada subsidiaries for the purpose of enabling Air Canada to undertake certain operations more or less outside direct airline business and the C.N.R. through a subsidiary has acquired shares in another business on behalf of Air Canada. From a statutory viewpoint there is a further link or relationship illustrated by chapter 6 of the 1974 Statutes of Canada, being the *Canadian National Railways Financing and Guarantee Act*, 1973. Section 7 of that statute is devoted entirely to matters relating to the financing of Air Canada by the Minister of Finance on the approval of the Minister of Transport and subject to approval by Governor-in-Council.

### C. *The Profit Motive; Advancement of Government Policies*

Governments are driven by many motives when forming agencies including Crown corporations of a proprietary nature. It may be the profit motive has no bearing, and perhaps even attainability, by reason of the nature of the enterprise or the economics of the times.

H. Carl Goldenberg, op. cit., p. 41:

"The services which the State itself usually undertakes to provide through a government commercial enterprise are those which it considers to be particularly affected with a public interest and which are in their nature a monopoly or quasi-monopoly. It may be the desire of the State to prevent wasteful competition in the provision of such services, or to prevent abuses in the exercise of monopoly powers, or to provide such services at or below cost to all the population or to as large a proportion of the population as possible. There may also be other reasons. Regardless of the causes, however, once the decision in favour of public ownership is made, the task that presents itself immediately is that of combining such public ownership with public accountability and efficient business administration. The organization which is selected or created to operate the government enterprise must be such as will perform this task most satisfactorily."

The application of the proper motive in the case of Air Canada must be determined from an examination of the *Air Canada Act* and the *Financial Administration Act*.

The *Financial Administration Act*, Schedule D, lists Air Canada as a "proprietary corporation". The term itself is undefined and is not employed in the Act except to state "proprietary corporation means a Crown corporation named in Schedule D". Some of the corporations so listed have minor regulatory functions. The major or exclusive function of the corporation in Schedule D appears to be to carry on an operating function or enterprise akin to



that of a commercial enterprise in the non-government sector of the community.

Air Canada, like some of the other corporations listed in Schedule D, is called upon by the Government of Canada to undertake in connection with its main enterprise some tasks required in the public interest which cannot be classified as a commercial undertaking. An example is the operation by the CBC of the International Service at the request and for the account of the Government of Canada. Others, such as the Polysar Corporation, carry on a commercial enterprise in the same manner as any corporation the shares of which are not owned by Government. Air Canada falls somewhere in between. Management in its appearance before this Inquiry has stated that the guiding principle of the airline is to conduct its operations with a view to producing a profit; that is, a reasonable return on the moneys invested. One of the exhibits received by the Inquiry includes a statement of "the mission of Air Canada" and in part states as follows:

"Air Canada is a Crown Corporation engaged in the carrying on of a competitive business both domestically and internationally . . . as a business enterprise Air Canada must be profit oriented and operated in accordance with sound business principles in order to achieve efficiency, to ensure a proper use of its resources and successfully meet competition."

The financial controls and the management policy are founded on this principle and the result of the operations of the company are measured by this standard. The primary objectives outlined in the *Air Canada Act* admit of such an approach and the nature of the undertaking on the whole perhaps requires such a standard. Air Canada operates in a highly competitive industry, both nationally and internationally. Some of its competitors are owned by other Governments, some are owned by private investors, and some by the public generally through the medium of shares trading in public stock exchanges. For Air Canada to otherwise manage its affairs would be considered unfair competition by some of the other airlines. In any case the airline is subject to domestic and foreign government regulation which in the main appears to recognize the profit motive.

However, Air Canada's corporate life is more complicated than some. It was in its conception, and to some extent must continue to be, an instrument of Government policy. This is recognized in the same document from which quotations appear above and wherein it is further stated:

". . . as a Crown corporation Air Canada must assist in the attainment of stated national, social, political and economic objectives."

From time to time, for example, Air Canada will be called upon to serve routes both inside and outside Canada where it will be demonstrably impossible to operate at a profit in the commercial sense. Someone other than this Inquiry will perhaps be interested in the question whether such special burdens should be charged to the authority seeking such service. Our in-

terest is only to examine the broad area of financial controls and fiscal management as they might be affected by this function of Air Canada's corporate existence.

#### D. *Corporate Structure*

The Corporation is classed by Schedule D to the *Financial Administration Act* as a "proprietary corporation" and the corporation has been organized on the general lines of a commercial operating company. The Chief Executive Officer is the Chairman of the Board of Directors and reporting to him directly and indirectly are the President, two group Vice-Presidents and 15 other Vice-Presidents. It should be noted as a corporate anomaly that the corporate President is not a member of the Board of Directors, although in practice he does attend all Board meetings. The Corporate organizational chart is appended hereto as Appendix B.

The Corporation and its Officers are subject to certain parts of the *Canada Corporations Act* incorporated by reference in the *Air Canada Act*. These provisions generally relate to general powers of the Corporation, directors' duties and powers, the making of by-laws, the Company books, and shareholders and directors' liabilities.

There is no clear distinction drawn between line and staff functions in the corporate organization but generally the company's operations are conducted through five regions under Vice-Presidents and several central operating staff divisions. The staff function is generally centred in the Branches at the Head Office. In some instances, such as marketing, the staff and operating functions are combined. In other instances, as will be seen in detail in the examination of the Finance Branch, there is a staff functional link between staff and operating Branches and Regions through employees providing the staff service in question in the Regions or Branches.

The corporation has one wholly-owned subsidiary, Air-transit, formed under section 18 of the *Air Canada Act* on application of the Corporation to the Governor-in-Council. Subsidiaries incorporated by this means are subject to the same limitations as to powers, objects and purposes as Air Canada itself. The company has, as mentioned above, made arrangements in the past with the C.N.R. for the establishment of C.N.R. subsidiaries which are in law affiliates and *de facto* are subsidiaries of Air Canada and are wholly financed and controlled by Air Canada. An example of this, Venturex Ltd., will be examined in detail later in Chapter 8.

#### E. *Audit Services*

As we have seen, the auditors of the Corporation are appointed by Parliament and are the same auditors as those appointed for the C.N.R. By section 67 of the *Financial Administration Act* the Auditor General is eligible

to be appointed as the Auditor or joint Auditor of the Corporation but such has not been done in the past. The functions of the auditor are set out in detail in the *Financial Administration Act*, portions of which were quoted above. In addition the auditor is authorized by section 78 of that Statute to bring to the attention of the Governor-in-Council, the Treasury Board or the Minister of Finance any matter in respect of the Corporation which, in the opinion of the auditor, should be so reported.

#### F. *Objectives of the Corporation*

The senior officers of the Corporation speaking chiefly through the Chairman of the Board operate the Corporation on a profit incentive basis. Inherent in the testimony received in this Inquiry is the recognition by the management of the airline that at the same time the airline is indeed an instrument of government for the proper advancement of government policies. For example, the Corporation is required to bring air services to regions of the country which may not necessarily be economically served by the airline. This role was contemplated in the original statute establishing Air Canada wherein it was provided that the Governor-in-Council would authorize the Minister of Transport to enter into a contract with the Corporation for the establishment of facilities and services for the efficient transport of passengers and goods across Canada and between points inside and outside Canada. The terms of the statutory provisions in this regard reveal a parliamentary intent or recognition of the fact that these services might well be performed at a net loss and hence make provision for doing so under a contract with the government. A more modern illustration of this role might be international routes which are opened pursuant to bilateral agreements negotiated between the Government of Canada and the governments of other countries to bring about air services between Canada and other countries which are not commercially profitable at least in the early phases.

At the same time corporate disciplines and efficiencies are all directed to the corporate goal of operations at a profit. A concomitant policy adopted by management is to finance capital acquisitions and refurbishments out of resources accumulated by the Corporation from its operations. These measures have resulted in the Corporation not having to increase its indebtedness to the government during the last two years. Borrowings have been carried out through ordinary banking connections and on a larger scale by the use of long term leases for aircraft instead of outright purchases.

#### G. *Magnitude of Business*

The Corporation operates a fleet of 120 jet airliners and employs approximately 22,000 people inside and outside Canada. It conducts its operations internationally in some 15 countries and internally into every province of Canada. The Air Canada financial record reveals a profit from

operations in ten of the last twelve years, although a loss of \$9,000,000. in operations was incurred during the calendar year 1974. The scale of operations is indicated by the fact that its total operating revenues in 1974 were about \$850,000,000. In 1974 Air Canada carried some twelve million passengers.

## *Chapter 5*

### FINANCIAL CONTROLS

The purpose of this chapter is to outline the basic corporate structure of Air Canada and to indicate the responsibility of each separate segment of that structure in relation to financial controls.

#### *A. Board of Directors*

The Air Canada Act in Section 5 provides for management of the Corporation by a Board of nine directors, of whom five are to be elected by The Canadian National Railway Company and four appointed by the Governor in Council. Section 9 of the by-laws provides for the annual election of the five directors elected by The Canadian National Railway Company and their term of office is therefore obviously a one year term. It has always been the practice of The Canadian National Railway Company to elect as directors of Air Canada persons who are also directors of The Canadian National Railway Company. Directors appointed by the Governor in Council are appointed for a specific term. Recently this term has been three years.

The Air Canada Act does not itself contain any provisions as to the duties and powers of the Board of Directors. However, Part IV of the Canada Corporations Act is made applicable (with certain exceptions) to the Corporation. That latter Act in Section 171 confers on the directors power "to administer the affairs of the Company, and . . . make or cause to be made for the Company any description of contract which the Company may, by law, enter into".

The Board holds monthly meetings, except during July and August and deals with a much broader range of subjects than corporate formalities. Its meetings are regularly attended by the President of Air Canada, Mr. R. T. Vaughan, who himself is not a director; by the Secretary of the Company, Mr. M. E. Fournier; and are frequently attended by Group Vice-Presidents and the Vice-President of Marketing. When matters are before the Board involving the affairs of any branch, other officers of that branch often attend to make presentations and answer inquiries. The evidence which was placed before this Inquiry indicates that the Board fulfills its function capably subject

to certain specific limitations placed upon it by the Company's customs and perhaps to some extent by the institutionalized method of appointing its members. Quite naturally, particularly in a technical industry like airlines, the Board relies heavily on recommendations of operating management in approving business decisions. Nevertheless, it represents a significant control, real and potential, over management in relation to such decisions because the necessity of seeking the Board's approval, even though that approval may amount in some instances to a rubber stamp, requires detailed and frequently well thought out and elaborate presentations to obtain that approval.

The Board annually approves the budget of capital expenditures for the forthcoming year before it is submitted for approval to the Minister of Transport in Ottawa. Its function in this respect, however, is limited in nature and the necessity of such approval does not, therefore, represent a significant financial control. The budget is very large (capital expenditures were \$180,000,000 and operating expenses \$815,000,000 in 1974) and cannot, of course, be presented to the Board in great detail. It is obviously not practical to ask for the Board's approval of each specific project, or indeed of the total proposed expenditures department by department. In any event, such a presentation would be of little significance because by far the greatest percentage of operating expenses are fixed rather than variable (salary and wages, fuel and oil, rent, commissions, landing fees, etc.). The Board does, however, in relation to the budget, examine and discuss in some detail the economic assumptions on which the budget is based, forecasts of traffic growth, product plans (new routes and services and capacity increases), forecasts of revenue growth and summaries of budgeted operating expenses and budgeted property and equipment expenditures for the year. Considering the limited nature of the function which the Board can perform in this area, the presentation to it by senior management of budget information is adequately detailed. Real financial controls in relation to the budget, however, must be found within the management of Air Canada rather than at the level of the Board of Directors.

The by-laws of Air Canada referred to below require Board approval of capital items of \$150,000 or over only if those items are not included in the approved capital budget. At first blush, therefore, it might seem that the Board's budget approval would do away with the necessity of approving significant capital expenditures on an individual basis. This is not the case. It must be remembered that Board approval is still required notwithstanding the by-law provisions mentioned below where the proposed capital expenditure, budgeted or otherwise, is \$150,000 or greater, because the requisite AFE must have Board approval.

Expenditure proposals requiring directors' approval are presented at almost every meeting of directors and are severally explained in agenda material in what we consider to be sufficient detail to enable the directors to properly fulfill their function in regard to such items. As mentioned earlier, however, the operation of an airline is an exceedingly technical matter and

we would not expect, nor did we find, that the directors second guess qualified operating management in relation to technical and specialized business decisions.

Shortly before each meeting of directors, all members of the Board receive from the Secretary a copy of the agenda for the meeting and written material for their study relating to each of the agenda items. Additional information, both written and oral, is, of course, furnished as a matter of course when the meeting actually takes place but the material submitted prior to the meeting is obviously of assistance to all directors in their preparation for the meeting.

The procedure followed by the Secretary of the Corporation in preparing for any meeting of the Board of Directors affords each branch a full opportunity to place on the agenda any matter related to that branch which the Vice-President of the branch feels should be brought to the attention of the Board. Approximately four weeks before each scheduled meeting of directors, the Secretary circulates a memorandum to the Chairman of the Board, the President, all seventeen Vice-Presidents, the General Counsel and the Directors of In-flight Service, Market Development and Product Development asking that they submit to him two weeks prior to the scheduled meeting any suggested agenda items which they would like to have included. This procedure should be borne in mind when considering the action of the Marketing Branch in entering into the Barbados leasing project and the McGregor project without seeking Board approval. It is also relevant when determining where matters went wrong in the administration of the affairs of Venturex Limited.

When their suggestions are received, the Secretary prepares a draft agenda and approximately one week before the scheduled meeting date, the draft is reviewed and settled by an Agenda Review Committee consisting of the Chairman, the President, the Group Vice-President, Sales and Service, the Vice-President of Finance, the Controller and the Secretary. It is following this meeting that the Secretary prepares the material, which is then mailed to the Directors six or seven days before the date of the actual meeting in order that they can prepare themselves for a discussion of the agenda items. The procedure which the Secretary adopts in this regard on a regular basis should represent a monthly reminder to the twenty-three senior executives, who are so consulted for suggested agenda items, of the need to keep the directors informed and to seek Board approval of any action taken or proposed which might be considered out of the ordinary course of business. In view of this procedure it is difficult, if not impossible, to understand how such a tremendous amount of executive time could be devoted to the McGregor transaction involving, as we are asked to believe it did, a novel acquisition in a controversial field without Board approval of the idea in principle. It is even more difficult to understand the failure of management to bring before the Board of Directors of the Company the Sunset Crest leases in Barbados until April 1974, when that project originated in March 1973.

## B. *Authorization of Disbursements*

### 1) *By-laws*

By-laws of Air Canada identify those expenditures and agreements obligating Air Canada on a firm or contingent, present or future basis, which must first be approved by the Board of Directors of the Company and those which may be approved by the Chairman of the Board and other corporate officers without the additional requirement of Board approval.

The following are the sections of By-law No. 1 relating to approval of expenditures by the Board of Directors:

#### "CAPITAL EXPENDITURES

23. Items included in the approved capital budget may be committed in the manner and to the extent that the Chairman of the Board shall direct.

24. (1) Any items which are not included in the approved capital budget shall require prior approval:

- (a) by the Board of Directors in cases where they involve an expenditure of \$150,000 or more; and
- (b) by the Chairman of the Board or such officer or officers as he may designate in cases where the items involve an expenditure of less than \$150,000, provided such approval given by him or under his authority does not exceed the maximum budget appropriation of the category affected.

(2) Items shall not be parcelled or divided in order to bring the expenditure below \$150,000.

#### PURCHASE OF EQUIPMENT, MATERIALS, SUPPLIES AND SERVICES

25. (1) All proposals for the purchase of equipment, materials, supplies and services not referred to in subsection (2), and which are estimated to cost \$150,000 or more under a single purchase shall be submitted for approval to the Chairman of the Board and to the Board of Directors. Contracts for such purchases shall be made only by or with the authority of the Chairman of the Board.

(2) All proposals for the purchase of fuel, replacement parts and stationery and such other materials, supplies and services as in the opinion of the Chairman of the Board or the President are required for the ordinary conduct of the Corporation's operations, which are estimated to cost \$150,000 or more under a single purchase, shall be submitted for approval to the Chairman of the Board or the President. Contracts for such purchases shall be made only by or with the authority of the Chairman of the Board or the President.

26. Contracts for the purchase of equipment, materials, supplies and services estimated to cost less than \$150,000 shall be made only by or with the authority of the Chairman of the Board or the President.



#### CONSTRUCTION OF CONTRACTS

31. (1) Except in cases of emergency or unless the Board of Directors otherwise decides, sealed tenders shall, in all cases in which it is possible to obtain competitive quotations, be invited and received before any construction is made involving an expenditure of more than \$25,000.

(2) Sealed tenders may be invited before construction contracts are made involving \$25,000 or less.

#### MISCELLANEOUS TRANSACTIONS

36. (1) Any transaction involving a guarantee, obligation, purchase, sale, lease or expenditure not elsewhere specifically provided for herein, and not being transactions referred to in Section 40, the consideration for which has the sum or value of \$150,000 or more, shall require the approval of the Chairman of the Board and the Board of Directors. A contract arising from any such transaction shall be executed under seal.

(2) Any transaction referred to in subsection (1), the consideration for which has the sum or value of less than \$150,000 shall require the approval of the Chairman of the Board or the President or such officer or officers as either may designate."

The reference to services in section 25(2) above should be read *ejusdem generis* with the consumable stores which precede the word "services". Hence it is difficult to understand the argument sometimes made in the course of the hearing that the accommodation leased in the Sunset Crest project in Barbados was acquired in the ordinary course of business and therefore Board approval was not required. The Sunset Crest project is caught by section 36 above and hence Board approval was required from the outset.

The Vice-President of Finance testified at the hearing that in 1969, Messrs. Touche, Ross & Co., the then auditors of Air Canada, recommended that the limit of the Chairman's authority to approve expenditures should be raised from \$150,000 to \$500,000. They felt at the time that the lower dollar limit was much too restrictive having regard to the nature of the Corporation's operations. No action was ever taken, however, to amend the by-laws in this regard.

## II) *Manual 300, Budget and Financial Administration*

Chapter 8 to the corporate Manual 300 sets out a description of procedures to be followed within the Authority for Expenditure (AFE) System. A brief summary of this system appears in Section H of this chapter. Certain of the more important approval procedures as outlined in Chapter 8 to Manual 300 are as follows:

- "2.11 *Source of funds for Unbudgeted P & E Projects:* Funds can be obtained for the acquisition of items which have not been specifically included in the approved budget in one of the following ways:

- 1 Funds can be obtained for items not specifically budgeted by listing the budget item number which has been assigned to category 2810 entitled—"Provision for items less than \$25,000".
- 2 Recommendations to acquire unbudgeted items will be directed to the branch budget representative in the office of the major deputy.
- 3 Lack of any available funds within the branch budget (regardless of category) to cover an unbudgeted project means that a request must be made to make use of Category surplus funds or funds that have been released to the Director, Financial Planning. In this case, the AFE should clearly identify as "Funds Required" in the budget item column and forwarded to the Vice President—Finance.

NOTE: In the event that:

Authorization of the project might result in  
TOTAL Company expenditures exceeding the  
TOTAL approved budget,

and/or,

Authorization of the project might result in  
TOTAL Company expenditures for the major  
category involved exceeding the approved category budget by an amount approximating 20%; then the branch concerned may be asked to reconsider the need for the item in question. If the need still persists, then a Property and Equipment Budget Revision may be necessary before final authorization of the AFE is possible.

- 2.12 *Source & Funds for Unbudgeted Operating Projects:* Funds can be obtained to cover projects not specifically included in approved Budget Centre Funds in one of the following ways:

- 1 Quarantining of funds from approved budget projects and/or a "net" budget surplus within the approved total budget of the Budget Centre concerned. The AFE should clearly indicate the source of funds.
- 2 If funds cannot be secured as shown in Item 1 above, then the covering AFE will be forwarded to the Branch Vice-President with a request for fund coverage. If the Vice-President can arrange to quarantine approved and/or surplus funds from some other Budget Centre within the branch, then full detail as to the source should be clearly indicated prior to authorization.
- 3 If approved funds within the branch budget cannot be quarantined to cover the unbudgeted project, then the Vice-President may still authorize the AFE if the amount is less than 50% of his maximum authorizing power for approved operating expense Special Projects. (Refer Section 4.) If the amount of the AFE is 50% or more of such authority, then the AFE must be forwarded to the Vice-President—Finance who will arrange for approval by the Chairman/President.

2.13 *Authorization for Over-/Under-Expenditures of P & E Projects:*

- 1 Over-Expenditures of P & E Items/Projects will be permitted without further authorization when:
  - a The over-expenditure is less than \$500.
  - b The over-expenditure is more than \$500, but less than \$50,000 providing that it is not more than 10% of the authorized project and that the funds necessary to cover this over-expenditure are available from the approved budget.
- 2 When a supplementary AFE to cover an over-expenditure is necessary, the level of authorizing signature required will be based on the COMBINED TOTAL of the ORIGINAL and SUPPLEMENTARY AFE amounts (Refer Section 4.10).
- 3 When it is anticipated that a major project will be under-expended by \$100,000 or more, immediate advice should be supplied in a supplementary AFE OR signed letter (directed to the Director, Financial Planning to facilitate financial planning). If letter advice is used, a copy of the letter should be sent to all those whose signatures appear on the existing AFE as well as all other officers holding a copy of the AFE.
- 4 Under-expenditures or surplus budget funds, except where a cancellation is involved, will be quarantined by the Finance Branch, and be available upon request for unbudgeted/over-expended projects once Branch funds have been exhausted.

2.14 *Authorization for Over-/Under-Expenditures of Operating Projects:*

- 1 Over-expenditure of OPERATING PROJECTS will be permitted without further authorization when:
  - a The over-expenditure is less than \$500.
  - b The over-expenditure is more than \$500, but does not exceed 10% of the authorized project and is within the sponsoring branch's delegated authority. (Refer Section 4.10).
- 2 When a supplementary AFE to cover an over-expenditure is necessary, the level of authorizing signature required will be based on the COMBINED TOTAL of the ORIGINAL and SUPPLEMENTARY AFE amounts. (Refer Section 4.10).
- 3 Under-expended (surplus) funds completed "budgeted" operating projects will remain as part of the current Expense Budget of the branch concerned unless eliminated via a budget revision. Unexpended funds from a completed project authorized as an "unbudgeted project" (i.e., funds not available in approved budget) will automatically be released from quarantine at the time the AFE is closed.

4.11 *Authority for Expenditure Proposal Reserved by the Board of Directors:*

Any proposal (excluding normal operating requirements such as fuel, oil, replacement parts, etc.) estimated to cost \$150,000 or more, under a single purchase regardless of existing budget approval (either P&E or Operating).

4.12 *Authority Delegated by the Chairman/President:* Except for those major expenditure plans reserved by the Board for final consideration, the Chairman/President have the final authority for Company expenditures. Certain of these powers have been delegated to major deputies having due regard for the type of expenditure and the significance of the amount in relation to branch activities. The following represents details of all such delegations, with certain specified restrictions pertaining to unbudgeted projects being the exception to the general rule.

1 *P & E Items and Operating Special Projects:*

- a Chairman/President's deputies (all branch heads) may authorize all AFE's (both P & E and Operating) for less than \$50,000 provided funds to cover the expenditure are available in appropriate, approved budgets of the branch.
- b If funds are not available in approved budgets of the branch, any AFE with a value of more than \$25,000 is to be directed to the Vice-President, Finance for funding clearance prior to final approval.

2 *Absence of the Chairman/President—Authority Delegation:* The Vice-President—Finance is authorized to sign AFE's on their behalf during their absence for periods of five working days or more on any one occasion.

NOTE 1: It is the intent of the above delegation schedule that all AFE's having a value of \$50,000 or more (regardless of P&E or Operating content) shall be directed to the Chairman/President for final authorization.

NOTE 2: When an AFE covers the acquisition of "outside services" to perform a job which is normally provided by another branch as a functional responsibility, the sponsoring branch must secure the approval of the Vice-President of the other branch on the face of the AFE."

The dollar limits referred to above have been adjusted by a memorandum of the Chairman as discussed in Section III below.

### *III) Delegation of Signing Authority*

The by-laws do not prescribe expenditure authorization levels of officers below the office of President. However, the limits of expenditure authority of other officers have been established and are set out in Air Canada Manual 300. These limits, however, must be read as adjusted by a memorandum of

the Chairman of the Board dated January 24, 1974. This memorandum unfortunately was not consolidated into Manual 300 when it was brought up to date in July 1974. As a result, as mentioned in Chapter 6, at least two members of the Finance and Marketing branches were not aware of the true state of the regulations with reference to the requisite authorization procedure for the McGregor AFE's. The present authorization limits may be summarized as follows:

- (a) Regional or Branch Vice-Presidents have expenditure authorization up to \$50,000 and may delegate this authority to their deputies.
- (b) Group Vice-Presidents and the Vice-President of Marketing have expenditure authority up to \$100,000.
- (c) The Chairman has expenditure authority up to \$150,000.
- (d) The authority of the Board of Directors is required in the case of AFE's of \$150,000 and above.
- (e) All expenditures over \$50,000 must first be submitted to the Finance Branch of Air Canada for comments before final authorization and if there is disagreement as to the expenditures between the Finance Branch and the submitting branch, the matter must be brought to the attention of the Chairman of the Board.

#### IV) *Comments*

It can be evidenced from the above summary of authorization procedures as laid down in the by-laws and Manual 300 that several contradictory statements exist as follows:

- (i) With regard to unbudgeted capital expenditures the by-laws (as described in section 24(1)(b) above) state that *any* unbudgeted capital item which involves an expenditure of less than \$150,000 and exceeds the maximum appropriation of the category affected, requires Board approval. However, section 2.11 of Chapter 8 of Manual 300 (as outlined above) states that for similar expenditures, Board approval is not required if the approved major category involved is not exceeded by 20%.
- (ii) It is even more confusing in interpreting the above contradiction or in understanding the by-laws and Manual 300 regarding unbudgeted capital expenditures when section 4.12 of Chapter 8 of Manual 300 above is read. This states that if funds are not available in the approved branch budget, then unfunded capital expenditures greater than \$25,000 (adjusted to \$50,000 by the Chairman's January 24, 1974 letter) must be directed to the Vice-President, Finance for funding clearance prior to final approval.

It should also be further noted that the by-laws make no reference to procedures to be followed in the case of unbudgeted operating expenses.

It can be concluded from the above that it is indeed difficult to interpret the sometimes confusing and contradictory set of rules to be followed by Company personnel in approving capital or operating expenditures. As a result the by-laws and sections of Manual 300 referred to above, which are intended to enforce financial controls over authorization procedures, are subject to question in regard to their effectiveness.

### C. *Law Department*

The Law Department is presently a directorate within the Presidential sector, the head of which, Mr. MacPherson, reports to Mr. Vaughan. Under By-law 1, section 44, the Department is required to approve "as to form" any document before execution by or on behalf of the corporation. As will be seen in the McGregor transaction, detailed in Chapter 6 below, the three letters of agreement signed by the Vice-President Marketing, on behalf of the corporation, were not processed through the Law Department in any way. The Barbados leases, the details of which are described in Chapter 7 below, were the subject of examination and negotiation by and with the advice of the Law Department, but the Law Department was apparently not consulted with reference to authorized procedures including approval by the Board of Directors. As will be seen from Chapter 9 below, the Law Department was not consulted with reference to an interpretation of the documentation surrounding the purchase by Mr. Yves Menard, then Vice-President Marketing, of a cottage or villa from the lessor with whom Air Canada at the same time was negotiating the extensive Barbaros leases mentioned above.

As regards the establishment, organization and operation of subsidiary and affiliated companies, all of which is discussed in some detail in Chapters 8 and 10 below, the Law Department appears to have played roles of varying importance. The general position of the corporation under its parent statute, and its effect on the relationship between the corporation and its ultimate shareholder, do not seem to have been referred to the Law Department in connection with the formation of the affiliated companies discussed elsewhere in this Report.

In Chapter 13 there is a discussion concerning the elevation of the Law Department as a control mechanism in the corporation and the utilization of that Department not only for approving as to form contracts and agreements and other corporate documents, but also for advising upon corporate powers, regulatory issues, signing authority and approval procedures, as well as utilizing the facilities of the Law Department in connection with the relationship between the corporation and the regulatory agencies with which it must inevitably deal.

### D. *Executive Committee*

Since June of 1971, a committee of management, consisting of eleven members, has been in formal operation under the title of Executive Com-

mittee. That title in normal circumstances refers to an Executive Committee of the Board of Directors, all members of which are themselves directors. This is not the case so far as the Air Canada Executive Committee is concerned. The only director who is a member is the Chairman. The other members are the Corporate Secretary and those senior officers who report directly to the Chairman. They include the President, the Group Vice-President Technical Services, the Group Vice-President Sales and Services, the Vice-Presidents of Finance, Personnel and Organization Development, Marketing, Computer and Systems Services, Public Affairs, and the Director Corporate Planning.

The Committee meets each Friday and by the date on which our Inquiry commenced, had held one hundred and eighty-eight meetings. Its meetings are minuted. It was established on the basis that it would be responsible for discussion, review and development of advice on major matters of corporate policy and on major operating matters of corporate significance. At each meeting, each member gives the Committee a review of the major events of the week affecting his particular area of responsibility and once a month each member reviews the financial results and operating performance of his area of responsibility during the preceding month. Essentially, it seems that the Committee is a forum for the discussion of current problems as a means of assisting the Chairman of the Board and indeed, the other members of the Committee, in their decision making responsibilities. It is a means whereby senior management keeps in close weekly contact with activities in all branches of the Corporation. If the airline's senior management is to function as a team, the teamwork will be developed at the Executive Committee level.

Because it brings senior management together weekly for a free exchange of views and an in-depth discussion of problems, it should operate effectively as an instrument of financial control. It is astonishing, therefore, that neither the McGregor transaction nor the Sunset Crest/Barbados leases ever came up for discussion at that Committee. Neither were they referred to anywhere in any of the minutes. Although Menard's recollection was that occupancy levels at Sunset Crest had come up for discussion at Executive Committee meetings, the Chairman, the President, the Vice-President of Finance, and the Group Vice-President Sales and Services, all testified that neither of those subjects specifically came up for discussion at any Executive Committee meeting. It obviously, therefore, does not operate as an instrument of financial control as presently constituted.

Chapter 7 of this Report, dealing with the Sunset Crest properties, makes it perfectly obvious that financial difficulties related to the Sunset Crest condominiums, apartments and villas which became apparent as early as March 1974 have continued to date. Many Executive Committee members were aware of these problems not later than May of 1974 and yet no one saw fit to raise them for discussion at the Executive Committee in the hope of reducing or eliminating continuing losses.

## E. *Audit Committee*

Air Canada is not required by law to have an Audit Committee, but after considerable discussion of the matter within the Corporation, particularly in the latter part of 1974, one was established by resolution of the Board of Directors passed on February 25, 1975. The Committee is composed of the Chairman of the Board, ex officio, three directors and the Vice-President Finance. The Committee is constituted to review the annual financial statements of the Corporation prior to such financial statements being submitted to the Board of Directors and to examine and consider such other matters relating to the internal and external audit of the Corporation's accounts and to its financial affairs as the Committee may, in its discretion, determine to be desirable. A representative of the Corporation's external auditors is entitled to attend meetings. These may be called at the request of either the external auditors or of the Vice-President Finance.

By the date this Inquiry commenced, two meetings of the Audit Committee had been held. At the first meeting, held on March 3, 1975, the 1974 financial statements for Air Canada were reviewed and discussed with the external auditors and the Committee resolved to recommend them for approval by the Board of Directors. At the second meeting, held on April 29, 1975, the external auditors' memorandum on the 1974 audit was received and discussed; the Venturex \$145,000 AFE relating to Ground Reception Services (referred to in detail in Chapter 8) was discussed and the report which justified the expenditure requested. The Audit Services Post Audit Report on the McGregor Travel AFE's was available but was not discussed because this Commission by that date had been constituted.

The Corporation is to be commended for its action in adding this additional financial control even though not required by law to do so. The reasons for doing so are detailed in a five page memorandum prepared by the Secretary of the Corporation and circulated as agenda item number 5 for the Board of Directors meeting on February 25, 1975. Although the Committee has had only a limited opportunity to function to date, there is no reason to expect that the anticipated benefits outlined in that memorandum which prompted its formation will not be achieved. These benefits were expressed to include improving the directors' knowledge and understanding of the financial statements and other financial information; increasing the directors' knowledge of the nature and scope of the functions of the shareholders' auditors; providing Committee members with a better understanding of the accounting and internal control systems upon which the validity of the financial information rests and of management's actions to maintain and improve it; reinforcing the external auditors' independence from management, thereby providing the directors with an additional degree of control; affording the external auditors an opportunity to gain additional understanding and insight concerning the Corporation; providing added leverage for the financial management of the Corporation in effecting necessary improvements; and providing added protection for shareholders and directors.



## *F. Advisory Committee on Subsidiary and Associated Companies*

This Committee was formed by resolution of the Board of Directors passed on November 26, 1974. It was established as a subcommittee of the Board to determine what authority the Board should properly exercise over the activities of subsidiaries and associated companies. Members of the Committee are the President and three directors.

The Committee was formed as a result of questions largely from one of the directors as to the Corporation's activities auxiliary to its airline function and following a report to the directors describing the Corporation's investments in subsidiary and associated companies.

At a meeting of the Board of Directors held on January 29, 1974 during a review by the Vice-President Finance of the results for the year 1973 and the current outlook for 1974, as a result of a director's question, the following minuted item appears:

"It was noted:

that a report on the Corporation's involvement, whether by investment or otherwise, in auxiliary operations and activities would be made to the directors at the February meeting;"

The report in question was not actually submitted until the meeting of April 30, 1974. It is a very detailed brochure prepared by Corporate Development Services and Finance and entitled "Concerning Diversification Strategy of Subsidiary and Associated Companies' Activities". It described diversification strategy as related to passenger services, commodity (cargo) services and other industry services. It lists all subsidiary and associated companies (eight in number) and summarizes the activities, corporate structure and financial reports of each. It also discloses consolidated financial results for 1973 of the Corporation's diversification program. This report is considered in more detail in Chapter 10 of this Report.

It is interesting to note in passing that the report makes no reference to the Barbados Sunset Crest leases either when describing the operations of Venturex Ltd. or when reporting on the Corporation's own diversification strategy. As at the date of that report, the Sunset Crest leases had not been referred to the Board of Directors for approval.

The need for some surveillance and control over subsidiary and affiliate companies should have been apparent to the management of the airline from the earliest adoption of the procedure of acquiring the subsidiaries and affiliates through CN Railway incorporations. A memorandum from Mr. Orser, then Vice-President Finance, to the Chairman forcefully pointed out the deficiencies in control in the case of subsidiary companies and recommended certain remedial measures. This same theme was the subject of a memorandum from the present Vice-President Finance, Mr. Cochrane, to the Chairman dated October 11, 1973. A telephone call by a member of the Board of Direc-

tors to the Chairman in January 1974, which is discussed in Chapter 6 below, was a further prod to management to establish procedures to bring subsidiary operations under control. This, together with discussions initiated by this Director at the directors meeting of January 29, 1974, resulted in the preparation of studies tabled at the April 30, 1974 Directors' meeting and subsequently brought up to date in 1975.

From this brief summary it can be seen that the Corporation did not respond until November 1974 to an obvious organizational need, manifesting itself at the very latest in early 1973. In the interval the airline, as will be seen in Chapter 7, was exposed to the risks of obligations being incurred by officers of subsidiary companies who were free from the constraints applied on them in their capacity as Air Canada employees. Some representatives of the airline during the hearings sometimes took the position that this was in fact no risk since all the funds came from Air Canada for all subsidiary operations. Such a position assumes that, in the extreme, Air Canada would simply deny its responsibility for subsidiary obligations by allowing any subsidiary which incurred an unauthorized obligation to default and presumably go into bankruptcy. This defence, or explanation, is not the slightest justification for lack of prospective conscious control of subsidiaries by officers and personnel in the same manner as controls have been systematically applied to the airline, its regions and branches.

