CORPORATE COUNSEL

IP Insider: Nortel's Catastrophic Success

After $2 billion in bankruptcy fees, Nortel approaches a dubious record.

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Five years ago, Nortel was the pride of the bankruptcy bar because its IP auction surpassed expectations many times over. Unfortunately, that success led to litigation fees that surpassed expectations many times over. Barring settlement, Nortel will soon eclipse Lehman Brothers as history's costliest bankruptcy, with over $2 billion in professional fees siphoned off of assets that are a fraction of Lehman's.

Judge Frank Newbould of Ontario lamented that "Nortel's early success in maximizing the value of its global assets through cooperation has disintegrated into value-eroding … territorial litigation." Canadian pensioners in wolf suits protested outside a mediation session in New York last fall, wearing sandwich boards that read: "Lawyers: Stop wolfing down Nortel pensions. Settle now!"

Back in 2011, the smartphone wars ignited a bidding contest that ended with a group led by Apple and Microsoft buying Nortel's patent portfolio for $4.5 billion, or five times Google's opening bid. Other asset sales brought the total in Nortel's lockbox to $7.3 billion.

But how to divvy up the proceeds? A fee spiral began when the three Nortel debtors opted for litigation and failed mediation instead of binding arbitration without appeal. In the spring of 2014, a simultaneous trial was held by video link before the bankruptcy courts in Delaware and Ontario.

In a nutshell, the Canadian debtor claimed over 80 percent of the proceeds as the patents' legal owner. The U.S. debtor claimed over 70 percent of the proceeds as the patents' beneficial owner. The European debtor demanded an outsize share because it drove R&D.

U.S. bankruptcy judge Kevin Gross called the Canadian debtors "nothing short of narcissistic." He likened the case to "three people trying to reach the top of a mountain by pulling the others down. … No one gets to the top."

The way forward was charted by Willkie, Farr & Gallagher on behalf of the U.K. pensioners, with similar arguments made in the alternative by DLA Piper for the Canadian pensioners. Drawing on equitable principles, the 50,000-plus Canadian and British employees argued that the lockbox assets should be allocated more or less "pro rata," in proportion to the claims made on each debtor. A pure pro rata approach would allow all creditors to recover 71 cents on the dollar.

Judges Gross and Newbould, in their rulings of May 2015, embraced a "modified pro rata" theory, with three especially large modifications. First, the courts didn't pool more than $1 billion in cash securities still on hand with the various debtors. Second, the courts left in place the U.S. debtor's guarantee of nearly $4 billion in bonds issued by the Canadian debtor. Third, the court honored over $2.5 billion in debts owed by one Nortel subsidiary to another. The net result, estimates the Canadian analyst Diane Urquhart, is that

U.S. claims will recover closer to 85 cents on the dollar, Canadian claims closer to 45 cents and U.K. claims closer to 65 cents.

Urquhart, who represents Nortel's disabled Canadian employees pro bono, would prefer to see courts embrace an outright "substantive consolidation"—pooling all of a corporate family's assets and liabilities—in a cross-border insolvency. But a "sub con," as it is called, is anathema to bondholders, and not easy to justify under the case law. Some practitioners see "modified pro rata" as a way to soften substantive consolidation—a novel and attractive compromise likelier to sway the bankruptcy judge and withstand appeal. Jay Westbrook, of the University of Texas School of Law, hails the result as "more universalist than not." In their appeals, the debtors attack it as "sub con" on the sly.

This May, the case lurched forward. Ontario's intermediate court denied leave to appeal. The District Court of Delaware belatedly certified a direct appeal to the U.S. Court of Appeals for the Third Circuit. It still remains for Canada's Supreme Court to deny leave to appeal, and for the Third Circuit to accept the direct appeal. Ideally, Canada will stay hands-off, the Third Circuit will affirm within a year, and the U.S. Supreme Court will shy away from such a fact-intensive case.

If, however, the Third Circuit flips, protracted chaos will ensue. The problem is that the appellate courts have no protocol for cooperation. So a U.S. reversal would leave the Canadian ruling in place, with no way to reconcile the results. The very horror of this scenario—after $2 billion in fees—makes affirmance a good bet. As one lawyer predicts: "The Third Circuit will be reluctant to disturb the symmetry of the two decisions because if they do, we go back to square one."

Beset by wolfish picketers, the parties have been locked in an intensive mediation since the fall. The plummeting of the British pound after the Brexit vote provides a golden window of opportunity for compromise, because it affords a premium of hundreds of millions of dollars to U.K. creditors.

And if the case does not settle soon, it is virtually certain to surpass Lehman's dubious record.

As of the last public disclosures early this year, the Nortel estate had paid $1.89 billion in professional fees, including more than $500 million to Ernst & Young as Canadian monitor and U.K. administrator; $316 million to Cleary Gottlieb Steen & Hamilton as U.S. debtor's counsel; and $205 million to Herbert Smith Freehills as counsel to the U.K. administrator. According to the UCLA-LoPucki Bankruptcy Research Database, which aggregates large cases completed through 2007, a bankruptcy of Nortel's size would be predicted to cost only about one-third as much (without regard to its length).

The closest comparison is Lehman's bankruptcy of the following year. The last widely reported figure for Lehman fees was $2.2 billion in September 2013 (well after Chapter 11 plan confirmation). But as a proportion of cash available for distribution, Nortel is already an order of magnitude costlier. The Lehman estate paid professionals $2.2 billion (2 percent) of its $93 billion in assets, and took three-and-a-half years to emerge from court protection. The Nortel estate has already paid professionals $1.89 billion (18 percent) of its $10.5 billion in assets. It's been under court protection seven-and-a-half years and counting.

Urquhart calculates that Nortel's fees will set the new record in April 2017, absent a settlement.

But there's another, even more obscene, cost. By May 2015, Judge Newbould counted 6,800 Canadian pensioners who had died before the bankruptcy could be resolved.

Despite the estate's fine work in maximizing its IP assets and coordinating a cross-border trial, and despite the judges' embrace of a novel and equitable legal theory, Urquhart says the money for professionals was poorly spent. "It's unconscionable," she says. "Vulnerable people who have a few years left to live deserve to live in dignity without the professionals taking 20 percent."

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