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Honourable Ted Menzies
Parliamentary Secretary to the Minister of Finance
Ottawa, Ontario, K1A 0G5

Dear Honourable Ted Menzies:

Thank you for your letter to me dated June 23, 2009 on the subject of federal bankruptcy laws, which gives the Government of Canada's reason for why severance and pension fund deficits are treated as unsecured creditor claims, except for the nominal amounts of severance and pension contributions collected and not yet remitted to the pension fund, that have been given super-priority status in recent bankruptcy law amendments.

Current Bankruptcy Laws Hurt Nortel's Canadian Pensioners, Disabled and Terminated Employees

As noted in Table 1, there are close to 19,000 Nortel Canadian pensioners, disabled and recently terminated employees with an estimated Canadian \$1,500 million of damages due to Nortel's expected liquidation. Nortel pensioners are expected to lose at least 28% of their pension income, while the disabled former employees will likely lose 90% of their income and the recently terminated employees will likely get only 10% of their severance, that was otherwise obligatory under employment standards set by provincial laws and common law precedents.

Table 1: Nortel Damages to Canadian Pensioners, Disabled and Terminated Employees

	# Impacted	Claims Cdn \$ Millions	Expected Loss Cdn \$ Millions	Income Loss %
Pensioners				
Pensions	17,500	\$1,250	-\$1,125	-28%
Health Benefits	11,000	\$180	-\$162	-90%
Sub-Total	17,500	\$1,430	-\$1,287	
Disabled Former Employees	450	\$170	-\$153	-90%
Severed Employees	1,000	\$100	-\$90	-90%
Total	18,950	\$1,700	-\$1,530	

Emergency Bankruptcy and Insolvency Amendment Sought

At the House of Commons Standing Committee of Finance meeting on June 18, 2009, representatives of Nortel Canadian pensioners, disabled and terminated employees have asked the Federal Government to make an emergency amendment to the Bankruptcy and Insolvency Act (BIA) to put pension, health and long term disability plan deficits and severance ahead of unsecured creditors, in what is known to be preferred status. The request is not for super-priority status above the secured creditors. These representatives have also requested that the Federal Government use its authority to set conditions under the Investment Canada Act for a significant proportion of the proceeds from the foreign purchases of Nortel businesses to fund Nortel's Canadian legacy pension, health and long term disability plan deficits and severance. The latter request is due to concern about Nortel's Canadian estate receiving only a small proportion of the expected cash proceeds from the Nokia Siemens Networks' purchase of Nortel's wireless business and the sale of Nortel's other businesses to foreigners.

Federal Government adoption of the recommended interventions would result in the Nortel Canadian pensioners, disabled and terminated employees having their expected losses eliminated not through a government bailout, but by reducing the Nortel junk bond holders' share of Nortel's global estate. Nortel's debt has been rated below investment grade since April 2002. Current Nortel debt holders are believed to be primarily foreign distressed debt managers, hedge fund managers and other speculative investors.

The Federal Government's Objection to the Requested BIA Amendment

The Canadian government's apparent objection to the emergency BIA amendment would be the one you described in your letter.

"In bankruptcy law, an appropriate balance is sought between the competing interests of the debtor and the creditors and between the creditors themselves. Changing the priority of unfunded pension liabilities and severance payments could have a negative impact on the cost and availability of credit. Increases in the cost and availability of credit would increase the cost of doing business and potentially reduce employment and economic growth. "

Preferred Status Will Have Only A Nominal Impact On The Cost And Availability Of Credit

In my opinion drawing upon many years of studying capital markets, preferred status for pension fund deficits and severance will have only a nominal impact on the cost and availability of credit in the debt market as a whole. **The estimated impact on the cost of credit is in the range of less than 0.05% to 0.26% annually, with the amount depending on the term and whether the corporate bonds are investment grade or junk, as estimated in Table 2.** Let me explain.

The cost of capital is the weighted average of the cost of equity and cost of debt, where debt is typically not more than half of total capital. The cost of debt is the interest rate on bonds, which is a combination of the risk free rate of return on government bonds plus a "default risk premium" on corporate bonds to compensate for the proportion of the corporate bonds that are expected to go into default and have losses.

The change in the "default risk premium" for bonds when pension fund deficits and severance get preferred status is a function of the following factors:

- (1) Expected Default Rate %
- (2) Increase in Expected Loss %
- (3) Proportion of Bonds Where Corporate Issuers Have Defined Benefit Pension Plans
- (4) Likelihood that Defined Benefit Pension Plans are in Deficit at the Time of Corporate Bankruptcy
- (5) A Factor for Defaults Occurring over Future Years Within the Time Period Before Bond Maturity

The layman's high level explanation for why preferred status can have only nominal impact is that the % of investment grade corporate bonds that enter liquidation is very small; the % of corporations that have defined benefit pension funds is only about one third in Canada; only a portion of pension plans should be in deficit at the same time that the corporations are liquidating due to government pension regulations; and, the average realized loss for unsecured creditors in bankruptcy is already very high and so the additional loss for unsecured creditors that arises due to pension fund deficits and severance being at preferred status is incrementally modest.