The report "Concerning Diversification Strategy of Subsidiary and Associated Companies' Activities" was actually tabled at the directors' meeting held on April 30, 1974 and the directors were invited to comment on it at the next Board meeting. Immediately after it was so tabled, the matter of renewal of the Sunset Crest leases in Barbados came up for discussion and the renewal of the leases was authorized or approved. Following discussion of the matter, however, the minutes state: "it was noted in connection with this and the previous item that recommendations would be made to the Board at a subsequent meeting as to what authority the directors should properly exercise over the activities of subsidiary and associated companies, and in the context of proposed amendments to By-law Number 1, over the business and affairs of the Corporation in light of its present scope and complexity".

The Diversification Report was considered in detail at the meeting of directors held on June 25, 1974 but no specific action was taken with respect to its subject matter. It is obvious, however, that this Committee was established in November of 1974 as a result of the Diversification Report and the discussion of its contents by the directors.

The Committee had met twice by the time its activities were examined by the Commission. At its first meeting held March 5, 1975, it adopted terms of reference and the broad policy that it would serve as a link between the Board of Air Canada and the boards and management of subsidiary and associated companies. It also considered the financial difficulties of Venturex Ltd. and determined to make a recommendation to the Board of Directors of Air Canada. Its recommendation in this connection was approved of by the Board of Directors of Air Canada in minute 1716 of March 25, 1975 when charges

from Venturex aggregating \$1,134,000 were authorized. (For a more detailed discussion of this matter, see Chapter 8 below.)

At the same meeting, the Committee in relation to the Barbados Sunset Crest leases discussed the question of whether officers of Air Canada serving as directors of a subsidiary company should be in a position to commit that subsidiary to undertakings in excess of \$150,000 without the prior approval of the Board of Directors of Air Canada. Because Air Canada in such circumstances would be ultimately liable in relation to the commitment, the Committee considered it appropriate that the directors of a subsidiary company should have no more authority than they would ordinarily enjoy as officers of Air Canada itself.

The Diversification Report of April 30, 1974 was updated to March 25, 1975 by Corporate Development Services and Finance with figures for the 1974 financial year. The updated Report was examined by the Committee at its meeting of May 28, 1975 and the Committee determined that:

- “(i) Although it was understood that certain activities of a subsidiary or affiliate company might not be profitable in themselves but resulted in profit for the parent, the Board of Air Canada should ensure from consolidated statements that this was indeed the case.”

In considering this part of the Committee's conclusions one should recall the argument made to this Commission on behalf of the airline that losses on the Sunset Crest Barbados leases should not be construed as losses but firstly be regarded as advertising and promotion expenditures for the development of the Barbados route, and secondly, that the losses on the accommodation should be netted against the profit realized from the resultant seat profits from the increased scheduled seat sales. An examination of the financial facts, however, reveals that the gross seat revenue during the period in question, from air passengers using the Sunset Crest accommodation, was less than the losses incurred on the accommodation. Furthermore, and even if this drastic financial situation had not resulted, the application of the losses of this adventure to advertising is at best an unplanned, uncoordinated and probably disproportionate disposition of advertising resources of the Company. This matter is further developed in Chapter 7.

At the meeting of May 28, 1975, the Committee further determined that:

- “(ii) It would consider further the suggestion that vacancies on the Boards of Venturex, Allied Innkeepers (Bermuda) Ltd. and CANAC Distribution created by the resignation of Menard should be filled by a member or members of the Board of Directors of Air Canada;
- “(iii) It would remind the Board of Air Canada that it was increasingly urgent for the Corporation's charter to be amended to permit engagement in travel-related activities without having to seek the assistance of the parent company, Canadian Na-

tional, and that every effort should be made to bring about preparation of the necessary legislation along the lines already approved by Cabinet in 1972."

There is a need for a tighter control over the operations of Air Canada's subsidiary and affiliated companies than has been exercised in the past. In particular, no officer of a subsidiary or affiliated company should have any power to commit that company to any obligation in excess of the authority which that officer possesses as an officer of Air Canada. Furthermore, the Board of Directors of the subsidiary or affiliated company should not have power to authorize a commitment in excess of \$150,000 without that commitment also being approved of by the Board of Directors of Air Canada. In these respects, our views coincide with those expressed in the minutes of the Advisory Committee.

It seems that over the short period of its existence, the Committee has made substantial headway towards establishing tighter financial controls over subsidiary companies and the Committee seems to be aware of its responsibilities and to be vigorously seeking proper solutions. We think its formation was a significant step in improving financial controls.

#### *G. Committee of Management*

The Chairman recently created a Committee of Management consisting of himself, the President, all seventeen Vice-Presidents, the General Counsel, the Secretary and the Directors of Market Development, In-flight Service, Product Development and Corporate Planning.

The Committee meets two or three times a year and its purpose is to get a feel for operations in the field. Formal minutes of meetings are kept but the principal function of the Committee is to gather information and to provide a forum for airing all complaints about any aspects of the airline's operations.

#### *H. Officers*

The Executive Organization Chart of Air Canada was filed with the Commission and is attached as Appendix B to this report. As depicted on that Chart, the Chairman of the Board is the Chief Executive Officer of the Company. The second level of management reports directly to him. This group includes the President; the Group Vice-Presidents of Sales and Services and of Technical Services; the Vice-Presidents of Personnel and Organization Development, Computer and Systems Services, Finance, Marketing and Public Affairs; and the Director of Corporate Planning. The General Counsel, the Secretary, the Director of Corporate Development and the Director of Flight Equipment Contracts, report to the President; the five Regional Vice-Presidents and the Director of Inflight Services report to the Group Vice-President of Sales and Service; the Vice-Presidents of Maintenance,

Flight Operations and Purchasing and Facilities report to the Group Vice-President of Technical Services.

### *Chairman of the Board*

Section 13 of the by-laws of the Corporation provides that "the Chairman of the Board shall be the Chief Officer of the Corporation and, subject to the direction of the Board of Directors, shall exercise general management and control over the Corporation's business and affairs". His duties are summarized in an exhibit filed with the Commission, which is quoted below. These include acting as Chairman of the Board, developing broad policy for Board consideration and assuming responsibility for long range planning and programming, conduct of public relations, development of financing and liaison with Parliament and the Federal Government.

He is a member and Chairman of the Executive Committee and the Board of Directors Agenda Committee and an ex officio member of the Audit Committee. He is not a member of the Advisory Committee on Subsidiary and Associated Companies. Evidence given before the Commission was to the effect that he is in daily communication at least with all executive officers who report to him directly.

### *President*

Section 12 of the by-laws requires that there be a President of the Corporation but the by-laws do not set out his duties and responsibilities except in omnibus Section 15 which states that other officers of the Corporation shall perform such duties as usually appertain to their respective offices or as may be determined from time to time by the Chairman of the Board or the Board of Directors.

Up to December 1973 when John Baldwin occupied the office of President, his duties were set out in a memorandum dated November 22, 1968, allocating between the Chairman of the Board and the President their respective duties, which memorandum states as follows:

#### ALLOCATION OF DUTIES

"Chairman of the Board and Chief Executive Officer—  
Président Général

- (1) Acts as Chairman of the Board and Chief Executive Officer.
- (2) Develops broad policy for Board consideration.
- (3) Is responsible for long-range planning and programming.
- (4) Is responsible for conduct of public relations.
- (5) Is responsible for development of financing.
- (6) Is responsible for liaison with Parliament and Government in regard to those matters.

President—  
Président

- (1) Acts as Vice-Chairman of the Board.
- (2) Is responsible to the Chairman and through him to the Board for the management and current operations in accordance with policies and procedures established by the Board; and acts as Chairman of the current operations management committee of the company.
- (3) Undertakes liaison with government agencies on matters of administration and policy within his area of responsibility.
- (4) Is responsible for such other duties as may be assigned by the Chairman of the Board."

\*\*\*\*\*

November 22, 1968.

Since the ascendency of Mr. Vaughan to the office of President no such edict has emanated from the Chairman or appears as an amendment to By-law 1. In the result, the President does not appear to have a precisely documented position in the Company structure. As well, he is not a member of the Board of Directors.

As regards the other officers, there likewise appears to be no written determination by the Chairman or by the Board of Directors as mentioned in Section 12 of the By-laws above. In some instances, the Commission has seen that the duties of senior officers can be discerned from an examination of their respective divisional and branch responsibility, as for example in the linear responsibility charts with respect to the "finance function". This would seem to be an organizational deficiency which manifests itself in a lack of quality control and responsibility, particularly in the finance function with which this Commission is directly concerned. This matter is the subject of further discussion in Chapter 12.

As has been stated, the General Counsel, the Secretary, the Director of Corporate Development and the Director of Flight Equipment Contracts report to the President. He was also described in the evidence as being responsible for acquisitions and corporate diversification. In this latter capacity, he sits as a director and Chairman of Airtransit, as a director of Allied Innkeepers (Bermuda) Limited, of Canac Consultants Limited, of Matic Cargo Ltd./Matic Ltée and as director and President of Venturix Ltd.

He is a member of the Executive Committee and Advisory Committee on Subsidiary and Associated Companies.

### *Responsibilities of the Vice-President Finance*

The Vice-President Finance is ultimately responsible for all the activities of the finance branch including accounting services, profit planning, financial planning, capitalization, investments, audit, accounting procedures, taxation,

financial reporting and forecasting and economic research. He is responsible for financial expression of strategic plans; co-ordinates annual profits and financial planning and assists in negotiating financial objectives for branches and in finalizing budgets. He is also a member of the Executive Committee and as such is responsible for reporting to management and to the Board of Directors on the actual results of various branches as compared to their targets and to previous years.

### *Responsibilities of the Corporate Treasurer*

The duties of the Corporate Treasurer are to administer the Pension Fund and advise on investments, to administer bank loans with a view to establishing credit, to invest short-term funds, to arrange long-term financing with the Federal Government and the CNR, to arrange for the raising of capital with the Government and outside sources, to supervise general cash management of the Corporation, and to supervise preparation of the capital budget and to obtain approval of same from the Ministry of Transport.

Presently, the office is held by the Vice-President Finance.

### *Responsibilities of the Controller*

The Controller of the company was formerly responsible for the accounting aspects of the Finance Branch and in that capacity had reporting to him the manager of the Winnipeg Accounting Centre. The manager of the Winnipeg Accounting Centre as of early 1974 now reports to the Vice-President Finance. The Controller is presently responsible for financial planning, developing and controlling a capital budget and expenditure system and management information system and cost development. He is also responsible for providing functional direction to the branch or regional controllers. His participation in financial planning is said to include the directing of branch activities in the development, monitoring and control of budgets outlooks and forecasts.

In all of the above functions, the Controller acts in the capacity of Assistant to the Vice-President Finance.

## *I. Internal Audit*

The internal audit group, under the leadership of the Director, Audit and Financial Consulting Services is responsible for achieving, on a company-wide basis, the development, establishment and maintenance of financial and operational controls to ensure the protection of the company's assets. Internal audit is also to provide a financial, analytical and consulting resource to assist Branches and Regions in making decisions by analysing proposals, developing costs and benefits, and performing an educational role for the Finance Branch. The audit programs performed to achieve the above-men-

tioned objectives are well documented and carefully cycled for Sales and Service Branch stations.

The internal audit group is also responsible for integrating audit activities with the external auditors to ensure that the books and records of the company are in satisfactory condition for audit and to avoid unnecessary duplication of work.

#### *J. Functional Responsibility of Branch Controllers*

The primary responsibility of branch controllers is to the branch Vice-President. They are said to have a functional responsibility to the Finance Branch for implementing the procedures of the Finance Branch and to come to the Finance Branch with any problems related thereto. Branch controllers meet quarterly with the Controller to discuss procedural problems. They are appointed by the branch Vice-President, but with the approval of the Vice-President Finance who has a veto power with respect to their appointment. The Vice-President Finance meets with branch controllers regularly, but, at least once a year on a formal basis to discuss their progress. The Vice-President Finance also meets with the branch Vice-Presidents at least once a year to discuss with them the strengths and weaknesses of their branch controller.

The scope of functional responsibility of branch controllers to Finance is set out in a chart filed with the Commission entitled "Linear Responsibility Chart—April 19, 1974". This chart, prepared by the Personnel and Organization Development Planning Department, was the only documentary record to which the Commission was directed throughout the course of the hearings with respect to this functional responsibility. Under the heading "Finance Function", the branch/region controllers are to:

- i) implement Company finance policies, plans, programs and procedures;
- ii) develop branch/region finance programs within parameters of Company policies, plans and procedures;
- iii) provide functional guidance and counsel to branch/region management;
- iv) provide inputs to Corporate Finance on the effectiveness of Finance policies, programs, plans and procedures.

#### *K. Accounting Controls*

For purposes of the systems' descriptions which follow, the Commission has considered that financial controls combine both internal accounting control and internal check. These controls generally comprise a plan of organization and methods and procedures that are related to the safeguarding of



assets, the reliability of the financial records, operational efficiency and adherence to managerial policies. The overall plan is a suitable blending of the foregoing. The typical means of accomplishing adequate internal control is through definition of the duties and responsibilities of various levels of management, a system of authorization and approval, and a segregation of duties. Segregation of duties requires that no one person be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties. In other words, controls depend largely on the elimination of opportunities for concealment of errors or irregularities.

Internal control can provide reasonable, but not absolute, assurance that its goals are being accomplished. The concept of reasonable assurance recognizes that the cost of a system of internal control should not exceed the benefits derived and also that inherent limitations must be considered in estimating the potential effectiveness of any system. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness or other personal factors. Control procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management with respect to either the execution and recording of transactions or with respect to the estimates and judgments required.

### *Organization*

Air Canada is a very large company and its operations are conducted in a large number of locations in Canada and elsewhere. Its locations range in size from very large operations to very small. The Company is organized in functional departments as follows:

- Marketing
- Finance
- Public Affairs
- Corporate Planning
- Personnel and Organization Development
- Computer & Systems Services
- Technical Services
- Sales and Services
- President's Staff

The duties and responsibilities together with the system of authorizations and approvals of each branch as well as within each branch, with the exception of the Presidential sector, are generally well defined but not always well documented. However, within the present organizational framework, it is not clear what role the Finance Branch plays in reviewing the proprietary of a given branch disbursement.

## *Systems*

### (i) Revenue

Revenue accounting is a unique aspect of the accounting process in the airline industry. Airlines treat the proceeds from the sale of tickets as unearned revenue in their accounts until such time as the passenger uses his ticket. The unearned revenue is shown as a liability of the airline and sales revenue is recognized only at the point of use. The process is a complex one of matching tickets used (flight coupons) with tickets sold (audit coupons) in order to determine: (a) that all tickets used were properly sold and (b) the appropriate amount of income that should be recognized. The reason for the complexity is a combination of the complex nature of the tariff schedule of airlines combined with the large number of transactions to be processed.

In common with most other airlines, Air Canada determines its income from month to month on the basis of the number of passengers who have flown given routes valued at an estimate of the average ticket value for that route. The average ticket value is determined using objective statistical sampling methods.

Subsequently, Air Canada does a specific match of flight coupons to audit coupons. This matching process not only identifies the "used but not sold" problems, but also compares the standard revenue for each route to the actual revenue for that specific ticket and determines a revenue adjustment. Most airlines do not do this latter step. In that area at least, therefore, it can be concluded that Air Canada's revenue accounting system was more sophisticated and reflected stronger controls than the average for the industry.

As mentioned in Chapter 12 below, our investigation revealed that at one time Air Canada followed a practice of allowing discounts through the mechanism of selling tickets at less than their face value. However, this practice was discontinued in early 1974. From a brief review of the current computerized processes in the revenue accounting system, there was no indication that the system was being used to provide discounts or kickbacks to travel agents. There was, for example, no indication of a systematic failure to followup "used but not sold" tickets. However, certain backlogs in the processing of individual flight coupons were apparent. These backlogs appear to be more indicative of a problem in industrial relations at the Winnipeg accounting centre than a systematic accounting procedural problem.

### (ii) Disbursements

The Finance Department's disbursement function is basically centered in Winnipeg. All expenditures of a capital nature or for specified operating expenses are initiated through an Authority for Expenditure System (AFE

System) which is described later in this Chapter. All other expenditures which cover day-to-day operations do not require an AFE. The responsibility for invoice approval for these services is divisional. Thus all approved invoices whether initiated by an AFE or not are submitted for payment to the disbursements group in Winnipeg from all locations of the company for payment.

The only exception to this rule is in the case of unusual disbursements which are either of a confidential nature or require immediate payment. In these circumstances manual cheques are prepared, either in Montreal or Winnipeg, for payment of these invoices. Supporting documentation and copies of such cheques are forwarded to Winnipeg disbursements via transmittal listings.

Approved invoices received in Winnipeg reflect a general ledger account code number, a vendor code number, and an AFE reference as required. In the event that no vendor code number exists, a code number is assigned. If the invoice exceeds \$1,000 a vendor investigation is conducted by the accounts payable supervisor. If the general ledger account number is either fixed assets or other specific operating expenses (e.g. consulting services), the AFE reference is used to pull the appropriate AFE file to ensure that the expenditure is approved.

Invoices received in Winnipeg under \$3,000 are processed for payment if the invoice has signatures which indicate receipt of the goods or services, approval for payment and an authorized account code. No independent check is performed of these signatures to determine whether the company's authorization and approval policies are followed. Invoices over \$3,000 are further reviewed by a senior, well experienced clerk, for reasonableness. This clerk questions and subsequently investigates any unusual invoices, but does not report to his superiors on how he has resolved any questions he has raised.

Invoices are individually inputted to the computerized payables payment system from which a computerized cheque emerges. Cheques are matched to supporting documents and then mailed out.

### (iii) Authority for Expenditure (AFE) System

As mentioned earlier, before an official can commit Air Canada to an expenditure for property or equipment, rental or consulting fees, he is required to obtain approval, as evidenced on an AFE form.

Special authorizations for expenditures via AFE's will normally be limited to:

1. building, equipment, or office alterations or modifications greater than \$1,000;
2. outside consultants' fees greater than \$1,000;
3. signs costing more than \$1,000;

4. expenses larger than \$1,000 which are classified as operating but which are incidental or ancillary to the acquisition of property and equipment (P & E) items, e.g. relocation of ground facilities;
5. leases for land, space facilities for:
  - i) equipment greater than \$1,000,
  - ii) real estate costing more than \$25,000 for the duration of the lease or a monthly rental in excess of \$500;
6. all other transactions involving guarantees, obligations, leases, or "out-of-pocket" cash when estimated to be greater than \$25,000 except for related day-to-day flying operations (fuel, food, oil, beverages, maintenance, overhauls, etc.);
7. routine maintenance done by outside agents hired for a fee greater than \$75,000;
8. all non-routine maintenance greater than \$1,000.

Copies of the AFE's are sent to Winnipeg, and a copy of all approved AFE's is forwarded to the Planning and Administration Manager of the Purchase and Facilities Branch. His purpose in receiving these AFE's is to:

- (a) use the data in the development of a corporate cash flow forecast of expenditures on property and equipment for the use of the Finance Branch;
- (b) forward the AFE's to purchasing agents to initiate buying action.

As well, early each month, a report is prepared in Winnipeg of all AFE's in excess of \$25,000 received in the prior month. This report, together with photocopies of all AFE's greater than \$25,000 but less than \$50,000 is submitted to the Co-ordinator, Capital Investments Managing Systems in Montreal. This individual uses the data to:

- (a) ensure that he has properly reviewed and evaluated already any AFE's greater than \$50,000;
- (b) consider whether any AFE's less than \$50,000 have been "deflated" from larger amounts that would have required Finance Branch review.

#### (iv) Budgetary Controls

Air Canada has a reasonably sophisticated budgetary control system designed to provide a plan for and control over future operations and activities. Its utilization in at least one branch is discussed and commented on in Chapters 11 and 13.

#### (v) Planned Program Budgeting System—PPBS

The budget system of Air Canada is dealt with in general in Chapter 11. The section thereof concerning the Marketing Branch should be discussed briefly at this point.

As an element of Air Canada's merchandising planning process, the Planned Program Budgeting System (PPBS) addresses itself to the commitment and control of funds related to advertising and promotion expenditures and revenue by program. The system is self administered by the Marketing Division. Its purpose is to provide the information needed for the effective and timely management of the Division's advertising/promotion programs.

Allocation of funds to merchandising programs is the responsibility of the Merchandising Division management. This procedure is completed in time to provide a total of advertising/promotion expenses and possible revenues for the annual profile exercise. Program timing and funding is used in the final detailed branch budget to break out the annual profile into monthly increments.

Invoices for advertising and promotion expenditures are received and approved by the Marketing Department and are monitored by the Marketing Controller's Group which ensures that they are for approved programs and that they do not exceed the budgeted figures for those programs. Invoices are then sent to the Winnipeg disbursements group for payment.

## **L. *Communications***

The matters referred to in this Chapter adequately demonstrate that senior management has established a number of systems of communication through which information should flow readily and expeditiously. If these systems operated effectively, they would represent a significant aspect of financial controls. We are thinking of such systems as the following:

- (a) nine of the senior officers report directly to the Chairman of the Board and he is in daily contact with each one of them;
- (b) ten of the senior officers are members of the Executive Committee and meet weekly with the Chairman to discuss all aspects of the Corporation's business. In addition, they receive weekly requests from the Secretary for items to be put on the agenda of the Executive Committee meetings;
- (c) once a month twenty-three of the senior officers are reminded by the Secretary in writing about the monthly meeting of the Board of Directors and requested to submit proposed agenda items for that meeting;
- (d) a large number of the senior executives, as a matter of course, lunch together in facilities furnished partly at the expense of the Corporation in a small dining room reserved for Air Canada senior personnel, in the Queen Elizabeth Hotel in Montreal.

If all of these sophisticated systems functioned as they should, the Chairman would be informed continuously about any significant corporate

plans, particularly if those plans were in any respect out of the ordinary course of the Corporation's business or were not unanimously acceptable to the senior management.

The systems, however, obviously, do not work. Take the Sunset Crest leases as an example, which will be discussed in further detail in Chapter 7 below. The plan to lease condominium units was first discussed in March of 1973. After arrangements to lease were concluded with Venturex as lessee, it was decided to assign the leases to Air Canada and use them in conjunction with scheduled flights rather than in conjunction with inclusive tour charters as had been the original plan. That decision, we understand, was controversial. During the period from May 1, 1973 until the lease term on the condominiums commenced in mid December 1973, many people in several branches of the airline were involved in planning the use of these units as part of the Corporation's southern winter program for 1973/74. During the period from mid December 1973 until April 1974, many other people within the airline were involved in attempting to find the solution to several unanticipated problems which had developed in relation to the marketing of the condominiums and which were costing the airline significant losses. An examination of the documents filed with the Commission establishes that by January 18, 1974, more than twenty-eight officers of Air Canada at various levels had knowledge of the Sunset Crest leases. Nonetheless, according to the Chairman's evidence, he did not find out of their existence until some time early in April 1974. We cannot explain why one or other of the elaborate channels of communication referred to would not have brought this matter to his attention, even while the proposed leases were in the planning stage and well before any commitment was made.

The McGregor Travel matter is perhaps an even more startling example of the failure of these communications systems to operate. This matter will be discussed in greater detail in Chapter 6 below. McGregor's first discussions with Air Canada concerning a possible investment in a nationwide travel company date back as far as February 14, 1973. These discussions continued through the balance of 1973 and all of 1974 until the transaction is concluded in an unusual manner on November 29, 1974. The Director of Corporate Development who reported to the President in relation to the McGregor matter and who was on loan to the Vice-President of Marketing, was spending a considerable portion of his total working time on the project. The Vice-President of the Central Region and the General Sales Manager of that Region were both very much opposed to the whole idea and felt that "the reaction of the travel agents would have been quite violent, . . . to this sort of arrangement". The Central Region is responsible for approximately 30% of the total corporation revenue and about 45% of that revenue is derived from travel agents. Again, the proposal was controversial. The Vice-President of Marketing was specifically asked by the Vice-President of Finance to bring this matter to the attention of the Chairman of the Board but did not do so. Despite the extended length of time during which the proposal was under consideration and the large number

of corporate officers involved in implementing the proposal, the matter did not come to the attention of the Chairman in any aspect until more than three months after the transaction was concluded. It is perfectly apparent, therefore, that the existing channels of communication, sophisticated as they may be, simply do not operate as elements of financial control.

It cannot be believed that the large number of officers involved in these two transactions deliberately withheld information from the Chairman. It can only be concluded, that within the airline there is a widespread insensitivity to the necessity of keeping top management informed. Such insensitivity can develop if the systems designed for the communication of information are clothed in so much formality that they lose their effectiveness. The management style adopted by the Chief Executive Officer and some of the Vice-Presidents might also have contributed to the reduced flow of information and to the fatal isolation of some individuals from the knowledge available in their immediate associates. It appears that this is the principal cause of the situation which arose in the Corporation and resulted in the trouble illustrated by the McGregor and Sunset Crest transactions and to a lesser extent the Venturex problems.

#### *M. Personnel and Remuneration*

Section 18 of the by-laws requires that the Board of Directors approve any appointment to a position which reports directly to the Chairman of the Board or to the President as well as the salary for such position and any change in that salary. It is apparent from the company organization chart, as filed with the Commission, that there are fourteen positions in this category including, of course, the Chairman himself and the President. In fulfilling its function in this regard, the Board is assisted by a Compensation Committee which it has established, consisting of the Chairman, the President and three members of the Board of Directors. We do not propose to make any comment about the salary levels established by the Board of Directors for these positions because we do not consider it part of the Commission's function to examine those levels and compare them with salary levels in other corporations of a similar size.

By way of example of Board control, the Commission investigated the procedure followed in the hiring of Mr. P. J. Chartrand as a Director of Personnel and Organization Development and ultimately as Vice-President of Personnel and Organization Development. Some elements of his hiring and subsequent remuneration were the subject of an article in the Financial Post on June 7, 1975.

The following portion of this section "M" concerns salary and related information never heretofore released to the House of Commons Transportation Committee or the public. For the purposes of this Inquiry, this information is to remain confidential and accordingly is enclosed under separate cover in a confidential supplement.

## N. *Information to the Minister of Transport*

During the hearings it became apparent to the Commission that the information provided in the minutes of the Board of Directors was circulated to persons other than Directors, including the Minister of Transport. The minutes, as observed elsewhere in this Report, frequently do not clearly describe the matters which were considered by the Board. The minutes of the corporation should be amplified in order to provide a sufficient description of the matters discussed by the Board so as to make the minutes understandable to persons not in attendance at the meeting. The minutes of the Board of Directors meeting held on November 28, 1972 with respect to the hiring of a senior officer, are illustrative of this comment:

"1343. With reference to Minute No. 1263 of April 25, 1972, and pursuant to section 18 of By-law No. 1; approval is given to a change in the salary and conditions of employment of an officer of the Corporation, as detailed in a memorandum filed with the records of this meeting."

It is an element of control from the point of view of the Minister of Transport, who reports to Parliament, that minutes of the Board of Directors meetings should be sent to the Ministry. As discussed elsewhere in this Report, the position of this corporation is different from that of any non-government owned public corporation in that there is no forum strictly comparable to that of the shareholders' meeting. The review by House of Commons committees performs some part of the role of the annual meeting of shareholders but does not afford the continuity in order to bring the experience and expertise to the forum which is frequently the case in public corporations, where large blocks of shares are held by investment institutions of considerable experience. The Minister of Transport in this sense acts as an experienced continuing advisor to the Members of the House of Commons charged with scrutinising the annual report of a Crown corporation.

It is a policy matter beyond the terms of this Inquiry as to whether Board minutes should for this or other reasons be so forwarded to the Minister. Assuming the plan is to be continued, the minutes should be written on a more informative basis. There are many illustrations which can be given in addition to that set out above.

The minutes of Air Canada have historically been drawn in a more comprehensive manner than in the case of non-government owned public corporations. The scope of these minutes is broader than generally found in commercial corporations. The style, however, is much less informative. If the minutes are to be an informative element of the corporate control system, they should communicate an understandable message.



## *Chapter 6*

### THE MCGREGOR TRANSACTION

In 1973 Air Canada entered into negotiations with principals of two Canadian travel agencies, McGregor Travel Co. Ltd., based in Montreal, (hereinafter referred to as "McGregor Travel") and Burke's Worldwide Travel Ltd., situated in Vancouver (hereinafter referred to as "Burke's Worldwide"), for the purpose of acquiring an interest in an amalgamation of these two companies. Before dealing with the genesis of the events which took place in 1973 and 1974 and which culminated in the payment by Air Canada on November 29, 1974, of a sum of \$100,000 by way of three cheques of \$30,000, \$30,000, and \$40,000 each to Mr. Robert McGregor, President of McGregor Travel Co. Ltd., it is important to describe the context in which negotiations took place.

#### *Background*

In 1972, Air Canada reassessed its overall philosophy, which had always been predicated on its ability to fly customers to destinations and fly them back safely. Under a strong impetus from its marketing department, it was felt that Air Canada, in order to remain competitive with other airlines, should become involved in the leisure field industry and offer its customers additional services as part of a total package. Whereas, traditionally, Air Canada's business had been restricted to carrying passengers, it became obvious that there was a demand from customers who wanted to be provided with these additional services. It was hoped that additional profits would be generated from a greater involvement on the part of the airline in offering these services, particularly in the leisure field. This gave rise to a marketing concept, known as the "total travel experience" (T.T.E.), which provided the customer with a package which included the air ticket, reception service at airports, ground transportation, ground accommodation, sightseeing and other amenities. The implementation of this concept required the establishment by Air Canada of commercial agreements with wholesalers and tour operators, who in turn sold the vacation programmes to the retail trade, such as the Sun Living Program in Barbados, Skifari, 14 Soleils. These corporate objectives and policies were outlined in a five year diversification

programme (1972-1977) upon which Air Canada would later rely to justify its entry into the leisure field.

The development of this new concept in 1972 brought about a closer business relationship between the airline and wholesalers. This experience led to the subsequent interest shown by Air Canada in 1973 and 1974 in acquiring some participation in a national travel organization.

The direct participation by Air Canada in investment opportunities which were clearly outside its corporate powers did not appear to present an insurmountable problem to the management of the airline. For some years prior to 1973 appropriate amendments to the Air Canada Act extending the powers of the airline and restructuring its financial system had been promised by Ottawa. Indeed, in November 1972, a memorandum to Cabinet recommended that these changes be enacted and, amongst other things, that the airline be authorized to "carry on the business of a retail travel agent". Whatever the reason, the proposed amendments were not forthcoming and Canadian National Realities Limited, which had been used previously by Air Canada for activities considered to be beyond its powers as defined by the Air Canada Act, could be used again.

#### *First McGregor-Burke Discussions with Air Canada*

The evidence has shown that discussions were first held in the month of March, 1973, between principals of McGregor Travel and Burke's World-wide following a suggestion made by one of the shareholders of McGregor Travel, Mr. Ben Webster. During the preliminary discussions, the parties defined their primary objective as the amalgamation of their companies with a view to establishing a national network of travel agencies. Both parties assumed from the outset that such an alliance required the participation of an outside investor who would be expected to acquire a minority position in the new company. Financial statements were exchanged between McGregor and Burke in order to establish their respective values and their respective interests in the amalgamated company, as well as to determine the amount of capital required to finance the transaction. In the early part of the discussions, sometime in April, 1973, Mr. Robert McGregor, President of McGregor Travel, met with Mr. Yves Menard, the Vice-President, Marketing of Air Canada and discussed with him the possibility of Air Canada acquiring a minority position in the new company to be formed. Menard delegated to Mr. J. J. Smith, Director, Corporate Development Studies, the task of exploring with McGregor and Burke the acquisition by Air Canada of a minority interest in the new company.

Smith's superior was Mr. Ralph T. Vaughan, (now President of Air Canada), who at the time was a Vice-President and Assistant to the Chairman, in charge of acquisitions. Smith normally reported to Vaughan and kept him informed of any project in which he was personally involved relating to acquisitions, including any acquisitions by Air Canada of a minority interest in a company. He would frequently discuss these projects

with Vaughan. Smith would also circulate to Vaughan his monthly reading file material consisting of the month's letters and memoranda, which, as will be seen later, Vaughan did not read. Furthermore, at the end of each calendar year, Vaughan reviewed the performance of Smith during the previous 12 months on the basis of written reports from Smith which detailed work done during the year and the status of each project. In July 1972, Vaughan and Menard had agreed to share Smith's time so that he divided his time between the Marketing Branch and Vaughan. In fact, prior to 1973, Smith had worked for Menard on certain projects such as the acquisition of a one-third share interest in Allied Innkeepers (Bermuda) Limited (see Chapter 10), and had kept Vaughan informed of all his work in the manner hereinabove described.

In the early part of May 1973, Smith was advised by Menard of a possible merger between McGregor Travel and Burke's Worldwide, and was asked to explore the viability of such an alliance and the opportunity for Air Canada to acquire an interest in the merged enterprise. Smith met with principals of McGregor and Burke to discuss the proposed plan and was provided with a copy of the financial statements of the two companies and a copy of a common budget presentation dated May 17, 1973 showing the projected operating statements and balance sheet of the new company to be called B. & M. International Travel. It should be mentioned that the proposal discussed between McGregor and Burke called for the inclusion in the merger of Campbell Travel Agency in Toronto.

A proposal dated June 14, 1973, was prepared by Burke, outlining the plan for such a national travel agency and Smith prepared a financial analysis also dated June 14, 1973, with particular emphasis on Air Canada's expected return on its proposed investment as a minority participant. Based on the valuation of the new company at \$1,500,000, McGregor and Burke were looking for a minority shareholder to invest the sum of \$600,000 so that they would be able to apply this money to pay off and retire their present outside investors. In return for such an investment, the investor would receive 40% of the shares of the new company with 60% being divided between McGregor and Burke in the following percentages: Burke 43% and McGregor 17%. Meetings were held during the summer of 1973, including one in June, 1973, attended by Menard, between Smith and principals of McGregor Travel and Burke's Worldwide in order to refine the proposal. One of the major sources of concern of Smith was to determine if Air Canada's investment would allow it to obtain a 15% return as required under Air Canada's diversification guideline.

Further studies and analyses were prepared by McGregor and Burke during July and August 1973, in the course of which the projected value of the merged company was reduced to \$900,000 and Air Canada's proposed participation was increased from 40% to 45%. Smith kept Menard informed of the status of the tripartite negotiations. Vaughan could have learned through the monthly reading file, the year end salary review and by receiving copies of some memoranda written by Smith. Smith may also have reported

informally to Vaughan. Vaughan testified however, that he did not read the monthly reading file and was not aware of these negotiations. In any event, on September 10, 1973, in a lengthy memorandum to Menard, copied to Vaughan, Smith summarized the discussions which had taken place between McGregor, Burke and Air Canada, and also discussed the following issues; the nature of the organizations of McGregor, Burke and Campbell, the advantages to be derived by Air Canada from such a merger, the unfavourable possibilities of the merger, the method of valuation, the transaction as suggested by McGregor and Burke, and finally, comments thereon.

### *Regional Reactions to Proposed Investment*

Among some of the unfavourable possibilities raised by Smith were the reaction of Air Canada's own field organization and the anticipated reaction of other travel agents. Before proceeding any further with the project in the fall of 1973, Menard sought to obtain the reaction of Air Canada's regional Vice-Presidents, Messrs H. D. Laing, Vice-President, Western Region, J. M. Callen, Vice-President, Central and Southern Regions, and M. d'Amours, then Vice-President, Eastern Region, (now Group Vice-President, Sales and Services), to the possible entry of Air Canada into the retail travel trade. A copy of Smith's memorandum of September 10, 1973, was forwarded to each Regional Vice-President for their comments. The consensus of opinions expressed by the field organization level at meetings, one of which was held on October 22, 1973 (attended by McGregor), was one of outright objection to a retail venture by Air Canada, given the hostile reaction which could be expected from the trade. An entry into the wholesale field, however, was considered to be acceptable. It was also felt that consideration should be given to the possibility of choosing an intermediary or a bank to make the investment and from whom Air Canada could eventually purchase an interest. This would enable Air Canada to maintain a low profile and prevent possible unfavourable reaction from the trade.

