INTERNATIONAL JOURNAL OF MULTIDISCIPLINARY EDUCATIONAL RESEARCH
ISSN:2277-7881; IMPACT FACTOR :6.514(2020); IC VALUE:5.16; ISI VALUE:2.286
Peer Reviewed and UGC Approved: VOLUME: 9, ISSUE:1(4), JANUARY: 2020

NORTEL CASE STUDY: A PIONEER CASE IN CROSS-BORDER GROUP INSOLVENCY

Dr. Binoy J. Kattadiyil
ICSI IIP, an IPA of IBBI, New Delhi

Adv. Ankita Agarwal
ICSI IIP, an IPA of IBBI, New Delhi

INTRODUCTION

In the current economic scenario, with the expansion and liberalisation in international trade, multi-national organisations are growing at a rapid speed. The speed for the development of an efficient global insolvency regime for group companies is far gradual. This area of cross border and group insolvency and the interplay between them seems amenable to development as a result of case laws. One such case is that of Nortel groupbased in the US, Canada and England, Europe and Middle East which set the precedence in the cross-border insolvency of group companies.

In the global scenario for group insolvency, there are two major methods for dealing with corporate groups undergoing insolvency, which are: *Procedural Coordination and Substantive Consolidation.*Under such mechanisms which little to no precedence in any jurisdiction, this case carved out its own path to arrive at the outcome of ***Pro-Rata Allocation***. The case is significant for being heard at the same time in two courtrooms, one in Delaware and one in Ontario, that were linked in order to receive live evidence together. The concurrent trials raise concerns about the enforceability and finality of the two independent court decisions and the financial implications of conducting separate proceedings. It has produced one judgment of the US court and one of the Canadian Court which arrive at the same outcome.

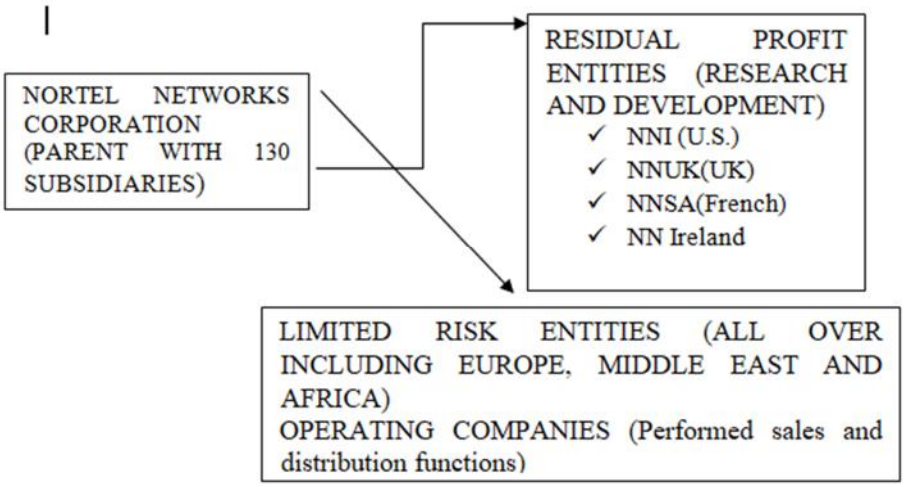
Through this Article, we seek to understand the process of arriving at the conclusion of Pro Rata Allocation as well as the consequences and reasons for such an outcome.

FACTS AND TIMELINE

Nortel Networks Corporation (NNC) was a Canada-based technology corporation. The Nortel Group comprised companies across the globe engaged in the business of telecommunications and networking solutions. Its principal driver of value was research and development. NNC, together with its 130 subsidiary corporations, formed the "*Nortel Group*", which operated in sixty sovereign jurisdictions. In order to maximize efficiency, the Nortel Group did not restrict its operations by jurisdiction. Rather, the Group "*operated along*

business lines as a highly integrated multinational enterprise with a matrix structure that transcended geographic boundaries and legal entities organized around the world."[1] It functioned "*without regard for its different legal entities*".

