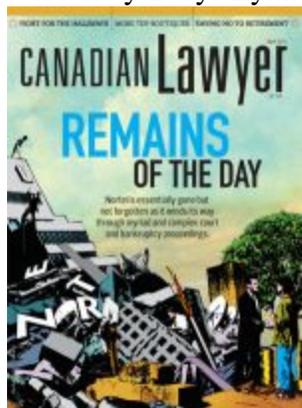


Remains of the day

Cover Story

Written by Daryl-Lynn Carlson Issue Date: April 2011



It was a Canadian icon and global trailblazer, then it took a turn for the worse that reverberated around the world. The Nortel Networks Corp. insolvency will be one of the most protracted and complicated undertakings for all of the lawyers and financial professionals involved, but when it is finally resolved, it will indeed set a new model for multinational companies facing financial difficulty.

Nortel, headquartered in Toronto, was a telecommunications giant that had grown to establish a presence in upwards of 70 countries and significantly diversified its product line. At its height, the company employed more than 32,000 people worldwide, and had more than 140 affiliates in 150 countries. But on Jan. 14, 2009, and attributing it to the recession, Nortel filed for bankruptcy protection under the Companies' Creditors Arrangement Act in Canada, Chapter 11 of the United States Bankruptcy Code, and in the United Kingdom under the Insolvency Act. But the telecom giant failed to recover and liquidation and insolvency proceedings are now underway involving as many as 40 law firms around the world and rendering the company the largest to liquidate in Canada's history, if not the world.

Derrick Tay, a senior partner at Ogilvy Renault LLP and head of the firm's insolvency and restructuring practice, was retained by Nortel to lead the liquidation and bankruptcy proceedings. He acknowledges the matter is forging new territory for all of the lawyers involved, particularly due to its global span. "I've been practising for 30 years and this is probably the most complex thing I've ever done in my life," he says with candour. Yet he explains, "The reason is that multinational companies are never set up with a contemplation of what they would do if they went bankrupt, so everything we're doing is new. What you have here is a company that operated in about 70 countries and for the most part, Nortel also outsourced most of its manufacturing. So there is a lot involved."

Since the filing, Tay has also been overseeing the sale of Nortel's assets, which has generated \$3 billion through auctions for what he refers to as the "black box" bank account, and the company has also settled a \$3-billion tax claim from the U.S. Internal Revenue Service. Most of Nortel's major assets have been sold by auction, one that was held over three days at Nortel's U.S. law firm in the fall of 2009 in New York City, which Tay attended. He says auctions are common in the U.S. as a resolution in a bankruptcy although the lawyers who attended from Canada and the U.K. had somewhat of a learning curve as neither country uses auctions in bankruptcies or insolvencies. In the end, he says, the asset sales have significantly boosted the company's ability to settle with its employees, pensioners, and creditors hopefully sooner than he expected.

Still, he says it will be many more years before the matter is resolved and off the desks of the

lawyers involved simply due to the geographic span of the company. “The thing that happens when a company such as this becomes insolvent, the geographical lines become very important because these are all different legal entities and each legal entity has its own creditors. Outside of North America or Europe, there are not many jurisdictions that recognize the concept of restructuring or bankruptcy,” he says. In the U.K., he filed insolvency documents for Nortel operations located in 19 other countries.

On a somewhat more positive note, Tay says Nortel was able to pay its employee benefits for two years following the company’s insolvency and liquidation. “You will not find in the history of Canadian insolvency any other case where even after liquidation, people’s benefits and health plans were paid for two years.” The 19,000 former employees in Canada had lawyers paid for by Nortel, and Ernst & Young was named the court-appointed monitor of Nortel’s Canadian proceedings to oversee the administration of the health and welfare trust (HWT) fund, which covers pensioners’ medical, dental, and life insurance benefits, as well as income support for some groups such as those employees on long-term disability leaves when the company went insolvent. As well, after the liquidation in 2009, Nortel established a hardship program for former employees who needed money and met a certain criteria, which Tay also says is unique as the law does not require employees to be treated better than other creditors.

While there have been some positive developments in the matter in Canada, there are significant shortfalls in employee HWT funds in other countries. In the U.K., employees are trying to access the Canadian HWT in lieu of the deficit in their country’s Nortel fund. “That’s another complicating factor and this could take a while to sort out,” says Tay. The possibility of additional lawsuits will only serve to prolong the insolvency process. “If people actually come to a deal, it could take months but if people litigate, it will take even longer to resolve this.”