One of the Regional Vice-Presidents, J. M. Callen, had earlier expressed the opinion that Air Canada's eagerness to invest in a merger of McGregor and Burke seemed to rest solely on the need of such investment for the survival of both firms, based on their respective financial situations as outlined in Smith's report of September 10, 1973. He was particularly critical of any investment in the McGregor company because of its serious financial condition. Another Vice-President, Laing, and the Regional Passenger Sales and Service Manager for Western Region, J. Methot, expressed some doubt in any case about the choice of McGregor and Burke as travel agencies with whom Air Canada should form an alliance. In fact, Methot of Air Canada submitted a list of western wholesalers to Smith on December 14, 1973, with whom a possible alliance would be preferable. The problem of Air Canada's venture into the travel business continued to be discussed with Laing, Vice-President, Western Region, who met with Smith and representatives of Burke in the latter part of 1973 and in the summer of 1974.

However, the evidence established that after the meetings held in the fall of 1973, Callen had not been kept informed of further discussions and had actually assumed that the project had been abandoned. For his part d'Amours told the Commission that, insofar as he was concerned, the project had been killed by the strong objections raised by him and the Regional Vice-Presidents at the October 22, 1973 meeting.

The possibility of Air Canada using an intermediary such as a bank to finance the proposed merger was investigated. Actually, on April 17, 1973, Air Canada had been approached by the Bank of Nova Scotia to discuss the opportunity of the bank entering into the travel industry, thereby following the example of The Royal Bank of Canada's investment in this field. After one preliminary discussion between Menard and one L. W. Woolsey, General Manager of the Marketing Department of The Bank of Nova Scotia, the idea was temporarily shelved. On November 8, 1973, Smith met with the Manager of the Dorchester and University Street Branch of the Bank of Nova Scotia to discuss the possible investment by the Bank in the McGregor/Burke venture. By the summer of 1974 any such plans were abandoned.

In addition to soliciting the opinion of Air Canada's Regional Vice-Presidents, Menard in the fall of 1973 also sought the advice of Mr. Raymond Lindsay, the General Manager of Econair Canadian Holidays Ltd., now known as Venturex Ltd., of which Menard was the President. This company is a subsidiary of Canadian National Realities Ltd. and was incorporated by Canadian National Railway Company as will be discussed in Chapter 8 herein.

In a rather tersely worded letter, dated November 5, 1973, addressed to Menard, Lindsay expressed the opinion that Air Canada was not empowered by law to enter into the retail travel field and that the McGregor/Burke network appeared to be traditional in its structure inasmuch as it concentrated mostly on commercial accounts and did not follow new trends in travel merchandising. Lindsay also expressed his sharp disagreement with the valuation by Smith of the companies to be merged and shared the opinion voiced by the Regional Vice-Presidents to the effect that a penetration of the wholesaling market should precede an entry into retailing. Lindsay, in his testimony before the Commission, attempted to downplay the real impact of his letter by insisting that he had intended it to provoke a discussion with Menard and Smith on the merits of Air Canada's involvement in such a scheme. Lindsay subsequently met with Menard to discuss some of the issues raised in his letter. On or about November 14, 1973, Lindsay received a memorandum from Smith in which he referred to a suggestion made by Menard to the effect that Econair could be used as a vehicle for the acquisition by Air Canada of an interest in McGregor/Burke.

### *Continuing Negotiations*

By December of 1973, negotiations between McGregor/Burke and Air Canada had been going on for a period of over seven months. Although Air

Canada was still showing an interest for a cross country alliance, Smith had expressed his concern to McGregor and Burke with the speed at which a transaction could be implemented, particularly in view of the reluctance expressed by Regional Vice-Presidents. The possibility that Air Canada might acquire an interest in McGregor Travel alone was also raised, but did not meet with the approval of McGregor on the basis that it would not be feasible. In addition, McGregor's financial situation, which showed a negative equity, and the avowed desire of McGregor Travel's principal shareholder, Mr. John Dobson, to sell his stock made it all the more imperative for McGregor to finalize the transaction, or at least to obtain some sort of commitment from Air Canada. McGregor forwarded a letter to Smith dated December 17, 1973 to be initialled as a working document of intent, but Smith refused to initial it. Nevertheless, McGregor was advised by Menard in a letter, dated December 13, 1973, that negotiations would be resumed in the latter part of January, 1974.

No progress was made in the early part of 1974, although McGregor and Burke were pursuing Air Canada in an attempt to obtain some commitment or an agreement in principle. At a meeting held on February 14, 1974, attended by Smith, Menard and McGregor, Menard explained that the lack of progress was due to the fact that a Parliamentary Commission which had reviewed Air Canada's Budget in 1973 had recommended certain amendments to its Act, which, if adopted, would preclude Air Canada's programme of acquisition within the leisure field industry. It was, therefore, Menard's hope that the Act would not be amended so that the financing by Air Canada of a McGregor/Burke merger could proceed within a seven week period. This illustrates the confusion prevalent in the head office of Air Canada on the subject of corporate powers and measures to be taken or which could be taken to overcome the problems.

In the absence of concrete developments, Dobson, and R. Tarbet, the Secretary-Treasurer of McGregor Travel, met with Smith on May 29, 1974, in order to obtain his assessment of the situation. In essence, Air Canada's position, as expressed by Smith on the occasion of this meeting, was that no further action could be foreseen until after the 1974 summer election and progress would be slow thereafter. McGregor's spokesman stated that the financial woes of McGregor Travel and Dobson's desire to sell out created a pressing need for recapitalization and, therefore, they wanted to know whether Air Canada was prepared to demonstrate its good faith and was willing to make an investment in or financial contribution to McGregor Travel and Burke's Worldwide. It was proposed that this be done either by extending to McGregor and Burke the favourable settlement terms for ticket sales given a large national travel agency by Air Canada, or by making a "disguised option payment". Smith replied that he felt that any of these alternatives would be difficult to implement. Smith reported these matters to Menard by way of a memorandum dated June 3, 1974.

On June 24, Smith travelled to Vancouver and met with Vice-President Laing of Air Canada and Taylor of Burke's Worldwide to reiterate

Air Canada's position previously outlined to Tarbet and Dobson on May 29, as mentioned above. In view of the further delays which could be expected before any agreement could be reached, Taylor stated that Burke did not feel committed any longer to the project and that, in any event, with the passing of time some financial considerations had changed which would require the renegotiation of the total package. From there on, Burke was no longer a party in the negotiations conducted between Air Canada and McGregor but was kept informed by McGregor. It should be mentioned that the Toronto agency, Campbell, mentioned above, had long since been dropped from the plan.

Smith summarized his June 24, 1974 meeting in a memorandum, copies of which were sent to Menard, Laing and Vaughan. Vaughan testified that this memorandum was the last one from Smith on this project copied to him. The President of Air Canada testified further that after seeing this memorandum he concluded that the project had been shelved indefinitely. However, it should be noted that in Vaughan's year end review of Smith's work, the document prepared by Smith for this purpose revealed that the McGregor deal was still an ongoing project.

Except for one meeting held in July, 1974, between Tarbet and Smith, negotiations between McGregor and Air Canada came to a standstill and no further discussions were held until the fall. This July meeting marked a milestone of some sort in the protracted negotiations between the parties inasmuch as a sum of \$100,000 was mentioned for the first time by Tarbet, who suggested that such payment could be treated as the first step in an option to be given to Air Canada on a future equity participation in McGregor Travel and would serve to satisfy McGregor's shareholders, who were impatient at the lack of progress and skeptical that there still existed a viable ongoing proposition.

#### *Air Canada—McGregor Travel Negotiations*

On July 24, 1974, McGregor wrote a letter to Menard wherein he reiterated the suggestion made by Tarbet to Smith and noted that, if implemented, it would circumvent the internal problem which Air Canada might have in making an acquisition outside the airline industry, would assure Air Canada of a strong position in the retail and wholesale chain, would preclude criticism from the regional officers and would bring together the nation's largest airline and a strong radio and television network, which McGregor and his staff said was now interested in investing in McGregor Travel.

It should be mentioned that, before the negotiations resumed in the fall of 1974, Mr. Raymond Lindsay, Managing Director of Venturex, who had been consulted by Menard in the fall of 1973 about the transaction, had not been kept informed of developments. He had actually brought forward in his filing system Smith's letter to him, dated November 14, 1973, in

February and March 1974. In view of the lack of developments, Lindsay had assumed that it was now a dead issue. However, in his capacity as Managing Director of Venturex, he did have dealings with McGregor Travel in 1974. By reason of these dealings, Lindsay had developed a personal and business relationship with McGregor, which might explain why, in mid-September, he was asked by Menard to meet with McGregor to discuss the financing necessary to keep the McGregor/Air Canada deal alive.

### *Discussions Preliminary to Actual McGregor Transaction*

McGregor and Menard met on September 16, 1974. According to McGregor's notes of this meeting, Menard suggested that following confirmation by Air Canada's Board of Directors of his diversification programme, Venturex be used as a vehicle to finance the transaction. An initial advance of \$100,000 would be made to McGregor before September 30, 1974, on a loan basis as an earnest payment to hold fast "a live situation" and the total amalgamation would be completed shortly thereafter. Menard also suggested that the mechanics of the payment should be discussed with Lindsay. This is the first mention of any support by Menard for the \$100,000 advance.

The following day, Lindsay and McGregor met. McGregor informed Lindsay that Air Canada should make a payment of \$100,000 to be treated as a loan or as an option convertible into equity as evidence of its good faith and of its intention to acquire an interest in McGregor, failing which McGregor would have to consider another source of financing. He told Lindsay that there were two problems which made it urgent for the payment to be made prior to September 30. First, McGregor's year end was September 30. Second, Dobson wanted out. He also stated that the payment of a sum of \$100,000 would help the financial picture of McGregor Travel and improve its position prior to the adoption of Bill 19, which was designed to regulate the operation of travel agencies in the Province of Quebec.

Menard had telephoned Lindsay on September 16, 1974 and asked how much would be needed to keep McGregor Travel going. After Lindsay and McGregor met on September 17, Lindsay sent a memorandum to Menard in which he summarized his discussion with McGregor and recommended that a sum of \$100,000 be paid out as a loan by Venturex to McGregor, prior to September 30, which loan could be repaid under circumstances to be determined or could be converted into equity following successful negotiations with Air Canada. Lindsay also recommended that the responsibility of channelling the sum of \$100,000 be given to Smith. The evidence has shown that on the following day, September 18, Menard and Lindsay discussed the content of the memorandum. Menard ruled out the suggestion made by Lindsay that Venturex be used as a vehicle for the transaction and stated that the transaction would proceed through Air Canada. It should be noted that the use of Venturex as a financing instrument was consistent with Lindsay's desire that the company become involved in



the total travel industry. Indeed, coincidentally, Lindsay expressed this view to Vaughan in a letter dated September 16, 1974.

Notwithstanding McGregor's request for payment of a sum of \$100,000 as a loan or as an option convertible into equity and Air Canada's apparent willingness to accommodate these demands before September 30, 1974, no payment was made before that date.

### *Planning of the Actual McGregor Transaction*

From this point onward the story becomes increasingly difficult to relate authoritatively because of conflicts between different witnesses and contradictory or unexplained letters and memoranda.

The matter of a payment of a sum of \$100,000 by Air Canada to McGregor as a loan or as an option convertible into equity was revived in late October or November. Lindsay testified that he returned from his holidays on October 21 and was told by McGregor that he had not heard from Air Canada. At McGregor's suggestion, Lindsay contacted Menard. According to Lindsay, Menard informed him that the transaction would proceed and that necessary funds would be provided from the Merchandising Budget of Mr. E. Parisi, Director of Merchandising, Marketing Branch. Menard is then alleged to have asked Lindsay to meet with Parisi and with McGregor and Tarbet.

Parisi's recollection of his initial participation in this scenario is somewhat different. He stated that sometime in late October or early November, he met with Lindsay who informed him of negotiations which had been conducted over a period of many months. Lindsay is alleged to have told Parisi that the deal was suspended because funds required to finance the project were not available in Menard's Marketing Budget. Parisi then offered the advice that funds released from his merchandising programmes which had been cancelled could be made available. The next day, Parisi spoke to Menard, who instructed him to allocate in his Merchandising Budget a sum of \$100,000 for a retail agent promotional support programme. This was done on November 12 by way of a memorandum from Parisi to Menard and P. R. Garratt, Controller of the Marketing Branch. Parisi stated that he suggested to Menard that in addition to the purchase of equity or of an option, Air Canada should obtain from McGregor additional revenues and other fringe benefits. Menard testified that he told Parisi to discuss the mechanics of the transaction with Lindsay and McGregor. Lindsay consulted Parisi and they agreed that, in view of the active part taken by Smith in earlier negotiations with McGregor, he should be involved in the transaction also.

The three of them met in Lindsay's office in the early part of November, during which meeting Parisi confirmed Menard's intention to have Air Canada pay McGregor Travel a sum of \$100,000 from his Merchandising Budget. It was decided that Smith would draft the necessary agreement in support of the payment which, at that time, would either be a loan, an

option to purchase stock or a loan convertible into equity. Neither Smith nor Parisi referred in their testimony to such a meeting with Lindsay. They did say, however, that on November 12, Parisi had informed Smith that the Marketing Department had decided to pay a sum of \$100,000 to McGregor for consulting services and had asked him to attend a meeting to be held the following day with McGregor. Smith's reaction was one of surprise because according to his evidence he had assumed that the project was dead. Lindsay's involvement in this transaction after Menard had decided not to put the deal through Venturex, has not been explained. However, he remained as an actor right up to the actual delivery of the cheques to McGregor on November 29, as described below.

Notwithstanding the complexities in the testimony of Smith, Lindsay and Parisi, there are some undisputed facts from which certain conclusions can be drawn.

- (a) Lindsay, Managing Director of Venturex, which at one point had been considered as a possible vehicle for the transaction, Parisi, Director of Merchandising, Marketing Branch and Smith, Director of Corporate Development Studies on the President's staff, were evaluating some kind of a loan or acquisition transaction for Menard and were in charge of choosing the appropriate channel through which the sum of \$100,000 would be disbursed to McGregor;
- (b) No mention had yet been made of any kind of services to be performed by R. McGregor of McGregor Travel;
- (c) The sum of \$100,000 had been set aside for the purpose of promotional funds in the Merchandising Budget of the Marketing Branch;
- (d) The sum of \$100,000 was first mentioned by Tarbet, Secretary-Treasurer of McGregor Travel;
- (e) This projected corporate acquisition was being handled by Marketing Branch officers without any guidance or advice from those responsible for acquisitions, if we accept Vaughan's evidence that he had no knowledge of the payment even though he was Smith's immediate superior and responsible for acquisitions;
- (f) There was some urgency in making the payment to McGregor Travel in order to rescue it from its precarious financial situation and to satisfy the pressure from its principal shareholder, Dobson, who wanted out;
- (g) Some of the participants already entertained doubts that it was within Air Canada's corporate powers or in accordance with its corporate objectives to acquire an interest in a travel agency or even to make a loan to one.

The role of each of the above participants in the scenario which was about to unfold was described by Menard. Smith's function was to do an

evaluation of McGregor/Burke and assess the financial aspect of the transaction. The contribution of Parisi and Lindsay was in the area of services to be rendered by McGregor from the point of view of determining how the channels of distribution could be better exploited for the best advantage of Air Canada. This confusion of objectives and means to attain these objectives was never cleared up. Neither was the reason for the complete disregard in the Marketing Branch of any semblance of corporate procedure or order ever explained. Since Menard had, in mid-September, vetoed the use of Venturex as a vehicle to close this transaction, the active participation of Lindsay in the strategic discussions and negotiations leading to the November 29 closing is perplexing.

On November 12, Parisi, following his discussion with Lindsay, produced a memorandum for Menard and Garratt, the Controller of Marketing, which recorded the release of funds budgeted within the Marketing Branch Budget for programmes now discontinued and the proposed applications for these funds. Included in this memorandum is the application, "RETAIL AGENT PROMOTIONAL SUPPORT PROGRAMME (Y. J. MENARD OR E. R. PARISI) \$100,000". No mention is made of any option arrangement as, of course, the Marketing Branch had no budget or authority with respect to investment in the shares of other enterprises in or out of the travel agency field.

According to the evidence, the effect of this memorandum was to authorize the appropriate officials in the Marketing Branch to re-direct the funds to be expended by that Branch, within the Branch's overall budget, amounting in 1974 to some \$23,000,000. The evidence is that no authority outside the Marketing Branch is required in order to make these realignments in the course of the year and no corporate consequences arise so long as the Marketing Branch stays within its overall budget. Therefore, since \$230,000 were released by reason of discontinued programmes, the Branch could deploy these funds for the purposes mentioned in Parisi's memorandum of November 12, including the Retail Agent Promotional Support Programme which, the evidence disclosed, was the source of the \$100,000 paid out to McGregor Travel.

It may be of some significance that the McGregor Travel name was not used to label the \$100,000 although in this memorandum an organization is identified with respect to almost every other new commitment. We must conclude that this was a deliberate attempt to hide the true nature of the transaction from anyone who might read the memorandum. Furthermore, no supporting documentation has been uncovered which indicates that the airline was going to receive value either in the nature of services or otherwise, for the expenditure of this money. Indeed, no copy of this memorandum was sent to anyone outside Marketing.

Pursuant to the general direction given by Menard to Parisi and Lindsay, as mentioned earlier, Smith, Parisi and Lindsay met on the premises

of Air Canada immediately prior to a meeting with representatives of McGregor Travel, which meeting had been arranged by Lindsay for November 13, 1974. The meeting between McGregor, and Tarbet of McGregor Travel and the above mentioned Air Canada employees commenced at the offices of McGregor Travel at about 4:30 p.m. on the 13th of November and later adjourned to L'Escargot, a bar situated in the Place Ville Marie complex. Parisi acted as spokesman for Air Canada's group. He informed the meeting that promotional funds in the sum of \$100,000 were available which Air Canada was prepared to disburse in favour of McGregor. In return, Air Canada expected McGregor to maintain its brand loyalty and act as a consultant on behalf of Air Canada in performing certain services by using "its influence in Quebec..." on behalf of Air Canada's interest with regard to the impending legislation by the Province of Quebec regulating travel agencies; and also in connection with the American Society of Travel Agents and other travel associations. Smith added that McGregor was expected to grant Air Canada an option to purchase common stock in an undetermined quantity for a nominal sum of \$1.00 and that such option would take the form of a gentlemen's agreement. It is important to observe that at this stage no mention is made of services in the Middle East or Latin America.

For McGregor and Tarbet this represented a new turn of events which left at least one of them, Tarbet, somewhat confused. First of all, promotional funds were being mentioned for the first time. In all prior discussions, the sum of \$100,000 was expected to be disbursed in the form of a loan which could be converted into equity or as an investment towards the purchase of equity in McGregor. There had never been any reference to services which McGregor was expected to perform. Moreover, it was McGregor's unequivocal evidence that the services which Parisi had outlined would have been performed by his firm anyway and, therefore, they were not part of the consideration for the payment.

Lindsay and Smith contended in their testimony that these were genuine services (that is, those services later described in the three agreements with McGregor Travel, dated November 28, 1974) which Air Canada expected McGregor to perform as part of the deal and which McGregor agreed he would undertake, including the promotion of travel to Latin America and the Middle East. Parisi made it clear that consulting services by McGregor in Latin America and the Middle East were not mentioned during this meeting. McGregor's and Tarbet's versions were to the effect that the sum of \$100,000 was really an earnest payment towards the exercise of an option for the purchase of 10% of the Common Stock of McGregor, which payment did not bear interest and was the first of a series of payments designed to give Air Canada equity participation in a network of travel agencies. The matters of the repayment by McGregor of the sum of \$100,000 and the expiry date of the option were also discussed, but no agreement was reached on these points.

Lindsay and Parisi stated that they expected Smith to draft an agreement encompassing the terms agreed upon between the parties. Smith testified that he understood that Parisi would draw up the service part of the agreement and that he would prepare the agreement dealing with the option after he had discussed it further with Tarbet. It was Smith who drafted the minutes of the meeting of November 13. For some unexplained reason this is the only memorandum dictated by Smith in the course of the McGregor/Burke episode which was not typewritten on Air Canada letterhead but rather on an untitled blank sheet of paper.

As agreed, Smith met with Tarbet on November 19 to refine the gentlemen's agreement purportedly reached on November 13. Smith and Tarbet agreed that the option would entitle Air Canada to purchase a 10% minority interest from the treasury stock of McGregor and could be exercised before December 31, 1975, or at any other date mutually agreed upon.

During the meeting of November 19, Tarbet gave Smith a copy of McGregor's pro forma financial statement for a nine month period ending June 30, 1974, which statement showed a capital deficiency of \$105,196, and advised Smith that the addition of \$100,000 to the receivables of the company would help to remove the capital deficiency of McGregor and would improve its financial picture prior to the adoption by the Quebec legislature of the Act and Regulations governing travel agencies.

These statements should have made clear to anyone perusing them at Air Canada that the whole exercise was fast becoming a salvage operation rather than a sound investment in a travel agency. The earlier income statement of McGregor Travel for the six month period terminating on March 31, 1974, a copy of which had been given to Menard by Smith with his memorandum of June 3, 1974, had shown a net loss for the period of \$10,315 and a capital deficiency of \$109,823. Furthermore, in the aftermath of the transaction, Smith reported in a confidential memorandum to Cochrane and McGill that the payment of \$100,000 had been a rescue operation. This payment enabled McGregor Travel to reduce its accumulated deficit. Even though the payment was reported as revenue for the period ending September 30, 1974, it was insulated from tax by an accumulated loss carry forward.

Minutes of the meeting of November 19 with Tarbet and attachments thereto were prepared by Smith and sent, accompanied by minutes of the November 13 "L'Escargot" meeting, to Menard, with copies of all this material to Lindsay and Parisi. In effect, these documents, read together, represent the very essence of the deal between McGregor and Air Canada which was to be concluded in the days following. An annotation in Smith's file indicates that these documents were delivered by hand on November 25 to Garratt and Seath, then the Treasurer of Air Canada and now the Controller, and also copied to Cochrane, Vice President Finance on November 26.

While Garratt and Seath acknowledged receiving this material, Cochrane denied that these documents reached him. Indeed, Cochrane's evidence on his role during the internal audit investigation of the McGregor payments would

have been inconsistent with his having had knowledge prior to the 29th of November, 1974 of the projected transaction. There is no evidence which explains why Cochrane would not receive this material from Smith. Neither is there any explanation why Smith circulated this material to Seath and Garratt on the 25th of November but did not send copies to Cochrane until the 26th of November.

Up to the period ending November 13, 1974, the only consideration to Air Canada contemplated in the discussions between Air Canada and McGregor Travel was the participation of the former in either a merger involving McGregor Travel or directly in McGregor Travel. On November 13 the subject of services to be rendered by McGregor personally were introduced into the discussion. Sometime in the months prior to November 13 a further element had entered the discussions, namely, the financial difficulties surrounding the McGregor Travel Company.

After the November 13 meeting, Parisi prepared a draft outlining supplementary services expected to be performed by McGregor Travel on behalf of Air Canada and which were to be incorporated in the agreement to be prepared by Smith. Although attempts were made by Air Canada's representatives in their testimony to link the services described in the draft with those enumerated in the minutes of the November 13 meeting, they appear to be of a totally different nature. Parisi testified that he discussed the nature of these promotional services with Menard and received his approval. Menard stated that he had not even known about the existence of Parisi's memorandum and that it did not represent the agreement that he had discussed with McGregor.

While these discussions were taking place between the principal participants, other actors were also taking an active role in the transaction. First of all, Paul Garratt, Marketing Controller, who had received Parisi's memorandum of November 12 pertaining to the transfer and allocation of funds to certain programmes within the Merchandising Budget, spoke to Parisi on November 13 or November 14 to obtain information to enable him to set up the programme. He was advised by Parisi to treat the matter on a confidential basis. A few days thereafter, during the week of November 18 and probably on November 20, Garratt testified to a conversation he had with Menard who asked for his assistance in disbursing the sum of \$100,000 to McGregor on an urgent basis. Garratt's recollection of the conversation was that Menard had mentioned that the money was required either as an investment or for payment for services to be rendered by McGregor. Garratt testified that he told Menard that a cheque could only be issued by the Finance Branch in Montreal or Winnipeg after supporting documents had been supplied, and that Menard should discuss the matter with Cochrane, Vice-President, Finance. Garratt then called Cochrane and told him to expect a call from Menard. Later on during that week, probably on the 22nd of November, Garratt spoke to Cochrane in Air Canada's private dining room at the Queen Elizabeth and Cochrane told him that he had not yet heard

from Menard. As it turned out, that same afternoon, Menard and Cochrane met. Garratt also received a call from Lindsay who mentioned that McGregor was upset about the delay ("hanging at the other end of the line").

In his testimony, Menard stated that he had attended at Cochrane's office and had advised him of the injection of funds by Air Canada into McGregor and that Cochrane had agreed to the project. Cochrane's version of that meeting, which he said took place on the afternoon of November 22, was that Menard explained that Air Canada was considering making a stock deal or an investment in McGregor Travel, and that this met with the approval of the Chairman. Menard's testimony, corroborated by that of the Chairman, Mr. Yves Pratte, was that at no time prior to the closing of the deal had he discussed it with the Chairman. Cochrane testified that Menard did not indicate any sense of urgency and that he was not seeking his advice or approval. Cochrane was left with the impression that the project was still in a conceptual stage. He offered the advice that should Menard require help in the transaction, he should arrange to have Garratt speak to the Controller, H. Seath. Finally, Cochrane reported that he advised Menard to obtain the specific approval of the Law Department and the Chairman because of the legal implications of the transaction, involving as it did an equity investment. Menard in his evidence recalled receiving this advice from Cochrane but admitted that he neither consulted the Law Department nor the Chairman before closing.

After this meeting, Cochrane called Seath and advised him that Garratt would contact him about a project which involved the acquisition by Air Canada of an equity interest in McGregor. According to his testimony, Cochrane did not hear further about the transaction until the middle part or end of December, when the payments of November 29 to McGregor were queried. As stated earlier, Cochrane specifically denied receipt of Smith's memoranda reporting on the meetings of November 13 and November 19, despite Smith's undated memorandum stating that a copy was sent to Cochrane on November 26, 1974.

At the beginning of the week of November 25, Garratt was advised by his secretary that while he had been away from his office, she had received a message from Menard's office to the effect that Menard had spoken to Cochrane and that Garratt could now proceed with the project and speak to Smith about it. On November 25, Garratt met with Smith who informed him that Air Canada was considering making a loan to McGregor or obtaining a stock option. According to Garratt, no mention was made of services which were expected to be performed by McGregor, even though, as stated above, Smith was present during the meeting of November 13 when services to be performed by McGregor were discussed. Then, on the following day, Garratt met with Seath in the latter's office. At some point during the meeting, Seath called in the Assistant Treasurer of Air Canada, Mr. Kendall, who was familiar with the procedure set out in Manual 300 in connection with the issuance of cheques.

A general discussion took place about the object of the transaction between Air Canada and McGregor. The transaction as explained to Kendall involved the payment to McGregor of a sum of \$100,000, which was urgently required, in return for consulting services, promotional work and advertising. No mention was made in Kendall's presence of an equity purchase or a loan to McGregor. (It should be mentioned that both Seath and Garratt stated in their testimony that they discussed whether the money would be advanced as a loan or as an investment or as an option. Seath asked Garratt for more information about the real purpose of the deal which Garratt was unable to provide. Instead he suggested that Seath speak to Parisi. That portion of their conversation probably took place before Kendall joined the meeting, hence Kendall's statement that no mention was made in his presence of an investment, loan or option).

Kendall offered the advice that since consulting fees appeared to be involved, an AFE (Authority for Expenditure) would be required. He also said that in view of the particular circumstances of the transaction, i.e., the urgency involved and the payment in advance for services to be performed, for a cheque to be issued at the request of Marketing a letter from the Chairman of Air Canada would be necessary. The discussion also dealt with the authority of Menard as Vice-President Marketing to sign an AFE. On that point, relying on Manual 300, under the section dealing with AFE's, page 15, Note 1, (Kendall was unaware of the instruction in the memorandum from the Chairman in January 1974, which inexplicably had not been consolidated into Manual 300 in the July 1974 consolidation), Kendall erroneously expressed the view that Menard's signing authority was limited to an AFE for an amount up to \$50,000 and that any amount in excess thereof had to be submitted to the Chairman.

We can conclude that the meeting of November 26 between Seath, Garratt and Kendall was held for the purpose of determining a way to disburse a sum of \$100,000 which was required in an urgent manner in a project which had received the blessing of the Vice-President Marketing. A way had to be found. It is important to remember that Garratt and Seath received copies of the Smith memoranda, dealing with the meetings of the 13 and 19 of November, on November 25, the day prior to the meeting with Kendall.

Parisi met with Seath on November 27, 1974 at 8:30 a.m. At that meeting, according to Seath's testimony, Parisi said that the company planned to invest \$100,000 in McGregor Travel. Seath told him that the Corporation had no power to lend money to invest in shares and Parisi replied "we realize that—McGregor Travel has some financial problems—they have a capital deficiency—the Province of Quebec is licensing travel agents in the Province now—Menard is concerned lest McGregor's licence not be granted—McGregor Travel is key to Menard's interest with the retail travel industry". When Seath asked what McGregor could do for Air Canada, Parisi told him that they would participate in joint advertising (prominent display of Air Canada products in McGregor's offices); do joint promotion in connection



with Air Canada's recently acquired routes to South America, the Middle East and Africa; act on Air Canada's behalf with the retail travel industry; and be useful in lobbying with the Quebec Government as it related to the licensing of travel agents. Parisi told Seath that these services had a value of \$100,000. Both of them looked at McGregor's financial statements in the course of their discussion and Seath appreciated the precarious position of McGregor. They also examined together Parisi's draft of November 15 outlining the basis of the promotional agreement between Air Canada and McGregor. Parisi referred at the meeting to an option in favour of Air Canada to acquire McGregor's shares but spoke of an equity investment in McGregor as if it was in the past. Seath was looking only at the services end of the arrangements with McGregor. He saw no investment value in McGregor and hence saw no value in an option to acquire McGregor shares.

When asked by Seath, Parisi said invoices would be issued by McGregor for the services to be performed. In Seath's view, this meant that the operation was a typical Marketing Branch expenditure—"advertising, promotion, consulting". It was not an investment at all from what Seath could see. Some of the services Seath expected to be performed by McGregor Travel, others by McGregor personally.

Parisi mentioned in his testimony that in the course of the meeting, Cochrane had called Seath on the telephone. According to Parisi's evidence, Seath then explained to Cochrane the very nature of the transaction between Air Canada and McGregor as Parisi had described it. According to Parisi, Seath then told him that Cochrane appeared to be in favour of the transaction. Both Seath and Cochrane specifically denied discussing the McGregor transaction on the telephone while Seath and Parisi were meeting on November 27. They both added that the only time they had ever discussed the McGregor matter was when Cochrane had called Seath on November 22 to advise him that Garratt would contact him about the marketing project involving the acquisition of equity by Air Canada in McGregor Travel.

This key discrepancy merits comment. If Parisi is to be believed when he contends in his testimony that Cochrane approved the transaction while speaking on the telephone with Seath, then it could be argued that, although the AFE's which were subsequently raised were not submitted for Finance's approval in accordance with the procedure outlined in the Chairman's memorandum, the Marketing Branch did in fact submit the project to Finance, which approved it. In other words, the buck would stop on the desks of Seath and Cochrane who, although they were in a position to veto the project, did nothing to prevent it, but, on the contrary, condoned it. This tenuous position is shattered when one remembers that at this point in the transaction no AFE had been issued, Kendall had indicated that the Chairman's approval was needed, and no one had yet prepared or even discussed agreements involving the Middle East and Latin America. Nothing in the evidence justifies anyone in the Marketing Branch taking such a position either as a general practice or in this transaction.

The material relating to the McGregor Travel transaction which Smith had delivered to Seath on November 25 included financial information about McGregor Travel which showed Dobson as a substantial investor. Dobson was a long time friend of Seath but until Seath read this material he had not known of Dobson's interest in McGregor Travel. After his meeting with Parisi and either on the afternoon of November 27 or some time on November 28, Seath called or met with Dobson, primarily to discuss with him matters related to the investment of Air Canada's pension funds. In the course of that meeting or conversation, Seath raised the subject of McGregor Travel and of Air Canada's imminent payment of \$100,000. They discussed at some length McGregor Travel's precarious financial position. Dobson's evidence was that he was greatly relieved by this conversation and by Seath's involvement because after almost two years of negotiation and delayed promises the matter had finally been placed in the hands of Finance and action could reasonably be expected.

At the time of this conversation with Dobson, Seath's knowledge of the McGregor Travel transaction was virtually complete. He knew that it had been switched from an "investment" to a "service" transaction because of some doubt about Air Canada's "investment" powers. He knew that three cheques were to be issued but he did not know they were to be issued to McGregor personally. He had been assured by Parisi that invoices would be submitted by McGregor Travel. He was unaware that the agreements (now to be referred to) were to be prepared and signed. However, the evidence does not indicate that he had any further involvement with the transaction until he again spoke to Dobson in circumstances that will be related later on in this chapter.

### *Preparation of the Transaction Documents*

At the end of the afternoon, on November 27, while Lindsay was in Parisi's office to discuss a matter unrelated to McGregor, Parisi called in his secretary, Mrs. S. Galbraith and proceeded to dictate to her three letters of agreement between Air Canada and R. Y. McGregor personally.

It should be mentioned that earlier on that day, or the day before, Garratt (according to Parisi) had called Parisi to say that there could be a problem raising one AFE and that three might be required. Garrett's testimony on the reasons for and origin of this problem is illuminating. At pages 2466 ff. of the transcript the following exchange takes place:

**The Witness:** No sir. I recall my thoughts at that time was that Finance branch had not and could not evaluate this particular transaction through Mr. Seath.

**The Commissioner:** Why didn't you let them say that?

**The Witness:** Well, I had heard Mr. Seath say—in my presence—that, you know, even if that had come to him as one document or three, it would have been very difficult, if not impossible, to evaluate it.

**The Commissioner:** All right. So why wouldn't you cause Finance to go on the dotted lines, as it were and say that?

**The Witness:** Well, only because it would have probably taken more time than I was led to believe that was available, to process the transaction; that it would be an unnecessary step in this case.

**The Commissioner:** And you were under some kind of a mandate from your superior, Mr. Menard to get this thing processed?

**The Witness:** He originally in his initial conversations with me indicated that there was some degree of urgency.

**The Commissioner:** And Mr. Lindsay had re-inforced that?

**The Witness:** Several times.

**The Commissioner:** So is it fair to say that either you or Parisi, thinking that you were carrying out the instructions to expedite, adopted the procedure of using more than one AFE to stay below the number required to circulation for Finance?

**The Witness:** Yes sir, but I would add in my view, only because I had heard Finance branch already say that they couldn't evaluate it anyway, even if it had been one amount or three, so that if it was me that initiated this idea, it would not be done with a view to circumventing the rules, but rather to expediate the transaction.

**The Commissioner:** But the rule is there presumably for the purpose of allowing Finance to say just what you thought they would say, "we don't know enough about it to evaluate it."

**The Witness:** That is probably what they would have done.

**The Commissioner:** Isn't that what the rule is for?

**The Witness:** Yes it is, I presume so.

**The Commissioner:** So whether you intended circumventing the rule, the fact is you circumvent the rule when you reduce the value of an AFE to avoid the Finance comments; is it not?

**The Witness:** It turned out that that is correct, sir. What you are saying is correct.

**The Commissioner:** Any way, you did not avoid but to expedite?

**The Witness:** That is correct. But I would go back to say that I don't recall who initiated the idea of doing it this way.

**Mr. Roy:** Q. When you say "doing it this way" you are referring to the idea of splitting up the AFEs?

A. That's right.

Q. Whether it was your idea or Mr. Parisi's idea?

A. That's right.

**The Commissioner:** But it would have to be one of the two?

**The Witness:** I would expect so, yes. Now, it is conceivable where Lindsay might have offered a view, but I don't think so."

Also, according to Parisi, in addition to the problem brought up by Garratt, Lindsay had informed him that McGregor could not accept the conditions forming the basis of the promotional agreement. This evidence of Parisi was denied by Lindsay. It was Parisi's opinion that in order not to violate Regulation 8-10-A of IATA, designed to prevent payment of kick-backs to travel agents, and because he felt (and indeed had been told by Seath), that Air Canada did not possess the corporate power to purchase an equity in a travel agency, the quickest way to channel the money into McGregor would be to pay it to McGregor personally in the form of consulting fees. Parisi did admit, however, that the prime objective was an investment and that McGregor was not in a position to perform services in Latin America and in the Middle East.

