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At Day's End, Nortel Bankruptcy Judges Land on What is Fair and Reasonable

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The courts in Ontario and Delaware have decided who is to be paid what from the more than $7.1 billion available to meet creditors' claims in the Nortel Networks insolvency, closing the 120-year-old book on Canada's first global research, development and technology enterprise.

Nortel filed for bankruptcy protection in January, 2009. The proceedings involved thousands of hours of detailed argument.

Ultimately, however, the courts ignored the representations of the various stakeholders, including arguments of legal ownership, equitable contribution, application of the Master Research and Development Agreement (MRDA) and contribution of intellectual property, to make what they considered to be a fair and just order in the circumstances.

The order, issued on May 12, 2015, addressed the allocation of the proceeds of the sale of all of Nortel's assets (most significantly, its intellectual property) and was placed in a notional "Lockbox" awaiting court order regarding distribution and allocation.

The claimants in the Nortel insolvency were divided as follows:

1. The Nortel Group - These were the parent corporation, Nortel Corporation, and the related and subsidiary corporations of the parent, including its U.S. subsidiaries and European subsidiaries.

2. Bond Holders - These bonds were issued by the Canadian Nortel Corp. and guaranteed by the U.S. subsidiaries.

3. The employees and retirees of Nortel Corp.

The dispute was not as to priority, but rather as about allocation of the proceeds in the Lockbox. The Nortel Group argued that, since it owned the assets that were sold, it was entitled to the majority of the funds distributed. There was in-fighting amongst the Nortel Group.

The U.S. subsidiary indicated that it had advanced the greatest amount of cash and so was entitled, by way of beneficial interest, to the greatest amount of fees to be distributed to the Nortel Group.

Nortel Corp. in Canada simply argued that it was the owner of all the assets which were distributed and hence was entitled to the majority of the distribution.

The European divisions of Nortel indicated that they contributed significant research and development which provided the most substantial value to the assets that were sold.

The bond holders indicated that their rights to receive payment derived from the entitlement of Nortel Corp., which bonds were, in fact, guaranteed by the U.S. subsidiary. In effect, their claims were derivative of Nortel Corp. and they felt that they would be entitled to the same distribution as Nortel.

The claimants and retirees indicated that since all creditors were unsecured, they needed to be treated the same in respect of the monies in the pot, and that their claims should rank proportionately with those of the bond holders and the Nortel Group.

The most substantial portion of the proceeds received from the sale of assets came from the intellectual property (IP) of Nortel Corporation. The employees argued that since they were the inventors of much of this IP, it would be inequitable and unjust not to be able to share in the distribution of these proceeds simply because the patents were registered in the name of Nortel Networks Corporation.

In that regard, the employees sought a portion of the proceeds under the doctrine of unjust enrichment.

Mr. Justice Frank J.C. Newbould of the Ontario Superior Court of Justice agreed that Nortel Networks would be unjustly enriched by receiving all the proceeds of the sale of the Nortel IP, at the expense of the creator/inventor employees who contributed to the creation of the IP, simply because the patents were registered in Nortel Network’s name.

The Master Research and Development Agreement (MRDA)

Research and development was the primary driver of Nortel’s value and profit. The residual profits of Nortel emerged only after fixed rate-of-return payments were made to all the various Nortel subsidiaries who contributed to the research and development under the MRDA in accordance with a residual profit-split method based on each entity’s expenditure on research and development relative to the research and development expenditure of all associated companies.

Nortel Corp. argued that the MRDA should be the template for the distribution of the proceeds.

The court reviewed exhaustively all of the provisions of the MRDA. The court further engaged in an analysis of Canadian contract law dealing with the factual matrix surrounding the making of a contract. The court also considered the purpose for which the MRDA was created, which was simply a method of splitting profits or losses on a tax efficient basis while Nortel operated as a going concern. The court considered that the agreement was intended to apply only to Nortel while it operated and not to deal with rights after Nortel and its subsidiaries stopped operating its business. Hence, the MRDA was disregarded by the court as the allocation mechanism.

The Jurisdiction of the Court Under the *Companies Creditors Arrangement Act (CCAA)*

Mr. Justice Newbould addressed the principles that should be applied to determine the allocation of the proceeds. He pointed out that a court has wide powers in a *CCAA* proceeding to do what is just in the circumstances. Section 11.1 provides that a court may make any order it considers appropriate in the circumstances, and thereafter, Mr. Justice Newbould relied extensively on the decision of *Century Services Inc. v. Cannon (Attorney General)* 2010 SCC ("***Century***") and concluded after reviewing the case that,

"The court has a broad, inherent jurisdiction to make orders as required to fill in gaps or lacunae not covered by specific provisions in the *CCAA*. As a court of general jurisdiction, the Superior Court of Justice has all the powers that are necessary to justice between the parties. Except where provided specifically to the contrary, the court's jurisdiction is unlimited and unrestricted in substantive civil matters".

"Given what the courts said in *Century* at paras 57 and 61, that the *CCAA* is skeletal in nature and does not contain a comprehensive code that lays out all that is permitted, that the incremental exercise with judicial discretion with respect to the *CCAA* has been adopted and has evolved to meet contemporary business and social needs and that when large companies encounter difficulty and reorganizations become increasingly complex, *CCAA* courts have been called upon to innovate accordingly".

Mr. Justice Newbould went on to say that it was a fundamental tenet of insolvency law that all debts should be paid *pari passu* (at the same rate) and that all unsecured creditors should receive equal treatment. He thereafter directed a *pro rata* (proportional) allocation as amongst all the creditors.

Substantive Consolidation

In order to achieve *pro rata* allocation, the court dealt with the argument that to do so would constitute substantive consolidation (in which the various Nortel companies, taken together, would be regarded as one big business). The U.S. Nortel claimants argued that this is impermissible under Canadian law. The court did not agree with this assertion, indicating that the funds realized from the sale of the proceeds that were in "the Lockbox" which was held on behalf of 38 Nortel debtor entities. This did not constitute substantive consolidation.

Thereafter, the court went on to state in obiter (opinion that does not constitute precedent) that substantive consolidation as a concept can be the subject matter of orders in both a bankruptcy proceeding and a *CCAA*. The court has the jurisdiction to do so on the basis of equitable jurisdiction. Mr. Justice Newbould relied on the decision of Mr. Justice Trainor in the case of *Re Northland Properties Ltd.* 69 CBR 266 and stated that by consolidating various estates, the court recognizes that certain creditors may be prejudiced as a result of same, with the main question being as to whether creditors will suffer greater prejudice in the absence of consolidation than the debtors will suffer from its imposition.

Mr. Justice Newbould adopted the seven factors in respect of substantive consolidation as follows:

1. Difficulty segregating assets.
2. Presence of consolidated financial statements.
3. Profitability of consolidation at a single location.
4. Comingling of assets and business functions.
5. Unity of interest and ownership.
6. Existence of inter-corporate loan guarantees.
7. Transfer of assets without observance of corporate formalities.

Conclusion

At the end of the day, the court ignored the arguments from the various stakeholders, including arguments of legal ownership, equitable contribution, application of the MRDA and the contribution of intellectual property to make what the court considered to be a fair and just order in the circumstances.

A complex and sophisticated series of legal arguments, long and complex facts and teams of lawyers ultimately led the court to the conclusion to do what was fair and just -- to divide the money amongst all the stakeholders on a pro rata basis.

Credit should be given to the time and energy spent by both our Canadian courts and the courts in the U.S. in sifting through all these issues and coming up with what they considered to be the right and fair thing to do.