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Nortel Networks: A New Twist on Substantive Consolidation?

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The recent release of the decisions in Nortel Networks' cross-border insolvency proceedings has reignited discussions on what is fair and reasonable in the context of asset-realization allocations to various debtor estates and from whose perspective the fairness lens should be viewed. As the decisions included features that are common to substantive consolidation, they have also fostered a debate on when that rarely used tool should be court-ordered.[1]

At its core, substantive consolidation provides a means to simplify a multi-entity corporate structure so that it "treats separate legal entities as if they were merged into a single survivor"[2] entity. In many respects, it is akin to the way accountants consolidate financial statements: Intercompany transactions are eliminated, and assets and liabilities are combined into one entity. In an insolvency context, the effect of substantive consolidation is to pool all asset recoveries and make distributions to creditors with allowed claims against that pool, regardless of the legal entity against which the claims arose, and without regard to intercompany claims or guarantees within the corporate group.

Substantive consolidation is considered where debtor companies effectively operate as one business unit, their operations are inextricably linked, and their assets and liabilities are so intermingled that it would be impractical or impossible to identify them by legal entity. Substantive consolidation is rarely used in insolvency proceedings because it usually results in prejudice to one or more major creditors and generally requires near-unanimous consent of the major creditors for it to be approved by a court.

1 The main cases dealing with substantive consolidation include *In re Owens Corning*, 419 F.3d 196 at 205 (3d Cir. 2005); *In re Baker and Getty Fin. Servs. Inc.*, 78 B.R. 139 (Bankr. N.D. Ohio 1987); *In re Lehndorff Gen. Partner Ltd.* (1993), 17 C.B.R. 3d 24; *In re PSINet Ltd.* (2002), 33 C.B.R. 4th 284; and *In re Northland Props. Ltd., Re*, 69 C.B.R. (N.S.) 266 (B.C.S.C.).

2 *In re Owens Corning*, 419F.3d 195 (3d Cir. 2005).

Pro rata is a variation on the concept of substantive consolidation. In contrast to substantive consolidation, *pro rata* keeps the debtors separate and allows for guarantee claims to be maintained in each of the debtors; it is similar in that it would also eliminate intercompany claims. Proceeds would be allocated such that the dividend rate in each estate would be the same.[3]

Nortel Networks

Nortel Networks was a Canadian-based multinational technology company with more than 130 subsidiaries worldwide. Nortel Canada had issued a series of bonds/debentures, and certain bonds were guaranteed by Nortel U.S.

Nortel evolved from a manufacturer of landline equipment to a high-tech communications company, with a significant emphasis on research and development (R&D). Nortel operated globally, with its major R&D centers being in Canada, the U.S. and the U.K. Nortel operated as an integrated organization through various business lines rather than by a legal entity. As with most multinational corporations, transfer pricing of goods and services among the various Nortel entities was of concern to the taxing authorities, particularly in Canada, the U.S. and the U.K.

From Jan. 1, 2001, to Jan. 14, 2009, the date of Nortel's bankruptcy filings, Nortel and certain of its subsidiaries, called residual profit entities (RPEs), operated under a master research and development agreement (MRDA) to address transfer pricing issues. RPEs funded R&D, represented approximately 30 percent of all of Nortel's entities, and had been based primarily in Canada, the U.S. and the U.K. Major terms of the MRDA included that Nortel Canada would hold title to virtually all

3 For a further explanation of *pro rata*, *see* ¶ 209 in the decision of Justice Newbould, and the top of p .100 and bottom of p. 104 in Justice Gross's decision.

patents[4] and that the RPEs would receive licenses on the patents that were perpetual, royalty-free, exclusive in the jurisdiction in which they had exclusive right to operate, and nonexclusive in jurisdictions where no exclusive licenses were issued. The licenses would be limited to the production/sales of Nortel products/services.

Restructuring and Sale of Assets

Early in the insolvency process, after abandoning its intention to continue as a downsized ongoing business, Nortel embarked on a process to realize on its assets by selling (1) various business lines; (2) all remaining intellectual property patents (called "residual IP") not sold with the business lines; and (3) tangible assets in the various jurisdictions that were not part of the business lines (*e.g.*, real estate and cash, "debtor proceeds"). Many of the patents were used by more than one RPE or in more than one business line, and there was uncertainty about the rights/restrictions of the license. As a result, Nortel Canada and the RPEs entered into agreements that, among other things, terminated the licenses and entitled the RPEs to share in the proceeds. This arrangement permitted Nortel's assets to be monetized in a dispute-free manner and the issue of allocation to be determined later.