On November 27, in Lindsay's presence, Parisi dictated three letters of agreement addressed to Mr. R. McGregor which were typed in draft form by his secretary the next morning. He allegedly referred his secretary to a precedent involving an agreement between Air Canada and an official of a country in the Middle East from which she was expected to copy. Mrs. Galbraith stated that she copied literally the applicable clauses from the precedent to which she was referred. However, even a cursory examination of the precedent reveals that none of its clauses were transcribed in the McGregor agreement. At Lindsay's suggestion, Parisi changed the term of the agreement, during which McGregor was expected to act as a consultant, from December 31, 1974 to March 31, 1975 in order to accelerate the process by which Air Canada would execute the option agreement. In view of Garratt's earlier statement to him the day before to the effect that more than one AFE might be required, Parisi decided to divide the value of services into units of \$30,000, \$30,000 and \$40,000 each.

Lindsay testified that he did not offer any suggestion or make any comment while Parisi was dictating the letters. He stated that the agreements represented the service aspect of the transaction and that he felt that Smith would handle the investment portion. It was only on the following day when he picked up the agreements to have them signed by Menard that Lindsay realized that they did not reflect what had been his understanding of the agreement.

Parisi testified that in view of the fact that the retention of McGregor's services as a consultant constituted a departure from the understanding reached between the parties, he called Menard on November 27 to inform him of the changes and Menard said that it did not matter because his major concern was the investment. Menard denied having such a conversation with Parisi and stated that he had not authorized Parisi to make the changes for such purposes or otherwise.

Knowing that he would be absent from his office the following day, Parisi asked Lindsay to coordinate the preparation and the signing of the necessary documents. That same evening, Parisi called Garratt at home and asked him to come into the office the following morning to prepare the AFE's. Again there is no real explanation for Lindsay's involvement at this stage, bearing in mind he was the Managing Director of Venturex which was in no way involved with the transaction.

These events illustrate the dilemma which the Marketing Branch had been facing from the beginning in trying to put the deal together. Menard testified that he had launched the project and had asked his people, i.e., Parisi, Smith and Garratt, together with Lindsay, to close the deal in the form of an investment and had left it up to them to determine the mechanics of the transaction. In view of the nature of the project, Menard had spoken to the Vice-President Finance in order to obtain his advice and approval. Menard's people then, in an attempt to convince Finance Branch that this was a good project from the point of view of the value which Air Canada would obtain, seem to have introduced the element of services to be performed by McGregor. This may have been an afterthought induced by the weak and declining state of the McGregor company's finances, and the obvious fact that the McGregor Travel shares had little or no value.

To digress for a moment from the narrative, McGregor and company had been, through Tarbet, supplying Smith and others in Air Canada with financial statements on forecasts and projections amounting to some \$29,000 profit for the year ending September 30, 1974. In fact the company for the fiscal period ending September 30, 1974 (without crediting the much discussed \$100,000 to earnings in that period) barely broke even and, in fact, showed a slight loss. Tarbet testified that, well before November 1974, the management of McGregor Travel were aware that there would not be a profit during that fiscal period but that there would be a loss the size of which would not be known until the audit for the period was completed.

It is further quite clear that before the \$100,000 was advanced by Air Canada, for whatever purpose it may have been advanced, the officers of the airline dealing with the McGregor project, were either well aware, or were in disregard of available and obvious facts if they were not aware, that McGregor Travel had incurred another significant loss. Tarbet acknowledged that by year-end (September 30) McGregor Travel knew that at best they would break even for the year. In the previous six years, McGregor Travel had lost money in three of the years and had never earned more than \$18,191 in the others. This rather bleak financial picture may lend some support to an explanation that the \$100,000 was in fact paid over for services, such as those relating to the then impending Quebec travel agents Legislation, since a \$100,000 investment in McGregor Travel shares could not be justified. The advance feature of the payment might be explained because of the knowledge in Air Canada of the dire financial straits of McGregor.

The poor level of staff work in Air Canada on the McGregor Company transaction as revealed by their files, is well illustrated by a memorandum from Smith to Menard dated November 20, 1974, eight days before the money is paid out. Attached to the memorandum are statements provided by Tarbet the day previous, which statements are dated the 6th of August, 1974 and show the forecasted profit of McGregor Travel at the end of September, 1974 of \$29,000. The company fiscal period had ended almost two months previously and a senior financial officer of McGregor Travel has testified, as stated above, that by the end of the fiscal period, the company did not expect any profit. This information is passed along to Menard with the further information that the proposed \$100,000 payment would be used in the McGregor company to reduce the capital deficiency by recognizing the amount as income. The memorandum goes on to state that a 10% minority interest would be available on treasury stock at Air Canada's option.

There is no reference whatever in the analysis of the situation at November 20 that the McGregor company is at best going to break even again or that Air Canada by paying \$100,000 for a 10% interest was placing a million dollar valuation on a company with no significant earnings record, no significant assets, and a substantial deficit.

Knowing the actual financial situation of McGregor, which showed a deteriorating situation, the Marketing staff could not and did not try and sell it to Finance on the basis that it would be a sound financial investment. Instead, Parisi and Garratt emphasized the service aspects of the contracts which would bring dividends to Air Canada, although at least Parisi and Lindsay knew that this was merely window dressing and that the real consideration for the transaction was an investment. Smith, on the other hand, seems to have laboured throughout under the impression that it was essentially an investment in a minority position of some kind. During the Inquiry, all persisted in taking the untenable position that some of these services were expected to be performed by McGregor and consequently value would accrue to Air Canada. At the same time they acknowledged that the real purpose of the transaction had been an investment in McGregor. Menard on the other hand, took the position at the hearings that the \$100,000 was paid for an option. However, as will appear, in April he explained the deal to the Chairman on the basis that the payment was a legitimate payment for services.

Had Air Canada's participants in the scheme openly admitted that it had never been entertained nor expected that McGregor would perform any of the services provided under the agreements, as was acknowledged in the testimony of McGregor and of Dobson, who described the whole thing as a "sham", (as did Parisi in effect, as well, at one point in his testimony), then one would not be as inclined to look for ulterior motives on the part of Air Canada's employees and search for impropriety. The inconsistency of the explanations by the participants as to the reason for the payment, and

the strange sequence of events in completing the transaction certainly raise suspicions as to the nature of the transaction.

### *Completion of the Transaction*

On the morning of November 28, Parisi's secretary typed a draft of three letters of agreement and testified that she copied from a precedent the indented clause in the two of the agreements which relate to the retention of McGregor by Air Canada as a consultant to influence governments and trade in the Middle East and in Latin America. Garratt, who had originally arranged to be away from his office on that date, came into the office on the morning of November 28 at the request of Parisi. He first attended at the office of Parisi's secretary to pick up the draft copies of the agreement and then went to Seath's office in order to ascertain if cheques would be issued on the basis of each AFE being accompanied by a letter of agreement. He could not recall whether he showed Seath a copy of the letters of agreement.

Seath's version of the meeting with Garratt was as follows: he met Garratt between 11:30 and 11:45 a.m. on Thursday, November 28. Garratt explained that he had been called in to prepare AFE's. Then Seath asked Lindsay, who had joined the meeting, whether three cheques would be required for three services. Lindsay answered in the affirmative. Seath asked whether invoices would be issued by McGregor and whether there was value for these services. Lindsay replied yes to these questions. Both Lindsay and Garratt left.

Afterwards, Garratt prepared a handwritten draft of three AFE's with the help of Manual 300, which describes the applicable procedure. He stated that he was unable to say whether he or Parisi had initiated the idea of splitting the AFE's. He then returned the draft copy of each of the AFE's and the contracts to Parisi's secretary with written instructions about distribution after completion. These instructions were left on Parisi's desk by his secretary. She was going on vacation the following week and because Parisi was going to be away the next day, Friday, she left Thursday night. Garratt, after drafting the AFE's on Thursday, left expecting that Lindsay would be coordinating the project at that stage and would obtain the signatures on the AFE's and on the agreements.

Parisi's secretary typed one original and two copies of the letters of agreement in final form after obtaining information from Lindsay pertaining to McGregor's full name and address. She also typed out the AFE's. These documents were put in a folder and picked up by Lindsay at approximately 3:00 p.m. to be brought to Menard before 3:30 p.m. for his signature.

Lindsay explained that he read the agreements while on his way to Menard's office. He then realized for the first time that they were not in accordance with what he had understood the deal to be and that they represented a departure from the earlier agreement. Notwithstanding the

foregoing, he did not deem it appropriate to discuss the changes with Menard and assumed that Parisi had already spoken to Menard about these changes. (It should again be mentioned that Parisi had stated in his testimony given prior to Lindsay's that he had obtained Menard's approval of the changes, which fact was denied by Menard.)

The originals and copies of the agreements and of the AFE's were presented to Menard for his signature and were individually signed in Lindsay's presence. (Lindsay submitted later in his testimony that he could not positively say that he had brought the letters of agreement to Menard for his signature). Menard's evidence was that Lindsay had said to him that the documents pertained to the McGregor investment transaction whereupon he had affixed his signature thereon without actually reading the documents. Menard also said that the AFE's bore the signature of Parisi and that Menard was authorized to sign AFE's up to \$100,000. (Parisi's secretary stated that Parisi's signature did not appear on the AFE's when they were taken to Menard, as her boss had been away from his office on the day they were typed.)

The agreements and the AFE's duly signed by Menard were then delivered by Lindsay to Mrs. Galbraith, Parisi's secretary, who had to retype copies of the AFE's because of missing carbons. She indicated that Miss Bangs, Lindsay's secretary, came to her office on Thursday, November 28, and asked for the letters of agreement so that she could deliver them to McGregor for signature. Miss Bangs found Mrs. Galbraith typing AFE's when she picked up the documents. The agreements were handed to her and she took them to McGregor Travel offices where McGregor signed them. Miss Bangs then left him one tissue copy of the agreements and brought back one original and one yellow copy of each of the three agreements to Mrs. Galbraith before 4:30 p.m.

Miss Bangs then added a rather puzzling fact. She stated that when she gave the agreements to McGregor for his signature she had the "feeling" that cheques were in the envelope which she handed to McGregor. As established later on this could not have happened in view of the fact that the cheques were only processed by Finance on November 29. She also raised the possibility that she may have gone back to McGregor's office on the 29 to deliver the cheques, although she had no specific memory of making a second trip. This possibility can also be excluded on the basis of the evidence given by Mrs. Roy, McGregor's secretary, who stated; (a) that no one from Air Canada had come to McGregor's office on November 29, except for Lindsay and Smith who paid him a visit late in the day and, (b) that if cheques in the sum of \$100,000 had been delivered to McGregor on November 28, he would have mentioned it to her.

It is a curious fact that by the end of Thursday, November 28, many of the actors of these events left on holidays of one kind or another. Menard, Parisi, Parisi's secretary and Garratt were absent on Friday, November 29. Of the active participants, only Lindsay, Smith and Miss Bangs remained.



On Friday, November 29, Lindsay spoke to McGregor on the telephone on two occasions. During the first telephone conversation, Lindsay told him that the documents had been signed and that the cheques were being prepared for delivery later on during the day. During the second conversation, according to Lindsay, McGregor told Lindsay that he had received the cheques whereupon Lindsay called Smith and asked him to accompany him to McGregor's office. When asked to describe the reason for meeting with McGregor, Lindsay stated that it was a gentlemanly thing to do". Smith's recollection was that Lindsay had asked him to accompany him to McGregor Travel so that the option understanding could be reconfirmed with McGregor. Both Lindsay and Smith emphatically stated that they had not brought the cheques with them, but that while they were in McGregor's office, they saw him take three cheques payable to him personally from the inside pocket of his jacket, which he then endorsed in their presence and gave to Tarbet to be put in safekeeping. On December 4, the cheques were deposited in the company's account with the Bank of Nova Scotia. Although Smith remembered seeing on McGregor's desk a copy of three letters of agreement signed by both McGregor and Menard, Lindsay had no such recollection. Smith acknowledged having read them and coming to the conclusion that they reflected what had been decided at the November 13 meeting. Lindsay and Smith declared that they made sure that McGregor understood that the payment by Air Canada had created an option for the purchase of 10% of the equity of McGregor Travel which could be exercised by the payment of a sum of \$1.00. They also discussed the repayment of that sum and the possibility that the 10% of the equity of McGregor would be voting redeemable preferred shares. This further emphasizes the unrealistic circumstances of this entire affair. If it were considered to be a good investment by Air Canada made to obtain entry into the 'total travel field', the airline would want common shares. On the other hand, if the airline executive considered it 'a rescue operation' as described in their memorandum, the better security of preferred shares would be sought. However, if the real consideration was the services, the option was a smoke screen and the type of shares or notes, etc., to which the option might relate did not matter.

No employee of the airline or of Venturex in his or her evidence before the Commission admitted delivering cheques to McGregor. Insofar as their testimony was concerned, it remains a mystery as to how the cheques reached McGregor. However, in a memorandum to file, dated December 3, 1974, prepared by Smith following the meeting of November 29 with Lindsay, McGregor and Tarbet, it is expressly stated that Smith and Lindsay handed over the cheques to McGregor. Moreover, McGregor categorically stated that Lindsay and Smith had brought the three cheques with them during the afternoon of November 29. Although this isolated incident does not appear to be too significant, it does seem to suggest the fact that two of the principal actors in the whole cast are attempting to minimize to some extent their actual participation in the disbursing of the funds. Faced with this rather flagrant contradiction and other inconsistent statements flowing from

their testimony, we must seriously ask ourselves whether they did not have an ulterior motive for denying that they had brought the cheques to McGregor. If the payment was a payoff of some kind, then, of course, it would be in their interest to deny it. Likewise, if it was not a kickback but a payment made in somewhat mysterious circumstances in order to rescue a sinking ship, which is what the evidence discloses, they would still have an interest in denying handing over the money. On the other hand, if this had been a transaction handled in a normal manner in accordance with the acceptable procedure within Air Canada, they would have no reason to deny that they had or might have given the cheques to McGregor, instead of categorically stating that they had not.

Smith's typewritten memorandum of December 3, 1974 contains handwritten annotations, which Smith said he added about a month later following a meeting with Cochrane. In his handwritten notes, Smith expresses some doubt about Air Canada's corporate power to invest in McGregor stock, which was valueless, and suggests that in any event Air Canada only has a verbal option which it had obtained in return for the payment of \$100,000 and that this option might be unenforceable.

These last comments appear to demonstrate that the only object of the McGregor transaction (excluding fraud, of which there was no evidence) was to bail McGregor out. Smith, a man with considerable financial background, had participated in previous major acquisitions or undertakings by Air Canada. He had been investigating and studying an investment by Air Canada into some travel agencies for at least 20 months. His memorandum now contains his written admission that the company in which Air Canada has, in some fashion, invested \$100,000 has no value and the option which Air Canada obtained in some mysterious and unwritten manner, was probably unenforceable. How then does he justify a \$100,000 payment after making such an admission? In his testimony he referred to the service part of the three agreements (which was never his responsibility in the first place and of which he only learned on November 13, some 18 months after negotiations had commenced) and stated these services are of value to the airline. Ironically, Smith, in the end, was left almost alone in holding firm to the argument that Air Canada would get its money's worth out of the services expected to be performed by McGregor and that the option was some kind of an unenforceable extra.

Dobson found out about completion of the transaction from McGregor shortly after November 29. He learned that three cheques had been issued to McGregor personally and endorsed to McGregor Travel and found out that they were expressed to be for "services". As he had understood the transaction was an investment, he called Seath on December 6 for clarification and asked what obligations the payment imposed on McGregor Travel and what restrictions it placed on the freedom of action of the McGregor Travel shareholders. According to Dobson's evidence, Seath told him that this was a separate transaction which stood on its own, that the money was

not refundable, that the McGregor Travel shareholders were under no restrictions as a result of the payment, but that Air Canada felt that the shareholders had a moral obligation to inform Air Canada before taking any action to dispose of their shares.

Seath's evidence of that conversation did not go into such detail but he acknowledged that he was surprised to hear that the cheques had been issued to McGregor personally and relieved to hear that the money had been put into McGregor Travel without creating any tax problem for either McGregor or McGregor Travel. This conversation makes it clear to the Commission that by December 6 at the latest, Seath knew all about the transaction, how it had been planned, how it had been changed before completion, how it had been actually carried out, how it had been treated by McGregor and McGregor Travel, and the minimum effect that it had on the future relations between Air Canada and McGregor Travel's shareholders. Why then, in the Air Canada internal investigation that followed, was Seath not questioned until April 15, 1975, apart from an initial inquiry by Sheehan, then the Corporate Controller, who spoke to Seath before the AFE's were forwarded on up to Cochrane in December of 1974.

### *Issuance of Cheques*

The evidence discloses that on November 29, the originals and copies of the AFE's and letters of agreement were brought by Kendall, Assistant Treasurer of Air Canada (who has no recollection of this) to Mr. James Ursel, Administrative Assistant in the Finance Branch, whose responsibilities included, inter alia, the signing of cheques issued in Montreal. Ursel explained that only a small percentage of cheques were issued in Montreal, the bulk of the accounting being conducted in Winnipeg. He described the normal procedure followed in relation to the issuance of cheques in Montreal. This consisted of examining the invoice or letter emanating from the originator to determine whether it bore the proper signature, and determining whether it contained adequate information pertaining to the Branch requesting the cheque, i.e., the budget code number, etc. After satisfying himself that the documents were complete, he would then send them to the person in charge of preparing the cheque, one Mr. Smith.

On the day in question, Ursel examined the documents brought to him by Kendall, who told him that the cheques were required urgently. He remembered seeing Menard's signature on the AFE's but had no recollection of seeing Parisi's signature. (Photocopies of the AFE's made on November 29, show both Parisi's and Menard's signatures. In view of the fact that Parisi was expected to be away from his office from November 28 until December 2, he probably returned briefly to his office on the 29 to sign the AFE's. In his testimony he stated that he thought that he had signed the AFE's on December 2 but added that he might have come back to his office on November 29 for the purpose of signing them). Ursel also examined

the letters of agreement and gave evidence that they contained the signatures of McGregor and Menard. He then gave the documents to Smith's replacement that day, Mrs. B. Malo, so that she could prepare the cheques. After the cheques had been signed by himself and one Mrs. Whitmore, Ursel brought them to Kendall (Kendall could not recall receiving them).

Mrs. Malo testified that she had perused the AFE's to verify the budget code number and remembered seeing the signatures of Menard and Parisi. She also examined the letters of agreement which were signed by Menard and McGregor. She prepared the cheques and gave them to Mrs. Whitmore for her signature and then to Ursel for him to sign. Afterwards, she prepared a teletype which was signed by Ursel and sent to Winnipeg at 3:10 p.m., November 29, notifying Winnipeg that three cheques had been issued to Mr. R. McGregor with indication of their respective numbers and amounts. She also stated that three photocopies of the AFE's, of the agreements and of the cheques were made that same day, one of which was retained in Air Canada's records in Montreal and the two others mailed to Winnipeg on December 5, together with a transmittal advice.

Mrs. Whitmore, Personnel and Administrative Clerk in the Finance Branch of Air Canada in Montreal, stated that very few cheques are issued in Montreal, probably less than 1%. They cover among other items, the payment of fees and expenses of Air Canada's directors, temporary secretarial service, provincial and federal tax returns, Touram staff payroll, and other miscellaneous items. She did say that on rare occasions, in urgent cases or during a mail strike, cheques could be drawn in Montreal which could include payment of consultant fees. The procedure she follows whenever a cheque is brought to her to be signed consists of verifying the authorization, i.e., either by a certified invoice or by a letter requesting an urgent payment. She followed this procedure on November 29 when the three cheques were brought to her. She was unable to remember if the cheques in question were accompanied by AFE's or agreements. She admitted that she could not remember having, prior to November 1974, signed cheques in excess of \$30,000 for consultant fees or cheques for future services. In any event, she signed the cheques and gave them to Ursel so that he could put his signature thereon.

### *Treatment of the Transaction in McGregor Travel Records*

The investigation and post-evaluation conducted by Air Canada's Internal Audit Department concerning the McGregor transaction is dealt with later in this Chapter, but some events directly related to the transaction itself should be commented upon here. In October 1974, the auditors of McGregor Travel, Messrs. Gardner, McDonald, started their annual audit of the fiscal year ending September 30, 1974. Mr. Robert Staples, the partner in charge of the audit, said in his testimony that he had known about negotiations between Air Canada and McGregor and had been kept informed of their status principally by Tarbet. Although the company had a capital deficiency of about \$100,000 and had since 1967 incurred losses during five of those

years, he described the financial situation of McGregor in 1974 as stable mainly because of the shareholders' guarantees. He admitted that the lack of working capital caused him some concern particularly in light of impending government regulations. He stated that McGregor and Tarbet had told him some time in August or September 1974 that Air Canada would make a payment of \$100,000 to the company before the end of September which would have the effect of improving the financial position of the company and permit the company to take advantage of its accumulated tax loss carry forward. Presumably this indicates that the transaction was not viewed by McGregor Travel as a capital transaction for some time prior to September 1974. Some time after November 29, Tarbet advised him that three cheques totalling the sum of \$100,000 had been paid to McGregor and had been deposited in the company's account.

Staples testified that when he did his audit in January, 1974, he did not have the proper documentation in his possession to enable him to determine what these payments really represented. He had asked Tarbet to see the agreements, but these were kept in McGregor's permanent files and were not then available. Staples testified that he was unable to secure information from McGregor, who was seriously ill at the time. In order to obtain enough information to determine whether the sum of \$100,000 should be treated by McGregor Travel as capital or income, Tarbet spoke to Dobson, who called Seath about the matter. Seath suggested to Dobson that Smith was the man to talk to, and Dobson then arranged through Smith for a meeting between Tarbet, Staples and Smith on February 18, 1975. According to Staples' testimony, during the meeting, Smith explained that the Air Canada payment had been made in the guise of consulting fees to keep McGregor alive, and, since Air Canada had deducted it as an expense in its books, it expected McGregor to treat it as income. Staples testified that he asked Smith to provide him with a copy of the letters of agreement which Smith refused on the basis that they were private correspondence between McGregor and Menard which were not in Air Canada's current files. Finally Smith is said to have told Staples and Tarbet that McGregor's shareholders could sell their shares without having any legal obligation to keep Air Canada informed pursuant to the option agreement.

Smith's version of what transpired at that meeting was recorded in a memorandum, addressed to Cochrane and McGill, dated April 22, 1975, after the McGregor transaction was the subject of questions in the House of Commons. In essence, Smith agreed that the payment had been a rescue operation and that Staples had raised the tax implications because the payments were made to McGregor personally and not to McGregor Travel. The only explanation for this feature of the transaction was that a payment by an airline to a travel agency would attract an IATA investigator. Smith offered the opinion that the funds had been released pursuant to the three letters of agreement and therefore should have been treated as revenue chargeable to September 30, 1974. This would enable McGregor to use available tax losses and to reduce its accumulated deficit.

After Staples had met with Smith, the Executive Committee of the Board of Directors of McGregor Travel met on March 13 and March 20, 1975, at the office of the company's auditors in order to discuss and approve the financial statements of the company for the year ending on September 30, 1974, and to discuss the transaction between Air Canada and McGregor; minutes of both meetings were filed with the Commission together with McGregor's notes of the March 20 meeting. Staples attended the first meeting because, notwithstanding the explanations given to him by Smith, he wanted to review the transaction with the Executive Committee of McGregor Travel. The provisional financial statements of the company were approved and it was decided that the sum of \$100,000 received from Air Canada related to the September 30, 1974, year end should have been reported as commission in that year. Bonuses of \$10,000 to McGregor and \$5,000 to Tarbet were also approved. McGregor informed the second meeting, also attended by Staples, that after discussions with Lindsay, McGill and Menard, he was able to report that the outside shareholders of McGregor would be bought out by the end of June 1975 and the price agreed upon was \$300,000. It was also agreed that the main purpose of the negotiations with Air Canada would be for the payment of the outside shareholders. Finally it was agreed that a bonus of 10% would be paid McGregor personally should further consulting fees be paid by Air Canada. The bonus of \$10,000 to McGregor in 1974 happens to amount to 10% of the Air Canada payment but appears to be an ordinary bonus, not necessarily directly related to the Air Canada payment, and comparable to that paid to Tarbet as comptroller.

John Dobson, who chaired both meetings, did suggest to the Commission that the bonuses paid to McGregor and Tarbet and a bonus of 10% to McGregor for additional consulting fees were a reward for McGregor's and Tarbet's efforts and also took into account the fact that McGregor's salary needed to be adjusted. The strange relationship between McGregor's bonus and future Air Canada payments must be viewed in the light of the fact that the minutes do not reflect the true purpose of the payment of \$100,000 as described by McGregor in his testimony. McGregor says it was for an option given to Air Canada to purchase equity and not for consulting services which were never expected to be performed.

### *Some Unanswered Queries*

It seems incredible that the auditor for McGregor Travel could not obtain copies of the letter agreements of November 28 from either his client, McGregor Travel, because the President McGregor was ill, or from the other party to the contract, Air Canada, because that company treated the agreements as personal correspondence between Menard and McGregor. In any event, that is Staples' testimony and Smith can only say that he cannot remember Staples asking for the contracts.

The evidence of McGregor, Parisi and Dobson was to the effect that the contracts and services were a sham and the main purpose of the trans-

action was to enable the airline to obtain an interest in McGregor Travel and through that company get into the total travel field.

The minutes of the Executive Committee of the Board of Directors of McGregor Travel for the meetings held on the 13 and 20 of March include the following references relative to this problem:

*March 13th*

"The meeting discussed the receipt of \$100,000 from Air Canada in payment of special consulting fees and it was decided that this amount related to the year to September 1974 and should be reported as commission in that financial year."

*March 20*

*"Air Canada"*

Mr. R. Y. McGregor advised the meeting of his discussion with Ray Lindsay, President of Venturix, John McGill, probable new Director of Marketing and Yves Menard, Director of Marketing for Air-Care [SIC].

He stated that the outside shareholders of McGregor Travel Company Limited will be taken care of by Air Canada by the end of June at the earliest. If John McGill takes over, this could happen earlier. Air Canada can accomplish the purchase of McGregor Travel Company Limited under the existing legislation.

Mr. McGregor also mentioned that Burke was still interested in making a deal with Air Canada, but it was his opinion that it was not necessary to put the two companies together in order for Air Canada to purchase McGregor.

*Financial Statements*

The financial statements were approved by the Executive Committee.

Messrs. R. Y. McGregor and R. J. Tarbet are to sign the financial statements for the banks.

*Sales of Shares to Air Canada*

After discussions, it was resolved that the Executive Committee would use its best efforts to ensure that shareholders will present their shares for purchase by the buyer.

The price agreed upon is \$300,000 for all of the outstanding shares. Should the transaction not be achieved by August 31st, 1975, the arrangements agreed upon will be reviewed. Shareholder bank guarantees must be released as part of any agreement.

*Intent of Air Canada Negotiations*

The chairman proposed that the meeting record the intent of the discussions with Air Canada. It was agreed that the main purpose of these discussions is to enable the pay out of the

outside shareholders of McGregor Travel Company Limited. A bonus of 10% will be paid to R. Y. McGregor should further consulting fees be received from Air Canada.

Should Air Canada or any of its related companies purchase the shares and re-pay the loans directly, there will be no consulting fees payable to R. Y. McGregor."

The action by McGregor Travel to treat the \$100,000 as consulting fee income in its fiscal year ended September 30, 1974 does not serve to clarify any confusion that may exist as to the real nature of these payments. If the amount was in fact a payment for an option one would expect the amount to have been reflected as a capital receipt (perhaps contributed surplus). Furthermore, the transaction would have been reflected in the period in which the funds were received. If the amounts were truly received for consulting services as spelled out in the letter agreements, then the \$100,000 would have been reflected as income, but in the period covered by the consulting agreement (December 1, 1974 to March 31, 1975) and not in the fiscal year ended September 30, 1974.

The accounting treatment followed by McGregor Travel in its 1974 financial statements suggests that the amount was received for consulting services rendered in the period ended September 30, 1974 and that there existed at that date no obligation to provide further services or issue share capital. It is beyond the scope of this Commission to comment on what accounting treatment would have been appropriate but it must be obvious that the classification of the moneys as income was dictated by the terms of the letter of agreement and the effect of the backdating of the receipt was to take advantage of a loss-carry-forward which otherwise would have expired on September 30, 1974. These circumstances raise the obvious question as to how much discussion went on between Air Canada Marketing Branch personnel and McGregor and his adviser in the "tax engineering" and corporate maneuvering prior to the somewhat hectic "closing" of the transaction on November 29, 1974.

As regards Air Canada, it remains an unanswered conundrum as to why:

- (a) If there was any uncertainty as to the corporate power of the airline to acquire these shares, there was no mention of any referral to the Law Department for an opinion or to any Law Department's opinion obtained in the past.
- (b) If an option arrangement had been considered and agreed upon, the Law Department was not asked to provide some share option agreement or an addition to the three service contracts to include a grant of option, and
- (c) The Law Department was not asked to approve the three letter agreements as to form in the manner required by the corporate by-laws.



Hanging over this entire affair must be a concern as to whether somehow the transaction offended the IATA Rules and Regulations as regards the dealings between airlines and travel agents. This possibility was referred to by Parisi and by Mr. W. J. Brooks, Director of Financial Planning in the Finance Branch, in their testimony and was inferred in the testimony of others. If the relationship offended IATA, then the question must be raised as to whether the steps which appear to have been taken were to disguise the transaction from the gaze of the IATA inspectors or whether these steps were taken for appearance purposes to cover over an improper transaction from the scrutiny of others. The evidence as it relates in great detail to the mechanics of the McGregor negotiations and transactions does not answer any of these questions. Furthermore, these events, coupled with the difficulties which Staples encountered when he attempted to obtain and examine the documents evidencing the \$100,000 payment, raised many queries, which were never satisfactorily answered by any of the witnesses at the Inquiry.

On the afternoon of March 20, 1975, Tarbet and Smith met again. Tarbet indicated that earlier that day McGregor had advised the Executive Committee that, following a meeting he had with Menard on March 18, a deal involving Air Canada's participation in McGregor Travel would be consummated by September 1975. Smith reportedly expressed his surprise at that suggestion. According to a memorandum of McGregor's, dealing with this meeting with Menard, he would have also told the Executive Committee that Menard had said to him that his successor, John McGill, was in favour of the deal.

### *Internal Investigation of Air Canada*

Air Canada's internal investigation of the McGregor transaction started after the three AFE's were examined during the first week of December by Mr. T. Bagg, Manager Planning and Administration in the Purchasing Department of Air Canada. Bagg who answers to the Vice-President Purchasing and Facilities and also has a functional responsibility to the Finance Branch, testified that in November 1974 his prime responsibility entailed the preparation of a monthly property and equipment outlook. The "functional relationship" is discussed in Chapter 5. Although Bagg's job description does not call for him to examine AFE's other than those dealing with capital expenditures in the P and F Branch, his practice is to review green copies of all AFE's which he receives. He explained that when he looked at the three AFE's of \$30,000, \$30,000 and \$40,000 respectively, he had a negative reaction which arose from a variety of suspicious circumstances: there were no accompanying attachments; they purported to cover consulting services for a sum of \$100,000; and there were three separate AFE's when one would appear to have been sufficient. In order to assuage his suspicions, he made a photocopy of the AFE's and forwarded them to Anderson, the

Co-ordinator of Capital Investment Managing Systems, in the Finance Branch, for further investigation. He stated to the Commission that he heard nothing further about the matter until it had become public in April, 1975.

In November 1974, Anderson, as Co-ordinator of Capital Investment Managing Systems, reported to Brooks, Director of Financial Planning. He testified that his functions entailed the preparation of the budget for the Property and Equipment section of the Finance Branch and also included the review, as required by the AFE regulations, of all AFE's in excess of \$50,000 and the preparation of the Finance Branch approval or disapproval of the expenditure in question. If the Finance Branch disapproved of the expenditure or the procedure relating to the AFE, the matter would proceed to the Chairman for a decision. He explained that one of the items he would scrutinize in his review of AFE's was whether programs had been split up. This appeared to him to be the case when he examined the three AFE's over \$25,000, for review to determine if it contained items which, but for splitting, would have required his examination. His recollection of the three AFE's pertaining to McGregor was that he had first seen a photocopy thereof during the first week of December accompanied by a note from Bagg. He explained that he had an uneasy feeling about them due to the fact that the amounts added up to \$100,000. He took them to Brooks who said that he would show them to the Controller, Sheehan. Later on, he found them on his desk with a handwritten note from Sheehan requesting that they be forwarded to Cochrane. Anderson did so by way of a memorandum bearing Sheehan's signature.

Brooks, the Director of Financial Planning in the Finance Branch since February 1, 1974, reported to Sheehan, the Controller of Air Canada, until the latter's resignation in February 1975. Brooks' general responsibilities included the reporting and forecasting of financial results to Senior Management of the company. In his testimony Brooks remembered Anderson showing him, in early December, copies of three AFE's and being concerned about a possible splitting which he explained as an attempt to circumvent Finance Branch opinion. In view of his prior experience in Winnipeg as Manager of Revenue Accounting, which involved some "policing" of travel agents, upon seeing the three AFE's, he was also concerned that there may have been a violation of IATA and CTC Regulations. He stated that he could not remember discussing the matter with Cochrane although he might have spoken to Sheehan about it. He did not hear about the AFE's again until the internal audit was in progress in 1975. He ended his testimony by saying that the AFE Regulations found in Manual 300 were being rewritten in order to prevent cases of splitting. However, the Director, Audit and Financing Consulting Services, Mr. Hugh Bowman, agreed that the proposed revision would not have prevented the "McGregor splitting" any more than the wording in the regulations at the time.

Until his resignation from Air Canada in February of 1975, Sheehan acted as Controller under the supervision of the Vice-President, Finance.

His principal responsibility was to establish good controls and to ensure that they were followed. He stated that some time in the latter part of December or early January 1975, Brooks brought to him a copy of three AFE's about which he was concerned because three payments appeared to have been made at the same time to one individual. Upon examining the AFE's, Sheehan also felt that this was a case of splitting which possibly involved a violation of IATA and CTC regulations. Prior to this incident he knew of other commitments being made by the company before his Department had had the opportunity to examine documents, and this had caused him to complain to the Vice-President Finance and to the Chairman since it defeated the purpose of the existing procedure. Sheehan said that he then went to see Seath who admitted that he had known about the commitment by Air Canada to McGregor but did not believe these AFE's violated the IATA, CTC or any other regulations.

Sheehan was aware of directives which Pratte had issued earlier (in November 1973) about the necessity for Air Canada and its subsidiaries to operate within the spirit of IATA regulations. Therefore, he decided to notify the Vice-President Finance and the external auditors of Air Canada about this situation. First, he drafted a handwritten memorandum to Cochrane bringing the AFE's to his attention. This is another document relating to the McGregor transaction which Cochrane denied ever having received. Then he met with Mr. Philip Aspinall, a partner in Coopers and Lybrand, the Air Canada external auditors, and related to him his concern about the payment by Air Canada to McGregor of the sum of \$100,000. He also told Aspinall about two payments made by Air Canada to Venturex which were a source of concern to him. Aspinall advised him to put his comments in writing but when Sheehan left the company on January 31st, 1975, he had not done so. It is interesting to note that neither Aspinall nor a great number of other people who in late February 1975 were investigating Menard's Barbados real estate dealings (discussed in Chapter 9) connected the apparent irregularities of the McGregor AFE's signed by Menard with the other Menard related problems. Neither Aspinall nor Cochrane raised this unusual transaction at the Audit Committee meeting on March 3, even though Menard had resigned in a much publicised resignation just three days previous.

The Vice-President Finance, Cochrane, testified that Brooks had mentioned to him in mid or late December 1974 that three AFE's may have been split. Later in his testimony, he stated that it had taken place in late December or early January. Cochrane then spoke to the Director of the Audit Group, Kruger, and asked him to verify whether value had been received by Air Canada in the McGregor transaction and whether there were other instances of AFE splitting.