While some former employees are on board with receiving, perhaps, two years worth of benefits from the HWT, a group of 40 employees on long-term disability is challenging the distribution process sanctioned by the CCAA process. They have retained Joel Rochon, of Rochon Genova LLP in Toronto, who is working on the matter on an unpaid retainer, while Mark Zigler of Koskie Minsky LLP in Toronto was appointed by the court to represent both Nortel’s pensioners and former employees, including those on long-term disability.

Zigler agrees the matter has been both protracted and complex and suggests that Canada needs to improve its insolvency laws. “Our laws aren’t very good when it comes to protecting pensioners and employees in insolvencies,” he says. “Nortel is much more complicated because it’s an international company with all sorts of assets and obligations all over the world and although the parent company was in Canada, it only meant that a lot of the debt flowed back to Canada and a lot of the assets that are in other countries can’t be accessed to benefit the creditors.” As well, he says there isn’t one single court that can decide everything in an international insolvency, which means the matter has to be brought to courts in Canada, the U.S., and the U.K. (Many of the proceedings between Canada and the U.S. have been connected with a video link.)

Zigler says the pension and disability benefits provided until the end of 2010 were a significant milestone for the former employees, but the matter needs to be resolved sooner rather than later as many pensioners and those on long-term disability are struggling to make ends meet. As well,

there have been some problems regarding his representation of both the pensioners and long-term disability groups. “We had an allegation of conflict because we represent both groups, so we got other lawyers to represent them,” he says. As well, in 2009, the court appointed long-term disability employee Sue Kennedy of Ottawa to be the key representative for a group of 260 employees who are disabled; another 100 disabled employees are in the Canadian Auto Workers union represented by lawyer Barry Wadsworth.

Zigler says both groups are very well-organized and extremely patient despite the protracted nature of the process. “It’s a really difficult situation in terms of knowing the outcome in the future,” he says. “I would say that ultimately, an insolvency is a losing proposition and once you get to the insolvency stage, it just becomes a fight between the employees, pensioners, and disabled employees.”

The challenge to Nortel’s insolvency benefits plan on behalf of the long-term disability employees initiated by Rochon is heading to the Supreme Court of Canada. Rochon represents 40 former employees who are taking issue with the HWT fund’s depleted assets, the allocation of the remaining HWT assets, and priority of the claims of the disabled compared to the bondholders and others seeking to access some of the worldwide estate assets so as to boost the amount available for them. “The trust fund that was established on behalf of the disabled and others was woefully underfunded,” he says. It had a shortfall of at least \$37 million dating back to 2008. He agrees the case has been particularly challenging as he says he has been unable to get full financial disclosure from either Nortel or the court-appointed monitor, Ernst & Young. “The timing and extent of disclosure in this case has been consistently shocking.” He adds: “When a company sets up money in an HWT, that money is part of a sacred trust, especially where the beneficiaries are disabled.” But he has so far lost his battle in the Ontario courts, so will launch an appeal to the SCC soon. Rochon also says each former employee who was receiving long-term disability when Nortel launched its insolvency has no alternative source of income along with high medical expenses, so it will serve as a matter of national scope and perhaps even lead to legislative changes. “In the context of a CCAA filing, having 40 people object is significant,” he says. “These claims should definitely have priority over multimillion-dollar executive bonuses and billion-dollar hedge funds.”

Jay Carfagnini and Gale Rubenstein of Goodmans LLP’s corporate restructuring group in Toronto are also involved in the case as counsel for the court-appointed monitor, Ernst & Young. In February 2010, Ernst & Young reported that the assets of Nortel’s HWT had a shortfall of \$37 million in its net assets as of Dec. 31, 2008. The trust supports pensioners’ medical, dental, and life insurance benefits, as well as income support for some groups such as long-term disability recipients.

Carfagnini says the case has been “very intense” based on the demands by the court. “It is complex because it is a true multinational company headquartered here with a high-tech sophisticated business,” he says. “We’re in court a lot to assist with our client, which has filed 60 reports to the court so far.”

He acknowledges there have been some precedent-setting developments in the Nortel insolvency such as the hardship program that compensated employees who lost their job and were in dire

need of money. For that program, no other creditors objected, which Carfagnini deems to be important for future insolvencies where employees are left in the lurch.

