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Is Nortel Going into Liquidation or Restructuring as an Ongoing Concern?

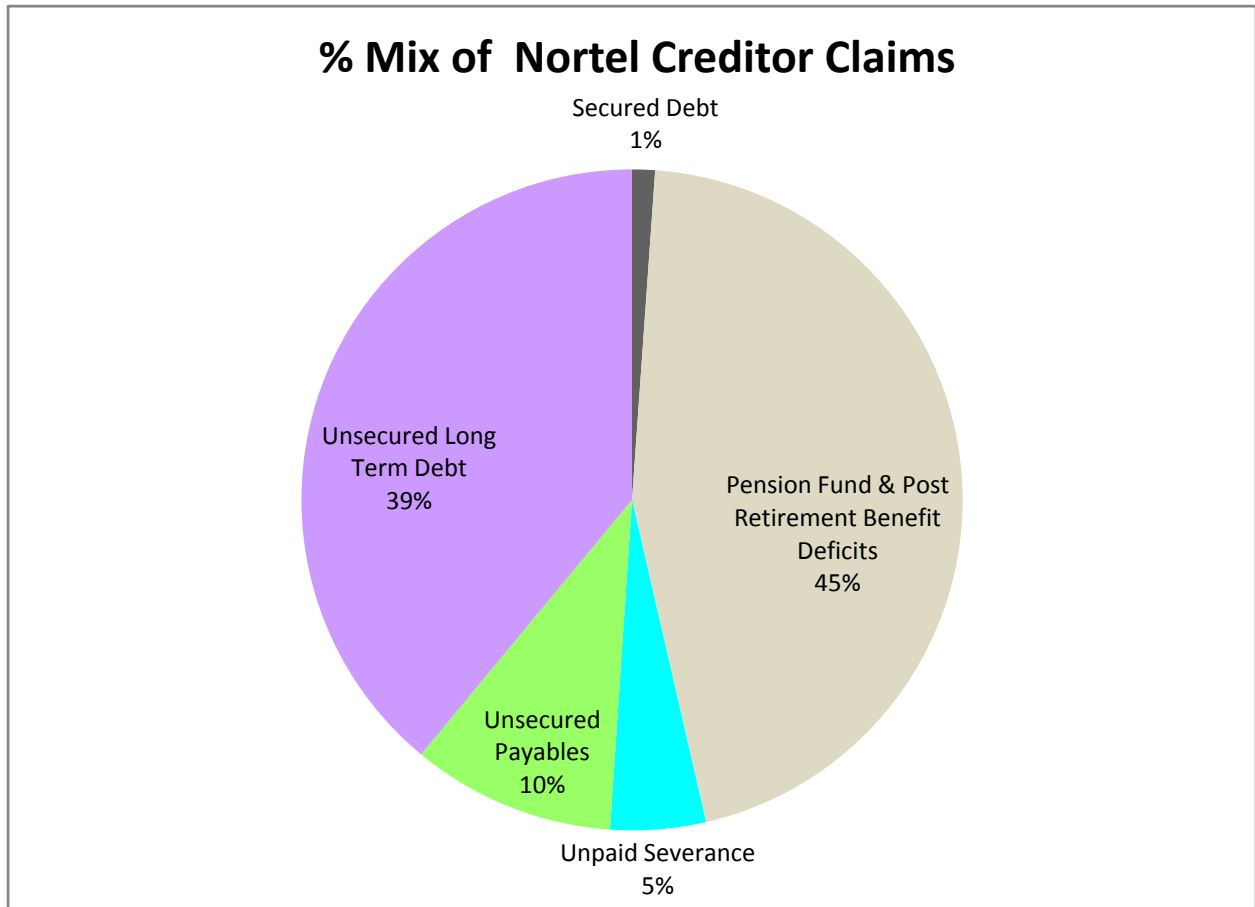
Nortel has a one hundred and fourteen year history as a Canadian based technology company. Its Canadian head office and Canadian research and development activities spawned a successful international business in the high growth telecommunications industry. However, in recent years, Nortel was operating at a cost structure above what its revenues could support and it was burning cash at the rate of US\$1 billion annually. The financial crisis and its consequent global recession is causing a large drop in telecommunications equipment sales throughout the world, with Nortel's revenues declining more than its peers in the industry. Nortel chose to enter bankruptcy protection in January 2009, by missing a US\$107 million interest payment, despite having US\$2.5 billion of cash on its balance sheet. Nortel's next major principal repayment on debt was not due until 2011, when US\$1 billion of debt has to be repaid or refinanced.