In Table 2, I summarize the findings of the analysis I have done on 10 year investment grade bonds and 10 year junk bonds using the 1920 to 2007 average for 10 year cumulative default rates. The estimated impact of pension fund deficits and severance getting preferred status is less than 5 basis points or 0.05% annually for investment grade 10 year bonds and less than 20 basis points or 0.20% annually for junk 10 year bonds. I stress tested the impact on bonds having a one year term, for a very high one year default rate of 4% and an extra loss of -31% on the defaulted bonds. I get that the preferred status for pension fund deficits and severance likely creating an increase in the cost of debt in the whole market of only about 26 basis points or 0.26% based on a one year term to maturity.

Table 2: Change in Annual Default Risk Premiums in Bonds Due to Pension Fund Deficits Preferred Status

Annual Default Risk Premiums in Bonds	Investment Grade	Investment Grade	Junk
Term	1	10	10
Status Quo in Bankruptcy Laws	2.44%	0.25%	1.78%
Pension Fund Deficit Preferred Status	2.70%	0.27%	1.97%
Change in Annual Default Risk Premium	0.26%	0.03%	0.19%
Assumptions:			
Risk Free Rate	3.50%	3.50%	3.50%
Default Rate	4%	4%	26%
Loss %			
Before	-61%	-61%	-61%
After	-100%	-100%	-100%
Percentage of Corporations with Pension Funds	33%	33%	33%
Percentage of Pension Funds with Deficits	50%	50%	50%

Unsecured Creditors Worse Off in Bankruptcy, But for Equitable Reasons

The sought BIA amendment will indeed impose significant cost on unsecured creditors of bankrupt companies that have defined pension plans with deficits at the time of the company's bankruptcy. However, there are well documented equitable principles supporting this cost for the unsecured creditors at the time of liquidation, relating to the needs of pensioners, disabled former employees and terminated employees. There would not have been a significant cost had the corporation fully funded the pension, health and long term disability plans while it was a going concern.

"The Carrot And The Stick" Approach To Encourage Restructuring As An Ongoing Concern

In theory, there is merit in having both the Federal CCAA and BIA giving preferred status to pension, health, disability plan deficits and severance over the unsecured creditors. However, the Nortel former employee representatives are seeking that only the BIA get an emergency amendment at this time. In this way the BIA amendment can provide benefit to the Nortel pensioners, disabled and severed employees without triggering retroactivity, since Nortel is under CCAA currently. The goal would be to get the BIA amendment, while Nortel is in CCAA and before it enters BIA, which is the expected likely outcome down the road.

The CCAA having a different approach for employment benefit plan deficits and severance than the BIA would be good public policy, in my opinion. If pension fund deficits remain a contingent unsecured claim for an ongoing concern until the company liquidates, there is a greater chance that the company will have a successful restructuring as an ongoing concern and as such will live to provide future special contributions to make up for the pension fund deficit. During CCAA, if pension fund deficits are priority claims above unsecured creditors, their crystallized nature at this stage could cause liquidation rather than strenuous efforts to restructure the company as an ongoing concern.

If the company must enter liquidation under BIA, the pension fund deficit becoming crystallized as part of the pension fund wind-up process has the desired effect of discouraging liquidation. The debt holders are more likely to work hard on the restructuring of the company as an ongoing concern, if pension plan deficits need to be paid first before them in liquidation. This is "the carrot and the stick" approach. Pension fund deficits being contingent unsecured claims only during CCAA is the carrot for restructuring as an ongoing concern and pension fund deficits becoming crystallized preferred status claims during BIA is the stick to deter debt holders from seeking liquidation.