He also says the U.K. proceedings have added complexities because it has a different insolvency regime with most proceedings not taking place in a court, but overseen by administrators appointed by the court. Through the U.K. process, four administrators are overseeing the restructuring of all of Nortel's interests throughout Europe, the Middle East, and Africa under the guidance of a lawyer. So it is essentially a three-way negotiation in each jurisdiction that is handling the matter, which is much different than most lawyers are used to and has required all of the counsel involved to be creative in resolving problems or questions that come up because of the matter's breadth, he says. As well, there is a tremendous amount of communication between all of the lawyers involved in all three jurisdictions to make sure they're on the same page.

Nortel has had its problems over the years. In 2000, the company posted an annual revenue of \$30 billion and an employee roster of 93,000 worldwide. Its share price on the Toronto Stock Exchange was \$120. But its forecast for 2001 was inaccurate and the company experienced a loss of \$27 billion and subsequently laid off half its staff. The following year, Nortel's chief financial officer Terry Hungle resigned following accusations he had broken the company's in-house trading rules with respect to some of his own stock transactions, which created some bad publicity for the company and caused the share price to plummet even further.

By the spring of 2002, its share price plunged to 69 cents and its long-term debt was downgraded to junk by Moody's Investors Service Inc. and Standard & Poor's Financial Services LLC. By the end of the year, the company employed just one third of the workforce it had in the year 2000. Then in 2004, Nortel fired for cause its chief executive officer Frank Dunn along with chief financial officer Douglas Beatty and controller Michael Gollogly over an accounting scandal. In 2008, all three were criminally charged by the RCMP with misstating the company's financial status in 2002 and 2003.

As a result of the accounting scandal, its investors launched a global class action and in 2006, Nortel settled the class action and agreed to pay investors \$575 million in cash and \$1 billion in stock, as well as pledging to co-operate fully with the Ontario Securities Commission and the U.S. Securities and Exchange Commission regarding ongoing investigations by both countries' law enforcement authorities into the company's financial restatements.

By 2008, Nortel tallied a net loss of \$5.8 billion and began an aggressive downsizing that resulted in reducing its global workforce to fewer than 30,000. That same year, its share price fell to 39 cents. So it was not a huge surprise that the following year it filed its bankruptcy applications in each of the three jurisdictions.

In the fall of 2009, Canada's Industry Minister Tony Clement approved the purchase of Nortel's two wireless divisions in Toronto by Swedish telecommunications giant Ericsson for US\$1.3 billion. Then late last year, Nortel announced that Guangdong Nortel Telecommunication Equipment Co. Ltd. (GDNT), which has a joint venture with Nortel, entered into an asset sale agreement with Ericsson for US\$50 million. Nortel issued a statement to say it will "work diligently with Ericsson and the other shareholders of GDNT to close the sale in the first quarter

of 2011.”

As well, Nortel and its principal operating subsidiary, Nortel Networks Ltd., and its other Canadian subsidiaries obtained a court order from the Ontario Superior Court that extends a stay of proceedings until June 30. The purpose of which is to provide stability to the Nortel companies to continue with their divestiture and other restructuring efforts and to continue to work toward the development of a plan of arrangement under CCAA. The company’s portfolio of patents still has to be auctioned off and is worth \$1 billion. An initial bidder was to be named last month.

As well, Ontario’s Superintendent of Financial Services has provided consent to Morneau Shepell Ltd., which administers the Nortel pension plans, to start new pension payments at a level of 50 per cent of full entitlement, which will be topped up by Ontario’s Pension Benefits Guarantee Fund. While Quebec pension legislation does not permit the commencement of new pension payments to those not already receiving a pension, they will get temporary advance payments from the administrator that will be deducted, with interest, from the commuted value transfer that will ultimately be paid to them.

In January, the Supreme Court of Canada dismissed the U.K. Pensions Regulator’s application for leave to appeal. The Ontario Court of Appeal had previously upheld a decision of the Ontario Superior Court, providing that the results of certain foreign proceedings were unenforceable in Canada. The SCC’s decision means that results reached in U.K. proceedings involving Nortel’s U.K. pension plan will not be enforceable in the Canadian court system.

A notice posted on Koskie Minsky’s web site notes the SCC’s decision “does not mean that U.K. parties are prohibited from asserting a pension claim in Canada. Rather, parties in the U.K. and other European countries will have an opportunity to file a claim in Canada through the EMEA Claims Procedure Order, which was granted by the Ontario Superior Court of Justice on January 14, 2011. Such claims must be filed with the Monitor by March 18, 2011. Please note that the EMEA Claims Procedure Order does not affect pensioners, former employees or disabled employees, as those claims will be subject to a separate Compensation Claims Procedure, the details of which currently remain subject to discussion.”