Nortel management volunteered to enter bankruptcy protection in order to avoid paying estimated severance of US\$500 million to cut 5000 jobs, or 17% of its workforce. Since current CCAA and BIA laws do not give super priority to severance, management likely perceived that not paying the severance would lengthen the time period it could operate before exhausting its US\$2.5 billion of cash. Management also likely perceived that it would be easier to get its bond holders to accept a lower face amount of debt, if it was seen to be preserving value for the bondholders by not paying severance. Management benefited from not paying severance by saving cash to pay themselves executive bonuses for completing the restructuring plan. As long as Nortel's plan is to restructure as an ongoing concern, the pension and post retirement benefits deficits would not likely be payable. The time period for Special Contributions to eliminate the pension deficit under Provincial pension benefit legislation would likely be extended to 10 years from the mandatory 5 years to assist in the company's turnaround.

Nortel does meet the technical definition of being bankrupt in terms of net assets being less than total creditor claims of estimated US \$11 billion, (including estimated total employment-related claims of US \$5 billion, well in excess of the amounts recorded on the balance sheet for December 31, 2008 based on updated actuarial reports for the defined benefit pension plans.) The situation is one of how the deficient net assets will get allocated: employment-related claims ranking equal to the unsecured creditors according to current bankruptcy legislation; employment-related claims being granted super priority above all other creditor claims; or employment-related claims being granted preferred priority above the unsecured creditor claims, but below the secured creditor claims.

Nortel directors and management do not appear to be working vigorously for Nortel to remain an ongoing concern. It would be interesting to know whether management and the large debt holders had planned all along to sell the businesses of Nortel and to disperse the cash proceeds to the debt holders and large suppliers, while avoiding the full payment of the pension fund and post retirement benefit deficits and severance. Figure 1 shows that there is much to be gained by walking away from pension fund and post retirement benefit deficits and severance and transferring the burden of them onto public pension guarantee insurance and employment insurance plans. Nortel's estimated pension fund & post retirement benefit deficits are 45% and unpaid severance is 5% of total unsecured creditor claims. The employment-related claims are 50% compared to the bond debt and unsecured supplier payables of 50% combined. By hoisting pensioners and severed employees onto the Ontario, U.S. and U.K. Pension Guaranty Insurance Plans and the Federal Employment Insurance Funds, the Nortel debt holders gets a substantial increase in the net assets available to them over what they would get if the severance and pension and health benefits deficits were paid in full.

Figure 1: % Mix of Nortel Creditors



How will Nortel's Liquidation Affect Canadian Research and Development?

Nortel's liquidation is expected to take place at fire sale prices. Canadian based intellectual properties, that are strategically significant to Canadian economic development and R & D jobs, will likely become controlled outside of Canada. Nortel has historically been Canada's No. 1 corporate spender on R & D in Canada. Nortel's Canadian R & D spending is running at about CDN\$800 million now down from a high of CDN\$2,800 million in the year 2000 tech boom. Canada provides 48% of Nortel's global R & D spending.

Canada's overall R & D spending as a % of GDP is at only 1.9% in 2007. Nortel's bankruptcy and the potential loss of its R & D activities within Canada will drive Canada's R & D spending well below Japan at 3.4%, the U.S. at 2.6% and Germany at 2.5%. This loss will not be replaced for decades. Canada's graduates in engineering, mathematics and sciences will have fewer Canadian job opportunities and need to move to other countries to pursue their career goals.

Federal Government Cannot Blame the Provinces for Not Protecting Terminated Employees and Pensioners

Nortel is setting a precedent amongst Canadian companies for not paying Canadian severance and pension and health benefits deficits, despite having US\$2.5 billion of cash and additional billions of dollars of possible sale proceeds for Nortel's businesses, intellectual properties and premises.