BASIC STRUCTURE OF NORTEL



Due to the Nortel Group's multinational scope, transfer pricing was a significant concern. In order to allocate profits and losses on a tax efficient basis, the Nortel Group developed a "Master Research and Development Agreement" (MRDA). Pursuant to the MRDA, a Canadian operating company was designated as the legal owner of all intellectual property. The subsidiaries within the Nortel Group could then be granted a license to make and sell the Nortel Group's products using NNC's intellectual property.[2]

[1] Richard Leblanc, The Handbook of Board Governance: A Comprehensive Guide for Public, Private, and Not-for-Profit Board Members (John Wiley & Sons, 16-May-2016)
[2]Nortel Networks Corporation (Re), 2015 ONSC 2987, Superior Court Of Justice – Ontario, 05.12.2015 (accessed at https://www. Ontarioco urts.ca /scj/fil es/judgments/2015onsc2987.htm)

COMMENCING THE PROCEEDINGS

The insolvency proceedings were initiated in multiple courts in the US, UK, Italy et cetera. In all the proceedings, it was argued that the insolvency proceedings would be smoother if cross border court-to-court protocol would be adopted. In an order given by the U.S. Court[3], the reasons for adopting elements of procedural co-ordination were discussed. The parties identified the "*mutually desirable goals and objectives in the Insolvency Proceedings*" as follows:

(a) harmonize and coordinate activities in the Insolvency Proceedings before the Courts;

(b) promote the orderly and efficient administration of the Insolvency Proceedings to, among other things, maximize the efficiency of the Insolvency Proceedings, reduce the costs associated therewith and avoid duplication of effort;

(c) honour the independence and integrity of the Courts and other courts and tribunals of the United States and Canada, respectively;

(d) promote international cooperation and respect for comity among the Courts, the Debtors, the Creditors Committee, the Estate Representatives (as such terms are defined in the Protocol) and other creditors and interested parties in the Insolvency Proceedings;

(e) facilitate the fair, open and efficient administration of the Insolvency Proceedings for the benefit of all of the Debtors' creditors and other interested parties, where located; and

(f) implement a framework of general principles to address basic administrative issues arising out of the cross-border nature of the Insolvency Proceedings.

The court referring to Nortel case stated that, "*The Judge of the U.S. Court and the Justice of the Canadian Court, shall be entitled to communicate with each other during or after any joint hearing, with or without counsel present, for the purposes of determining whether consistent rulings can be made by both Courts, coordinating the terms upon of the Courts' respective rulings, and addressing any other procedural or administrative matters*"[4]

[3]In re: Nortel Networks, Inc., et al., Chapter 11, Case No. 09-10138(KG), In The United States Bankruptcy Court For The District Of Delaware (accessed at https://www.deb.uscourts.gov/sites/default/files/opinions/judge-kevin-gross/nortel-allocation-opinion-and-order_0.pdf)

[4]Nortel Networks Corporation (Re), 2015 ONSC 2987 (accessed at https://www.insol.org/_files/Fellowship%20Class%20of%202014%20%202015/Literature/Session%2017/Nortel%20Canadian%20Judgment.pdf)

As to the question of why only procedural co-ordination and not substantive consolidation, the courts also relied on the case of *In Re Owens Corning*[5]wherein the U.S. Court held that this remedy of substantive consolidation in group insolvencies should only be applied in "*extraordinary circumstances"* where no other option than that of a merger of these separate legal entities is available. Nortel's operations did not satisfy the legal and factual requirements for substantive consolidation. While Nortel operated as a highly integrated enterprise, the evidence on record established that the Nortel affiliates respected corporate formalities and did not mingle their distinct assets or liabilities. Since Nortel respected and maintained corporate separateness among its distinct legal entities both before and during its insolvency, substantive consolidation could not be applied.[6]It is for these reasons that a solution that was not resulting in substantive consolidation but would result in maximum returns for all the stakeholders of various countries that pro-rata allocation was introduced.

[5]In re Owens Corning, 2005 US LEXIS 17150 at 205 (3d Cir 2005) [Owens].

[6] Michael Barrett,Substantive Consolidation After Nortel: The Treatment of Corporate Groups in Canadian Insolvency Law, last accessed on 16.01.2020 at https:// www.insolvency.ca/en/whatwedo/resources/SubstantiveConsolidationAfterNortel_TheTreatmentofCorporateGroupsinCanadianInsolvencyLaw.pdf