Kruger left Air Canada on January 15, 1975 and was replaced by Bowman as Director of the Audit Group. The Audit Service Group performs field audits, inventory investigation and also post-evaluation of specific matters at the request of the Vice-President Finance or the Chairman. Kruger testified that after Cochrane asked him on January 6, 1975, to review all

AFE's of recent vintage including any involving McGregor Travel, he asked Mr. D. Cobb, Project Manager of Operations Analysis to look into the matter.

Cobb testified that his duties included those of Manager of the Audit Service Unit in Montreal, which entailed performing special project type audits. Kruger specifically asked him to look into the three McGregor AFE's and one AFE in the sum of \$145,000 involving a payment by Air Canada to Venturix (this AFE is discussed in Chapter 8). Cobb recalled that, according to Kruger, Cochrane had some misgivings about these AFE's.

Cobb first spoke to Anderson, who told him that a copy of the AFE's had already been sent to Cochrane with a memogram from Sheehan. After examining the "McGregor" AFE's, Cobb felt that splitting was involved inasmuch as they did not appear to be separate and distinct, they bore the same date, they involved the same type of services and the cumulative amount of the project would have required the Chairman's approval. Cobb was under the impression that projects in excess of \$150,000 had to go to the Board for approval; those between \$50,000 and \$150,000 had to be submitted to the Chairman and those below \$50,000 required the approval of a Vice-President or a person designated by a Vice-President. (Manual 300 and AFE procedures were reviewed in Chapter 5 above, where it was seen that Cobb's understanding of the rules was not accurate.) He gave this information to Kruger by way of a memorandum, dated January 10, 1975, in which the expression "flakey" was used to describe the McGregor AFE's. The word "flakey" had been coined by Kruger and connoted, according to him, the idea that there was no substance to the AFE's. Cobb's memorandum stated in part:

"The three McGregor amounts are individually within Menard's approval limit, but it appears to be a case of splitting a total so as to not require the higher approval of d'Amours and Pratte. Since each is under \$50,000, Anderson did not see them in advance but only when he received copies from Winnipeg. He then spoke to Sheehan who suggested Cochrane be informed. Anderson then sent a memogram with copies of the AFE's to Cochrane for his information."

Upon receipt of Cobb's memorandum, Kruger said he met with Cochrane to discuss its content and Kruger then forwarded his comments to Cobb in a handwritten memorandum, dated January 13, 1975 which stated in part:

- "(2) I don't agree that the McGregor Travel items are necessarily related. Don't suggest it—foot in mouth disease.
- "(3) In comments/audit report relate the inadequacy of the AFE's to post-evaluation—how can we determine that results were obtained etc., etc., if appropriate."

It is interesting to note that one of the investigators (the evidence indicates it was Whitrod) endorsed notes on the margin of this memorandum, one of which stated: "Can we query in such cases? What are our prerogatives? Would these require reviews in Winnipeg? Can we 'route' queries through

VP Finance for query with other VP's. . . . not necessarily related but certainly related as to percent paid, method used, time period involved. They certainly require an answer as to why handled this way."

Kruger in his evidence stated that notwithstanding the wording of parts of his memorandum, he was directing Cobb to extend his investigation to cover any other recent AFE's which should be reviewed and to report on the adequacy of the McGregor AFE's. If this was his intention, the wording of his instructions to Cobb leaves a lot to be desired.

Cobb stated that he enlisted the aid of one of his assistants, Whitrod, to help him in his investigation. In any event, Whitrod and Cobb proceeded to gather information pertaining to the financial situation of McGregor Travel and to determine if Menard held any interest in it, and in this connection obtained a Dunn & Bradstreet Report. At one point Whitrod prepared an analysis of McGregor Travel revenues which showed that the \$100,000 represented 4.8% of the agency's total revenues contributed to Air Canada. Whitrod's comments were collected in notes and in a letter dated January 23, 1975, addressed to Cobb, in which he concluded that the three AFE's had been split. His comments included the following:

"2. Adequacy of AFE's

. . .

- (b) Some control features are not evident in covering regulations in Publication 300.
  - 1. It is not clear where responsibility rests to ensure that AFE's are used according to company policy as outlined in regulations.
  - 2. Individuals can exercise control over both the expenditure *and* receipt of goods or services. This counter to good business practice. In the case of the McGregor transactions cheques were issued against the AFE's and no certified billing was processed indicating services were received. Some provision is required to determine that results, services or goods were received.
  - 3. Where funds are found from Budget surpluses it could be a means of using up the surplus prior to the end of the year.
  - 4. Splitting of AFE's into smaller amounts to enable local authorization permits actions as in 2 above thus circumventing examination by higher management prior to implementation.

We are left with some questions:—

- a) What prerogatives does Finance have (and particularly Audit Services) to question AFE's authorized by Branch heads and to verify that satisfactory results were obtained.
- b) Where queries must be directed to Branch heads, can they be routed through the Vice President, finance for handling?"

Whitrod also suggested that the nature of the consulting services to be provided by McGregor would impinge upon the functional responsibility of the Vice-President, Public Affairs, who did not appear to have given his approval to the transaction. Cobb stated in his testimony that although no regulations in Manual 300 dealt with splitting, Whitrod's opinion that AFE's had indeed been split confirmed his initial impression. Without any specific prohibition it must be obvious to all employees utilizing AFE's that they are a control device whose effectiveness can be reduced or eliminated by simple artificial division.

On January 30, Cobb spoke for the first time to one of the participants in the McGregor transaction, Garratt, who told him in an "off the record" conversation that the transaction had been initiated by Menard and that the sum of \$100,000 had been paid in advance in consideration for services to be performed by McGregor in Canada in connection with travel agent legislation and the exercise of his influence in the travel industry on behalf of Air Canada. No mention was made of any purchase of equity by Air Canada in McGregor Travel as a result of the transaction. Garrett mentioned to Cobb that he had spoken to Menard and Cochrane at the time and understood that they had discussed the transaction together. According to Garratt, Menard felt that McGregor's services were worth \$100,000. Cobb did not ask Garratt who had decided to split up the AFE's, but concluded that it was a clear case of splitting.

Based on his conversation with Garratt, who as Marketing Controller was relying on the executives in the Marketing Branch for his information about the McGregor transaction, Cobb stated in his testimony that he understood that Air Canada would obtain \$100,000 worth of services to be rendered by McGregor. However, when he asked Garratt how the AFE's would be closed without a report being submitted by McGregor, Garratt answered that he had not thought about the problem. Cobb was not excited by the fact that Garratt made his comments "off the record" and apparently did not even ask Garratt why it was necessary to do so. As it turned out, on March 10, 1975, Garratt wrote a memorandum to Parisi advising him to forward, in accordance with regulations in Manual 300, to Winnipeg, the yellow copies of the agreements for closing purposes, although the term provided under the agreements had not yet expired. He prepared a letter dated March 10, 1975 which was signed by Parisi and sent to Winnipeg.

It was the position of Air Canada as advanced through counsel on examination of witnesses concerned with the AFE procedures, that there was nothing improper or even unusual in 'closing out' these three AFE's by forwarding to Winnipeg Accounting, even before the expiry date of the three contracts, the documents described in the AFE routines. This leads to only one of two possible conclusions: either the AFE close-out procedures represent nothing but paper shuffling without any accounting control connotations; or, contrary to the company's protestations, these steps were taken by Garratt to bury the AFE's from sight once and for all. It is difficult to accept the explanation that the AFE's could be properly removed from circulation by the controller of the Marketing Branch immediately after he had been interviewed

by Cobb and perhaps others of the Audit Section of the Finance Branch, simply because the regulations authorize such a step once all the monies authorized by the AFE's had been advanced. Where the object of the expenditure was services which were to be performed within a specified period, and where payment was made in advance (all pursuant to three contracts authorized by AFE's which many of the Air Canada employees connected with these events considered to have been "split" contrary to regulations), it is startling to find that the chief financial officer of the branch concerned moved to close out these AFE accounts on the 10th of March 1975 without any recorded effort on his part to ascertain if the airline had received or would receive anything for its money.

On February 11, Cobb reported to Cochrane the results of his investigation into the McGregor and the Venturix AFE's. He attached to his memorandum the AFE's and the three letters of agreement. In his letter to Cochrane, Cobb condensed, amended and deleted some of the points contained in Whitrod's letter to him of January 1975. For instance, he deleted the recommendation made by Whitrod that the Vice-President, Finance should discuss with the Director of Merchandising and the Vice-President, Marketing the reasons why the AFE's had been split. Cobb stated that he left it to Cochrane to determine what further action was required. Cobb's memorandum made reference to the fact that the McGregor AFE's referred to services which impinged on responsibilities of the Vice-President Public Affairs, Mr. Claude Taylor and that the latter's approval of the service agreements had not been obtained. In view of this comment, Cochrane raised the subject with Taylor, as discussed below.

According to Cochrane's testimony, he met with Kruger's successor, Bowman to discuss the contents of Cobb's letter. It should be mentioned that when Bowman took over Kruger's responsibility as Director of Audit Services on February 1, 1975, he was not aware of the investigation into the McGregor transaction. He first learned of it when he received a copy of Cobb's memorandum to Cochrane of February 11. Cochrane testified that he told Bowman to secure more information in order to establish whether Air Canada had or would obtain value in return for the payment of \$100,000 and also asked him to arrange for the implementation of changes to regulations governing AFE's. Cochrane's request for more information was relayed by Bowman to Cobb.

Cobb's memorandum in part states: "While the McGregor transaction does not appear to be technically within the spirit of AFE regulations, we assume that in view of the unique circumstances, no further action is appropriate." No reasonable explanation is given by Bowman or his colleagues for the statement that no further action is appropriate.

This memorandum was shown to Taylor, Vice-President Public Affairs, by Cochrane between the 18 and the 20 of February, 1975. Upon being told by Cochrane that the investigation was continuing, he asked to be kept posted of the results. Even though these contracts with McGregor represented a direct invasion of his field of responsibility by the Marketing Branch,

Taylor did not take the matter up with the Chairman, or with Menard, or even raise it at a weekly Executive Committee meeting. Equally significant perhaps is the fact that Taylor, shortly thereafter, was directly involved in the investigation of Menard's Barbados dealings, which led to Menard's resignation, but still did not contribute to those important discussions among the most senior executives of the airline his knowledge about the strange McGregor transaction, Menard's involvement therein, and the then current Finance Branch investigation of that affair.

In summary of the foregoing, Cochrane, who had initiated the investigation of three McGregor payments some time in December, was still asking his subordinates over two months later for information which would enable him to determine if Air Canada had or would obtain value for its money. Cochrane himself did not go directly to Menard or his "functional" man in the Marketing Branch, Garratt, with direct questions regarding 'splitting' and value received. Cochrane testified that he had not by February 28 related the findings of his underlings with reference to the McGregor payments to the information communicated to him by Menard at the end of November 1974 about a proposed transaction between Air Canada and McGregor Travel.

It is difficult to understand why the Vice-President of Finance did not, by mid February, 1975, after receipt of the various reports from his staff, possess sufficient information to enable him to conclude that a transaction had taken place of a serious and questionable nature, the theme of which had been composed by the Vice-President of Marketing and orchestrated by his senior staff officers. At this stage of investigation, it could be reasonably concluded that serious doubts had arisen as to the motives of these senior officers in Marketing and doubts as to whether the Vice-President, Marketing, was fully aware of the ramifications of the transaction or, if aware, fully appreciated the nature thereof. Either the Vice-President, Finance, was aware of the identity of all the participants in the transaction and did not pursue the matter aggressively as Whitrod, a member of his staff, had recommended; or he was not aware, but ought to have been aware from available information, of the identity of the participants and the serious improprieties resulting. In any case, he did not press the matter by a direct intervention with the Vice-President, Marketing, or indeed with the Chairman.

These comments apply with equal force to the role played by the senior staff officers in the Finance Branch who inexplicably occupied themselves with this matter (and no doubt other matters) in December, January and February without convening a meeting of all persons whose names appeared in the transaction, or arranging a direct meeting with Menard, on Cochrane's authority or accompanied by him. In fact, the Finance Branch simply kept asking for more information from its lower echelons. If it had not been for the events which occurred during the last week of February, which led to Menard's resignation for reasons unrelated to the McGregor transaction, and the subsequent events in April, which culminated in the public disclosure in the House of Commons of the McGregor transaction, one wonders whether



the lid would not have remained on the McGregor matter forever. It seems that until then the only upshot of the investigation was going to be the introduction of changes in Manual 300 in order to prevent further splitting of AFE's, rather than a relentless pursuit of the truth to throw light on a mysterious transaction, or at the very least a proper transaction strangely executed.

The "investigation" lay dormant until the last week of February when the threatened public disclosure of Menard's ownership of a villa in Barbados within the Sunset Crest development occupied the time of many senior Air Canada personnel including those involved in the investigation of the McGregor matter. It is worth noting that at no time during this week in February, which culminated in the resignation of Menard, did Cochrane or Taylor, two Air Canada Vice-Presidents, or for that matter Aspinall, the outside auditor, disclose to the Chairman Menard's involvement in the McGregor transaction then under investigation. These three individuals knew that the Chairman was, in his words, "agonizing over a decision" involving Menard and they were asked for advice and counsel by the Chairman throughout the week.

The next incident connected to Air Canada's investigation of the McGregor deal occurred on March 7 during a meeting between Pratte and Cochrane. According to Cochrane's recollection of what transpired during that meeting, he brought with him a copy of Cobb's memorandum of February 11, 1975 and informed the Chairman that a transaction had taken place between Air Canada and McGregor which involved the performance by McGregor of certain consulting services for which three AFE's instead of one had been raised for a total sum of \$100,000; and that he was not in a position to determine whether Air Canada would receive value. Cochrane testified that he was relieved when Pratte reacted to this revelation by asking whether this was the "McGregor stock deal", which suggested to Cochrane that Pratte already knew about the transaction. Cochrane also asserted in his evidence that he told the Chairman that there were other matters of concern to him, namely the preferential treatment extended by Air Canada to certain travel agents in connection with the deposit of funds, a payment of a sum of money of approximately \$4,000 to an Air Canada executive which had been authorized by the President of Air Canada, and the possible future violation of certain IATA rules involving Air Canada's relationship with Venturex. Cochrane was unable to say whether he had shown the Chairman the three AFE's, the three agreements, or the memorandum of February 11, during this meeting. Cochrane's testimony on this meeting is in part as follows:

\* "A. Yes, sir. As Mr. Henderson pointed out, there were a list of items that we were discussing and when we came to this one I indicated that there was one more thing because we had had many discussions concerning Mr. Menard and so on in the past couple of weeks which resulted in his resignation. I said that there was one more thing concerning Mr. Menard that I wanted to speak to him about and I said that it was the McGregor deal I believe I said and he said, "you

mean the McGregor stock deal?" And I said, "no sir, I don't believe it was that. It is really a consulting thing." And there are three AFE's when there very well could have been one and at that time I had—I believe I had Exhibit something or other here, 99 in my hand, and I said—and worse than having three when maybe there could have been one, that wasn't concerning me as much as the fact that I had been unable to determine whether the company was going to get value for its money at that time.

Q. What did Mr. Pratte say.

A. Well, Mr. Pratte asked me if the money had been paid out and I said, "yes, sir," that the money had been paid out.

Q. Yes.

A. That was really all about what was said at that point.

In conversation towards the end—I think that I mentioned some other items and so on—but somewhere along there I let him know that I would continue my investigation to find out if we did get value or not and at the end of the conversation I indicated that I was relieved that he had known about McGregor as such—not about the consulting thing, but had known about a stock deal and he said yes he had and that was the end of the conversation.

That doesn't mean that he knew about a deal that was completed obviously.

Q. Well now, Mr. Cochrane, you said that you believed—you used the word relieved and I asked you the question to tell the Commissioner what I had asked you myself elsewhere.

Well, what did you mean by "relieved"? What was the sense of being relieved.

A. Well, since—I was relieved since after having—Mr. Menard resigned under circumstances of a conflict of interests, in my mind was—I thought that, you know, just maybe the chairman had not been informed and that therefore—and I had, of course, up until that time I hadn't informed him of any dealings with McGregor that I was aware of, hadn't mentioned the name to him I don't believe, sir."

Pratte recalled this meeting of March 7 with Cochrane but denies that he reacted to the information about the payments to McGregor by stating to his Vice-President Finance that he had known about the transaction all along and that it involved a stock deal. Rather, the Chairman told the Commission that Cochrane informed him that he had doubts about payments made by the Marketing Branch to McGregor and that the investigation was continuing. According to Pratte, he then told his Vice-President to continue his investigation but "not to rock the boat", meaning that he should do so without further disrupting the important activities of the Marketing Branch, which was still in turmoil over the resignation of Menard the previous week. Pratte stated that Cochrane mentioned to him that the agreements referred to consulting services

having to do with opening of new routes but that he had not seen the agreements at that time nor the AFE's nor, for that matter, any document.

Pratte added that he enquired of Cochrane if anything else bothered him. Cochrane answered that Menard had approached him the previous October at the suggestion of Garratt and had disclosed that he was considering purchasing some equity in McGregor Travel for \$100,000. Cochrane said further that he had told Menard that such a payment was within his signing authority but that he should discuss the matter with the Chairman. According to Pratte's evidence, he then told Cochrane that Menard had not come to him at the time to discuss the project and, in effect, he reprimanded Cochrane for not having reported directly to him and that in such instances, he was to report to the Chairman and not rely on a Vice-President to do so. Pratte's evidence on this meeting is, in part, as follows:

"Q. When was the first, when and by whom was it first brought to your attention that there had been some payments made by the marketing branch under the authority, the authorization of Mr. Menard to McGregor in November of 1974?

A. It is on March 7th.

Q. Would you tell the Commissioner the circumstances by which you learned of these payments?

A. Well at that time I learned of a payment of \$100,000.

Q. From whom? And how was it related to you?

A. As I do with other vice-presidents, I meet my vice-president of finance, quite regularly, and as often as I can, and as often as he cares to see me I suppose. And those are informal meetings when he either wants to discuss with me or wants to inform me of or wants to get my approval.

So on March the 7th, a Friday afternoon, he came to me with a number of files and I think it was rather late in the afternoon and he started to go through a pile of stuff that he had, and at one point in time,—it was neither at the beginning of the meeting nor at the end of the meeting; in other words it was clear to me that it was not the purpose of our meeting was not to discuss this question of payment to McGregor—he said to me that in view of the Menard resignation . . .

Q. The week previous?

A. Which was the week previous, he wanted to let me know about the payment to McGregor. Now I don't remember whether he said Bob McGregor, Mr. McGregor of McGregor Travel, or McGregor Travel, but it was one or the other. A payment of \$100,000 that had been made to Mr. McGregor subject to the qualifications I have mentioned, and I asked him what was wrong, what was worrying him about the payment. Well, he said, "It's a payment that's been made for consulting services." I said, "What's wrong with it?" Well, he said, "The problem is that it is consulting services but

we have difficulty in laying our hands on the report." And I said, "What is the problem, if we have paid \$100,000 for a report, there must be a report somewhere." I remember having raised my voice; it was the end of the week and it was late in the day and I was a little impatient, and I said, "For God's sake Mike, there must be a report." Well, he said, "The problem is that we are having difficulty in finding the report." And I said, "Well, can you issue a stop payment on the cheque?" "Oh", he said, "No, the money has been paid. The cheque has been cashed." Well I said, "The money is gone and Menard is gone." That was a rather sick joke. And I said you know, "Is there anything I should do now?" Well he said, "No, we have not finished our investigation." But he said, "But I just wanted to let you know." I said, "Well, that's fine, you pursue, you carry on your investigation.", but I said, "For God's sake, Mike, don't rock the boat. I have enough problems with that branch now." I said, "You know, I have been receiving petitions, letters, asking me to reconsider my decision re the Menard resignation. I've had to stop petitions circulated at the vice-presidential level, and you know the whole branch is in a messy state of disorganization. That is very serious because they are responsible for scheduling and most of our planning activities. And we're already a few weeks late.", which of course he knew because finance also has a great deal to do with planning activities; "And if we're not careful, we're not even going to be able to put the summer '75 schedule together." And of course he knew how upsetting the Menard resignation had been. He told me, you know, I am sure he knew, everybody knew and he also knew about the efforts that had been made to try to get signatures on a petition by vice-presidents to me. As a matter of fact, Menard had to issue a teletype across the system to stop that from going on. I was receiving letters and petitions from all the members of the branch asking me to reconsider my decision. I said to him, "Carry on your investigation but don't add to my problems."

And then he said—I told him, "You know, we've had this Barbados thing and now you're telling me about a payment of \$100,000 that worries you". I said, "Tell me Mike, is there anything else that you know?" I said, "I've got the right to know. Is there any payment that has been made under the authority of anyone or to anyone, including myself, including the president, that worries you? Is there any transaction that you know of that you think should be brought to my attention, because you know, I think I have to know, and I would rather know before the fact than after the fact." Or words to that effect. I am trying to summarize the conversation as precisely as I can, but I can't swear that I used exactly the same words, although some of the words are pretty close.

"Well", he said, "There is only one thing I think you should know." He said, "Back in October Menard came to me and he told me that he was coming to me at the request of his branch controller, Paul Garratt. And he said that he

was about to conclude a transaction for dealing with equity participation, a stock deal, I think he mentioned." I think he mentioned the expression, a stock deal. "And that had to do with equity participation in a national retail travel agency."

Q. This is Cochrane speaking to you?

A. No, no. That is Cochrane telling to me . . .

Q. Relating to you?

A. Relating to me.

Q. A conversation of?

A. A conversation with Menard which he said at that time took place in October.

Q. Fine.

A. And Menard—now, I am still telling you what Cochrane told me. He tells me, "Menard told me that of course he had full authority to do, to make the transaction. It was within his signing authority. That was the expression that he used. But nevertheless, because of the request of Garratt, he wanted me, Cochrane, to know about it." And Cochrane continued, he said, "I told Menard that even if it is within your signing authority, you promised me, you, (Menard) promised me, (Cochrane) not to do anything without getting the specific authority of the chairman."

And I said, "Well, I never heard about it". And then matters were more or less stopped there; and we carried on the conversation on the matter of what was the role of the V.P. finance in a matter like that. I was both assuming that no transaction had ever been made because I said to Cochrane, I said, "You know, this is all over but certainly there has to be a way whereby you inform me of any intent or any intention of any V.P. to proceed in that manner." And I think he agreed with that, but he said,—I've got his promise, and I've got to assume that people will live up to their promise, specially at that level." I said, "that's fine but nevertheless I want to know". And we had an amicable discussion, his pointing out to me that if he is to be effective as vice-president finance, he cannot be viewed as a spy on my account, and I fully agreed with him. On the other hand, his agreeing also that I had to be kept informed. And since that time we have pursued the discussion and we have come to an agreement as to how the thing should be handled; and very simply that V.P. Finance telling the V.P. concerned that, "I will inform the chairman." Or both of them coming to me. So there has been, there was no disagreement between us as to any future action to be taken by him under similar circumstances."

. . . . .

"Q. Reverting to this meeting on Friday, the 7th March, with your Vice-President Finance, do I understand that Mr.

Cochrane was in fact relating to you that there were two transactions going back to the fall of 1974, originating in the Marketing Branch, which—well, one which had been the object of discussion with Menard which you have just related?

A. Well, I don't want to put words in his mouth. You know, one thing is clear is that was my understanding and so far as I can appreciate his understanding of the situation, those were two separate things.

Q. Two separate things.

A. I did not relate one to the other, and he never said anything that would have indicated to me that one was related to the other because when we were dealing with the professional consulting services deal, the transaction,—we were talking about getting a report, and that was his concern that he had difficulty in laying his hands on a report.

Q. And the other matter was an equity investment by the airline which had been the object of a discussion between he and Mr. Menard in October '74?

A. That is right.

Q. And as far as he knew, had never materialized?

A. That's right. And you know I never made the connection between the two, and I am sure that he never made the connection between the two at least from what he told me.

Q. On the occasion of this conversation with Mr. Cochrane, were you shown any documents at all by your V.P. Finance?

A. Mike had in his hands at the end of the meeting, he had a file, and he said, "Well, do you want to see the documents?" And I said, "You've summarized them for me, haven't you?" And he said "Yes." And I said, "Well, I don't need to read them." And that was it.

. . . . .

"Q. Coming back again to March the 7th, I wonder if you could read Exhibit 99, which is the Cobb to Cochrane memorandum of February 11th, and as best you can recall tell us how much of the information contained in that document was conveyed to you by Mr. Cochrane on that Friday, March the 7th?

A. Well, I didn't know then that the \$100,000 had been paid in advance. I can't tell you whether I was told, whether it was to McGregor personally or McGregor Travel,—I can't recall that. I certainly didn't know and wasn't told that there were three AFE's and three cheques.

**The Commissioner:** Q. Mr. Pratte, I apologize for taking you back, but I got behind you in my notes, and I don't want to make a mistake in any part of what you're saying.

Would you tell me what it was that neither Mr. Cochrane or you associated, I take it during the 7th of March, 1975 session, they—you didn't link together to something, two conversations?

A. No, I didn't link together the conversation that Cochrane reported to me, that he reported having had with Menard back in October about the stock transaction, an equity participation; I didn't relate that to the \$100,000 payment that he had spoken to me about previously.

Q. I see, okay.

A. And I have no recollection whatsoever that he said anything that to my mind at least that indicated that he was making the relationship between the two. As a matter of fact, I am personally convinced that he didn't make the relationship between the two."

Some time shortly after his discussion with the Chairman on March 7, Cochrane decided to become more directly involved in the "investigation". We have not been able to pinpoint the exact date of this decision. It may or may not have been after an inquiry from the Chairman shortly after the latter's return from Europe on March 14, as to whether Cochrane had found out anything more about the McGregor \$100,000 payment. Cochrane's reply was negative but he confirmed that his investigation was continuing and that he had decided to take personal charge of it. Mr. Pratte's evidence on this point was as follows:

"Q. So you did have a conversation with Mr. Cochrane?

A. Yes, I had a conversation with Mr. Cochrane. As a matter of fact, I know I had a meeting with him on the 17th to deal with the revision to outlook process and AFE process. And I also had a meeting with him I think, sometime during the week; it is not clear, but anyhow, I know that during that week I saw him and asked him whether he had thought about our conversation dealing with the things that might be of concern to him, and he said, yes, that he had thought about it, that the only thing that in his view that was outstanding was the \$100,000 payment to McGregor, and that although he had made some efforts—and I think he mentioned at the time that he had tried, he had spoken on the telephone with Paul Garratt, he personally but I cannot be sure; but he said, "In spite of our efforts, we have been unable to uncover anything more and I am still unhappy with the payment. And I am not too sure that the company has received value for the money it spent." And then I told him that the successor to Menard would be appointed by the Board at the forthcoming meeting in a few days time, and that I would ask the successor to Menard to pursue the matter after his appointment, after having taken control of the branch. And that is how it was left."

Cochrane requested Bowman to instruct Cobb to obtain further information. Cochrane also spoke to Garratt and asked whether reports would be

received from McGregor. At Garratt's suggestion, Cochrane interviewed Smith and for the first time heard that, while McGregor's services had a value for Air Canada, as a result of the transaction there existed a stock option in favour of Air Canada based on a "gentleman's agreement" with McGregor. This conversation appears to have taken place on March 18 or a day or two thereafter. It is of some significance to note that it took from the first week or 10 days in December until the latter part of March for the Finance Branch to learn that there was in addition to the "service contracts" a handwritten option of some kind.

As a sidelight, some of the persons involved in this investigation turned their attentions in part to the need for revision of the AFE procedure in Manual 300 to formally deal at least in an indirect fashion with the practice of "splitting" AFE's. On March 17, Cobb wrote to Brooks and asked for his comments about recommendations contained in his letter of February 11 to McIntyre in Winnipeg and the latter's reply of February 13 concerning a revision of Manual 300 AFE provisions. Anderson called him to say that his recommendations would be incorporated in the new draft regulations dealing with AFE's.

On March 18, Cobb spoke to Garratt. The latter reported that he had spoken to Parisi who in turn had written to the Manager, Disbursements, in Winnipeg to close the AFE's. Garratt apparently did not reveal at that time that it was Garratt himself who had originated the closing out of the three McGregor AFE's and had drafted the letter to Winnipeg which Parisi signed.

Extraordinary as it may seem, Cochrane and his staff by the end of March were still searching for an explanation for this transaction. At that point in time, more than two months had elapsed since the beginning of the internal investigation conducted by Finance Branch. Except for three conversations between Cobb and Garratt, one on January 30 when Garratt told Cobb about the transaction on an off-the-record basis, a second one before February 11, when Cobb inquired about the closing procedure, and a third one on March 18 when Garratt told Cobb that Parisi had taken steps to close the AFE's, none of the other actors, including the originator and the approver of the AFE's, who had been intimately involved in the actual inception and implementation of the transaction, were interviewed or asked to give their file to the investigators. Only later on, after the bubble had burst, did Cobb and Cochrane, who spoke to Smith and Garratt, interview the participants.

Although one may have expected that in view of Menard's resignation on February 28, the investigation would have been pressed more vigorously and could have been conducted more simply and more directly, no such sudden determination appeared. Instead, more conversations and more meetings took place but no definite picture emerged from the quagmire of facts. Perhaps some participants were tempted to deflect the investigation into a project for the revamping of AFE regulations, perhaps others simply hoped the matter would disappear from view when the AFE's were closed out.



One parallel should be drawn between the McGregor investigation and the Villa investigation discussed in Chapter 9. On Sunday February 22, 1975, Mr. Taylor, Vice-President Public Affairs, telephoned Mr. Cochrane, Vice-President of Finance, to tell him of the impending newspaper report concerning the now well known Menard Villa in the Barbados. Without awaiting any authority from the Chairman, Cochrane that same Sunday afternoon instructed the External Auditor, Aspinall, to investigate the purchase of a villa in Barbados by the Vice-President Marketing of the airline. No question arose as to the delicacy of the Vice-President Finance directing the investigation of a more senior vice-president. Such strength and dispatch were not manifested in the McGregor investigations. Indeed, until the officials of Air Canada became aware of the impending public disclosure of the McGregor matter the Finance Branch investigation of it had been at times lethargic and had seemed largely concerned with demonstrating a need to tighten the AFE regulations relating to splitting and only late in the day became mildly concerned with the question as to whether Air Canada received value for the \$100,000 payment.

To revert to the story, Cochrane at about this time (March 17), made the decision that the McGregor Travel payment should be referred for discussion to the newly created Audit Committee of Air Canada. Some time shortly before March 25 he called the Chairman of that Committee, Mr. William Allen one of the Air Canada Directors, and asked for permission to put it on the agenda at the next meeting. Allen gave his permission, but later asked (at the Directors' meeting of March 25) whether it was essential that the matter be considered at the Audit Committee. When Cochrane assured Allen that the matter was of considerable importance, it was confirmed as an agenda item. In those conversations, Cochrane did not discuss the subject with Allen in any except the most general terms.

On April 14, Cochrane met with Bowman and Cobb, to settle the agenda of the next Audit Committee meeting and to gather the material in support of the agenda items. On the same day Cochrane mailed to Allen the agenda and the supporting material. On receipt of the material, Allen authorized Cochrane to send copies to the other Audit Committee members. This Cochrane did on April 23. The meeting was actually held on April 29, but because this Inquiry had then commenced, the McGregor item was deferred. There was no evidence before this Inquiry as to whether the Chairman did or did not know by April 14 that the McGregor matter had been placed on the Audit Committee agenda.

There is a lack of precision in the evidence as to the first notice to Air Canada of any threatened public disclosure of the details of the so-called McGregor transaction. The best evidence indicates, however, that the first news came through a telephone call from Jolivet, a Director of Air Canada, who lives in the City of Vancouver. Jolivet called the Chairman of the airline and spoke to him at about 5:00 p.m. Tuesday afternoon, April 15, 1975. He reported that he had heard some gossip in Vancouver about Air Canada

making kickbacks or improper payments to travel agents. The Chairman advised Jolivet that he was unaware of any such payments but undertook to make inquiries. He then contacted Mr. d'Amours, Group Vice-President Sales and Services, within whose jurisdiction the relationship between airline and the travel agencies fell. D'Amours denied that Air Canada was making kickbacks to any travel agents. D'Amours then ventured the opinion that Jolivet's information might in fact refer to a payment of \$100,000 by Air Canada to McGregor Travel in late 1974, which information d'Amours had learned from Mr. John McGill, the then Vice-President Eastern Region (within which region McGregor Travel operated) late in 1974 or early 1975.

The Chairman then spoke to McGill who by this date had replaced Menard as Vice-President Marketing. McGill had also received a call from Jolivet earlier on the same day and had told him that Air Canada had no practice of making kickbacks or improper payments to travel agents. When the Chairman reported to McGill the suggestion about McGregor which d'Amours had made, McGill explained that he had heard from his long-time friend McGregor some time during the previous December about a \$100,000 payment by Air Canada to McGregor. He had asked Menard about it in the process of taking over the Marketing Branch files, and had been told that the transaction was perfectly all right and that "all the documentation had been done in Finance". The Chairman then instructed McGill to inquire into the matter immediately and to report further to him the following day. The Chairman also asked McGill to speak to Cochrane about the subject. It should be mentioned that when Cochrane reported to the Chairman around March 17-18 that he was taking personal charge of the investigation, the Chairman volunteered that he would have Menard's successor, when appointed, look into the matter as well. Although McGill was confirmed in this appointment on March 25, the Chairman had not asked him to research the McGregor matter by April 15 because, in the Chairman's words, he did not think it proper to do so before Menard's actual departure (April 18).

McGill on April 15 requested and received the Chairman's authority to speak directly to McGregor to find out what he could about the transaction. McGill proceeded to McGregor's home late that evening and was advised that the payments had in fact been made to him personally under contracts requiring him to perform services, but that such services were not intended to be performed, the real purpose of the transaction being to establish a relationship between the two companies which would entitle Air Canada to participate in the equity of McGregor Travel at such time in the future as Air Canada should wish to do so, upon payment of a nominal consideration. This meeting left McGill with the hope, not based on anything specifically stated by McGregor, that Air Canada might be able to recover the moneys from McGregor Travel.

It is of some pertinence, at this juncture, to relate how two senior employees of Air Canada, besides Messrs. Cochrane and Taylor, came to have knowledge of the McGregor payments shortly after they were authorized by

Menard and made in late November 1974. At that time, John McGill was Vice-President Eastern Region. His office was in Montreal but not in the corporate Head Office at Place Ville Marie. He and McGregor had been good friends for many years. They saw one another socially on a regular basis. McGregor told the Commission that he had from time to time reported informally to McGill on the status of his negotiations with Menard's branch. In the same fashion, either in a telephone conversation or at a luncheon meeting, in early December 1974, he told McGill that he had finally received \$100,000 from Air Canada. There is no evidence that McGill heard from McGregor or anyone else at that time about the particulars of the transaction. Except for a brief conversation on the subject with d'Amours which will be commented upon in the following paragraph, McGill did not disclose this information to anyone else at Air Canada until the April 1975 events.

McGill has testified that he made no inquiry in December 1974 of McGregor upon hearing of this payment for the first time, despite the fact that McGregor was the largest travel agency within the Eastern Region, for which McGill was responsible. It seems strange indeed, in an airline which had been assessed several fines by IATA for improper payments to travel agents, (and particularly strange in the light of a memorandum from the Chairman of the Board in June 1973 prohibiting improper dealings with travel agents), that the Vice-President Eastern Region would not have pressed his principal producer in the travel agency field for details about his dealings with the Marketing Branch at Air Canada's Head Office. Perhaps even stranger is McGill's apparent failure to call the Marketing Vice-President or to ask his own Group Vice-President, d'Amours, to do so, in order to ascertain the relationship between the companies. This failure on McGill's part is particularly difficult to understand in the light of the inquiry by d'Amours of McGill, mentioned below, concerning an allegation that McGregor was steering its business to CP Air. However, that is the evidence given to the Inquiry.