Nortel says it cannot afford to pay severance when Nortel is paying US\$45 million in KEIP and KERP bonuses tied to the company cutting costs and getting out of CCAA. Nortel paid regular employees bonuses in 2009Q1 that are estimated to be an annualized amount of CDN\$68 million based on an average 15% of the payroll for about 5000 continuing Canadian employees. This compares to estimated severance owed of about CDN\$125 million to an expected 1,100 terminated Canadian employees. The lack of compromise by the executives and the continuing employees versus what is being imposed on terminated employees and retirees is just plain unfair and wrong.

The Nortel Canadian defined benefit pension plans have a wind-up deficit of -31% or an estimated -CDN\$1,250 million based on a Mercers' updated actuarial report for the period ending December 31, 2008 released in May 2009. The Nortel unfunded Canadian post employment and retirement health and other benefits have an estimated liability of another -CDN\$200 million.

It is erroneous to say that the Federal Government should be reluctant to intervene in the Provincial jurisdiction for severance and pension benefits, because the Federal Government Companies' Creditors Arrangement Act (CCAA) and Bankruptcy and Insolvency Act (BIA) effectively throw Provincial pension benefit and severance standards out the window by the apparent intent of the Federal Government to do so.

The CCAA and BIA are silent on both severance and pension fund deficits, except for the recent and somewhat meaningless amendment that gives super-priority to only \$3000 of unpaid severance. The CCAA and BIA treat unpaid severance and cuts in pension benefits as claims equivalent to the unsecured creditors.

In October 2006, the Court of Appeal for Ontario confirmed the decision of Justice Farley in Ivaco Inc. versus the Superintendent of Financial Services of Ontario that the Federal CCAA is paramount to Provincial pension benefit laws. The silence of CCAA on pension fund deficits gives the CCAA judge the authority to set aside the applicable provincial law on Special Contributions in deemed trusts to make up for pension fund deficits. Provincial laws strive to provide preferential status for these Special Contributions, but the CCAA judge can ignore them when he decides that the payment of these Special Contributions negatively affect the company's ability to be an ongoing concern. No judge would risk the possibility that his decisions would cause the CCAA restructuring to fail. In addition, where the CCAA judge determines he is likely to lift the CCAA stay because the company is liquidating, he is free to take the position that the Provincial laws governing pension benefits should not be applied within the CCAA process, because they are not applied in the BIA under whose terms the liquidation will occur.

Ultimately, Ivaco was unable to restructure and virtually all of its assets were sold, generating a pool of funds for distribution to creditors. It was out of these proceeds that the Superintendent sought to recover the unpaid Special Contributions, on the basis of the deemed trust and lien provisions of the provincial Pension Benefits Act. Justice Farley denied the super priority status of the Special Contributions under CCAA and so they entered BIA on the same basis as unsecured creditor claims.

The Federal Government is responsible for the Companies Creditors' Arrangement Act and Bankruptcy and Insolvency Act, which is nullifying the severance and pension benefit standards in Provincial Legislation. Provincial legislation protects pension benefits and severance due to their equitable nature applicable to individuals who are not large debt holders and suppliers to corporations, who are in the business of taking risks, are diversified and have income tax deductions for their losses.

But the CCAA and BIA ignore these equitable principles applicable to terminated employees and pensioners under Provincial legislation and these federal acts actually facilitate the large foreign debt holders of Nortel to get a higher disbursement of net assets, by hoisting Nortel's moral and equitable obligations for severance and pension deficit obligations onto Canadian taxpayers.

An emergency amendment of the BIA to give super priority status to severance and pension deficits, over the bondholders and unsecured suppliers will protect Canadian terminated employees and pensioners. This emergency amendment will also cause the debt holders to prefer a restructuring plan that has Nortel be an ongoing concern rather than be liquidated.