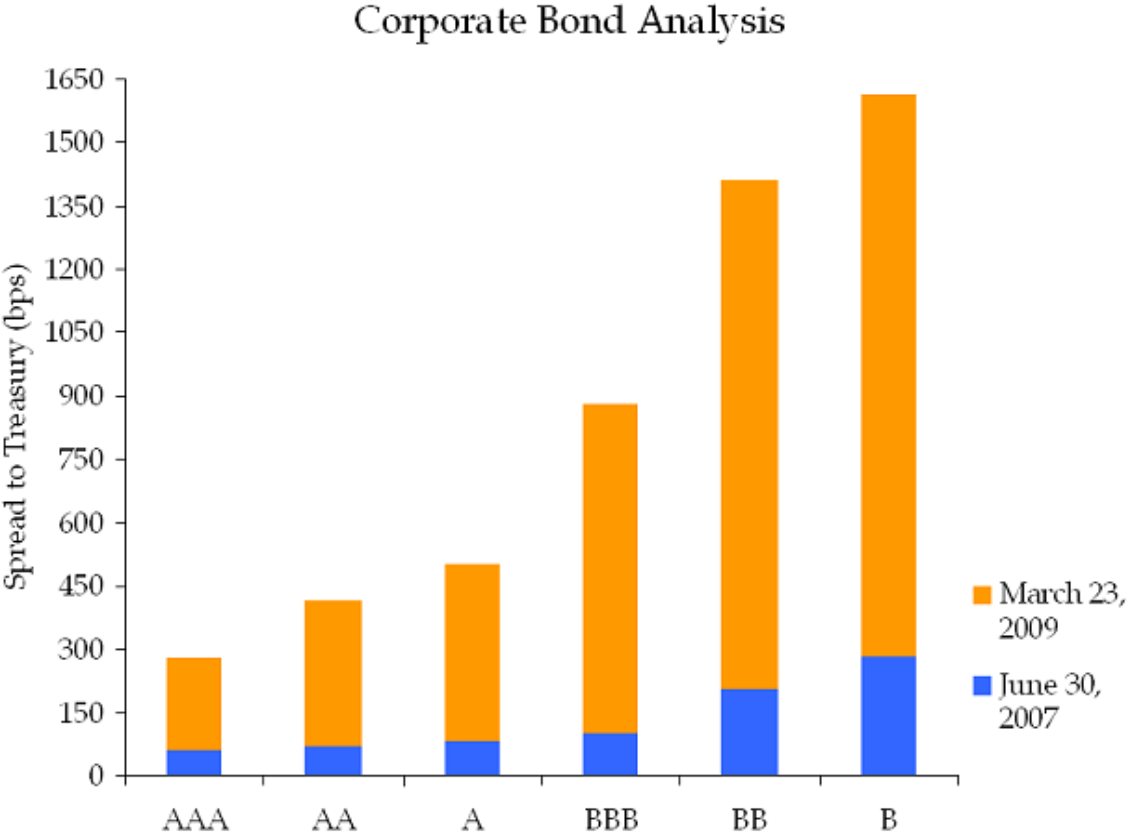
Why Is The Federal Government Concerned About The Cost Of Credit From Preferred Status For Pension Fund Deficits When There Were Undeterred Abuses In The Structured Credit Markets?

My conclusion is that the BIA should be amended to provide preferred status for pension, health and long term disability plan deficits and severance.

- Debt holders getting a cost of debt that is better by less than 0.05% to 0.26% annually is not worth more than Canadian pensioners, disabled former employees and terminated employees having income to live. This cost of debt is not enough to override the pension benefit and severance standards otherwise available in primarily Provincial laws.

- The nominal additional cost of capital must be measured against the benefits to corporations from having defined benefit pension plans and paying severance, which are lower employee turnover and higher employee productivity.
- The nominal additional cost of capital must also be measured against the benefits to governments from lower taxpayer spending on welfare, pension guaranty insurance and unemployment insurance programs, when debtors bear the burden of pension, health and long term disability plan deficits and severance.
- The countries that have already moved to preferred status for pension deficits and severance for their citizens in times of crisis have not seen large increases in the cost of debt for bond holders as a whole.
- It is almost a farce in the context of today's financial crisis to argue that there can be no preferred status for pension, health and long term disability plan deficits and severance in bankruptcies, when the estimated increase in the cost of credit ranges from less than 0.05% to 0.26% annually. Investment banks and debt players throughout Canada and the world were designers, distributors and/or buyers of toxic structured credit products that caused the financial crisis, where the cost of debt measured by increased credit default risk premiums rose 2.50% to 13.50% for the market as a whole, shown in Table 3 below.

Table 3: Recent Experience with Default Risk Premiums in the 2007 to 2009 Financial Crisis There has



There is already agreement in principle to consider the requested amendment amongst all the Federal Political Parties, since there was unanimous consent in the House of Commons on June 16, 2009 for the motion presented by Mr. Marston (Hamilton East—Stoney Creek), seconded by Mr. Mulcair (Outremont),— That, in the opinion of the House, in light of the legitimate concerns of Canadians that pensions and their retirement security may not be there for them in their retirement years, the Government of Canada should begin to work with the provinces and territories to ensure the sustainability of Canadians' retirement incomes by bringing forward for review by the Federal-Provincial-Territorial Research Working Group at the earliest opportunity, measures such as: (c) ensuring that workers' pension funds go to the front of the line of creditors in the event of bankruptcy proceedings;

Nortel's liquidation has been facilitated by the Federal Crown Corporation, Export Development Canada (EDC), withdrawing its previous US\$750 million line of credit to Nortel on January 15, 2009 and then lending US\$ 300 million to Nokia Siemens Networks for its planned purchase of Nortel's core wireless equipment business. Whether one agrees or disagrees with EDC's actions based on its assessment that Nortel was not commercially viable, the Federal Government has no assurance to my knowledge that Nokia Siemens will keep R & D jobs in Canada and it should not be walking away from the collateral damage that these EDC decisions and Nortel's liquidation are having on the legacy 19,000 Nortel pensioners, disabled and terminated employees. The Federal Government should adopt the measures sought by the Nortel pensioners, disabled and terminated employees because it is equitable to do so for Nortel and all Canadians in similar circumstances in the future, can be done without retroactivity while Nortel is in CCAA, and has only a very nominal impact on the cost and availability of credit for the market as a whole.

Sincerely,

Diane Urquhart

CC: Honourable Tony Clement, Minister of Industry
Honourable James Flaherty, Minister of Finance