In later December 1974 or early January 1975, d'Amours inquired of McGill about alleged preferred treatment being given by McGregor Travel to CP Air over Air Canada. D'Amours was reassured by his Vice-President Eastern Region that this was not so and passing reference was made by McGill about a deal between Marketing and McGregor Travel. No further details were provided by McGill to d'Amours, or indeed, were asked for by d'Amours. McGill did not volunteer anything about this conversation to the Inquiry. Neither explained why knowledge of a deal between Marketing and a travel agent would produce a feeling of re-assurance rather than utmost suspicion. D'Amours testified that this was the sum total of his knowledge about the McGregor deal until that day in April when the Chairman called on him and he immediately associated this casual conversation with the most unspecific rumour from Jolivet about kickbacks to travel agents. D'Amours and McGill were directly responsible in Air Canada for the travel agency, McGregor Travel, in the sense of sales revenue and commissions. Menard and the Marketing Branch were not. At least on the surface, the news of the payments

to McGregor or his company of \$100,000 was a direct invasion of the area of responsibility of the Sales and Services Branch by the Marketing Branch. Yet it evoked no surprise in the Sales and Services Branch executives and no cross-communication between the Branches. Thus, one more simple way to bring the McGregor affair back into proper corporate control was lost.

On Wednesday, April 16, while the Chairman was in Ottawa (on matters not connected to the McGregor matter) McGill gathered a complete file on McGregor Travel and handed it to the Chairman when the latter returned from Ottawa on the afternoon of April 16. The file contained the three letters of agreement, the three AFE's and other material. He reported to Pratte that he had spoken to McGregor the previous evening and had been told that no consulting services had ever been intended and that the deal consisted of an option on 10% of the stock of a national travel agency to be incorporated.

The Chairman conveyed the impression to McGill during this conversation that he knew nothing about the transaction. McGill, in his testimony, stated:

"Well, I had assumed all along that whatever transaction had taken place, you know, taken place with the full knowledge of whoever needed to know about these things, and in discussion with Mr. Pratte that night, Tuesday, it became apparent when he told me that he knew nothing about a deal between Mr. McGregor and Air Canada, and the fact that \$100,000 had changed hands, and I was taken aback that he did not know anything about it and I jumped to the possible conclusion that if he didn't know anything about it that, you know, maybe it wasn't—you know, that there was something wrong or that it wasn't as straightforward as I thought it was . . . and so I took the liberty of calling Mr. McGregor and meeting with him to try to determine exactly what the nature of the deal was and what had happened . . . and he told me that."

On the morning of April 17, McGill confronted Cochrane with this information and was told that he must have misunderstood the Chairman's remarks because the subject had been discussed between the Chairman and Cochrane on March 7 (and indeed again on or about March 18). Both McGill and Cochrane met with the Chairman later in the day to clear up this misunderstanding, and the Chairman, when reminded by Cochrane of the previous meetings, confirmed that he had been so informed. Cochrane stated in his testimony:

"A. Well, I told Mr. McGill that he and the chairman in quite strong language must be mistaken because I had discussed the matter with the chairman in early March and I suggested that maybe he—that being Mr. McGill and myself should meet with the chairman at the earliest possible moment to clear up at least that aspect of the matter. So, we did meet and I'm sorry I can't remember exactly when but it was within twenty-four hours—well, within thirty-six hours. I can't remember the exact time."

**The Commissioner:** Before or after the public disclosure of the McGregor deal.

**The Witness:** Before, I believe.

**The Commissioner:** Still before.

**The Witness:** Yes.

**Mr. Campbell:** Q. And what occurred on that occasion.

A. Well, on that occasion, I reminded the chairman that I had told him of the consulting and that we had discussed it in early March and reminded him of that conversation and he then said yes, that he remembered that conversation and that therefore I had informed him of the thing."

On Thursday afternoon, April 17, Elmer McKay, member of Parliament, disclosed in the House of Commons the \$100,000 payment by Air Canada to McGregor, the three letters of agreement, the three AFE's and asked for explanations from the Minister of Transport. (These questions are set out in full later in this Chapter). Earlier that morning, Claude Taylor had received advance notice of the forthcoming disclosure in the House of Commons and had so advised the Chairman. Pratte, at that time, handed to Taylor for perusal the "McGregor file" put together by McGill on the previous day.

That same Thursday morning, but before any rumour had been received concerning a public disclosure, Pratte had called on Menard for explanations about the McGregor transaction. According to Pratte's evidence, Menard told him that this was a perfectly legitimate contract for consulting services and that everything was above board. Menard added that if Air Canada ever wanted to go into the retail travel business, it had an option to acquire stock in McGregor Travel. Pratte told the Commission that he was "shocked and dumbfounded" at Menard's explanations and that, upon leaving his office, he went to d'Amours and McGill and told them he was giving up in attempting to learn the truth of the matter from Menard. "We don't speak the same language any more".

Pratte then had lunch with Vaughan to apprise him of the situation after Taylor's warning about an impending disclosure in the House of Commons. It will be remembered that Vaughan had been under the impression since June 1974 that Menard's plans in this area had been shelved. It will also be recalled that Vaughan never read Smith's monthly reading file. Had he done so, he would have been made aware of the McGregor payments at least in January 1975 upon reading Smith's memorandum of December 3, 1974.

On April 17, two meetings chaired by Pratte were held. The first one, late in the afternoon, was attended by Pratte, Lindsay, Parisi and Smith and also at the end by Cochrane. According to Smith's version of the events, Pratte reproached him, Lindsay and Parisi for having led Menard astray. The second meeting was held during the evening and was attended by Air Canada's representatives, Pratte, Vaughan, Taylor, McGill, Cochrane and d'Amours and by McGregor and his legal counsel, Richard Holden.

Following a meeting of the Board of Directors of Air Canada held on April 22, the Chairman, according to Cochrane's testimony, told Cochrane that he was satisfied that he had handled the McGregor matter in a proper manner. Finally, according to the evidence, a letter was drafted by the Chairman addressed to the Minister of Transport explaining the circumstances of the McGregor transaction. This letter was communicated by telephone on April 18.

Menard's evidence about his meeting with Pratte on Thursday morning, April 17, is somewhat different from the latter's account. Menard told the Commission that the Chairman came to his office around 10:30 to discuss some budget papers and that, at the end of the meeting, asked him point blank how he felt about the McGregor deal. No reference was made to letters of agreement or AFE's, according to Menard. Menard expressed the view that the deal was for legitimate services and that everything was above board. According to his evidence, that was the end of the brief conversation concerning McGregor and Pratte left his office.

During the afternoon of April 17, Pratte called Parisi, Smith and Lindsay, and others, to his office and gave them a proper dressing down. Pratte asked many questions about the transaction and, according to his testimony, obtained no satisfactory answers. Ironically, Pratte was scheduled to host a farewell dinner for Menard that very evening. In the late afternoon he rang up Menard at home to suggest that the dinner should be cancelled, in the circumstances. Menard who, according to his evidence, had still not read the letters of agreement, maintained that there had been nothing wrong and that this was a tempest in a teapot. A short time later, Pratte instructed his secretary to ring up Menard and cancel the dinner.

In the meantime, on the afternoon of Thursday, April 17, Elmer MacKay put the following questions to the Minister of Transport in the House of Commons:

**"Mr. Elmer M. MacKay** (Central Nova): Mr. Speaker, I wish to direct a question to the Minister of Transport. I regret I did not have the document or I could have taken this up with the minister in committee. Will the Minister cause an investigation under the Inquiries Act into the circumstances whereby the President of McGregor Travel of Montreal received \$100,000 in advance late last year ostensibly for three consultant tasks involving relationships with provincial governments and, according to two of the letters of agreement, influence governments and trade in the Middle East and Latin America for the benefit of Air Canada?

**Hon. Jean Marchand** (Minister of Transport): Who received the \$100,000? I did not get the name.

**Mr. MacKay:** The name is Bob McGregor—R. Y. McGregor of McGregor Travel, Montreal.

**Mr. Marchand** (Langelier): He received the \$100,000?

**Mr. MacKay:** May I put one further question to the Minister?

**Mr. Marchand** (Langelier): It is a serious question but I shall have to inquire because I was not aware of that fact.

**Mr. MacKay:** Would the Minister not agree—assuming that this is right, and I have the documents for him—that this type of approach by Air Canada through a travel agency official could be misinterpreted by the governments of other nations and also impinge on the prerogatives of some of the Minister's colleagues including the Secretary of State for External Affairs, as well as being questionable business ethics which could involve the jurisdiction of IATA. Is he not concerned about the implications of what Air Canada is apparently doing, not through regular channels such as the international affairs division of our airline, but rather through a travel agent?

**Mr. Marchand** (Langelier): When I have the information I will give the opinion the hon. member is inviting."

In the evening of April 17, the meetings continued at Air Canada's head office in Place Ville Marie. McGregor, accompanied by his counsel, came to the meeting to give his version of the November transaction. McGregor repeated to the Air Canada officials that he had been having discussions with Menard and his people for some time prior to November 1974 and he expressed surprise at being told that the Chairman knew nothing about this project. He confirmed that no consulting services had been intended notwithstanding the text of the three agreements which had been imposed upon him by Air Canada. He referred to the \$100,000 as an "earnest payment" and stated that he considered that Air Canada acquired an option to purchase 10% of his stock for \$1.00.

Prior to attending at the offices of Air Canada on the evening of Thursday, April 17, McGregor had two or three telephone conversations with Yves Menard earlier in the evening. In the course of one of these conversations, Menard told him to explain to the Air Canada brass the nature of services that he had undertaken to provide and had not performed because of his illness. Menard's evidence is to the effect that he read the letters of agreement for the first time when excerpts were flashed on the T.V. screen that evening. Menard told the Commission that those letters did not represent the deal he had negotiated with McGregor. He left with his wife the following morning, April 18, for a vacation in his Barbados villa.

The Air Canada Executive Committee held its regular weekly meeting on Friday, April 18. The prepared agenda was shelved and the two main topics discussed were the McGregor payments and the scheduled appearance of the Chairman on a nationally televised public affairs programme the following Sunday evening.

The Honourable Jean Marchand had spoken to the Chairman of Air Canada the previous day following the disclosure by MacKay in the House of Commons and had requested a report on the McGregor matter as soon as possible. The airline's Executive Committee, on the basis of the fragmented information gathered in previous days, drafted and approved a written report

by the Chairman to Marchand. In view of the urgency, this letter was telecopied to the Minister of Transport around noon, Friday. Shortly thereafter, Pratte, accompanied by Vaughan and McGill, travelled to Ottawa to deliver the letter in person to the Minister. Pratte then held a meeting with the Honourable Jean Marchand which was not attended by Vaughan or McGill.

On Saturday, April 19, the meeting of the Executive Committee reconvened in Montreal. Pratte reported on his meeting with the Minister the previous day and decided to hold a special meeting of the Board of Directors the following Tuesday, April 22. After consultation by telephone with most of the directors, the decision was reached that Pratte should appear on W5 the following evening as originally scheduled. Around 6:00 in the evening of April 19, after the text of a proposed press release had been approved by the Executive Committee, a telephone call was placed to Menard in Barbados for his comments.

We noted earlier that Menard had travelled to Barbados on Friday. Shortly after he arrived in his villa, James Reed of CTV reached him by telephone. Reed then had in his possession copies of the letters of agreement between Air Canada and McGregor. He read extracts from these letters to Menard and asked for his comments. Reed's handwritten notes of his conversation with Menard were filed as an exhibit. They demonstrate, as indeed did his oral evidence before the Commission, that Menard confirmed the authenticity of the three agreements and stated that the whole transaction was known to the Chairman and the Vice-President Finance of Air Canada. When Menard was recalled as a witness on the last day of the hearings, he denied ever having told Reed or anyone else that Pratte had had knowledge of the McGregor transaction. Insofar as Cochrane's knowledge was concerned, he explained that he was referring to his brief conversation with the latter in mid November 1974 which has been commented upon earlier. Menard also explained to the Commission that, 24 hours after having learned of the contents of the letters of agreement, he was still in a semi-state of shock and his first reaction was to support the people who had worked for him and negotiated the deal with McGregor.

It is in this context that Menard's conversation with Vaughan and Taylor in the evening of Saturday, April 19 must be seen. Menard suggested no change whatever to the draft press release and approved it. The three consulting services agreements were not disclaimed by the former Vice-President Marketing and the transaction was not exposed for what it really was.

On Tuesday, April 22, an all day meeting of the Air Canada Board of Directors was held in Montreal; the only item on the agenda was the Air Canada—McGregor transaction. The directors were provided with copies of the letters of agreement and the AFE's. Pratte reported to the directors on the events of the previous seven days and offered to produce any Vice-President if the Board members so wished. It was in the course of that meeting that the Chairman was advised by the Honourable Jean



Marchand that a Commission of Inquiry would be set up to investigate the transaction. At the conclusion of the meeting, Claude Taylor was brought in to approve the text of the press release.

### *Conclusions*

The inquiry into the McGregor transaction leaves many unanswered questions, the most important of which is whether there was any impropriety involved or whether this was simply a case of an improperly conceived and wrongly executed transaction. When one analyzes in depth the circumstances of the transaction and reviews all the evidence given, the picture which emerges is not clear. What may have been, at the early stage of the negotiations, a genuine attempt on the part of Air Canada to explore its financial participation in a merger between McGregor and Burke, in order to form an alliance of travel agencies with all the trappings and pitfalls it entailed, quickly became a rescue operation.

If we were only dealing with a transaction which was bad from an investment point of view and/or from the point of view of the inopportunity of Air Canada's entry into the retail travel agency field which is clearly the case, then it would not appear to be within the purview of the Commission to dwell on these points. On the other hand, if there is evidence or strong presumptions that a deal was entered into for illegal considerations, then the Commission is required to comment on it. We are greatly disturbed by the manner in which the McGregor matter was handled both before and after the fact. We have attempted to stress in the above summary of the evidence, certain elements of the evidence which give rise to doubts about the credibility of certain witnesses and therefore the real motives of some of the actors should be subject to caution. In the same vein, Air Canada introduced as evidence a newspaper article, to show that some American airlines were being prosecuted for paying kickbacks in the form of free transportation and cash to travel agents. Was Air Canada attempting to show that kickbacks in one form or another are the rule rather than the exception in the airline industry? If so, then it surely reflects on the McGregor transaction and raises additional doubts.

#### *A. Conduct of Certain Air Canada Employees Before the Fact*

The Commission's interpretation of the evidence is that Menard, Smith, Parisi, and Garratt, all of the Marketing Branch, and Lindsay, behaved in a manner less than adequate for the conduct of their employer's business in the preparation for and the execution of the plan to make payment of \$100,000 to McGregor Travel. The conduct of other employees after the fact is the subject of a separate comment below.

More specifically, the inadequacy of the conduct of these employees can be described as follows:

1. The 'splitting' of the \$100,000 transaction into three transactions of \$30,000, \$30,000 and \$40,000.

The purpose of this splitting seems to have been to avoid the Finance Branch review and comments which would have been required on an AFE for \$100,000 because of the revised AFE requirements, in force since January 1974, requiring such review and comment in the case of AFE's in excess of \$50,000. Alternatively, the splitting may have been prompted by the mistaken view that this was necessary to keep the payments within Menard's authorization limits. If the Finance Branch makes negative comment on AFE's in excess of \$50,000, such comments are to be forwarded to the Chairman of the Board who will resolve the differences between Finance and the Branch in question. The splitting of the AFE's, therefore, circumvented the possibility of the review of this transaction by the Chairman and should it be reasonable for the authors of these AFE's to have anticipated opposition from the Finance Branch, then the action in splitting the AFE's was tantamount to revising the Regulations established by the Chairman, or to obtaining the equivalent to the Chairman's approval.

Before jumping to the conclusion that this was the only possible purpose for the splitting, one must realize that not all the management personnel involved in this transaction were aware of the memorandum from the Chairman of the Board in January 1974, mentioned earlier, which also extended the signing authorization of the Vice-President Marketing to \$100,000. For example, neither Kendall nor Garratt was aware of this memorandum and hence the need for Finance Branch comments, except that Garratt testified that he was aware of a Marketing Branch "Powers and Limitations" memorandum which set out the same information.

It is also not entirely clear that the personnel involved in the action which led ultimately to the delivery of \$100,000 to McGregor ever anticipated that the transaction would come to light. The AFE review system, whereby every AFE over \$25,000 was to be listed by accounting personnel in Winnipeg and the list reviewed in Montreal, was not implemented by the Finance Branch until September 17, 1974 and it is not clear that this surveillance programme was known to the officials in the Marketing Branch. Alternatively, the senior officials in the Marketing Branch might have been reconciled to ultimate discovery of the transaction by senior management of Air Canada but by that time the transaction would have been concluded and their colleagues faced with a *fait accompli*. Presumably their defence on that occasion would be that proffered, and sometimes persisted in before this Commission by various representatives of the airline, namely that the corporate plan adopted by the Board of Directors of the company contemplated diversification into ownership in travel agencies and therefore the action required no Board approval and was within the expenditure authorization level of the Marketing Branch. Neither Pratte nor Vaughan in their testimony accorded the slightest validity to this argument that no Board approval would be required. Only a momentary glance at the Board approved corporate strategy is required to see

the complete fallacy of any such argument. The 1975-1979 Corporate Plan under the heading of Diversification provides:

*"Strategy No. 10—Diversification*

To diversify profitably into new activities in the travel and transportation related industries for the purposes of:—  
(approximate order of priority).

- a) Assuring the corporation's continued growth by achieving a greater degree of control of the total leisure travel product and the total cargo transportation product. In this regard diversification ventures should respond to specified marketing requirements in the following order of priority:—
  - i) lodging
  - ii) tour wholesaling
  - iii) retail passenger channels of distribution
  - iv) cargo channels of distribution."

It is interesting to note that in the approved "corporate programmes in support of Corporate Strategy No. 10—Diversification" nothing in relation to item iii) above is mentioned. Specific items and completion dates are provided, however, for such proposed ventures as the joint hotel programme with the CNR, Hilton Hotels and Trizec Corporation.

Another possible motive, purpose or intent of the authors of the McGregor transaction might be that the payment was forced upon them by the obvious urgent need for money by McGregor Travel in the fall of 1974. Negotiations had dragged on for 18 months and had advanced to a stage where perhaps some or all of the Air Canada personnel involved might have considered the transaction irreversible. A crisis arose when the financial straits of McGregor Travel became apparent to this group and provided the note of urgency that was required to remove any small obstacles remaining in the path of this payment to McGregor. In the haste brought on by this urgency, the "services scheme", protected by the splitting of the AFE's, may have seemed to be the only readily available expedient and at least one of the Marketing executives was quoted in the evidence as having said so.

Whatever may have been the motives of this segment of the staff of the Marketing Branch in the Head Office of Air Canada, the resultant pay-out to McGregor is accurately assessed by the Chairman in his evidence when he agreed that this transaction was "badly conceived and wrongly executed".

2. *The preparation of the AFE's together with the support letter agreements appear to have been designed to disguise the true nature of the payments.*

The AFE's themselves cite as the object of the expenditure, "outside professional consulting services". The budget item number is labelled as "operating". These two references are of course diametrically opposite to any

reference which would indicate a capital expenditure such as share acquisition or payments for an option to acquire shares. The notation on the AFE relating to the \$40,000 expenditure makes no reference to the related letter of agreement provision referring to "the improvement of its relationships with the Canadian retail trade and Provincial Governments". It would be difficult for a reviewing authority in the airline to detect from the wording used in that AFE the services for which McGregor was being paid. In any case, the wording of the AFE does not parallel the wording or expressed intent of the letter of agreement.

3. *The disbursement of funds for which the Airline did not receive any value.*

Clearly no consulting services were rendered nor was it ever intended that such services would be rendered. If there was to be some value by way of a share option, it has been made clear that no option was received. McGregor has described the payment as an "earnest payment". He stated that McGregor Travel would be obliged under a gentleman's agreement to issue shares in his own company or thereafter in a reorganized national travel agency. It has never been suggested that the gentleman's agreement was enforceable and accordingly its value must be relatively insignificant. Even were it enforceable, no one seriously advanced the argument that an option to acquire for one dollar a 10% interest in a corporation in a deficit position and with a poor earnings history could be worth \$100,000 or anything approaching that sum.

*Workings of the Control System*

The preventative aspect of the Air Canada control system did not work to prevent the payments being made to McGregor because certain employees, one of whom was a senior officer of the airline, apparently set out to circumvent the controls.

According to Smith who, as we have said, was responsible both to the Vice-President Marketing and to the President, two documents descriptive of the McGregor transaction were sent to the Vice-President of Finance on November 26, 1974. This was two days before the actual cheque writing took place and three days before delivery of the cheques to McGregor. Had the Vice-President Finance received the documents, or had Garratt, the Controller of Marketing, communicated the same information to the Vice-President Finance, or had the Vice-President Finance in fact received the same information by telephone through Seath during the Seath-Parisi conference, or had the Vice-President Finance reacted to his earlier conversation on November 22 with Menard about the McGregor acquisition transaction by communicating the substance thereof to the Chairman or the Executive

Committee, presumably either the Vice-President Finance and/or the Chairman or the Executive Committee, would have immediately stopped the transaction and the delivery of the cheques as being in violation of the many rules, plans and procedures mentioned above. Unhappily, none of these communication pores opened up, the cheques were processed, the contracts signed, and the moneys paid over.

### *Functional Responsibility*

Considerable mention has been made in the testimony of the importance of the control provided by the presence of a Finance Branch trained controller within each of the major branches of the corporation and of the "functional responsibility" of these controllers to the Finance Branch. There is no clear definition of this "functional responsibility" within the airline, but various witnesses described it as the responsibility of the branch controller to the Finance Branch for the adequacy of systems and procedures within the branch, the reporting of deviations from laid down policy, development of meaningful forecasts and reporting of variances from plan. We are left with the impression, principally from the evidence of Cochrane, that Garratt, the Controller of the Marketing Branch, should have advised the Finance Branch of the possible improprieties associated with the three McGregor AFE's and to have done so at a time when disbursement could have been prevented. Garratt, in short, should have responded to these AFE's in the same manner as did Mr. Bagg in the Purchasing and Facilities Branch. The only documentary record to which the Commission was directed throughout the course of the hearings with respect to this "functional responsibility" was the "Linear Responsibility Chart—April 1974", which under the heading "Finance Function" states:

#### *"Branch/Region Controller*

Implement Company Finance policies, plans, programs and procedures.

Develop Branch/Region Finance programs within parameters of Company policies, plans and procedures.

Provide functional guidance and counsel to Branch/Region Management.

Provide inputs to Corporate Finance on effectiveness of Finance policies, programs, plans and procedures."

There is, of course, a vital distinction between the position of Garratt and the position of Bagg with reference to these AFE's and indeed the McGregor transaction *in toto*. Bagg, in transmitting the suspicious AFE's to Finance, was not reporting or commenting upon any action by his superiors, but rather did so as a by-product of the performance of his duties to his own superiors. Garratt, on the other hand, is asked by those advancing the functional responsibility theorem to communicate critically to the Finance Branch about his superior, the Vice-President Marketing. He is asked to play the role

of a spy or informant and to do so sufficiently expeditiously as to allow Finance to intervene to prevent the transaction taking place. This must inevitably place the Finance "agent" in the other branches in an invidious position. The Vice-President Finance by way of further explanation or justification of such a system stated that the Branch Controller's salaries and advancement is subject to the joint action of the Vice-President Finance and the Branch Vice-President. It is difficult to believe that this kind of support would ensure normal advancement in position and remuneration throughout one's career in the airline without regard to actions contrary to the wishes of the superior that the controller must in his functional role from time to time take. It asks too much of human nature that the object of his action (in this case it would have been the Vice-President Marketing, the equivalent of a Group Vice-President) would not in the long run be able to effectively rid himself of this undesirable influence and, in doing so, forewarn his colleagues in the other Branches of this man's functional propensities. Reliance on the functional role in the case of Garratt also puts unnatural strains on the relationship between the head of a department and one of his staff, however justified the staff member's action might be according to the company code. Thus, it might well be that the functional theory will work as regards the flow of operational information and even critical information when it does not reflect on the reporter's superior (as in the case of Bagg), but the extension of the functional theory to controllers in Garratt's position, vis-a-vis Menard, however logical, is unrealistic. This conclusion is supported by the excerpt quoted above from the Linear Responsibility Chart. Nowhere does that Chart with anything approaching precision, require the Branch Controller to act as a policeman or investigative agent on the part of the Finance Branch, particularly in the prospective sense.

In fact, however, Garratt gave testimony to the effect that he did not see any suspicious circumstances in connection with these AFE's and, therefore, felt no need to report them to the Finance Branch. It is difficult to understand how Garratt satisfied himself that the airline would receive value for an expenditure that would be made before any service was to be rendered. The most likely explanation is that Garratt did not satisfy himself but rather accepted the explanations given to him because he did not want to question the merit of a project supported by his Vice-President who signed the AFE's. The functional responsibility failed in these circumstances. This is not surprising. A control based on the need to question one's superiors or report to others on their superior's performance is a control that will frequently fail.

#### *B. Retrospective Aspects of Control Systems—Detection*

Ironically, the functional or semi-formal functional relationship did bring about an investigation of the McGrégor disbursements. This occurred when Bagg, the Controller of the Purchasing and Facilities Branch, sent to his former colleague in the Finance Branch, Anderson, copies of the three AFE's

he had received in the course of his duties in the P & F Branch. The extent to which this is an accident can be seen from the fact that nowhere in Bagg's job description is he required to peruse AFE's which do not commit the corporation to capital expenditures, nor is the P & F system designed to ensure that all AFE's flow past him. Furthermore, Bagg has no apparatus within the AFE system to enable him to ascertain whether in fact he has seen all the AFE's for any period in question. Nevertheless, accident or otherwise, the functional responsibility relationship, however informal it may be, did expose the McGregor transaction.

It is interesting, and perhaps of some significance, that Bagg stated in his testimony that, while he was curious about consulting payments to a travel agent, his suspicions were aroused when he considered the total of the payments going to one person and the necessity for three AFE's. He concluded that one would only go through the additional paperwork involved in the preparation of three separate AFE's for the purpose of reducing the amount of each individual AFE to less than \$50,000 and hence avoid Finance Branch's scrutiny and comment. He therefore sent copies of the AFE's, together with an attached note, to Anderson of the Finance Branch. Thus the Controller in the P & F Branch reached the opposite conclusion from that of the Controller in the Marketing Branch, Garratt, with reference to the splitting of these AFE's. In fact, only Garratt and Bowman amongst the ten or twelve Finance Branch or Controller personnel who were called upon to assess these AFE's failed to classify them as "splitting". Bowman told the Commission that he only concluded that these AFE's had been split after reading the newspaper reports.

It must be observed that the specific control mechanism that proved effective in detecting these irregularities was one that had not been designed for this purpose by the persons who established the system. Air Canada's view on this question is that while the control may not have been contemplated to work in exactly this fashion, it does represent an example of the effective application of "functional responsibility". Despite Air Canada's comment, it is the view of the Commission that Bagg's action is more indicative of the control conscious attitude of the man rather than the system.

The opinion has been expressed by Air Canada officials that even if Bagg had not drawn Anderson's attention to the three McGregor AFE's, Anderson would have queried them on his own. The basis of this opinion rests on the fact that Anderson receives, early each month, a listing from Winnipeg of all AFE's processed during the previous month in excess of \$25,000. As stated earlier, Anderson's responsibilities included the evaluation of the merit of capital expenditures in order to provide Finance Branch comment on projects authorized by AFE's in excess of \$50,000. He therefore reviewed the listings from Winnipeg to ensure that all the listed AFE's of \$50,000 and over had already been reviewed by the Finance Branch. His purpose in receiving data on AFE's in the range of \$25,000 to \$50,000 was to look for situations where the amount might have been artificially deflated either through splitting or underestimating the true cost. There is no reason

to conclude that the opinion of Air Canada in this regard is wrong and that the Anderson review would not have triggered an investigation.

There was considerable evidence given in the hearings concerning budget procedures, which is discussed below in Chapter 11. That evidence indicates that, since the Marketing Branch was within its total 1974 budget in November 1974, there would be little likelihood of anyone within the Finance Branch querying the case of the intra-departmental variation of the Marketing budget. Certainly Garratt in his direct role as Marketing Controller, or his indirect functional role, would not query the payment on the basis of budget variation since he had implemented the realignment of the Marketing Branch budget when the proposal to do so was detailed by Parisi as mentioned earlier.

It is the responsibility of the Branch Controller to prepare an analysis of the Branch financial statement for review with the Branch Vice-President each month. The review emphasizes the outlook for total expenditures for the balance of the year. After this report has been reviewed by the Branch Vice-President, a copy is to be filed with the Finance Branch. In this specific case, Garratt had no need to report on the variance created by the McGregor disbursements, since his Vice-President, Menard, was already familiar with the transaction. Since December is the last month of the fiscal year, management attention is concentrated on the total year report and the necessity of Branch reporting to the Finance Branch for the month's transactions is dispensed with. The McGregor transaction was included in the finance reports for the month of December and presumably would therefore not be included in the November report by the Marketing Controller which, as mentioned above, is submitted through the Marketing Vice-President to the Finance Branch.

The testimony given indicated that Cochrane was made aware of the McGregor payments prior to December 20, 1974 and that he immediately requested Kruger, the then Chief Internal Auditor, to conduct an investigation into the payments. Various members of the Finance Branch staff have given explanations to the Commission as to why this investigation extended over such a long period of time and produced so little information. The explanations given included Christmas vacations, major reorganization of personnel assignments within the Finance Branch, time demands connected with the annual closing of accounts and audit thereof, and other priorities of the internal audit group. These explanations suggested that the investigation was given low priority. In addition, internal audit memoranda indicated that members of that department did not want to fully investigate the matter. On January 13, 1975 Kruger replied to a memorandum from Cobb, an investigating auditor: "I don't agree that the McGregor Travel items are necessarily related. Don't suggest it. Foot in mouth disease". On February 11, 1975 Cobb reported to Cochrane (with a copy to Bowman, as the new Chief Internal Auditor): "in view of the unique circumstances no further action is appropriate".



Cochrane's testimony indicates that his initial reaction to the situation was that the payments indicated a procedural violation to avoid Finance Branch prior review. He fully expected that the investigation would indicate that value had been received for the payments and that on completion of his review he could report the matter to the Chairman on the basis that there had been a post-review by Finance Branch rather than a prior review. He could not pinpoint when he first became concerned that perhaps value might not be received, but as the thought began to jell in his mind he put the item on a list of points for discussion with the Chairman, which meeting took place on March 7.

To regain one's perspective in all this detail, it is necessary to state in summary that this investigation began in the first week of December with Bagg's discovery of the AFE's in the P & F Department lists. It reached the Chairman three months later on March 7. In the meantime no meetings had been convened by the investigators between themselves and the principals concerned with the transaction; no direct confrontation had occurred between the Vice-Presidents Finance and Marketing, even after the latter's resignation on February 28, and no report on the investigation had been sent or revealed to the Chairman. Lowden, one of the Commission accountants, testified, from an accounting viewpoint, that despite the three months period consumed in these investigations, allowance had to be made for the intervention of the Christmas holiday, the year end accounting activities, the changing personnel and the departure of Kruger. Nevertheless, having taken all this into account and having considered the other agencies and tribunals within the company available to investigate this matter, the length of the investigation stretched beyond all reasonable limits and the methods utilized by the investigators do not commend themselves as the tools used by persons bent on discovering the truth in a hurry. A payment by an airline of \$100,000 in advance for rather nebulous services to be performed, partly abroad, by a Montreal based travel agent should have been sufficient to alarm the investigators. If more be needed to spur them on, this was a large payment to a travel agent not long after a flurry of IATA fines were levied on several airlines and a memorandum had been issued by the Chairman of Air Canada instructing that Air Canada must comply with the spirit of IATA Regulations.

What remains an unanswered conundrum is the question as to why the investigation was not a top priority matter even on the grounds of curiosity. The mystery thickens when one compares the lack of verve and thrust in the McGregor investigation to the energy promptly directed to investigate the Menard Villa transaction in the last week of February.

The meeting with the Chairman took place approximately three months after the investigation began. It has never been satisfactorily explained why the suspicions of the Finance Branch, that no value was to be received, were not immediately aroused by the terms of the agreement, which provided for full payment for the consulting services before they had been rendered.

It is also difficult to understand why Cochrane and others did not bring the investigation to the attention of Pratte during the last week of February, 1975, when consideration was being by all of the members of the Executive Committee to the question of Menard's integrity on another matter.

The fact that Cochrane did draw the McGregor payments to the attention of Pratte on March 7, 1975 and Pratte's testimony that he had no real understanding of the total transaction until mid-April, 1975 suggests that there was a serious problem in communications at the senior executive level. Cochrane left the meeting with the impression that Pratte was not interested in hearing any more about the matter and that he understood the nature of the transaction. It should be stated, however, that Cochrane did not drop the matter but moved to have it included on the agenda for the Audit Committee meeting in April. Even this fact is ambiguous. It either reflects to Cochrane's credit that he still pursued the details of the McGregor action in order to properly assess it, or that he realized that others might question the adequacy of the airline's financial controls, the Finance Branch lethargic investigation and Cochrane's failure to mention the McGregor investigation during the Menard Villa debates in February, or that Cochrane had serious doubts after the March 7 meeting that Pratte really appreciated the McGregor deal and understood what the investigation had revealed.

Pratte's view of the situation at the conclusion of the meeting of March 7 was that Cochrane would continue his investigation to determine whether or not a report was to be received from McGregor for the consulting services, but that Cochrane would conduct his investigation in a manner that would stir up as little ill feeling as possible within the Marketing Department. Pratte stated that he felt this was justified on the basis that Menard had already resigned and the funds had already been disbursed. Menard's resignation had caused considerable dislocation within the Marketing Branch and Pratte did not think it would serve any purpose for Cochrane to conduct a conspicuous investigation of the matter at that time. In Pratte's words he instructed Cochrane to "carry on your investigation . . . don't rock the boat. I have enough problems with that Branch now". In testimony he explained that the Marketing Branch was then involved in preparing the 1975 summer flight schedule.

From an accounting standpoint, it is difficult to understand why the work on the 1975 summer schedule would be disturbed by an investigation of disbursements made through the communications expense centre of the Marketing Branch. However, in fairness to the senior management of the airline, then embattled by media attack and exposés and the resultant Menard investigation, they were very conscious of a wave of reaction in the Marketing Branch favourable to Menard over the resignation incident. The Branch was behind in its summer schedule preparation, which is a vital function of the Marketing Branch, and senior management of the airline were reluctant to

disturb the operations of that Branch further. Hence, Pratte's explanation of his comments to the Vice-President Finance with reference to the continuance of his investigation.

*Handling of the funds received from Air Canada by McGregor*

The three cheques paid to Mr. Robert McGregor by Air Canada were endorsed over to McGregor Travel and deposited in a corporate bank account in early December, 1974. The resulting bank balance was used almost immediately to repay a corporate bank loan of McGregor Travel. A careful review of various aspects of McGregor Travel's accounts revealed no evidence that any of the funds were routed to any Air Canada employee.



## Chapter 7

### THE SUNSET CREST LEASES—BARBADOS

In this Chapter, Air Canada's first (and for reasons that will appear, perhaps its last) venture into the field of block leasing of tourist accommodation is examined. The accommodation involved and the term and rentals involved are as follows:

- (a) 103 one-bedroom condominium units in a 110 unit building situated in the Sunset Crest Development on the west coast of Barbados leased for a term of one year from December 20, 1973 to December 19, 1974 at a rental per unit of \$4,116 (an aggregate rental of \$423,948). These leases were renewed for a further one year period from December 20, 1974 to December 19, 1975 and an additional condominium was added. The annual rental per condominium unit was increased from \$4,116 to \$4,733 thereby involving an aggregate annual rental commitment of Air Canada of \$492,232;
- (b) 72 apartments in the same Development rented for one year from December 20, 1974 to December 19, 1975 at a total rental of \$408,888;
- (c) 25 two-bedroom villas in the same Development leased for a 17 week period during the 1973/74 winter season commencing December 22, 1973 at a weekly rental per villa of \$224 (a total rental commitment of \$95,200). The lease of these villas was renewed for a 17 week period during the winter of 1974/75 commencing December 20, 1974 at a weekly rental per villa of \$256, an aggregate rental commitment of \$108,800.

By the time the leases of the condominium units and the 72 apartments expire on December 19 of this year, the total rent paid by Air Canada under this program will have been \$1,529,068.

