

ADVERTISEMENT

Menu

Part of the  canada.com Network

Breaking up is hard to do

Saturday, August 13, 2011

By James Bagnall, Ottawa Citizen



Among those waiting for the proceeds from Nortel to be divided up is former CEO Mike Zafirovski, who is seeking \$12.4 million, including \$3.6 million for two years worth of bonuses. He is also seeking an unspecified amount in connection with a class-action lawsuit.

Photographed by:

Pat McGrath, The Ottawa Citizen, Ottawa Citizen

On a hot August day in 2009, Mike Zafirovski was giving shape to his four years at the helm of Nortel Networks. The Macedonian-born businessman, athletic and trim, was analysing himself much as you would do for a Harvard Business School case study. He talked in rushed, clipped tones about the challenges he faced, how he tried to meet them, why it had been necessary for Nortel to file for bankruptcy protection seven months earlier.

It was a clinical presentation to an audience of one, but Zafirovski seemed on edge. He had been the only Nortel director on Jan. 13 prepared to vote against seeking bankruptcy protection, known in the U.S. by the name of the enabling legislation, Chapter 11. Zafirovski took on the top job because he had been seduced by the idea of managing a historic corporate turnaround. That was the Harvard case study he had wanted to author. Not this mess.

Zafirovski hadn't even managed to pull off Plan A while under court protection - which was to shed a few assets, employees and costs, then see Nortel re-emerge as a competitive, stand-alone firm. That strategy was tossed out in June 2009 when the company's directors voted for Plan B - the systematic sale of each of Nortel's main business units.

"This is obviously not what I wanted to do," Zafirovski was saying on that day in August. "But once in (bankruptcy court) the goal became to make this one of the better examples of what it's possible to do in Chapter 11."

Zafirovski didn't stick around to help achieve that goal. Five days later, he announced he was leaving, returning to his Chicago home to reconnect with his family and mull over his experiences.

Yet, oddly, Nortel's bankruptcy may be worthy of that Harvard case review.

It's not just that it involved what was once the most valuable firm in Canada's history, or that it produced so many surprises. What makes the case so interesting is that it opened a window into the soul of a

century-old corporation, along the way revealing sharp conflicts between its employees, retirees, bankers, executives and suppliers. The proceedings also shed much light on the publicity-shy mob of independent professionals who provided the firm with such expensive guidance.

-

When Nortel filed for creditor protection two-and-a-half years ago, it gave birth to a mini-industry supplied by thousands of lawyers, accountants and investment bankers. During the 30 months to June 30, 2011, Nortel shelled out nearly \$300 million for professional services and advice. While that is well short of the \$1 billion plus likely to be expended on the Lehman Brothers proceedings - the biggest bankruptcy of them all - it is very large in relation to Nortel's size.

Canada's largest tech firm had just \$9 billion in assets the month before it filed for creditor protection while Lehman Brothers - whose 2008 bankruptcy triggered the global financial meltdown - had nearly \$700 billion.

No professional firm is doing any better generating fees from Nortel than Cleary Gottlieb Steen & Hamilton LLP, the New York based partnership that serves as the company's lead law firm in the bankruptcy. With more than 1,000 attorneys in 12 offices around the world, Cleary Gottlieb is well placed to serve Nortel's many international interests. To date, it has billed Nortel \$135 million.

Like other firms that charge at least \$50,000 per month for services rendered in Nortel's U.S. unit, Cleary Gottlieb regularly submits bills that must be approved by the court. It charges anywhere from \$230 per hour for paralegals to \$1,040 an hour for senior partners such as James Bromley, the top lawyer on the Nortel file.

The invoices are rarely challenged - and they are paid in full before any of Nortel's creditors get a dime. For thousands of Nortel employees waiting to see how their claims for lost benefits be resolved, the court filings make for depressing reading. Consider Cleary Gottlieb's application for compensation for just the month of June 2011. The New York firm lists about 175 attorneys, associates, paralegals and summer associates on the Nortel file. Collectively they charged for 14,180 hours of service, representing \$6.1 million in billings. One associate, Emily Bussiegel billed for nearly 314 hours - equivalent to more than 10 hours daily including weekends.

What did they all do? The bulk of the time was devoted to "employee matters," case administration, litigation and work related to patents. Nearly \$20,000 was spent on photocopying and \$4,400 on mailing.

Lawyers aren't shy about what they include in their invoices. In a recent application for interim compensation from the U.S. court, Toronto-based Torys listed dozens of charges for time spent preparing invoices - or billing for billing. Tory partner Tony DeMarinis spent 1.8 hours to review and prepare "account materials for fee approval application." For that, he billed Nortel \$1,755.