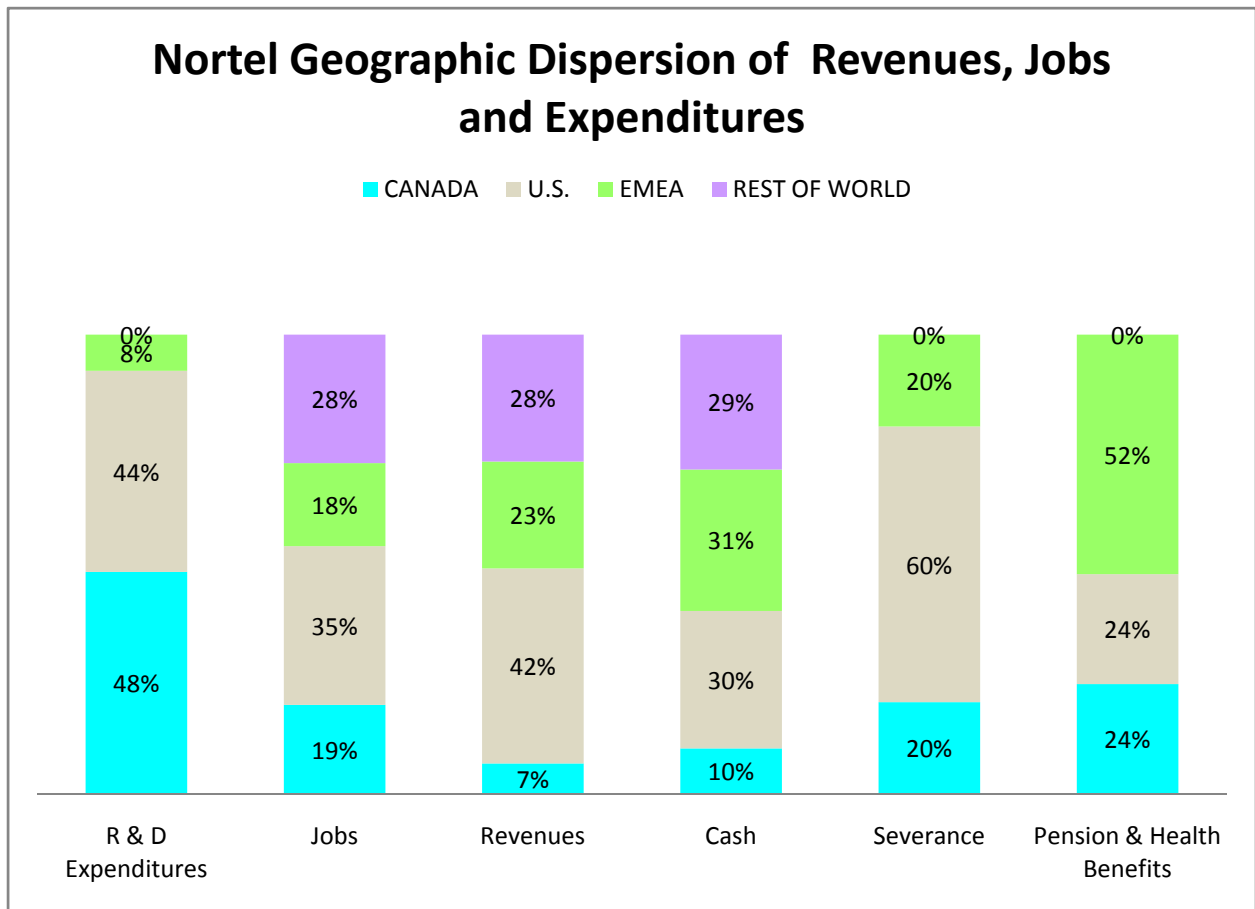
The Federal Government is also administrator of the Investment Canada Act that has powers to set conditions on the sale of Nortel businesses to foreign buyers. The conditions could require that the buyers continue Canadian R & D expenditures and jobs. They could require that a significant portion of the sale proceeds be allocated to the severed employees and pensioners. Similarly, if the Federal Government decides to buy the Ottawa Carling Facilities of Nortel, it should require that the proceeds of its purchase be allocated to the severed employees and pensioners.

Nortel Foreign Debt Holders and Unsecured Suppliers are Squeezing Canadian Operations

Nortel's large foreign debt holders and unsecured suppliers are squeezing Nortel's Canadian home base, and will likely cause the Canadian pensioners and terminated employees to get only a nominal cash settlement for their claims of say only \$0.10 on the dollar, unless there is Ontario and Federal Government intervention to assure that Canada is allocated a higher percentage of the cash currently on the balance sheet and of the expected cash proceeds from the sale of Nortel businesses, intellectual properties and premises.

