Nortel Bankruptcy Sets Dangerous Precedent For Lending

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Law360, New York (April 6, 2016, 10:45 AM ET) --Lenders are no fools. They care deeply about the promises they receive in return for the money they hand over to the borrower. And if a 2015 ruling in the long-running Nortel Networks bankruptcy case is allowed to stand as it goes to appeals this week, it could lead to more restrictive lending to borrowers in the future.

For decades, our commercial law has allowed enterprises to divvy up promises as they see fit. Companies often conduct business through multiple, related entities. This allows lenders to extend credit knowing they'll receive repayment for their loans from particularly asset-rich subsidiaries, that are not on the hook for all of the debts of the business. This adroit use of the corporate structure allows borrowers to get funds at a lower cost and, in the extreme, can mean securing a loan or not — which can be the difference in a business being able to operate.

Until recently, a lender taking a promise from a subsidiary of a business could rest assured that its only other competition to the subsidiary's assets would be the other creditors. A recent case, however, threatens to overturn this accepted wisdom and bring uncertainty to financing of large enterprises.

Nortel Networks was a multinational operation started and based in Canada. Most of its revenues were generated by its subsidiaries located in the United States. The cash these units generated meant the U.S. units were able to borrow money by issuing bonds backed by their own credit. The buyers of these bonds knew they were senior to the equity holder of the U.S. companies, which was its Canadian parent, as well as others who may have claims against other Nortel units scattered across the globe.

In early 2009, after years of declining fortunes, Nortel's various operating units sought bankruptcy protection. In years past, bankruptcy was a place where a debtor sought to reorganize its affairs and return to the marketplace. Not so much today. Today, bankruptcy has become the realm of sales. Usually, when a major business files for bankruptcy, it will see the bulk of its operations sold off to the highest bidder.

This is what happened in Nortel's case. Its various business operations were sold as operating units. Nortel's prize asset — its hoard of intellectual property — sold at auction to a group of some of the

world's leading technology companies for $4.5 billion. Two and a half years after filing for bankruptcy, all of Nortel's assets had been converted to cash. The final step was to divide the cash — well more than $6 billion — among the various creditors.

This was no ministerial task. There were vigorous disputes over who owned the assets that had been sold. For physical assets, it was clear which entity owned them prior to sale. The intellectual property was another matter. The Canadian creditors claimed the Canadian parent, which held legal title to all of Nortel's intellectual property prior to the sales, owned it. The U.K. and European creditors claimed the company as a whole had created the assets, and thus the entire company owned them. The United States creditors pointed out that the various subsidiaries in each country had been granted an exclusive license to use, sell and market the intellectual property in that country. Accordingly, they asserted that each unit owned the right to sell, use and market the intellectual property in that country.

In 2015, six years after the company filed for bankruptcy, a pair of U.S. and Canadian bankruptcy judges jointly sided with the Americans on this score. After parsing through the various agreements among the Nortel entities as well as intellectual property law, the court ruled that the intellectual property was in effect owned by the appropriate subsidiary in each country.

Despite this, the court then curiously departed from settled law and sound principles by issuing a ruling that parceled out the funds based on how much the various entities owed their creditors. In essence, the court would add up what the U.S. creditors were owed, what the Canadian creditors were owed, and what the U.K. creditors were owed, and then divvy up the proceeds accordingly. If one group had, for example 40 percent of the claims against it, that group would get 40 percent of the pooled funds.

Rather than allocating the assets by how much each side owned, as is typical in these cases, they would be divided by how much each side owed. This disregard for the ownership interests in the assets has little to commend it. But this is a game that can only be played once.

There is little about Nortel that is unique. It was a multinational enterprise. While it operated as a whole, it was careful to respect corporate form. Indeed, it was because of the fact that Nortel kept its subsidiaries separate that those buying the bonds of the U.S. company were content to rely on its credit alone.

Such reliance on corporate structure is commonly respected. In Owens Corning, the lender lent money to one part of the Owens Corning enterprise, and took guarantees from the rest. These subsidiaries did not have many claims against them, and thus, like the lender here, the lenders in Owens Corning knew they would have first claim on the subsidiary's assets, above those who lent to other members of the corporate group. In rejecting an attempt to disregard the borrower's corporate structure, the court in that case noted, "This kind of lending occurs every business day."

The reason for the court's reluctance to undo carefully structured transactions was clear. Our commercial law system allows businesses to have whatever corporate structure they see fit. With that structure in place, they can seek credit by whatever basket of promises will allow them access to funds at the lowest possible costs. Those lending the money protect themselves via contract. They know which parts of the corporate structure they can turn to for repayment, and they know they will not be competing against creditors of other related entities for a limited pile of funds.

The Nortel bankruptcy court was understandably frustrated by some of the arguments offered by several of the parties and by what it viewed as not wholly credible evidence on some valuation issues. That said, these deficiencies do not support the jettisoning of sound commercial practice.

Each side of Nortel's global units headed back to the courtroom on April 5 to deliver oral appeals arguments. Should the allocation method offered by the Nortel ruling withstand an appeal, lenders run the risk of thinking they can no longer rely on corporate structures when extending monies. Having relied and lost, they will be less likely to rely in the future.

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