

LESSONS FROM NORTEL: WHAT DO THE RECENT ALLOCATION DECISIONS MEAN?

Around 33,000 UK-based pensioners of the Nortel group look set to receive a greater share of the group's \$7bn worldwide assets, following a joint allocation hearing in the US and Canadian courts. This should mitigate earlier difficulties encountered in trying to use the Pensions Regulator's anti-avoidance powers to recover monies from non-UK companies. The decision may also have wider implications for unsecured lenders to a company which is part of a multi-jurisdictional group headquartered in the US or Canada.

WHAT WAS THE BACKGROUND TO THIS?

In January 2009 Nortel Networks Corporation and various subsidiaries across Canada, the US and a number of EMEA jurisdictions were placed into insolvency procedures in, respectively, Canada, the US and England. At this time the Nortel Networks UK Pension Plan (the NNUK Plan) had an estimated funding deficit on the solvency basis of over £2bn.

WHAT ACTIONS DID THE PENSIONS REGULATOR INITIALLY TAKE?

The Pensions Regulator's Determinations Panel found that Nortel Networks UK Limited, the sponsoring employer of the NNUK Plan, was insufficiently resourced and that it was reasonable to impose a Financial Support Direction (FSD) against 25 other companies in the group. A key factor here was its finding that the financial affairs of the worldwide Nortel group were inextricably linked.

The US and Canadian courts held, however, that the FSD process breached stays on legal proceedings which were in place due to the insolvency procedures in those jurisdictions. This led to a settlement of the FSD claims against the US parties, whilst the status in Canada remains uncertain.

WHAT GAVE RISE TO THE ALLOCATION HEARINGS?

Following the events of early 2009, the insolvency office-holders in the different jurisdictions had worked together to sell Nortel's worldwide business assets and intellectual property. However, the office-holders had been unable to agree how to allocate the sale proceeds amongst the group entities despite extensive negotiations and two formal mediations. As a result, \$7.3bn of recoveries remained in an escrow account.

The US and Canadian courts were therefore asked to decide how these sale proceeds should be allocated. In an unusual move, they held a joint trial with evidence submitted by video link and prepared their judgments independently but co-operatively.

WHAT DID THE PARTIES ARGUE?

The US, Canadian and EMEA entities respectively argued that sale proceeds should be allocated by reference to:

- ◆ the relative revenues generated by each entity;
- ◆ the legal ownership of the assets sold; and
- ◆ the relative contributions of the entities to creating the value of the assets sold.

The trustees of the NNUK Plan and the Pension Protection Fund (PPF) argued for an allocation which would allow a pro rata distribution between all group creditors.

WHAT DID THE COURTS DECIDE?

The courts found the allocation arguments put forward by Nortel entities in the US, Canada and the EMEA to be self-serving, irrational and unhelpful. In an echo of the Determinations Panel's finding, they found that there was overwhelming evidence in support of Nortel having been operated as "an integrated, global whole, for the benefit of all of Nortel." Although a master R&D agreement had eventually been put in place which assigned the majority of the IP generated to a Canadian company, this was tax driven and did not seek to govern how group entities should allocate their assets in the event of a group-wide insolvency.

The courts held that a pro rata allocation of the sale proceeds would yield the most acceptable and equitable result. Each Nortel entity will therefore be allocated a pro rata share of the sale proceeds based on the proportion that the allowable claims against that entity bears to the total allowable claims against all Nortel entities.

The courts stressed that this did not constitute a global substantive consolidation. Separate legal entities will not be treated as if they and their assets have been merged into a single entity which is responsible for all external liabilities and where intra-group claims have been cancelled out. Instead, each entity's rights to cash in hand and intra-group claims, settlements and guarantees will continue to be recognised. Each entity will still be required to distribute the funds allocated to it in accordance with its own insolvency procedure and with local insolvency laws.

WHAT ARE THE IMPLICATIONS OF THESE DECISIONS?

This is a victory for Nortel's pensioners (both in the UK and Canada) who should now receive a distribution of up to 71 per cent of their claims. The decision to adopt a pro rata allocation method means that the UK employer will receive its share of funds directly. Whilst the FSDs might have led to a greater recovery still, there have in practice been legal obstacles to enforcing those FSDs. The allocation decisions mean that the employer will no longer need to rely upon the FSDs to enable it to claim funds from better-resourced companies elsewhere within the group.

This is also a victory for the PPF as it effectively means a reduced funding strain on the PPF when compared to the alternative allocation methods.

The decisions are relevant more generally to any lender considering making unsecured advances to a local entity that is part of a multinational enterprise headquartered in North America. It is clear that the US and Canadian courts will, in appropriate circumstances, disregard the geographical structuring of that enterprise in order to achieve equity among creditors. Such potential lenders will now be advised to seek information about both the group's organisation of its business globally and any significant creditors such as pension schemes elsewhere within the group.

The decisions do, however, leave it open for the legal entities that constitute the multinational enterprise to agree in advance on how the individual entities would allocate their assets in the event of an enterprise-wide insolvency.

The decisions of the US and Canadian courts may be appealed.

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