There's nothing wrong with this sort of thing, but the contrast is sharp between the fees paid to professionals, who get their money up front, and the financial fate of thousands of former Nortel employees and pensioners, who must wait for their settlement, which is unlikely to be recouped in full.

Fortunately, bankruptcy judges have considerable discretion under Chapter 11 and its Canadian equivalent, the Companies Creditors Arrangement Act. Canadian judge Geoffrey Morawetz has approved several orders aimed at easing the short-term financial burdens faced by different groups of Nortel employees. For instance, employees who were laid off without receiving severance, along with

pensioners' survivors receiving income supplements, were allowed to draw up to \$3,000 each. A pittance, to be sure, but drawn out of Nortel's bank account long before would normally be the case.

The court also ensured that many Nortel pensioners and other employees continued to receive medical, dental and other benefits to the end of 2010. More recently, Nortel's Health and Welfare Trust - the vehicle through which the company provided employee benefits - is being wound up, with the proceeds to be distributed to former employees. The trust, unfortunately, was severely underfunded which means employees will receive little more than one-third of the value of the promised benefits. They are free to submit a claim for the remainder, but they will have to line up with everyone else for an uncertain, and probably much delayed result.

That it took special orders to make even this possible says much about the bankruptcy process. The idea, of course, is to prevent creditors from grabbing any of Nortel's available cash until there's agreement on who should get what.

Morawetz throughout has been sensitive to the short-term problems faced by many of Nortel's former employees, though the company's 360 plus disabled employees were upset with the small amounts they will receive from the Health and Welfare Trust.

Pensioners are certainly in better shape, not least because the main pension fund was kept separate from Nortel's operations, unlike the case with the Health and Welfare Trust. Even so, the pension fund doesn't contain sufficient funds to match obligations. Even before proceeds from the final Nortel estate are considered, pensioners outside Ontario can look forward only to a two-thirds payment. Ontario pensioners could realize 80 to 90 per cent, thanks to a provincial top up program. All these pensioners are entitled to make claims as unsecured creditors to try to regain 100 per cent.

However, not all Nortel employees received their pension from an independent fund. Many were financed through general company revenues, an arrangement that halted the instant Nortel entered bankruptcy protection.

Whatever the situation facing Nortel pensioners, Morawetz appears frustrated by the delays in reaching a global settlement about how the final estate is to be divided.

"For many of these individuals, the delay in receiving a meaningful distribution can be significant," Morawetz wrote in an order dated June 29. "It is not just a question of calculating the time value of money. For this group of creditors, time is not on their side."

Nor, it seems, is the math. One of the most difficult parts of being a creditor is the uncertainty over the proceeds. Even at this late stage, with nearly all the business assets sold off, it's difficult to know how well the creditors will do. The courts determined in 2009 that all proceeds from the sales would be kept in escrow - untouchable - until there is agreement on how they will be distributed. And, despite the fact the decks are nearly cleared, it may not be anytime soon.

-

The difficulty is that two issues must be resolved at the same time. The first concerns the number of claims in total - and these are many. Each court has established a system for submitting and vetting claims to make sure they are genuine, but even this has proved a headache. There are some \$35 billion in claims in total, but this includes many duplicates because individuals and suppliers have filed separately in Canada, the U.S. and, sometimes, Britain. The U.S. court has received nearly 8,000 claims, including a request by former chief executive John Roth for \$1 billion. According to his filing, he is seeking indemnification against a variety of lawsuits that still hover over him and the company he led.

Indeed, nearly every former Nortel CEO has filed a claim for foregone pensions and benefits. Zafirovski for instance is seeking \$12.4 million, including \$3.6 million for two years worth of bonuses to which he feels entitled. He, too, is seeking money in connection with a class-action lawsuit, though the amount is unspecified.

But the claims by executives and suppliers pale beside those submitted by Nortel's bondholders (\$4 billion plus) and its various pension funds (\$3.7 billion from the British fund alone, for unfunded liabilities).

The more claims that are accepted, of course, the smaller the amount available for each creditor. Nortel to date has raised \$7.6 billion from the sale of assets and should have at least \$1 billion cash in hand, producing a total of nearly \$9 billion. If the courts actually accept \$30 billion or so in claims, that would mean most claimants would receive less than 33 cents on the dollar owing.

Fortunately, it's likely the total demands on the Nortel estate will be much lower. Consider the company's experience earlier this year when the Canadian estate reported more than 1,000 claims representing the \$35 billion in claims. As of May 31, the firm had reviewed 553 claims valued at \$9.5 billion. But it accepted only 476 claims worth \$2.6 billion. Nevertheless, that leaves a very large amount potentially owing to creditors.