#### *Background*

Up until 1970, by far the greater percentage of Canadian traffic to Barbados and outer Caribbean travelled on scheduled flights. The total number of passengers from Canada in that year was 115,965 persons. Of

these travellers, all but 16,400 used scheduled airlines and Air Canada's share of the total market, whether scheduled or charter, was 74%. Non-scheduled traffic travelled by charter aircraft.

By 1972 the total Canadian passenger traffic to Barbados and outer Caribbean had increased to 175,300. However, the number of passengers travelling by scheduled airlines increased by only 25% while the number of passengers travelling by charter more than trebled. Air Canada's share of the total market had declined to 59%, scheduled and charter. Air Canada was losing its predominant market position to Barbados by virtue of the fact that ITC (Inclusive Tour Charter) operators were providing to Canadian consumers charter products that were more appealing to vacationers and significantly cheaper than Air Canada's scheduled product to Barbados.

ITC's are produced and distributed by tour operators. Their function is to design a product encompassing various elements such as accommodations, car rental, sight-seeing and air and ground transportation. The tour operator of an ITC contracts for aircraft capacity, hotel or resort accommodations and other ground services in bulk and is therefore able to negotiate discounted tariffs. In so doing, he is able to offer travellers a total vacation package priced considerably below scheduled vacation prices. The latter, of course, combine normal air fares and hotel and ground service rates.

ITC's are marketed to the public through normal retail channels and most tour operators further enhance their competitive position in relation to scheduled traffic by a policy of paying travel agents higher commissions than do scheduled airlines (up to 15% during off peak periods).

In an effort to improve its competitive position in the face of a declining market share, Air Canada, in the winter of 1971/72 initiated its Sun Living Program which attempted to stimulate scheduled air traffic by offering a choice of a wide range of appealing accommodations at destination. It was hoped that the availability of scheduled air travel, the ability to fly on any day of the week and to return at any time, coupled with the wide range of accommodation in various price categories, would help to offset the "cheap vacation" attractiveness of ITC's, involving as they did, inflexible and infrequent schedules and the choice of only a seven or a 14 day vacation.

While the Sun Living Program so instituted enjoyed some modest success, it did not have the effect of reversing the tendency of the traveller to switch from scheduled to charter transportation.

A further problem was developing with respect to the 1973/74 winter season. Studies undertaken by the Southern Routes Marketing Group in Air Canada indicated a significant shortage of room capacity in Barbados in relation to the air seat capacity available from Canada. In part, this was due to a virtual standstill in any expansion of the available Barbados tourist accommodation and in part to the fact that the ITC operators were contracting for blocks of the available accommodation to satisfy their own requirements. The studies indicated that there appeared to be a considerable risk as to the continued availability of rooms to satisfy scheduled vacation

demands. A memorandum of March 27, 1973 from the Market Development Manager, Southern Routes to the Marketing Director, International Routes stated that Air Canada's 1973/74 estimated Sun Living bed night requirements exceeded by 15,849 bed night accommodation allocations tentatively arranged by that date. In that memorandum, authority was requested to enter into agreements with hotel and villa operators for the protection of rooms to meet the Sun Living forecast demands.

At about the same time, Air Canada commissioned a travel data study to determine public attitudes towards its Sun Living Program in an attempt to determine to whom and how the Sun Living Program could best be presented. This study which was completed in April of 1973 established that the price of a southern vacation was the single most important criterion among the majority of travellers.

All these problems were well recognized throughout Air Canada. Indeed, the Corporate Plan 1973/77 refers to declining Caribbean traffic, the necessity of the airline making available to the consumer preplanned and flexible vacation packages, and the probability that room accommodation, particularly of the mid to low price variety, might soon be difficult to obtain in the Caribbean, and sets out as an achievable objective, effective competition for a share of the market by offering a 'southern vacation product that is not limited to travel "but also includes the availability of features such as recreational vehicles, boating, vacation homes, spectator sports, etc.".

Also, the 1974 final marketing plan for southern routes listed as a program the following "Resort accommodations—program to acquire or lease properties at major southern destinations on a long term basis at relatively inexpensive rates so as to effect economies in the cost of ground packages and thereby close gap between scheduled and charter vacation prices".

### *Sunset Crest Development*

The Sunset Crest Resort was developed by Sunset Crest Limited, a Barbadian company, which in 1973 was jointly owned by Mr. A. Laforet of Barbados and by Barbados Shipping and Trading Company Limited. It is described in detail in a brochure filed as an Exhibit in this Inquiry. The complex consists of approximately 225 privately owned villas, a large apartment hotel known as the Golden Anchorage, a building containing 110 condominium units known as Golden View, an apartment building with 72 units known as Golden Palm Apartments, a beach club for owners and guests at the resort, a pool, two shopping centres, four tennis courts, a children's playground and Rent-a-Car facilities. Fielding's Guide, in describing the Sunset Crest facilities states, "Best buy in the Caribbean? It just has to be!" The Golden View condominiums were completed and

ready for occupancy by December of 1973. The Golden Palm Apartments were only completed and ready for occupancy by December 1974.

All of the villas and ultimately all of the condominiums were privately owned, but made available for lease to the public when their owners were not in residence, through Sunset Crest Rentals Limited, a Barbadian company entirely owned by Mr. Laforet. Sunset Crest Limited owned the Golden Anchorage apartment hotel and the Golden Palm apartments. Sunset Crest villas first appeared in the Air Canada Summer 1973 Sun Living Program but no lease agreements were required since, during the summer months, the supply of rooms in Barbados is greater than the demand. During that period, requests received by Air Canada for accommodation at Sunset Crest were simply relayed on to Sunset Crest for confirmation.

Lease negotiations commenced in March of 1973 and the negotiations for the villas were conducted separately from the negotiations for a lease of the condominiums. Apparently this occurred because, at that time, while Venturex was considering leasing the condominium units, Air Canada itself was planning to utilize only the villas as part of its Sun Living Program. Mr. Lezama was negotiating for the villas on Air Canada's behalf. Mr. Lindsay was negotiating for the condominiums on behalf of Venturex.

### *The Villas*

Negotiations for leasing the 25 villas were conducted on Air Canada's behalf by Mr. M. Lezama, Market Development Manager, Southern Routes. He travelled to Barbados in the early part of March 1973, inspected the properties and had preliminary discussions with Sunset Crest Rentals Limited. On his return, he sought and received authority to lease the villas from Mr. A. J. Ballotta, Marketing Director, International Routes. In order to reduce the risks of under utilization of the accommodation, Lezama convinced two of Air Canada's Sun Living wholesalers to join Air Canada in the venture and to share to the extent of 25% in any profits or losses from the leasing operation. At that time it was anticipated that villa rental expense would exceed villa rental revenue by \$25,000. Negotiations to lease the villas were concluded with Sunset Crest Rentals Limited when Laforet was in Montreal on or about April 13, 1973 and a standard Sunset Crest Rentals agreement was signed under date of July 26, 1973. The lease included 25 two bedroom villas for a period of 17 consecutive weeks commencing December 22, 1973 at a weekly rental of \$224 Canadian funds. The lessees were Air Canada, Fairway Tours and Canadian Travel Advisors Limited. The leases contained no renewal option.

It was agreed between Air Canada and the tour operators that the latter would be responsible for managing the villa leasing operation; for the payment of rentals due to Sunset Crest Rentals Limited; for the organization of package tour programs including the villas for sale to Air Canada's customers under the Sun Living label; and for arranging adequate employee or



other representation at the point of destination. The tour operators formed a Barbadian company under the name of Southern Management Consultants Ltd. for this purpose. An agreement between Air Canada and the tour operators setting out these arrangements was drafted but never signed.

The program operated for a 17 week period during the winter of 1973/74. Rentals paid to Sunset Crest Rentals Limited exceeded rentals collected by \$39,141, \$9,776 of which was the responsibility of the tour operators. After taking into account air revenues from 419 passengers of \$86,200, Air Canada calculates that it received a benefit from the leasing operation in the amount of \$56,835 before any internal cost allocation. This, of course, assumes that these seats would not otherwise have been sold. It also assumes that the scheduled operations could still be profitable after absorbing about a \$30,000 loss on the rental accommodation.

### *Condominiums*

While Lezama was carrying on his villa negotiations with Sunset Crest Rentals Limited, Laforet of that Company phoned Mr. Yves Menard, Vice-President, Marketing of Air Canada to remind him that 100 individual one bedroom condominium units in a building then under construction at Sunset Crest would be available for lease at the commencement of the winter season in 1973. This subject had previously been discussed between Menard and Laforet in late December of 1972. Laforet requested an Air Canada decision in respect of the proposition by early April 1973.

Prior to that time, there had been discussions at a meeting of the Board of Directors of Venturex concerning the advisability of Venturex entering the ITC market by late 1973. Menard felt that the condominium units might fit in with those plans and on March 9, 1973 convened a meeting with Mr. R. T. Vaughan, then Secretary of Venturex and of Air Canada, and Mr. R. H. Lindsay, General Manager of Venturex, to discuss the opportunity. Menard was at the time a director and President of Venturex. It was decided at this meeting that Lindsay should go to Barbados immediately to explore the possibility of using the condominium units as part of an ITC program.

Lindsay visited Barbados on March 15, 1973, reviewed the facilities available on the Sunset Crest property; visited the construction in progress on the condominium building; discussed with Laforet the type of contract that would be required to lease the condominiums and was advised of interest being shown in the condominiums by other Canadian tour operators.

He returned to Canada on March 18, 1973 and reported the results of his visit to Menard in a letter of March 19, 1973. He reported that the condominiums would be available for Venturex to operate an ITC program beginning in December 1973 and stated that Laforet had given him until April 6 to take up the option on the condominiums. Lindsay observed that all accommodation in Barbados was presently at a premium; that no better value than Sunset Crest existed and recommended that the authority of the Board of Directors of Venturex to sign a contract with Sunset Crest be sought.

On the same date, Lindsay wrote Mr. N. E. Taylor, Product Development Director, International Routes for Air Canada, stating that Venturex anticipated undertaking a modest ITC program beginning approximately December 22, 1973 and asking whether Air Canada had aircraft available which it would charter to Econair for one flight per week at an average price of \$130 per seat. The letter refers to the expiry of the condominium option on April 6 and requests a reply by March 31. Lindsay received a reply to this letter from Mr. A. J. Ballotta, Marketing Director, International Routes on March 22. The reply stated that it would not be possible to determine the availability of an Air Canada aircraft for charter until June and that Ballotta would want to be assured that Venturex's Board of Directors had approved of the program before Air Canada would make any commitment of aircraft to Venturex. Lindsay replied to Ballotta on March 23, 1973 pointing out that the Econair Board could obviously not approve any program until aircraft availability was known and stating that June was too late for an Econair program utilizing Air Canada equipment.

Also, on March 19, 1973, Lindsay wrote Mr. G. N. Pratt, a solicitor in Air Canada's Legal Department, referring to the proposed Venturex ITC program, seeking a legal opinion as to Venturex's power to charter aircraft, contract for ground facilities and promote public inclusive tour charters. Pratt replied on March 23 stating that Venturex had corporate power to act as a charterer and to lease hotel space, but raising some question as to whether or not the Air Transport Committee would issue an ITC permit to Venturex in view of its close corporate relationship with Air Canada. The letter states that "The ATC might well take the view, based on the intent of the ITC regulations, that Air Canada is, through Econair, [Venturex], acting indirectly as a tour operator and that, therefore, a permit to operate inclusive tour charters where Econair was the charterer would not be granted". In view of this risk, he recommended that any contract for hotel space contain an out clause and a clause allowing Econair to assign the contract to Air Canada without consent. It should be observed that no authorization was obtained, or even considered, from Air Canada for this venture by Econair.

Despite the problems of charter aircraft availability raised by Ballotta and the possible difficulty with the ATC charter regulations, Lindsay continued to explore an ITC program for Econair because of his belief that both Air Canada and Econair would benefit from an ITC program and that such a program would be a significant contributor to the capabilities required to make Air Canada a leading travel conglomerate. He prepared a number of in-depth studies identifying a range of alternatives with such a program. His preference of alternatives was to contract for the units, to obtain an equity interest in one or more of the tour operators, to design a package using the condominium units and to produce through such tour operators, an appropriate inclusive tour or inclusive tour charter product. Lindsay wrote at the time "Investment resources for such a plan can be derived from Air Canada's Diversification Budget".

The financial implications of the proposed condominium leases were discussed by Lindsay with Mr. J. G. Burns, Manager, Financial Analysis, some time in early April 1973 and Burns advised the Vice-President Finance, the Controller and the Treasurer of the proposal by memorandum of April 12, 1973. That memorandum states that "this contract works out to a total cost of approximately \$450,000 on an annual basis which represents a \$79 per week cost for each condominium (one bedroom apartment). The revenue that would offset this cost breaks out at \$300 per week for the 17 week winter season at a 70% occupancy rate and \$150 per week for the 35 week summer season at a 40% occupancy rate." The memorandum points out that Lindsay was available to discuss the numbers and would like the opportunity to elaborate on the summary data which Burns had prepared. No suggestion was made by Burns, nor is there any evidence that the Finance officials to whom his memorandum was addressed subsequently made any suggestion as to the need for Air Canada Board approval or for an AFE.

Laforet extended his deadline of April 6, 1973 for an Air Canada decision in relation to the condominiums and travelled to Montreal to discuss the proposed leasing arrangements with Lindsay on or about April 13, 1973. Two meetings were held with Lindsay, Pratt, Laforet and his solicitor, Mr. R. Clifford Chapman, in attendance. An understanding was arrived at which formed the basis for a draft lease contract prepared by Pratt. The draft was forwarded to Menard with Lindsay's letter of April 17, 1973 with the recommendation that an Econair Board of Directors meeting be called to approve it and to authorize Lindsay to execute it on behalf of Econair, probably in September of 1973, by which date it was expected that the required minimum number of 100 condominium units would have been sold to individual owners and be available for lease. The letter also includes a memorandum for submission to the Board of Directors of Venturex outlining the condominium opportunity in more detail.

The lease proposal was to contract for condominiums on condition that not less than 100 of such condominiums would be available for a term of one year from December 21, 1973 at an annual rental of \$4,116 per unit. Separate contracts would be entered into with each unit owner. The contracts would contain two successive one year renewal options at a rental increase not to exceed 15% per year.

The understanding arrived at with Laforet on April 13, 1973 was apparently not reduced to writing but on the basis of this understanding, Laforet returned to Barbados and immediately commenced to obtain the necessary authority from the individual condominium owners to enter into leases on their behalf with Econair.

On April 25, Lindsay prepared a memorandum for the Air Canada Executive Committee meeting of April 27 describing Econair and its advance booking charter operations in some detail. The memorandum makes the statement that "formalities aside, Econair is in effect an instrument of Air Canada and CN Realities acts only on behalf of the airline". It also states that "Econ-

air depends entirely upon Air Canada for its resources and general policy guidance" and that "the future activities of Econair beyond the summer of 1973 had yet to be specified". It is surprising that the memorandum makes no reference to the proposed condominium leases from Sunset Crest. A copy of the memorandum was submitted to the Department of Finance before the Executive Committee meeting and J. G. Burns drew the Barbados omission to the attention of the Vice-President Finance in a memorandum of April 26. The memorandum refers to Lindsay's paper regarding Econair . . . (prepared) . . . for the Executive Committee meeting and states "no mention whatsoever was made of the 110 condominiums in Barbados. You may want to raise this point since we know that the law branch is working on the contracts for these condominiums". The Vice-President Finance, apparently, did not do so.

The evidence before this Commission is that the Sunset Crest leases were never discussed at a meeting of the Executive Committee. There is no reference to them in the minutes and Pratte, Cochrane, Vaughan and Fournier all gave evidence that they had no recollection of the leases having come up for discussion. Menard's evidence is to the contrary. He says that the Executive Committee discussed the Barbados project prior to the question of the lease renewals being referred to the Air Canada Board in April 1974. He also says he discussed the occupancy rate of the project at Executive Committee meetings.

In view of the number of senior officers in Air Canada who were involved with these leases and the number of problems which they created, the evidence that the leases were never discussed at an Executive Committee meeting is generally very difficult to accept. The Executive Committee meeting of April 27 is a good illustration of the reason for this difficulty. Lindsay prepared a memorandum for the Executive Committee seeking guidance as to the activities of Econair beyond the summer of 1973. Lindsay had just recently concluded verbal arrangements with Sunset Crest for the leasing of 100 condominium units and had prepared a submission to the Econair Board seeking authority to sign the contracts. Pratt had drafted the condominium leases and the draft was submitted to Menard. The future of Econair was discussed at the Executive Committee meeting and the following paragraphs appear in the minutes of the Executive Committee meeting:

"Future activities of Econair beyond summer 1973 had still to be specified. The charter granted Econair gave it the widest possible scope of activities, subject to a Board expectation of 15% ROI, 20-35% gross margin on sales and 15% net margin on sales before income tax. A Board meeting would be held in the week of May 7 to determine Econair's future functions. The corporate (diversification) plan contained several proposals which would require an instrument such as Econair, although perhaps with a modified complement of directors.

Following consideration, it was resolved that recommendations for Econair's new activities (emanating from the May Board meeting or elsewhere) would be referred to Committee for approval."

Can one reasonably expect that a discussion of Econair's future could have taken place at that time without arrangements concerning the condominium leases being raised. Vaughan, Orser, Menard and Lindsay were all at the meeting and were all fully informed of the then state of the condominium lease arrangements involving, as they did, the expenditure of half a million dollars a year for what was potentially a three year term. In addition, is one to understand that despite the second paragraph quoted above, no reference back to the Executive Committee for approval was to be made after the Econair Board of Directors on May 10 authorized execution of the leases. Again it must be remembered that this new and financially significant venture is being undertaken without any reference to the Air Canada Board.

A meeting of the Board of Directors of Econair was held on May 10, 1973 and Lindsay's description of the condominium lease opportunity was presented. The directors authorized Econair to lease not less than 100 condominium units from Sunset Crest for one year from December 19, 1973 at an annual rental of \$4,116 per unit subject to approval of the lease documents as to form by legal counsel and to ratification by the directors at a subsequent meeting. Lindsay was authorized to execute the agreements on behalf of Econair. The financial information presented to the directors when they were considering this matter was the same financial information as Burns had reported to the Vice-President Finance, the Controller and the Treasurer in his memorandum of April 12, 1973 referred to earlier in this chapter.

Immediately after the directors' meeting of May 10, Laforet was advised of the directors' decision to lease the condominium units. The leases were actually executed by Lindsay in Barbados on September 4, 1973. By that date, authority to lease had been obtained by Laforet from the owners of 103 condominium units. The originals of all 103 leases were filed with Fournier, then Assistant Secretary, Air Canada, by September 10, 1973.

### *Assignment of Leases to Air Canada*

The decision to assign the Sunset Crest condominium leases from Econair to Air Canada was made some time during the period between May 10, 1973 and June 15, 1973 when the directors of Econair approved in principle the acceptance of an offer from Air Canada to undertake Econair's obligations under those leases for a consideration stated to be approximately 4% in excess of the contract price agreed with Sunset Crest Rentals Limited. Neither the making of such an offer by Air Canada nor the acceptance of an assignment of Econair's obligations under those leases was authorized by the Board of Directors of Air Canada at this time. The subject was first raised with the Air Canada Board only on April 30, 1974.

Neither Vaughan, nor Lindsay, could remember who made the decision to assign and neither of them were involved in much discussion concerning the advisability of doing so or otherwise. Mr. M. d'Amours, a Group Vice-President Sales and Services, does not remember being consulted in connection

with this decision. Having regard to the problems of marketing the units which later became apparent, one would expect so critical a decision would have been discussed in detail before being taken. As far as the evidence at the Inquiry is concerned, however, the decision simply seems to have happened.

It is important to appreciate that this expensive primary venture was undertaken on the authority of a resolution by the Board of Directors of a CNR subsidiary comprising Menard, d'Amours, Parisi, Drummond and Callen, none of whom in their roles as officers of Air Canada had any such authority.

In Lindsay's memorandum on this subject dated June 1975 he states in paragraph 10 that he believed Ballotta made it clear during the course of the May 10 Econair Board meeting that he desired to acquire the condominium units for the Air Canada Sun Living Program but no decision was made at that particular meeting to assign the units to Air Canada as there was some expectation that Econair would enter into an ITC program beginning in December of 1973. This recollection seems to be borne out by the minutes of the Econair meeting of May 10, 1973 in which estimated costs and benefits of the condominium lease program were "based on inclusive tour packages offered under Air Canada's Sun Living Program".

In any event, by June 15, 1973, Ballotta had indicated on behalf of Air Canada that he required the condominium units for the Sun Living Program. In addition, by that date Lindsay knew that Econair would not be obtaining charter equipment from Air Canada as anticipated.

The absence of discussion in relation to such an important decision is even stranger in the light of Lezama's memorandum to Ballotta of June 15, 1973, the very date of the Econair Board meeting authorizing the assignment of the leases to Air Canada. That memorandum points out for the first time, so far as the Commission is aware, the existence of the problem which continues to plague the Sunset Crest operation even at this late date. It says in part:

"based on scheduled air fares to Barbados of \$237 and \$292 for one and two week stays respectively, the all inclusive condominium vacation prices of \$361 for a one week holiday and \$563 for a two week holiday are uncompetitive to ITC vacation prices for accommodations of similar and in some instances of superior quality primarily because of the difference in air seat cost of the schedule compared to the ITC. Because of the higher all inclusive prices at which the condominium fares will be sold through the scheduled tour product, we can only reasonably expect to sell 45-50% of the available units which will generate revenue for the airline amounting to \$338,496...it is assumed that at this occupancy factor (i.e. 50%) that the condominiums will operate at a loss unless blocks of rooms are sold through other outlets. . . . it would obviously be a financially attractive arrangement to Econair to lease 50% of the condominium on a guaranteed basis to a Canadian ITC operator. This, however, would have long term adverse side effects on the credibility of the sched-

uled tour product which is also addressed to the Canadian leisure market. For it would not take long for passengers who purchased the latter to find out that they were paying approximately \$70 and \$140 per person more for a one and two week holiday respectively while staying at the same property."

The memorandum offers alternative suggestions to ensure profitable operation of the condominiums, one of which is the merchandising of all units through the Sun Living Program, but at vacation prices competitive to that of ITC's. In effect, this would involve discounting the mid week scheduled air fare to Barbados from either \$237 (for a one week vacation) or \$292 (for a two week vacation) to \$175.

Lezama was not aware when he wrote this memorandum that the decision had been made to assign the condominium leases to Air Canada. He was so advised of that fact when he met with Ballotta on June 18 to discuss the matters he had raised in his memorandum of June 15. At that meeting, Lezama was also advised that the units were to be merchandised at the minimum level possible in order to compete directly with ITC's. Air Canada would attempt to recover its investment in the units but not set out to make any profit. All savings would be passed on to the consumer in the interests of offering a competitively priced product.

Lezama pointed out some of the adverse implications of that decision in his memorandum of June 21, 1973. These were:

- (a) Without discounting the air fare, if prices competitive to ITC's were to be offered, ground accomodation would have to be discounted below its real value and the property would not be financially viable by itself;
- (b) Selling ground accommodation below real value could create adverse reaction on the part of other property owners in Barbados with whom Air Canada was also dealing as part of its Sun Living Program and cause a breakdown or a strain between these properties and Air Canada;
- (c) While such discounting would provide a competitive scheduled package in winter, it would not do so during the summer vacation period;
- (d) The provision for tour operators' commissions in the scheduled package were considerably lower than such commissions in comparable ITC packages and consequently did not provide the necessary motivation to the tour operator to promote and sell the scheduled package in preference to an available ITC package;
- (e) At an 85% winter occupancy factor and a 60% summer occupancy factor, a direct subsidy of \$155,000 would be required for a break even operation of the condominiums. Even at an occupancy rate of 100% year round, a subsidy of \$5,000 would be required for a break even operation.

We have dealt with this aspect of the condominium leases in some detail not in any attempt to second guess the business judgment of management. The plan of offering ground accommodation below real value as part of a scheduled tour package could well have generated additional scheduled passengers so as to produce overall revenues for Air Canada in excess of ground accommodation losses. We do so merely to show the magnitude of the problems which might be encountered so far as tour operators, other Barbados hotels, marketing the units and potential losses on the accommodation were concerned. The consequences to Air Canada if any of those problems developed, and of course most of them did, would be substantial and turned out, in fact, to be so. It is difficult to understand and to accept, therefore, that decisions were taken without widespread discussion within the executive management and specific reference of the matter to the Executive Committee and indeed, to the Board of Directors of Air Canada at that time.

In preparation for the actual signing of the condominium leases, Lindsay wrote to Menard on July 27 advising that the contracts would be ready for execution in early September and asking that an Econair Board meeting be held to authorize the assignment of the condominium contracts to Air Canada. On the same date, he also wrote to Pratt of Air Canada asking him to prepare a contract between Econair and Air Canada transferring to Air Canada all Econair's obligations and responsibilities under the condominium leases and to Ballotta pointing out that he "should, from the Air Canada side, ensure that by early September a proper 'Air Canada' legal review has been made of our draft contract and if Air Canada Board approvals are required, that these have either been obtained or the matter placed on the agenda of a future meeting". Unhappily, no such action was taken.

Before the condominium leases were actually assigned by Econair, Lezama wrote to Pratt of the Air Canada Law Branch asking for his opinion as to the corporate power of Air Canada to enter into lease contracts relating to the 25 villas and to accept an assignment from Econair of the condominium leases. Pratt concluded that such contracts were within the corporate powers of Air Canada and so advised Lezama by letter of October 1, 1973.

As has been stated, the 103 condominium leases were executed on behalf of Econair by Lindsay in Barbados on September 4, 1973. The assignment of the condominium leases from Econair to Air Canada was not executed by Econair until November 23, 1973. That document was never executed by Air Canada and there is no document in existence under the terms of which Air Canada formally assumed Econair's obligations under the condominium leases. This latter fact is of no significance to this Inquiry because there can be no doubt, despite suggestions to the contrary made at the hearings by counsel for Air Canada, that Air Canada was bound, as a matter of good business judgment, to provide the funds required to permit Econair to honour all its obligations and fully intended to do so. The delay until November 23, 1973 was occasioned by some problems relating to paper work which Laforet encountered in dealing with the 103 condominium owners.



Although the Econair directors' minutes of June 15, 1973 referred to 4% of the contract price as the consideration payable to Econair for the assignment (approximately \$17,000) this consideration was ultimately fixed at \$30,000, apparently by Menard and Ballotta. Econair was credited with this amount by Air Canada before its 1973 accounts were closed.

At a meeting of the directors of Venturex Limited (the new corporate name of Econair) held on January 24, 1974, the directors ratified the condominium leases entered into on September 4, 1973, as well as the subsequent assignment of those agreements to Air Canada. Again it never occurred to any of the directors of Venturex that any report to or approval by the Air Canada Board was either necessary or advisable.

### *Implementation of the Condominium Program*

During the summer of 1973 Air Canada commenced to prepare for utilization of the condominiums as part of its Sun Living Program. Cost/benefit analyses of the condominium project and of the institution of ground reception services were undertaken by Burns of the Department of Finance and reported to Lezama, to the Vice-President Finance and to the Controller on July 12, 1973. These indicated a \$1,000,000 net benefit to Air Canada after taking a condominium subsidy of \$155,000 into account. This net benefit was calculated on the following assumptions:

- (a) that the condominiums achieve an 85% winter occupancy rate and a 60% summer occupancy rate;
- (b) that all travellers using the accommodation would arrive via Air Canada;
- (c) that none of such travellers would otherwise have travelled to Barbados or if so, would have used another airline.

All of these assumptions are optimistic in the extreme. It has been determined from the evidence before this Inquiry, that any attempt to measure additional airline revenue attributable to the Sunset Crest leases would be futile. There is simply no information available that would enable one to assess such factors as passengers attracted from other airlines and passengers who would have gone to Barbados in any event staying at other accommodation. It is totally a matter of conjecture, therefore, to determine what effect, if any, the leasing of the Sunset Crest accommodation had on airline revenue.

Lezama's letter to Menard of July 16, 1973, asked for his approval of the southern route plans for winter 1973/74 and for his advice as to the budget centres to which the related costs of these plans should be allocated. Menard's approval was received by memorandum of July 30. He instructed Lezama to include the costs for providing these services in his 1974 budget requirements. An amount of \$155,000 was included in the 1974 advertising and promotion budget in respect of the Barbados Sunset Crest condominium

leases. This amount represented only the anticipated shortfall rental income. It did not include any other program expenses.

Before the start of the leasing program in December 1973, it was necessary to provide for a functional room and seat inventory control system. As a Reservec II computer program could not be designed and implemented in time, this responsibility was placed on the tour operators of the Sun Living Program. It was also necessary to design and implement a plan of ground receiving services in order that passengers could be met at the airport, transported to Sunset Crest, taken to their rooms and generally taken care of during their vacation. A study conducted in May 1973 had indicated that such services could not be implemented internally without at least one year's lead time. The two tour operators with which Air Canada was involved in relation to the lease of the 25 villas were both experienced in performing such services and were involved in the villa program in any event. Responsibility for performing these services was undertaken by those tour operators. The estimated cost of ground receiving services for all southern destinations for the one year period commencing December 1, 1973 was \$103,900.

Responsibility for rental of the condominium units either within the Sun Living Program or through any other operators or agents was left with the two tour operators as the sole designated sales agents. In addition, it was their responsibility to collect all condominium rentals and to forward the monies to the Manager of Revenue Accounting in Winnipeg at two week intervals. Where condominiums were rented as part of the Sun Living Program packages (whether at Air Canada offices or through the facilities of a travel agent) passengers would be issued two legal documents at the time of purchase—one an air ticket, the other a tour coupon, including accommodation vouchers. Monies collected for the air tickets were remitted to Air Canada in the normal way. Payment for the tour coupon (including the ground accommodation) was forwarded to the tour operators both by Air Canada Sales Offices and by travel agencies. It was anticipated that Air Canada would receive from Sunset Crest Rentals Limited lists of the persons who actually occupied any of the villas or condominiums and that this information could be checked against similar information supplied by the tour operators and provide a check as to the accuracy of the latter.

The responsibility for reservations, marketing, ground receiving services and room inventory control and collection of all condominium rental monies was left with the tour operators and it is apparent that their full cooperation would be required if the program was to be financially successful and financially well controlled. Air Canada personnel did not directly assume responsibility for any of these aspects of the program. Air Canada Marketing Personnel were apparently concerned only with an attempt to develop a scheduled tour package competitive with inclusive tour charters in the light of wide disparities between the air fare elements of the two packages. The summer months represented the major problem and consideration was being given to reducing the bed night price from \$6 to as low as \$3 in the hope of

providing a high percentage of occupancy while still keeping the projected operation within the \$155,000 budget subsidy.

### *Authorization of Expenditures for the Program*

In Section 36(1) of the by-laws of Air Canada, "any transaction involving a guarantee, obligation, purchase, sale, lease or expenditure not elsewhere specifically provided for herein . . . the consideration for which is the sum or value of \$150,000 or more requires the approval of the Chairman of the Board and the Board of Directors". Such a transaction for less than \$150,000 requires the approval of the Chairman of the Board or the President or such officer or officers as either may designate. Leases are not otherwise specifically dealt with in the by-laws. There is a provision, however, in section 25 subsection (2) of the by-laws that all proposals for the purchase of fuel, replacement parts and stationery and such other materials, supplies and services as in the opinion of the Chairman of the Board or the President are required for the ordinary conduct of the Corporation's operations which are estimated to cost \$150,000 or more under a single purchase shall be submitted for approval to the Chairman of the Board or the President. Below \$150,000, authorization shall be by such officers as the Chairman may designate. He has done so by Manual 300 which is described in Chapter 5 relating to AFE procedures.

The villa leases involved a commitment of \$95,200; the condominium leases involved a commitment of \$423,948 for the first year. Neither was approved by the Board of Directors or by the Chairman prior to April 30, 1974 although executed, as we have seen, as early as July 26, 1973 and as late as September 4, 1973. The President was aware in his capacity as Secretary and later President of Venturex, of both such leases and may be assumed to have approved or indeed, to have authorized their execution.

It was stated by him at the Inquiry hearings that this was the only authorization required because both of such lease arrangements were in the ordinary conduct of the Corporation's operations. This description cannot be accepted. Both launched the Corporation into a new area of operations which involved significant risks, the financial risk of not being able to properly market the accommodation and the commercial risk of creating adverse reaction on the part of the property owners in Barbados with whom Air Canada had worked closely in the past and possibly causing a breakdown or strain in relationships between these property owners and Air Canada. Air Canada depended on the goodwill of these other property owners in order that the balance of its Sun Living Program in Barbados and perhaps elsewhere in the Caribbean area could be effective.

The by-laws are perfectly clear in relation to this matter and specify that contracts including leases involving commitments of \$150,000 or over, require the approval of the Chairman of the Board and the Board of Directors. Leases under that figure do not require the approval of the Board of Directors but

do require the approval of the Chairman, the President, or some other officer designated by either of them.

In the period between March 1973 and January of 1974 when plans were being instituted to utilize the leased accommodations, more than 27 senior officers of Air Canada were involved in one aspect or another of the planning. The Legal Branch had drawn and approved of both lease agreements and the assignment of the condominium leases from Econair to Air Canada. All these persons were aware of the total financial commitment involved. Ballotta had been specifically reminded by Lindsay that "if Air Canada Board approvals are required, that these had either been obtained or the matter placed on the agenda of a future meeting". No one took any action to obtain the required Board approvals or even to raise the matter for discussion with the Chairman. This evidences a blatant disregard of established procedures at all levels of responsibility and is indicative of the total breakdown of normal channels of communication within the marketing, sales, financial and legal administration. As the Commission was not authorized or required to examine any of the administrative and operational areas of the airline, this comment is limited to the areas mentioned.

One reservation should be noted in this regard. Although the Chairman's evidence was that he first found out about the Sunset Crest leases only in April, 1974, Vaughan, the President thought that both he and Menard told the Chairman of the proposal to lease the Barbados accommodation through Venturix, and Menard's evidence was that the Chairman knew all about the whole Barbados operation all along. This serious conflict in the oral evidence is perplexing. The foregoing comments assume that the Chairman was not aware of the lease proposals before the commitments were entered into. If he was aware then the full responsibility is his, not only for the failure to seek Board approval but for the failure to follow prescribed disbursement procedures for the rental expenses involved.

Chapter 8 of Manual 300—Budgeting and Financial Administration describes the Authority For Expenditure (AFE) system of Air Canada. That system requires the completion of an AFE form in order to obtain authority to enter into obligations and to incur charges or make payments with respect to all special items/projects, whether budgeted for or not. Expenditures chargeable directly to the Company's operating expense accounts which require AFE coverage are defined in subsection 1.27 of Appendix 5 to Manual 300. Included are real estate lease proposals where the minimum total commitment involved is \$25,000 or more. An AFE is also required to cover renewals of existing leases where the renewal commitment is \$25,000 or more. From a reading of these provisions, there is absolutely no doubt that AFE's were required in connection with the condominium leases. An AFE is also required in connection with the villa lease even though under the terms of the agreement with the two tour operators who were joint lessees with Air Canada of that property all rental payments were initially to be made by the tour operators with Air Canada being responsible for 75% of any rental shortfall.

No AFE's were ever raised, either in relation to the condominium lease payments or the villa lease commitments or their renewal. The condominium leases required payment of \$30,099 every two weeks from January 3, 1974 until April 25, 1974 and payments of \$8,755 every two weeks thereafter until December 20, 1974. The villa leases required payments of \$20,000 monthly from January to April 1974 and \$15,200 in May 1974 with Air Canada responsible for making good its share of any deficit no later than April 30, 1974. The only authority that was ever issued to authorize these payments was a letter of Miss L. A. Courtemanche to Mr. Brooks, Manager, Revenue Accounting, Winnipeg, dated November 16, 1973.