On the sale of the business lines, Nortel Canada granted either an assignment of the patents, or a nonexclusive license to use the patents, to the respective purchaser. The sale of the business lines consisted of tangible assets (accounts receivable, work-in-process, fixed assets, etc.) and IP (patents, licenses of patents, customer relations and workforce in place). The major portion of the proceeds was attributable to its IP. The net proceeds of the sales of the business lines was approximately $2.8 billion.

The residual IP consisted of the patents that had not been sold to purchasers of the business lines, but rather had been licensed to one or more purchasers of the business lines. The proceeds from the sale of the residual IP was $4.5 billion. The combined sale proceeds of the business lines and the residual IP totaled $7.3 billion. The funds remaining from the debtor proceeds was approximately $1.7 billion. Six parties were the main participants in the litigation to allocate the sale proceeds and debtor proceeds: (1) the CCAA monitor (on behalf of Nortel Canada); (2) the Canadian Creditors' Committee (primarily representing the Canadian current and former employees and pension administrators — hereinafter, CCC); (3) Nortel U.S.; (4) the ad hoc committee of bondholders; (5) Nortel Europe, Middle East and Africa (Nortel EMEA); and (6) U.K. pension claimants (UKPC).

Notwithstanding negotiation and mediation attempts, the stakeholders did not reach a settlement on how to allocate the proceeds of realization, particularly with respect to proceeds of the IP included in both the business lines and the residential IP. This inability to allocate the proceeds was primarily due to the fundamental differences in interpretation of the MRDA.

Positions

Nortel Canada stated that the sale proceeds should have been allocated based on the value of the property rights of each Nortel debtor.[5] Nortel Canada advocated that all of the patents were owned by Nortel Canada and that the licenses granted to the RPEs were of limited value because they were restricted to the sale/production of Nortel products. Sales of the business lines were to third parties (*e.g.*, Ericsson) that would be integrating the business lines into their own businesses and would not be selling Nortel products. Accordingly, Nortel Canada noted that it should have been allocated the majority of the sale proceeds.

The CCC generally supported the position of Nortel Canada, but, as a fallback position, also suggested an allocation that would have resulted in the same recoveries for creditors of each Nortel debtor.

Nortel U.S. noted that the sale proceeds should have been allocated based on the fair market value (FMV) of the assets being sold, including the FMV of the licenses that had been terminated. Nortel U.S. advocated that the licenses were extremely broad (perpetual, exclusive for its jurisdiction and royalty-free), which effectively provided the RPE beneficial ownership of the patents in its exclusive territory and resulted in the licenses' FMV having the greatest proportion of the IP value. In addition, Nortel U.S. asserted that because the U.S. market was by far the largest market for Nortel products, it should receive the largest portion of the sale proceeds.

The bondholders generally supported Nortel U.S.'s position. However, Nortel EMEA advocated that the proceeds from the IP should be allocated based on the relative contributions of each Nortel entity to the creation of the IP. This would basically be done by allocating the IP proceeds proportionately to the R&D expenditures incurred by each of the Nortel debtor groups. Finally, the UKPC's position was that Nortel was an integrated organization, and as such, each creditor, regardless of which debtor it may have had a claim against, should receive the same *pro rata* distribution.

The positions of Nortel Canada and Nortel U.S. suggested polar opposite results. Nortel Canada suggested that it receive 83 percent and Nortel U.S. receive 14 percent of the sale proceeds. Nortel U.S. suggested that it receive 73 percent and Nortel Canada receive 11 percent of the sales proceeds. The UKPC's position came closest to resembling substantive consolidation.

Decisions

Decisions were rendered by Mr. Justice Frank J. C. Newbould[6] and Hon. **Kevin Gross**[7] following the joint hearing over a 21-day period. First, out of the sale proceeds, each Nortel estate (*i.e.*, Nortel Canada, Nortel U.S. and Nortel EMEA) would be entitled to receive a share relative to the claims allowed against such estate, namely the percentage that all allowed claims against that Nortel estate is to the total allowed claims against all the Nortel estates. Second, the allowed claims would include intercompany claims (including a $2 billion claim by Nortel U.S. against Nortel Canada that the courts had approved) but would exclude a

4 For the purposes of this article, the terms "patents" and "intellectual property" are used interchangeably.

5 For the purposes of this article, Nortel Canada, Nortel U.S. and Nortel EMEA are each referred to as a Nortel debtor and collectively as the Nortel debtors.

6 *See* www.canlii.org/en/on/onsc/doc/2015/2015onsc2987/2015onsc2987.html?searchUrlHash=AAAAAQAGbm9ydGVsAAAAAAE&resultIndex=13.