The second big issue involves an even more difficult dispute. If it were simply a matter of adding up all the claims globally, it would be easy to calculate who gets what, especially since Nortel has hardly any secured creditors. This means nearly all creditors owed money are on roughly equal footing in terms of priority. Most everyone should receive the same number of cents per dollar owed.

Unfortunately, Nortel's bankruptcy has been complicated immensely by the fact there are three very strong regions, all competing for the same pool of money. Global bankruptcy proceedings are never easy but most involve companies with a main centre of operations, which can usually take control and push through a solution. Not so in the case of Nortel, where the headquarters is in Canada, the largest number of employees is in the U.S., and there are major operations in Britain and mainland Europe. "There is no simple solution to the legal predicament that faces all parties," Morawetz wrote.

The problem in a nutshell is that Nortel's European operation is making very large demands on the Canadian estate - some \$10 billion. And that's only the bit that European creditors have quantified. Their claims are related largely to pension deficits but also include money owing because Nortel's accounting did not properly account for the value of services provided over the years by the company's European operations - or so the British claimants allege.

The dispute is intractable in part because of differences in the way Britain treats pensioners in bankruptcies. Nortel's British pensioners have had their annual income secured through a government agency. It is the agency that is pursuing the claim for a piece of Nortel's Canadian estate. The distinction is key because the political pressure on the British agency to produce quick results is lacking. In Canada, Nortel's pensioners are on their own, and eager for a quick deal - though not at any price.

Several efforts to mediate the dispute over the size of the claims and how they should be allocated by country have failed. One, which was led by retired U.S. judge Layn Phillips, ended unsuccessfully in April. The various parties, including Nortel's European claimants, submitted 43,000 documents, including 16,000 related to Nortel's excruciatingly complicated transfer pricing system - the accounting it used to allocate costs and revenues between its divisions when it was a going concern.

More recently the courts launched another attempt at mediation. Early in June, a joint session of the Canadian and U.S. courts considered the matter in the form of a motion.

On June 29, Morawetz warned that "the nature and length of the arguments presented at the motion will necessitate careful drafting and separate rulings by the U.S. Court and this (Canadian) Court."

The rulings, in short, could take some time. And there is the distressing possibility the court ruling could be appealed.

In the meantime, Morawetz is compelling the parties to undergo mediation to be directed by the Honourable Warren Winkler, chief justice of Ontario.

"Participation in this mediation is mandatory," Morawetz intoned. "Any agreements reached as a result of mediation will be binding on the parties."

However, Winkler does not have the authority to impose a settlement. And it's not clear what will impel European claimants to moderate their position, even in the face of the upcoming rulings of the U.S. and Canadian bankruptcy courts.

-

As Nortel's thousands of creditors await the mediation and court rulings, key players in the bankruptcy proceedings are winding down their efforts.

From the beginning, New York investment banker Lazard has been a constant presence. Nortel hired the firm in the fall of 2008 to advise it on strategies for shoring up its base of capital and, perhaps, for entering bankruptcy protection as a last resort.

At a series of crucial meetings of Nortel directors early in January 2009, it was Lazard's managing director Terry Savage who declared Nortel was very well prepared for a stint in bankruptcy protection. His firm had done hundreds of corporate restructurings in the previous decade and had seen many mistakes.

Nortel, he pointed out, was starting the process with more than \$2 billion in cash on its books, which gave it more flexibility to operate its divisions than corporations who let their reserves fall too low.

However, things did not go as planned. Once under court protection, Nortel shifted strategy fundamentally. No longer was the plan to re-emerge in fighting form. The company would sell all its units. Directors were pleasantly surprised by the \$3.1 billion raised in the first two years through asset sales, not least because the great fear had been that Nortel's customers would bolt, forcing the bankruptcy court to simply liquidate everything for minimal return.

Two months ago, directors were shocked by the additional \$4.5 billion gained through the sale of company patents; the original valuation, according to Zafirovski in mid 2009, was for just a few hundred million dollars. To be fair, Zafirovski made that calculation during the depths of a stock market swoon, and long before a burgeoning smartphone industry gave those patents so much value.

Perhaps they had underestimated the value of their company all along. But then, to a person, the people running Nortel were all outsiders. None of the directors had worked at Nortel during its glory years. And certainly the outside professionals did not view Nortel with the passion of its early engineers.

Savage knew Lazard would do well, however the bankruptcy proceeding turned out. That's the way it is with hired guns.

Nortel retained Lazard for \$250,000 per month, and gave it the right to claim a certain percentage of asset sales, should these arise. The sale of Nortel's wireless products and enterprise networking

divisions to Ericsson and Avaya respectively, generated millions in fees for Lazard. By April 30, 2011, Lazard had earned \$21.3 million.