14.1.2009	• Nortel filed for insolvency (EMEA, Canada, US estates filed for insolvency in coordination). Nortel Network UK defined benefit scheme had an estimated deficit of £ 2.1 bn.
-	• Interim funding and settlement agreement (IFSA) was agreed between Nortel estates which freed up cash around the Group to enable all the companies to continue trade.
January 2010	• UK Pensions Regulator issued a warning notice to almost all other EMEA entities, the US and Canada ('Target Companies'), to put in place financial support.
June 2010	• Determination Panel gave notice that it was reasonable to issue Financial Service Directions (FSDs) against Target Companies. If the FSDs were not complied with and contribution notices were issued against the EMEA entities, the rank of the claims in the administration would be unclear.
November 2010	• Joint Administrators applied to the High Court in England for direction on how these claims should rank in the administration. • HC view- Regulators claims would rank as expenses- ahead of unsecured creditor claims.
April 2011	• U.S. Debtors along with NNL and NNC sold Nortel's patent portfolio and related assets for 900 million dollars. The sale of IP Assets resulted in a price of 4.6 billion dollars.
October 2011	• High Court decision appealed by Joint Administrators. Court of Appeal upheld HC order but gave permission to appeal in SC(Supreme Court).
May 2013	• Appeal in SC
July 2013	• Verdict of SC. (overturned HC and earlier orders- Regulators claims would rank as provable debts alongside other unsecured creditors)
2014	• US and Canada had had 4 mediations to resolve Purchase Price Allocation (PPA) consensually between parties. Mediations were unsuccessful and would be resolved through courts.
May 2015	• Both courts handed down virtually identical rulings, to calculate each entity's sale proceeds known as modified pro-rata approach.
-	• French and US estates filed appeal against modified pro rata approach and appointed a conflicts administrator. • One final round of mediation was done and was successful.
October 2016	• Global Settlement was reached. Contained 4 documents- Allocation of PPA Proceeds, settlement between Regulator and EMEA estate, settlement in France, Deed of release.
May 2017	• Successful approvals from US, Canada and Europe Courts taken and PPA proceeds released.
June 2017	• Joint administrators had to file an application in the English High Court where they called for anyone who had post appointment claims. The court asked for the post appointment claims to be submitted by 27 October 2017.

PRO-RATA ALLOCATION

Owing to the fact that neither only procedural co-ordination nor substantive consolidation could fully conjure up a solution to satisfy all the claimants, the courts came up with a concept of pro-rata allocation which allocates the sale proceeds according to the percentage of Nortel's allowed claims that each estate (US, Canada, EMEA, UK) held. The courts also emphasised on the fact that they were not adopting pro-rata distribution which would be cash in each estate would not be reallocated, nor would inter-company claims be ignored. There was no aim that each creditor should receive a common dividend.[7]

The courts were able to find that they had a broad discretion to make any allocation order that was appropriate to the insolvency proceedings before them. The immediate issue for the courts was the allocation of sale proceeds, and the courts were therefore concerned with ownership and responsibility for the value of Nortel's intellectual property.

For the purpose of carrying out this allocation, an agreement titled "Master Research and Development Agreement" (MRDA).The MRDA, however, did not control allocation. In the absence of an agreement governing allocation for entitlement to assets and the value of those assets, the Court's task was to arrive at a fair and equitable mechanism to allocate the billions of dollars of Sales Proceeds to numerous international entities for the benefit of their creditors. Adopting a modified pro rata allocation model recognized both the integrated approach while maintaining the corporate integrity of the Nortel Entities.[8] This methodology does not constitute global substantive consolidation.

The U.S. Court has the authority to adopt a pro rata allocation. The U.S. Bankruptcy Code permits courts to "*issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]*"[9].The Court is not directing a central insolvency administrator in one jurisdiction, that all of the Nortel Entities be treated as one, that all claims be determined within one proceeding under the supervision of one insolvency administrator, that there be one plan of reorganization for all Nortel Entities or that creditors receive a common dividend on a pro rata, *paripassu* basis. The Court is not adopting a pro rata distribution, but an allocation to separate interests. The Court's pro rata model recognizes that separate Estates exist, will continue to exist, and will ultimately be utilized to make distributions to creditors through whatever means is determined by the Courts following the Allocation Dispute. Moreover, the

[7]Global dispute over allocation of Nortel assets,LexisNexis,accessed at https://www.lexisnexis.co.uk/blog/restructuring-and-insolvency/global-dispute-over-allocation-of-nortel-assets

[8] Ibid at 2.

[9]11 U.S.C. §105(a)

Court recognizes the separate and distinct integrity of each of the Debtors by recognizing cash-on-hand intercompany claims and settlements.[10]

The calculation for pro-rata allocation was done on the basis of Pro Rata Share which meant that as at any Distribution Date, with respect to the holder of an Allowed Claim in any Class against a Debtor, the product of (A/B)*C where:

A= the amount of the particular Allowed Claim;
B= the aggregate amount of all Allowed Claims in the Class; and
C= the total amount of available Creditor Proceeds to be distributed to holders of Allowed Claims in such Class on the particular Distribution Date.