As mentioned earlier, the ground receiving services were performed at several southern destinations by Southern Marketing Consultants Limited, a company formed by the two tour operators responsible for this function. These services were projected to cost \$103,900. Payments were to be made by Air Canada to Southern Marketing Consultants Limited of \$15,300 on January 2, 1974 and at the rate of \$3,500 on the 1st day of each month thereafter up to September 1, 1974 with any balance owing in respect of the twelve month period ending November 30, 1974 to be settled by December 31, 1974. No AFE was ever issued in relation to these expenditures even though Manual 300 requires an AFE for operating expenses for special projects related to services such as "contractual arrangement with outsiders including changes thereto, e.g. terminal services for or by another airline". The only authority or direction Winnipeg Accounting ever received to make these payments was Miss Courtemanche's letter of November 16, 1973 referred to above.

There is no exception in the AFE system in respect of leases entered into in the ordinary course of business. All lease commitments involving more than \$25,000 require that an AFE be raised. The explanation offered by Finance Branch officials for the failure to require AFE's in relation to the lease payments was that they considered the payments to be in the ordinary course of business and therefore not of a type requiring an AFE. This indicates both a lack of judgment on the part of those Finance Branch officials and a lack of knowledge of their own AFE system. Had AFE's been required, the ground receiving services agreement, involving more than \$100,000, would have required the prospective comments of the Finance Branch directed to the Vice-President of Marketing. Should these comments have been adverse to the recommended expenditures, the matter would have gone to the Chairman for ultimate determination. The condominium leases, involving more than \$150,000 would have required finance comments to the Vice-President of Marketing, the Chairman, and the President, and approval of the Board of Directors.

The comments made earlier in this Chapter in connection with the failure to refer this whole subject to the Board of Directors are equally applicable to this total disregard of established financial procedures. The best of financial control systems cannot exist as a control in such circumstances.

## *Operating Difficulties*

In a memorandum of December 24, 1973, Lezama summarized the objectives of Air Canada in connection with the condominium leases. One of the objectives listed was "to endeavour to recover our investment but not set out to make any profit on the units so as to pass on to the consumer all savings in the interest of offering competitively priced packages". The memorandum recognized and pointed out, however, that the achievement of this objective would depend on the effectiveness of the merchandising and selling campaign and the acceptability of the property from both the trade and consumer viewpoint.

Problems in relation to achieving this objective developed at a very early stage. The lease term commenced December 20, 1973. By January 18, 1974 an urgent requirement to examine the whole program had developed. The control element of the program was not functioning as originally intended because Southern Marketing Consultants Limited was not carrying out the agreement to provide statistical information required to perform the reconciliation. Despite this lack of statistical information, there was reasonable evidence to believe that the program was currently missing its objective by a wide margin. There was also an indication that Air Canada's interests were being subordinated in favour of the interests of the tour wholesaler and the other properties in the development. An audit or investigation was suggested to ensure that if this was true, it be stopped and the control system and agreements tightened to prevent further loss to Air Canada. At the time, Mr. E. R. Parisi, Director, Commercial Services in the Marketing Branch, was in charge of tour development. He studied the situation and in a memorandum dated July 27, 1974 recognized that "in spite of the handling, reporting and monitoring procedures that had been agreed upon, there was no completely effective way of ensuring that Air Canada's interests were not damaged."

To correct this, it would be necessary to establish an on-site presence that would supervise and audit the terms of the agreement and ensure their fulfillment. Attached to his memorandum is a summary of the major problem areas and of the action taken to remedy these situations. He recognized that Air Canada could suffer revenue losses by a tour operator diverting scheduled Sun Living passengers to his own ITC operation; by a failure to release unsold units for sale locally; by locally sold units not being properly accounted for and credited to Air Canada; and by the failure of the tour operator to remit. He believed, however, that the corrective action which he had instituted in relation to these problems would be effective as long as Air Canada established an on-site presence.

Percentage occupancy of the accommodation was increasing, from 26% in December of 1973 to 56% in January and 93% in February of 1974. This suggested to Lezama that during the winter period, at any rate, the product was as saleable as ITC's despite the fact that Air Canada had voluntarily restricted itself to selling inclusive tours only for weekday as opposed to weekend departures. This restriction permitted a lower price per package because

the air fare price for a weekday departure to Barbados was significantly lower than the price of a weekend departure.

He recognized at this time, however, that Air Canada's ability to maximize the use of the ground accommodation in the seasons of spring, summer and fall would be severely impeded if it was used only in connection with scheduled inclusive tour packages. The price advantage of weekend ITC's in the summer months was too substantial. To counteract this, he recommended either acquisition of an established tour operating company which would provide Air Canada with a captive outlet for a percentage of the ground accommodation which would then be sold as part of Air Canada's own ITC package or creation of a partnership with selected tour operators who would share the financial risk of the ground accommodation and thus be fully committed to its effective distribution. If either of these formulae could be implemented, he was in favour of renewing the option contained in the condominium leases and leasing the villas for another winter season.

Until this time scheduled package tours using the Sunset Crest accommodation had been priced on the theory that the ground accommodation could be discounted and subsidized in order to develop a product competitive with ITC's and thus improve passenger revenue on the route. In a memorandum of March 13, 1974, Parisi, in discussing the question of whether or not the lease should be renewed, questions whether a loss related to the ground facility represents a healthy approach. Menard ultimately agreed with this proposition and in a memorandum to Parisi of April 8, 1974, laid down the policy by which this venture should be governed.

"If it is true that a good ITC operator is able to make a reasonable profit by combining a low charter airplane seat price margin with a good hotel room margin, then we should be able to do the reverse without having to lose on either of the two main elements: the schedule-airplane seat and the bed night.

Whatever adjustments need to be made in order to live within the above policy should be discussed and the program should then be submitted to me for approval before proceeding."

Menard then issued instructions that all marketing plans involving the use of the accommodation must produce an overall year round yield equivalent to a 9% return on investment. This instruction represented a new constraint on the program and required a reworking of scheduled inclusive tours and sales to other tour operators in response to local inquiries. Lezama and Mr. S. S. Kukreti, Product Leader, Financial Analysis, co-operated in developing a program designed to price units at rates which would produce a profit from the ground accommodation with its use divided as between scheduled inclusive tours and inclusive tour charters.

From February of 1974 onwards, both Marketing and Finance Branches became deeply involved in development of proper and adequate controls and procedures to monitor and control the leasing operations. Because of "a lot of uneasiness on the part of intra and inter branch members about the overall

supervision or lack of centralized control over the program", (letter Miss Courtemanche to Mr. Mooney of March 27, 1974), Marketing was attempting to transfer total control over the program to Winnipeg Finance but Winnipeg Finance adopted the attitude that some of the shortcomings of the program should be resolved by the people responsible for establishing it in the first place. Mr. R. S. Kruger, Director, Audit Services, examined the program in depth and reported on the weaknesses in control and marketing which his examination revealed. These are set out in detail in a memorandum from him to the Vice-President Finance and the Controller of May 10, 1974.

The weaknesses are indeed glaring. Because the tour operators had an exclusive right to market the accommodation, Air Canada had very little control. The rooms were being sold by the tour operators who had their own hotel vouchers which were not available to Air Canada offices and agents; passengers occupying rooms were travelling to Barbados on other than Air Canada flights; and during the months of February and March when the condominiums had a 95% occupancy rate, only 26% of the Air Canada seats blocked to accommodate passengers taking the tour were used. One of the tour operators itself had an interest in other villas which would, of course, be marketed locally before the Air Canada villas. Air Canada depended on Sunset Crest for the local sale of condominium units when Sunset Crest had their own apartments and hotel rooms to satisfy the local demand. Condominiums independent of a package tour were rented at the discounted accommodation rate used to make scheduled inclusive tour packages competitive with ITC's at \$140 per week when the local market rate was \$230 per week. This report prompted a series of meetings in the months of June to October 1974 inclusive. The proposed program for winter 1974/75 and summer 1975 was discussed with Regional representatives and a development plan prepared which provided for a combination schedule/charter approach to the merchandising of the project; which established proposed schedule and charter pricing proposals; and forecast sales and revenue objectives required to achieve the objective of an appropriate return on the investment.

Lezama prepared a development plan for the program establishing objectives and assigning responsibilities. A comprehensive merchandising program was settled by October 1974 involving detailed program and control procedures, responsibilities for periodic reporting, room inventory systems and controls and on-site administration in Barbados, all under Air Canada's direct control and supervision rather than the responsibility of tour operators.

The on-site presence was established by appointing Venturex as administrator and receiving agent for the properties for the period from October 1, 1974 to December 1975. There is no mention of any consultation with Group Vice-President Sales regarding the use of Sales Branch staff and facilities already established in Barbados for this purpose. A memorandum of understanding as to the duties of Venturex in this regard was executed under date of November 26, 1974. Venturex in turn entered into contracts with Sunset Crest Rentals Limited and with a Mr. C. R. Day to act on behalf of Venturex



to perform certain specific functions and duties in Barbados. An expenditure program involving \$110,000 over the full contract period was provided for to cover payroll expenses, office equipment, visual enhancement of the properties and such welcoming items as cocktail parties on arrival, beach bags and towels. The appointment of Venturex to act in this capacity was not referred either to the Executive Committee or to the Board of Directors of Air Canada but as an expenditure of less than \$150,000 was involved, the approval of the Board of Directors was not required by the by-laws of Air Canada. No AFE was raised to authorize the expenditure of the \$110,000. The only authority for the payment was a letter of instructions from Mr. Tangry, Co-ordinator, Contracts and Agreements, Finance Branch to Mr. K. G. Britton, Manager, Disbursements, Winnipeg, forwarding the on-site agreements and requesting that the payments be made to Venturex and charged to Advertising and Promotion. The legal department apparently did not approve these contracts as to form as required by the by-laws.

It appears that the new procedures instituted during the latter part of 1974 served to improve, if not eliminate the control deficiencies in relation to the program that became apparent in the early part of 1974. The evidence discloses no continuing control deficiencies subsequent to October 1974 and indeed Tangry, in his review of the program to December, 1974, makes no reference to continuing control deficiencies.

### *Renewal of the Lease Agreements*

The lease of the 25 villas contained no renewal option. The condominium leases provided for two successive one year renewal options at successive annual rental increases of 15% exercisable in each year on or before March 19. This meant that a decision as to exercise of the first renewal option had to be made after only three month's experience with the program.

By January 1974, construction of the 72 apartment Golden Palm building on the beach front had commenced and by letter of January 10, 1974, Menard indicated to Laforet of Sunset Crest Rentals that Air Canada wished to rent this additional accommodation. By letter of January 15, 1974, Laforet confirmed to Menard that he would hold this accommodation available for rent to Air Canada on a year round basis at a price to be agreed upon.

By letter of February 22, 1974 to Menard, Laforet advised that he would be in Canada before March 20 to negotiate the renewal of the condominium leases and a contract for the rental of the Golden Palm Apartments. As Menard expected to be out of the country by the time of Laforet's arrival, he placed the negotiations in the hands of Mr. J. J. Smith, Director of Corporate Development Studies suggesting that he contact Lindsay, who had negotiated the lease for the then current year, and also discuss the matter with either Ballotta or Lezama. Lindsay handed over his complete

file on Sunset Crest to Smith and in his letter to Smith of March 6, 1974 expressed, as his opinion, that Air Canada should contract for the 72 new Golden Palm apartment units.

Laforet's visit to Canada was postponed until April 5, 1974. Because the condominium leases contained no provision for extension of the option exercise date, Menard, on March 14, 1974, forwarded letters to Laforet exercising the options and stating in his letter that:

"The letters of this date which are also enclosed, are sent to you at this time because the option to extend must be exercised by March 18, 1974 and there is no provision in the contracts for extending this date.

Air Canada is, of course, prepared, and indeed wishes, to negotiate reasonable amendments to the contract and the meeting of April 5 has been arranged for this purpose."

By that date, Lezama had expressed his opinion that he would support exercising the condominium and villa options if the accommodation could be marketed in conjunction with ITC's whether by acquisition of an equity interest in a tour operator or by a partnership with a tour operator.

On March 26, 1974, Laforet wrote to Smith arranging a meeting in Montreal for April 5 and offering the 72 new Golden Palm apartments to Air Canada at an annual rental of \$408,888. He also telephoned Smith on March 19 listing the matters he wanted discussed at the April 5 meeting. Smith reported his conversation in a memorandum to Menard dated March 20, 1974 and listed the preparations that were necessary within Marketing before decisions could be made on the various leasing opportunities.

By April 5, 1974, when Laforet arrived in Montreal, no study was available from Finance as to the financial results of the first year's lease for the period which commenced December 20, 1973. Similarly no projections were available from Finance as to the forecast results for the following year, whether of a program involving only the 103 condominiums and the 25 villas, or of a program with the 72 Golden Palm apartments added. However, on April 4, 1974, Parisi wrote a memorandum to Menard and Ballotta enclosing a preliminary analysis based on information supplied by Lezama. He projected a loss for the renewal year of \$504,078 using assumed winter occupancy of 69.8% and summer occupancy of 42.8% and this before all costs had been allocated to the program. He also pointed out that no budgetary provisions had been made for a setup that would control, monitor, promote and sell the extra rooms "which inevitably would put the program in a more negative posture". It should be noted that he is here referring to the program, discussed earlier, established through Venturex in November 1974, which involved expenditures of \$110,000. On the assumption that 80% occupancy was achieved winter and summer, the loss as so projected would be reduced to \$42,785. Neither at that time nor now is there any evidence to suggest such a rate of occupancy could be achieved at economic rentals.

Smith, Pratt and Kruger met with Laforet on April 5. Agreement was reached,

- (a) to renew the 103 condominium leases for a further one year term commencing December 20, 1974 at an annual rental per unit of \$4,733, a 15% increase over the rent payable for the then current year;
- (b) to lease one additional condominium for a one year period on the same terms;
- (c) to lease the 25 villas for 17 consecutive weeks commencing December 20, 1974 at a rental of \$256 per villa per week, a 15% increase over the rental for the winter season then about to be completed;
- (d) to lease the 72 new Golden Palm apartments for one year from December 20, 1974 at an annual rental of \$408,888. It was agreed that this lease would contain two successive options to extend the term for a one year period;
- (e) a tighter control would be established over sales inventory.

A memorandum of the agreement was prepared on that date and signed by Smith and Laforet. Menard was not at the April 5 meeting but he subsequently approved of the agreements arrived at and the memorandum. On April 8 Menard signed two letters renewing the condominium leases and actual leases of the 25 villas, the 72 apartment units and the one additional condominium added for the 1974/75 season. He forwarded them all to Laforet with his letter of April 8, 1974. The letter stated that "these letters and contracts are executed subject to the approval of the Board of Directors of Air Canada. They will be included on the agenda of the next Board meeting which is to take place on April 30, 1974". The documents themselves are not expressed to be subject to any such condition but Laforet in his evidence confirmed that he had agreed to such a condition. No legal advice was sought by Marketing as to whether any oral waiver of the written agreements, including the documents of renewal, was enforceable in Barbados or would prove a defence in Quebec. This is a very careless and risky way to handle a million dollar transaction.

On April 9, 1974, Smith prepared and forwarded to Menard a draft of a memorandum for submission to the Board of Directors of Air Canada summarizing the actions taken to provide access to accommodation in Barbados and requesting the Board's ratification. The document is a fair summary of the rental history of the condominiums and villas but contains no information whatsoever concerning financial results of the leasing operation to that date.

On April 10, Menard forwarded a copy of this memorandum to the Chairman of the Board, the President and the Vice-President Finance with a memorandum explaining his instructions that the accommodation must be leased so as to yield a 9% return on investment. He also explained that Marketing plans for the accommodation were being prepared subject to his review and indicated that there was a need for a much tighter control of the room

inventory, last minute sales, audit, billing and payment arrangements. The Finance Branch had been asked for their assistance in this regard.

Also on April 10, Menard forwarded copies of the Smith draft Board memorandum to Ballotta and Parisi and requested information which he would need if it became necessary for him to discuss the leasing arrangements at the Board meeting. In particular, he asked for comparisons between ITC prices and scheduled inclusive tour prices, copies of the Sun Living brochure and an outline of the 1974/75 program for the accommodation. It is apparent that he intended to attend the directors' meeting which was held on April 30, 1974, but the minutes do not show that he was in attendance.

On April 25, 1974, Smith forwarded the Sun Living brochures to Menard and reminded him of his undertaking to the Chairman, the President and the Vice-President Finance that the accommodation units were to be priced so as to make a profit. Smith's memorandum of April 9 had defined prices which would achieve that purpose if assumed occupancy was achieved. The brochures did not meet the minimum requirements for profitability and Smith recommended that Menard discuss the matter with Ballotta who was of the opinion that Menard's instruction concerning a 9% return on investment could be achieved without sacrificing a competitive scheduled inclusive tour package if parts of the accommodation were made available for use by the charter market at significantly higher prices than those at which the accommodation was built into a scheduled inclusive tour package.

On April 22 the Finance Branch completed a preliminary status report on the question of whether or not the Barbados leases would be a profitable commitment for Air Canada. This was forwarded to the Chairman by the Vice-President Finance on the same day. In the Chairman's handwriting on the document is the writing "BF Board meeting" which is interpreted to mean, and which the Chairman testified that it did mean, "bring forward to Board meeting". The Finance report does not contain any financial information concerning operating results to that date. It does, however, refer to a budgeted shortfall of \$155,000 which was anticipated when pricing the accommodation for competitive and development reasons and which was based on 85% winter occupancy and 60% summer occupancy. In addition, it states that the actual shortfall (subsidy) is likely to be greater than originally estimated as results to the end of February indicated approximately 62% utilization of the apartments on a cumulative average basis. The report points out that the program is still in its embryonic stage and consequently that it appears unfair to draw any conclusions regarding its success or failure and recommends that "in order to reap the benefits of Air Canada's efforts already invested in the Carribean, it would seem desirable to continue the program for at least another year. Before renegotiating the agreement for 1975/76, a thorough examination of the program should be carried out and its profitability assessed in line with overall corporate objectives."

Lezama had described the villa program for winter 1974/75 at a Tour Product and Communication Briefing on April 11, 1974. At that time he did

not know of the proposed increase in the weekly rental of the villas during the renewal term from \$224 to \$256. In a memorandum to Parisi of April 29, 1974 he questions the feasibility of utilizing the villas at the bed night rate of \$14.50 required to achieve a 9% R.O.I. and says:

"In the attachment to Mr. Menard's letter to the Chairman of April 10, it has been shown that the average rental yield required to cover cost at an 80% occupancy is \$11.42, while the minimum average yield per bed night to achieve an R.O.I. of 9% after tax on the internal 'ground investment' is \$14.50 (net). Had I been advised before the conclusion of the agreement of the minimum bed night yield referred to above, I would certainly have recommended against it, for at this level our product will be uncompetitive and out of the reach of a substantial portion of the market. In Sun Tours' W 73/74 ITC Program, the per person all inclusive vacation price for a party of four at the villas was \$389 for two weeks. It is anticipated that this price will be increased to approximately \$439 to \$449 next winter. At the rate proposed for our program, a comparable two week vacation would cost \$619 and at this price, the original forecast will at least be halved and the program will undoubtedly show a substantial loss."

The matter came before the Board of Directors of Air Canada on April 30, 1974 as agenda item number 7 and was spoken to by the Chairman. The Vice-President Finance was in attendance but was not asked for any comment at the meeting. Included with the material which was made available to the directors before the meeting was Smith's memorandum of April 9, 1974 and Menard's letter to the Chairman, the President and the Vice-President Finance of April 10, 1974. The Finance Report of April 22 was not included in that material but the Chairman had it available among his papers at the meeting. Parisi's projection of April 4, 1974 that the program would lose \$504,078 during the renewal period was not before the Board and indeed, by the date of the Board meeting, Menard had not communicated this projection to the Chairman. Lezama's memorandum of April 29 concerning the villa program in which he recommended against renewal of the villa leases was not before the Board of Directors.

There was considerable discussion in relation to the proposal and questions were raised as to how commitments of this magnitude could have been entered into without prior Board authority. The Secretary's notes of the discussion at the meeting read in part as follows:

- (a) "could be that such leases were considered routine matter, required for ordinary conduct . . .".
- (b) "can the Board accomplish anything in looking at these transactions?"
- (c) "object of these rentals is not to make money—to break even; it is to increase scheduled load factors."
- (d) "feels strongly that a deficit position demands that the directors know what obligations are being entered into."
- (e) "risk is not \$1M when nothing is rented."

- (f) "suggests that rental obligations in excess of a certain amount or length of time be brought to the Board."
- (g) "feels Board should be concerned about the *magnitude* of the risk."
- (h) "suggests that any contractual obligation over \$1/2 M be brought to the Board. *Agreed* Chairman would consider the matter and make recommendation to the Board."
- (i) "question of what kind of control directors should have over subsidiaries. . . . pointed out that authority to assign leases never came to Board."

After this discussion, the Board approved of the various actions which had been taken with respect to the Sunset Crest leases. The minute concludes with the following paragraph:

"It was noted in connection with this and the previous item that recommendations would be made to the Board at a subsequent meeting as to what authority the directors should properly exercise over the activities of subsidiary and associated companies, and in the context of proposed amendments to By-law No. 1 over the business and affairs of the Corporation in the light of its present scope and complexity."

The Chairman's evidence before the Commission was that he first heard of the Barbados leases in early April of 1974. The conflicting evidence of Vaughan and Menard in this regard has already been noted. It is obvious from the Secretary's notes of the comments made at the meeting that all the other directors heard about these leases for the first time at the meeting. The Chairman had vacationed in Menard's villa on the Sunset Crest property for a week or ten days in January of 1974 but he said he did not find out during that vacation that Air Canada was leasing 25 villas and 103 condominiums in the immediate area and in the same development. Another director was vacationing in Barbados at about the same time at another resort on the Island. He heard during this vacation that Air Canada owned a big place on the Island called Sunset Crest. He telephoned the Chairman on his return to ask about this matter. The Chairman after checking with Menard, informed the director that Air Canada owned no property in Barbados. The director also believes that he raised a question about this subject at the director's meeting of January 29, 1974 but received no reply. The first time he became aware of the Barbados leases was when he was reading the material for the directors' meeting of April 30, 1974.

Two things are of concern about the foregoing. The first, of course, is the management's disregard of required corporate procedures in leaving the matter of Board approval of the leased condominiums until those leases came up for renewal. The other is the paucity of information in regard to so significant a commitment that was available for the Board's consideration at the meeting and the fact that the Board was not told and the Chairman was not aware that Parisi, the officer in Air Canada then in charge of the program, was projecting a \$504,000 loss on the program during the renewal

period. The Board members can perform their control function effectively only if they have all information before them which is necessary to reach a proper decision. This was not the case in relation to the Barbados program and it is understandable why several of the directors expressed the depths of concern that the Secretary's notes of the meeting indicate.

It is perhaps worthy of comment that Menard had committed Air Canada to the condominium lease renewals by his letter to Laforet of March 14, 1974 exercising the condominium option. This action was taken because the option period would otherwise have expired on March 19, 1974. He had also executed and forwarded to Laforet on April 8 all the lease documents which the Board subsequently approved. Admittedly, these were forwarded "subject to the approval of the Board of Directors of Air Canada" and Laforet acknowledged that this was the understanding reached at the meeting of April 5, 1974. Nevertheless, at least in relation to the renewal of the condominium leases, Air Canada was committed regardless of Board approval or disapproval by Menard's letter of March 14, 1974.

### *Budget and Operating Results*

In relation to the condominium program, Lezama had established by June 21, 1973 that the forecast shortfall of rental revenues for the first year of operation was \$155,000. By September 11, 1973 provision for this amount had been made in the 1974 budget. The anticipated rental shortfall in relation to the villa program for the 17 week winter operation was \$25,000.

It appeared as early as April 22, 1974 when the Finance Branch prepared its preliminary status report that the budgeted shortfall of \$155,000 in relation to the condominiums would be exceeded. The estimated total shortfall at that time was \$235,000. Lezama was instructed on May 17, 1974, in a memorandum from Mr. P. R. Garratt, Marketing Controller, that if any additional funds were required for the program they would have to be derived from the balance of his approved merchandising budget for 1974.

By memorandum of July 2, 1974, Lezama asked Tangry, Finance and others for assistance in developing an estimate of the final subsidy figure required to the end of 1974. The actual results to the end of June 1974 were reviewed by Tangry and he estimated in a memorandum of September 4, 1974 to Lezama, that the total program result for the year would be a shortfall of approximately \$250,000 for the period ending December 31, 1974. The actual result to June 30, 1974 was a shortfall of \$82,000.

The actual loss for the first full contract year ending December 31, 1974 was \$422,546 as reported in Parisi's memorandum of April 3, 1975, to the Chairman of the Board, the President and the Vice-President Marketing. This loss results after charging the program with all Barbados Government taxes, all costs of on-site administration, all advertising and promotion and other program expenses. The loss for the renewal term (ending December 31, 1975) projected in that memorandum was \$500,938. The

financial information used by Parisi for writing this memorandum was supplied to him by the Finance Branch.

In the 1975 marketing budget, no provision was made for a rental income shortfall in relation to the Sunset Crest because according to Cobb, "Mr. Parisi expected that hotel revenues would equal rental costs". This statement is totally inconsistent with Parisi's projection of April 4, 1974, that rental expenses for the winter 1975 season would exceed rental revenues from the condominiums and the apartments by more than \$411,000. The failure to budget for such a significant anticipated rental deficiency is inexcusable. Those responsible for the program, and Parisi was in charge at that time, must have been aware that without a budgeted loss, the program would have to be financed out of monies set aside for other approved budgeted programs. The marketing budget for 1975 had, however, included Sunset Crest anticipated expenses of \$259,150, made up of \$134,150 for advertising support; \$40,000 for on-site administration and \$85,000 for Government taxes.

Actual results of the program for the renewal period were only available to March 31, 1975 and covered the period subsequent to December 20, 1974. In this period an actual rental shortfall of \$130,839 occurred. If Barbados Government taxes, on-site administration costs, advertising, promotion and other program expenses were added to this figure, the actual loss for the program would be significantly higher.

Parisi's views as to the reasons why these losses were suffered are summarized in his memorandum to the Chairman of the Board and others of April 3, 1975. These are:

- (a) There was too large a price differential for what was essentially the same package between Air Canada's Sun Living scheduled tour package and the inclusive tour charter package offered at the same resort by Air Canada's prime tour competitor. The comparative prices for a two week winter holiday were \$638 and \$449 respectively;
- (b) The absence of an Air Canada competitive inclusive tour charter product;
- (c) Malpractices by wholesalers associated with the program which were discovered in January of 1975;
- (d) The lateness of the merchandising program for winter 1974/75 planning which only commenced in late summer of 1974;
- (e) Erratic management of the program due to learning process and insufficient time to devote exclusively to it;
- (f) Minor sales support due to limited value of the program to field sales by the Sales Branch.

The mere listing of these deficiencies and the size of the loss incurred in the whole program which will have developed by the time the leases



expire on December 19, 1975 evidences the financial consequences of the breakdown of a system of communications inside the airline which simply does not function in the marketing, sales, finance, law areas and between those areas and the Chairman (Chief Executive Officer) and the President. Had the program been considered by the Executive Committee, the Chairman and the Board of Directors before the commitments were made in May of 1973, it is doubtful that the problems would have been as severe or the losses as great. Indeed, the program might not even have commenced in those circumstances, or if commenced, would have gone on so long in the present form.

The argument was made at the hearings that the overall program must be assessed after taking into account the contribution which the program made to increased passenger air fare revenues. Tangry's memorandum of March 3, 1975 to Bowman and Parisi states that during the first year of the program total passenger revenues generated by Sunset Crest tours sold were \$349,300. This amount does not, of course, equal the loss on the ground accommodation during the same period of \$422,546. To charge the losses to advertising and promotion is simply illusory. This practice necessarily results in the deflection of advertising resources of the corporation away from the major source of revenue in order to find a budget peg on which to hang this operational loss.

### *Second Renewal*

The option to renew the Sunset Crest leases for an additional year was due to expire on March 20, 1975. Pratt of the Law Department reminded Parisi of this fact in his memorandum of March 4, 1975. Parisi obtained an extension of this date to May 1, 1975 in order that the Finance Branch would have time to prepare a financial analysis of the results of the program for its first full year of operation and for the winter of 1974/75. Tangry of the Finance Branch did this analysis and his material is attached to Parisi's memorandum to Pratte of April 3, 1975 in which Parisi reported a loss from the year's operation of \$422,546 and a projected loss for 1975 operations of \$500,938.

On April 24 in preparation for the Board meeting called for April 29, 1975, Parisi forwarded a memorandum to the Vice-President, Marketing, summarizing the Sunset Crest program from its commencement. Mr. J. S. McGill, successor to Menard as Vice-President, Marketing, attended the meeting of directors and using Parisi's memorandum as part of his presentation recommended against renewal. The directors approved that recommendation but this approval is not minuted. The Secretary explained that the practice in Air Canada in preparing minutes has always been that decisions requiring no affirmative action are not recorded. Since this was a decision not to exercise an option, the failure to minute was in accordance with this practice.

This minuting practice is improper, particularly when the question involved is whether or not to exercise a legal right. The matter for decision here was whether or not to exercise an option. The decision not to exercise amounted to the disposition of a property right. That decision should have been minuted. To do otherwise is to destroy both the communicative and recording purpose of corporate minutes.

The agenda item was part of the material made available to directors before the meeting. The Secretary's handwritten notes concerning the discussion read as follows: "Recommendation—not to renew—didn't make money in first or second year—we do not have the ability to market; should be put together by wholesaler. Don't have ability to market ground portion." Despite this frank discussion by the Board and its decision, repeated efforts were made by Air Canada during this Inquiry to demonstrate that this was a useful promotional endeavour carried on in the ordinary course of business.

By letter of May 8 to Laforet, McGill advised Laforet of the Board's decision not to renew. Laforet was in Toronto at the time of the directors' meeting of April 29, 1975. He received a telex from Air Canada on April 30 advising him of the decision not to renew. When informed of this decision, three wholesalers made bids to lease all or part of the accommodation after December 20, 1975. Before he left Toronto he had concluded a deal with one of those wholesalers to lease all the accommodation then under contract to Air Canada, that is, all 104 condominiums, 25 villas and 75 apartments. All of these leases provided for a rental increase of 15% over the amount presently being paid by Air Canada.

### *Bookkeeping Procedures for the Sunset Crest Transactions*

The manner in which Air Canada kept track of the financial results of its Sunset Crest Program is somewhat unusual. Rentals received were not accounted for as revenue when received nor were rental payments and other program expenses charged as expenses when paid or incurred. All receipts and disbursements were accumulated in a suspense account in Winnipeg with the net debit balance charged at year end as an advertising and promotion expense. The net debit or credit balance in this suspense account was included with sundry receivables on the balance sheet forming part of the monthly financial statements. The accumulating debit balance of losses was not recorded as an operating expense monthly and was reflected as such only at year end. Hence these monthly financial statements did not disclose to members of the Executive Committee that losses were accumulating in respect of the Sunset Crest Program. D'Amours in his evidence before the Commission stated that he only became aware of the fact that the Sunset Crest Program was operating at a loss in about the month of April 1975, some sixteen months after the Program commenced and some five months after completion of the first year of the Program which produced a loss of \$422,546. It seems obvious that accounting for the results of the Program through a suspense

account deprived the members of the Executive Committee of current financial information in relation to the project.

The loss on the Sunset Crest Program was considered to be an advertising and promotion expense on the basis that the total purpose of the Sunset Crest Program was to sell airline tickets. The effect of charging unbudgeted losses in this manner obviously required a cutback of other budgeted advertising and promotion programs. It is a matter of conjecture only what damage to the overall Air Canada sales effort these cutbacks produced.

The method of accounting for the Sunset Crest losses through a suspense account may or may not be acceptable practice. Some differing opinions in this regard were expressed in evidence before the Commission. Whether or not an acceptable method, its use should be criticized in the circumstances of the Sunset Crest Program where it operated to hide information about continuing losses from persons who might otherwise have been able to suggest solutions to the problems which were creating those losses.

### *Summary and Comments*

1. The directors of Econair authorized a commitment of \$423,948 in relation to the condominium leases on May 10, 1973. They did so when Econair's only financial resources were monies furnished to it indirectly by Air Canada. Menard and d'Amours were on the Board at that time and were Vice-Presidents of Air Canada. Vaughan was Secretary of Econair and of Air Canada and was in attendance at the meeting. Parisi and Drummond, both of the Marketing Branch of Air Canada, were also directors and Fournier, Assistant Secretary of Econair and Air Canada, also attended the meeting. All of these persons should have realized that a commitment of this nature by Econair should first be approved of by the Chairman and the Board of Directors of Air Canada. They should also have realized that merely because they were acting in the capacity of directors of Econair, they should not take on themselves approval authority larger than any of them had individually, larger than all of them had collectively and larger than that which the Chairman of Air Canada was himself legally entitled to authorize.

2. In order to assess the executive response to the losses arising in this adventure, it may be helpful to note that one of the principal reasons for the substantial losses incurred was the decision to switch use of the accommodation from a proposed inclusive tour charter program by Econair to a scheduled tour package in Air Canada. The condominiums were originally leased in order that a program competitive with ITC's could be developed through Econair. It should have been obvious to the persons involved in this decision that a product competitive to ITC's could not be developed using scheduled fares without producing a sizeable loss on the ground accommodation. Lindsay's original planning of the Econair charter operation involved an air fare of \$130 as part of the package. This was \$107 lower than the weekday schedule fare and \$162 lower than the weekend schedule fare. The decision to transfer the accommodation for

use as part of the scheduled product automatically therefore, either increased the price of the tour package so as to make it non-competitive or required discounts to offset these price differences in relation to the ground accommodation. The persons involved should have recognized these consequences and discussed the proposal to transfer thoroughly before arriving at a decision. There was no evidence that so important a decision was discussed in any depth in any forum. Further comment is made below on the apparent communication difficulties of the executive branch of Air Canada.

3. Comments have been made in Chapter 5 above on the effectiveness of the systems of communication within Air Canada. Despite the number of senior officers who were responsible for planning the Barbados program and for its actual execution in the period from December 20, 1973 to April 1974, if the Chairman's evidence as to lack of knowledge until April 1974 is accepted, it appears that no one felt responsible for acquainting the Chairman with the program or its problems. Perhaps each expected that someone else had done so. Certainly all officers junior to Vaughan, then Assistant to the President, d'Amours, Group Vice-President, Sales and Services, and Menard, Vice-President Marketing, were entitled to expect that one or other of those persons would have reported the matter to the Chairman. In this regard, an exception must be made as far as the Law Department is concerned. That Department was involved in the Barbados program from the very beginning and indeed, drew all of the agreements involving Air Canada or Econair commitments. No expectation that the matter would be reported to the Chairman by others was sufficient to justify their failure to inform him. The function of the Legal Department, admittedly, is to approve contracts as to form only. The risk of repetition of the Barbados incident would be reduced if this approval by the Law Department as to form were expanded to include procedures for authorization of the execution of contracts.

4. So far as the evidence indicates, over the whole period preceding April 1974, the only person who raised the subject of Air Canada Board approval was Lindsay in his memorandum on July 27, 1973 to Ballotta.

5. In deciding to institute and implement the program, the officers concerned completely disregarded not only proper corporate procedures but also established financial procedures and controls. The officers in the Finance Branch, well aware of the requirement of the established AFE procedures, accepted or indeed, provided a memorandum of instruction as sufficient authority for expenditure of all rental payments and program expenses.

6. The program represented a venture into a field of activity in which Air Canada had no prior experience and there was no appreciation of the problems which might develop and the costs which those problems might produce until they actually happened. This Chapter has detailed the inadequacies of the controls which were instituted and related the other problems that developed. The program should have been more thoroughly studied in co-operation with all branches that might have made a con-

tribution, including the Sales Branch. Instead, the officers expected that all problems could be dealt with by abdicating full responsibility for the administration and the success of the program to the two tour operators who were given exclusive authority.

7. The material available to the Board of Directors on April 30, 1974, when they were considering the question of whether or not to approve renewal of the leases for the accommodation, was totally inadequate. Actual financial results of the program to date were not presented nor was the information that a program loss for the renewal year had been projected by Parisi, the officer responsible for the program.

8. A rental deficiency in respect of the program should have been budgeted for the 1975 year. Parisi's projection in 1974 of a \$504,078 loss from the program in 1975 assumed that rental expenses would exceed rental revenue by \$411,078. No budget provision was made for this amount. This means that any rental subsidies necessary in respect of the 1975 operations will have to be financed at the expense of other approved and budgeted advertising and promotion programs.