Along the way, the priorities of the investment banker changed. In the first month of the bankruptcy, we see Savage billing two hours for a dinner with Zafirovski, one hour for drinks with Murray McDonald, managing partner with Ernst & Young, the accounting firm responsible in Canada for running the process. Lazard had nearly 20 associates and partners working on the Nortel file. Not quite half their time was spent on finding buyers for Nortel units. The rest was spent "interfacing with Nortel personnel" and other professionals, and conducting analyses of how much Nortel's unit were worth. By April 2011, just three Lazard bankers were on the case, with most of their attention focused on "acquisition processes." They were soliciting and evaluating bids for Nortel's patents.

Now the end appears in sight. Lazard has its reward and is more than satisfied that it helped to raise more money for creditors than they originally expected.

For Nortel's pensioners and suppliers, it's been an excruciating trade-off. The delays produced more in the way of cash for those creditors, but as Morawetz observed, time is not on their side.

NORTEL SNAPSHOT

On Dec. 31, 2008, just two weeks before it filed for bankruptcy protection Nortel had a market value of less than \$160 million. But, in the past two-and-a-half years, the firm has sold off just about everything it owned for nearly \$8 billion, plus a \$1 billion or so in cash.

On Dec. 31, 2008, Nortel employed 30,300, including nearly 6,000 in Canada and more than 10,000 in the U.S. Buyers of the company's assets hired 10,000 plus while fewer than 2,000 employees remain with Nortel. Soon these, too, will be gone.

At the height of telecom boom in 2000, Nortel's shares were worth \$366 billion and the firm employed 95,000.

MAJOR BILLINGS IN THE U.S. PORTION OF THE BANKRUPTCY PROCEEDINGS

MAJOR BILLINGS IN THE U.S. PORTION OF THE BANKRUPTCY PROCEEDINGS

Cleary Gottlieb Steen \$135 million

Lazard \$21.3M+

Fraser Milner Casgrain \$11M

Huron Consulting \$6M+

Ernst & Young \$2.0M

Torys \$1.4M (starting Oct. 28, 2010)

TIMELINE FOR LEGAL EVENTS

TIMELINE FOR LEGAL EVENTS

2009

Jan. 14: Nortel files for bankruptcy protection

March: Nortel implements bonus program for key executives and employees to entice them to stay through the bankruptcy proceedings

June 9: Interim Funding Settlement; U.S. unit pays \$157 million to Canadian jurisdiction to settle inter-company accounting claims.

In exchange, U.S. wins right to file a \$2.1-billion claim against final proceeds from asset sales. There's also agreement that sale proceeds will be set aside until there's a deal on how to allocate it. Negotiations begin on a protocol.

July 30: Court creates a fund for former employees or retirees facing hardship. Individuals can receive up to \$3,000 each.

2010

June: Negotiations at an impasse over how to allocate proceeds from asset sales.

November: U.S. Judge Layn Phillips leads non-binding mediation efforts to reach deal. He tries again in April 2011. They prove unsuccessful.

Dec. 15: Order authorizing payments to 742 former Nortel employees on pension, long-term disability and short-term benefits. \$24 million Cdn. paid out by July 31, 2011.

2011

March 18: 19 debtors from Nortel's European group filed 84 proofs of claim seeking \$9.8 billion from the company estate.

June 7: Joint hearing conducted over how to allocate proceeds. Judges declare decisions will be reserved "for a considerable time."

June 29: Hon. Warren Winkler appointed mediator. If a deal can be reached, it will require approval of the courts.

TIMELINE FOR KEY ASSET SALES

2009

Jan. 14: Nortel files for bankruptcy protection, explores ways to reduce costs and become more competitive.

July 24: Company has given up effort to re-emerge from court protection as a standalone entity. Sells CDMA wireless unit to Ericsson of Sweden for \$1.13 billion and transfers 2,500 employees.

Sept. 14: Nortel sells Enterprise unit to Avaya of New Jersey for \$915 million and transfers 6,000 employees.

Nov. 22: Ciena of Maryland buys Nortel's optical products unit for nearly \$700 million.

2010

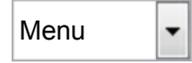
Oct. 19: Government of Canada pays \$208 million for Nortel's 370-acre R&D campus in Nepean.

2011

July 1: Consortium led by Apple and Research in Motion pays \$4.5 billion for 6,000 Nortel patents.

© Copyright (c) The Ottawa Citizen

Share this story



Postmedia Network Inc. All rights reserved.
Unauthorized distribution, transmission or republication
strictly prohibited.