7 *See* www.deb.uscourts.gov/sites/default/files/opinions/judge-kevin-gross/nortel-memorandum-order-re-motions-reconsideration-70615.pdf.

claim against more than one Nortel estate in respect of the same claim (*i.e.*, creditors having a guarantee claim against another Nortel estate). Third, the debtor proceeds would be retained by each Nortel estate and not included in the calculation of the allocation of the proceeds referenced in number 1. Lastly, the creditors having guarantees would be allowed claims for their shortfalls only against the Nortel estate that granted the guarantees (but the shortfalls would not be included in the calculations of the allowed claims).

In arriving at the decisions, the courts recognized the integrated nature of Nortel's operations and felt that a modified *pro rata* allocation would be an equitable manner in which to allocate the sale proceeds. The courts (1) determined that the MRDA was tax-driven and not an appropriate guide for allocating the proceeds; (2) concluded that the MRDA was never intended to set out how the assets were to be allocated in the event of an enterprise-wide liquidation of Nortel (management never conceived that Nortel could ever become subject to insolvency proceedings); (3) decided that it would not be appropriate to allow guarantee claims to be counted twice in determining the allowed claims; (4) explained that the decisions were neither a substantive consolidation nor a *pro rata* distribution; (5) explained that the arguments espoused by the "various parties had validity and error because the arguments are not rooted in an agreement, which applies to the facts, because all of their approaches yielded an unsatisfactory result and the evidence upon which they relied did not comport with the manner in which Nortel operated"[8]; and (6) adopted a "modified *pro rata* allocation model [that] recognizes both the integrated approach ... while maintaining — or at least recognizing — the corporate integrity of the Nortel Entities."[9]

Nortel US, the bondholders and other parties filed motions in the Canadian and U.S. proceedings for reconsideration and clarification following the release of the decisions, to which the CCAA Monitor, UKPC and others opposed. For the most part, these motions were dismissed pursuant to decisions released on July 6, 2015. However, two important aspects of the decisions were clarified. First, bondholders are permitted to claim against guarantors for the full amount of their claims, not just the shortfall amount. Claims on the guaranteed bonds would only be counted once for allocation purposes. Second, for the purposes of determining claims against an estate, intercompany claims would be considered among individual debtors (*i.e.*, within a jurisdiction) as well as among the Nortel debtors (*i.e.*, among Nortel Canada, Nortel U.S. and Nortel EMEA).

Conclusion

Nortel is among the most complex insolvency cases due to the number of jurisdictions and the nature of its principal assets (intangibles). The *Nortel* allocation case was unique in many respects and resulted in decisions that demonstrated the respective judges' understanding of the business world and their creativity. Among other things, the decisions (1) were consistent with each other (it could have been a fiasco otherwise) while respecting the independence of each court and using different reasons to arrive at their respective, identical decisions; (2) set out the allocation of the proceeds and not the distribution that would occur in each Nortel estate; (3) permitted the inclusion of intercompany balances in calculating the allowed claims; (4) allowed guarantee claims to be made against the guarantor of the Nortel estate, for the full amount of the guarantee; (5) recognized the sovereign jurisdiction of the various Nortel estates; (6) suggested that for distribution purposes, there would be substantive consolidation among the various Nortel entities that are part of each of the Nortel Canada, Nortel U.S. and Nortel EMEA estates; and (7) produced a narrower range of recoveries for creditors of each Nortel debtor than suggested by Nortel Canada or Nortel U.S.

Essentially, the decisions provide the same result as substantive consolidation but for three key differentiators: (1) respecting the origins of the debtor proceeds; (2) recognition of intercompany balances; and (3) recognition of guarantee claims, without which they would have drawn even more ire from the bondholders. The judges' reasoning suggests that full substantive consolidation would have presented a host of issues, including practical issues associated with creating one central estate, which would have required the termination of proceedings in two of the jurisdictions. Substantive consolidation would have also been prejudicial to the creditors of Nortel U.S. as it would have eliminated its $2 billion intercompany claim against Nortel Canada, which had been approved by the courts and eliminated contractual guarantee claims.

By developing a novel methodology not advocated by any of the parties, the judges seem to have structured a result that reflects the contribution of each Nortel debtor to the value of the patents and is least prejudicial to the parties. It may also provide certainty to the thousands of stakeholders who have been awaiting recovery for the past six years. The case also offers some lessons for future international restructuring matters, such as (1) joint trials can streamline disputes requiring adjudication because they place great onus on the courts to arrive at consistent results in each of the jurisdictions; (2) substantive consolidation, in some shape or form, even if named differently, may be a prerequisite to arrive at an equitable result within a reasonable period of time for allocation and distribution purposes; and (3) as is often the case, cooperation among the stakeholders is key to managing costs and avoiding court-imposed results. abi

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8 *In re Nortel Networks Inc.*, Case No. 09-10138 (KG), 2015 WL 2374351 (Bankr. D. Del. May 12, 2015).
9 *Id.*