The pro-rata allocation was done in a four part process wherein,
First, Fund Allocation was done. This step was most ostensibly like substantive consolidation. Each entity in the Nortel Group was entitled to a pro rata share of the asset realization based on the percentage of claims against that entity relative to the total claims against the Nortel Group. Once the funds were allocated, each entity independently administered its own claims process.
Second, all inter-corporate claims were to remain outstanding. This step was to make sure that the end result of this allocation would not be that of a merger as would be in the case if substantive consolidation was done.
Third, each corporate entity was to retainall their cash in hand and apply it towards the entity's creditors. This helped maintain the separate legal entity principle to all the companies under the Nortel Group.
Fourth, creditors with guarantees were entitled to make a claim for the full value of the guarantee.
The result for all creditors was a 71 percent return on their claims against the Nortel Group. This allocation was of immense consequence to the UK Pension Claimants, who received a significantly higher proportion of the assets than if a pro rata allocation had not been adopted.[11]

CONCLUSION

Scholars of the subject have argued that the process of pro rata allocation is comparable to that of substantive consolidation. The point of similarity being

[10]Adam J. Levitin, Business Bankruptcy: Financial Restructuring and Modern Commercial Markets, Wolters Kluwer Law & Business
[11] Michael Barrett,Substantive Consolidation After Nortel: The Treatment of Corporate Groups in Canadian Insolvency Law, last accessed on 16.01.2020 at https://www.insolvency.ca/en/whatwedo/resources/SubstantiveConsolidationAfterNortel_TheTreatmentofCorporateGroupsinCanadianInsolvencyLaw.pdf

that the distribution of assets is done with no regard to the source of the asset. The difference however lies in the fact that pro-rata allocation doesnot involve transfer of wealth whereas in a substantive consolidation process the result is that of a merger. Consolidation in principle should only be used for insolvency of corporate groups in exceptional situations such as that of sham companies, fraud or inseparable mingled assets and liabilities.

This approach is considered perfect to maintain distinct legal identities while also distributing assets to all the creditors of the group regardless of which jurisdiction they fall in. In the case of Nortel the group maintained distinct corporate personalities, their own creditors, own cash proceeds and inter-corporate loans and agreements.

This case is a significant milestone in cross-border group insolvency for the reason that even though the jurisdictions and the applicable insolvency laws to various Nortel corporations were so distinct, the Courts, Creditors as well as the Insolvency Coordinators went beyond the text of the statutes to set a precedence for working together applying the principles of both procedural co-ordination and substantive consolidation that resulted in maximum returns for the claimants of the Group. This was a case that set the precedence for finding innovative solutions without disturbing the sanctity of the legislations in place, for the benefit of the stakeholders involved.

REFERENCES:

1. Richard Leblanc, *The Handbook of Board Governance: A Comprehensive Guide for Public, Private, and Not-for-Profit Board Members* (John Wiley & Sons, 16-May-2016)
2. *Nortel Networks Corporation (Re), 2015 ONSC 2987*, Superior Court Of Justice – Ontario, 05.12.2015 (accessed at https://www.ontariocourts.ca/scj/files/judgments/2015onsc2987.htm)
3. *In re: Nortel Networks, Inc., et al., Chapter 11, Case No. 09-10138(KG),* In The United States Bankruptcy Court For The District Of Delaware (accessed at https://www.deb.uscourts.gov/sites/default/files/opinions/judge-kevin-gross/nortel-allocation-opinion-and-order_0.pdf)
4. Nortel Networks Corporation (Re), 2015 ONSC 2987 (accessed at https://www.insol.org/_files/Fellowship%20Class%20of%202014%20%202015/Literature/Session%2017/Nortel%20Canadian%20Judgment.pdf)
5. In re Owens Corning, 2005 US LEXIS 17150 at 205 (3d Cir 2005) [Owens].
6. Michael Barrett, *Substantive Consolidation After Nortel: The Treatment of Corporate Groups in Canadian Insolvency Law,* last accessed on 16.01.2020 at https://www.insolvency.ca/en/whatwedo/resources/SubstantiveConsolidationAfterNortel_TheTreatmentofCorporateGroupsinCanadianInsolvencyLaw.pdf
7. *Global dispute over allocation of Nortel assets,* LexisNexis,accessed at https://www.lexisnexis.co.uk/blog/restructuring-and-insolvency/global-dispute-over-allocation-of-nortel-assets
8. Adam J. Levitin, *Business Bankruptcy: Financial Restructuring and Modern Commercial Markets,* Wolters Kluwer Law & Business