Despite its complexity and no real end in sight for lawyers and courts to finally clean up the Nortel matter, all who are involved say it’s been a compelling case to learn from. As Ogilvys’ Tay says: “I can say that this case has strengthened my ability to problem solve and there’s been great co-operation between all the lawyers involved,” he says. “I thought I had done it all before this but this has been an inspiring experience that will last for a long time.”

Carfagnini also believes the matter will provide a road map for other global insolvencies, bankruptcies, and restructuring which lawyers in many jurisdictions can learn from. “This has been a very good exercise of three jurisdictions working together co-operatively,” he says. “It’s been a complex but very interesting experience.”

comments

+ 13 # Greg McAvoy 2011-04-05 20:48

I am a former Nortel employee who was on long term disability until we were terminated on Dec. 31 2010. I am surprised that Jay Carfagnini and Gale Rubenstein would be telling Canadian Lawyer that the Nortel trust supports pensioners' medical, dental, and life insurance benefits, as well as income support for some groups such as long-term disability recipients. The concept of support implies that there are accumulated assets within the trust for all these purposes and that there is no distinction between pay as you go benefits and funded benefits. The HWT is an administrative conduit for the pay as you go annual medical, dental and life insurance benefits. For the funded benefits, like employer sponsored disability insurance, the HWT assets are the needed insurance reserves to pay the future income of the disabled and the survivors of deceased employees.

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+ 10 # Carol Sampson 2011-04-06 10:50

Derrick Tay, of Ogilvy Renault LLP, takes pride in Nortel having paid its employee benefits for a record two years following its CCAA filing. Let's put this into perspective. Nortel volunteered to pay about \$74 million of employee benefits during 2009 and 2010, not including the \$34 million of pension fund contributions that it was obliged to pay under pension benefits regulation. Employee benefits paid out of the pension fund and health and welfare trust during these two years are paid from funds already owned by the employees. The employee benefits voluntarily paid by Nortel are beyond the pale relative to the estimated \$130 million of professional fees and \$200 million of special bonuses and ongoing incentives paid in Canada during 2009 and 2010.

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+ 12 # jackie bodie 2011-04-06 11:31

Derrick Tay suggests that Nortel's hardship program is unique as the law does not require employees to be treated better than other creditors. The hardship program pays money as an advance on an expected future settlement, so it can hardly be interpreted to be favourable treatment compared to other creditors. Only \$750,000 was set aside for hardship and former employees must have no income or have inordinate medical costs to qualify. The maximum payment per person is \$9,600 over 8 weeks and another \$2,500 for medical emergencies. 8 weeks worth of funding is akin to putting a bandaid on a sinking ship for someone who has to pay for a disability for the rest of their life. A lawyer making \$1000 per hour describing these hardship payments as significant is out of touch with reality.

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+ 11 # Josee marin 2011-04-06 15:21

In February 2010, Ernst & Young reported that Nortel's HWT had a shortfall of \$37 million in its net assets as of Dec. 31, 2008. We agree, because this shortfall is based on the HWT legal obligation being only the future income of disabled and survivors. We are surprised that Jay Carfagnini and Gale Rubenstein of Goodmans disagree with Ernst & Young's February 2010 report and are fighting for an HWT settlement for pensioners' death benefits. The Application for Leave to Appeal to the Supreme Court of Canada argues that the HWT has no legal obligation to pay pensioners' death benefits, because the pensioners have not died and the group term life insurance policies within the HWT automatically terminate upon Nortel's bankruptcy.

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+7 # Jan Dignum 2011-04-08 20:11

How insulting it is to hear Mr Tay say that the LTD were fortunate to get 2 years for benefits post-filing... This so-called "Benevolence" would not have been necessary had Nortel not wrongfully taken money from the Trust and borrowed money from the Trust. It's not fair that 9 Nortel executives are given a constructive trust on \$7 million of annuities in Nortel's name, but the \$57 million in the Nortel estate taken from the HWT are not returned to pay for the disability insurance Nortel provided its employees. The Nortel creditors should not be allowed to keep the disability settlement that rightfully belongs to the 360 disabled employees and their 160 children now forced to live in poverty.

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