The concerns about the allocation of cash for Canadian pensioners and severance payment arises since: Canada is a cost center for research and development and head office activities, with Figure 2 showing that Canada represents 48% of total R & D expenditures and 19% of total jobs globally; Canadian sales revenues are a small 7 % of total global sales revenues; and we believe that the large debt holders and unsecured suppliers are primarily outside of Canada, with the dominant Canadian creditors being the Canadian pensioners and terminated employees, who are less powerful than the large foreign debt holders and unsecured suppliers.

Figure 2: Nortel Geographic Dispersion of Revenues, Jobs and Expenditures



Of Nortel's \$2.5 billion of cash, only 10% of it is in Canada. Canadian severance and Canadian pension and post retirement benefits are 20% and 24% respectively of the global amounts owed for these types of claims.

The international operations of Nortel pay Transfer Pricing Agreement (TPA) cash payments to Canada on a quarterly basis to pay for its research and development and head office activities. These TPA payments do not currently, and appear not to have historically, adequately funded Canada's research and development and head office functions. The TPA's are inter-corporate agreements at US\$315 million annually at this time, which appear to have been lowered by an undisclosed amount from what they were previously. Canadian operations have a cash burn rate of about negative US\$170 million including the TPA cash payments and US\$485 million if the TPA Payments were to be curtailed. There is non-arms length Debtor in Possession Financing to Canada of US\$200 million from the U.S. based Nortel Networks Inc. that has a priority charge on the Canadian assets (of which US\$80 million has been utilized to date.) This DIP financing lessens the amount of net assets available to pay for the Canadian severance and pension fund deficit, while preserving the cash available in the U. S. for the largely U.S. and foreign debt holders.

Also, the Canadian operations have an estimated compromisable accounts payable to the U.S. based Nortel Networks Inc. of US\$654 million. This large inter-corporate obligation to the U.S. is paid from the net assets of Canada that would otherwise be available for the Canadian severance and pension fund deficit.

Nortel's decision to file for CCAA bankruptcy protection and to not pay an estimated CND\$125 million of severance to about 1,100 Canadian employees is offloading the cost of the mass lay off of Canadian employees onto the Employment Insurance Fund. The total cost to the Federal Government is estimated to be CND\$44M, of which CND\$20M is in EI claims and CND\$24M in lost tax revenue.

If Nortel liquidates as now expected then the Canadian pension fund deficit is offloaded in part onto the Ontario Pension Guarantee Fund. The OPGF pays for the pension fund deficit % applicable to the first CND\$1000 of monthly pension benefit, creating a minimal pension guarantee of CND\$12,000 per annum.

The Canada Revenue Agency Could Help to Increase Canadian Net Assets Available

There is US\$2.1 billion of unutilized Canadian prior period income tax losses and investment tax credits that may be lost upon Nortel's liquidation. The tradable market value of these tax benefits would be about US\$1.3 billion if Canada Revenue Agency would be willing to negotiate their use by an acquirer who is not in a similar business but would make commitments to create research and development expenditures and jobs in Canada.

Steps the Federal Government Should Take

- (1) Emergency amendment of BIA to give super-priority to unpaid severance and pension fund deficits in liquidations. Make comparable changes to CCAA.
- (2) Industry Canada to make conditions under Investment Canada Act for part of sale proceeds to foreign buyers of Nortel businesses be used to pay severance and pension fund deficit.
- (3) If Federal Government purchases Nortel's Ottawa facilities, then do so on condition for sale proceeds to fund unpaid severance and pension fund deficit.
- (4) Canada Revenue Agency to negotiate the use by acquirers of Nortel's unutilized prior period income tax losses and investment tax credits in exchange for research and development and job commitments.
- (5) If the Federal Government is unable to use its variety of powers to force Nortel to pay severance and fund the pension fund deficit, then the Ontario Government and Federal Government should contribute to a fund for Nortel's severance and pension fund deficits because it did so for the auto industry and it provided support funding for the Canadian banking and insurance industries. Nortel is equally if not more deserving as it is in the high growth research and development oriented telecommunications industry.