

**Case:** Re Nortel Networks Inc et Al (US Court of Appeals for the Third Circuit, No 11-1895)

**Synopsis:** The United States Court of Appeals for the Third Circuit (the “Court”) affirmed the decision of two lower courts to enforce the automatic stay against the Trustee of Nortel Networks UK Pension Plan (the “Trustee”) and the UK Board of the Pension Protection Fund (“PPF”) with respect to their participation in UK pension proceedings that could ultimately determine whether Financial Support Directions (FSDs) should be issued against Nortel Networks, Inc. and NN Caribbean and Latin American and others (together, the “US Debtors”) in respect of claims by the PPF and the Trustee for the £2.1bn shortfall in its defined benefit scheme.

**Topics covered:** Pensions deficit; Financial Support Directions; Chapter 11; Automatic Stay

## Background to the case

In 2008 the UK Pensions Regulator (‘TPR’) concluded that Nortel Networks UK Limited, the principal employer under the Nortel Networks UK Pension Plan, was insufficiently resourced to meet its pensions obligations and that grounds existed to start proceedings under the Pensions Act 2004 to recover the deficit (in the order of in excess of £2 billion) from Nortel Networks UK Limited (‘NNUK’) and its associates, under the moral hazard provisions of the Pensions Act 2004. Early in 2009 different parts of the Nortel group simultaneously initiated local insolvency filings, in the case of US Debtors, for US chapter 11, and in the case of European entities, including NNUK, for UK administration. In 2009 and 2010 TPR, pursuant to the UK statutory procedural requirements, issued warning notices in respect of the potential issue of financial support directions against a number of Nortel entities, including the US Debtors.

The Trustee and PPF filed proofs of claims in the US bankruptcy cases of the US Debtors for contingent and unliquidated amounts, alleging that the US Debtors may be obligated to provide financial support to meet the NNUK pension plan’s funding shortfall, the precise amount of which claims depended upon the outcome of the UK pensions proceedings brought by TPR.

## The Facts of the US case

In February 2010 the US Debtors obtained an order from the US Bankruptcy Court to enforce the automatic stay to prevent the Trustee and the PPF from continuing with their participation in proceedings brought by TPR to determine whether and the extent to which the US Debtors were liable under UK pensions legislation for the pension shortfall. The Trustee and PPF appealed against this order and sought to rely on the ‘police power exception’ to the automatic stay.

By way of brief reminder, the automatic stay comes into effect as soon as US chapter 11 bankruptcy proceedings are filed and means that the commencement or continuation of a

judicial, administrative or other action or proceedings against US debtors in Chapter 11 proceedings to recover a claim is deemed to be void or of no force or effect, unless one of the statutory exceptions applies. If the police power exception did not apply, any participation would be in violation of s362 of the US Bankruptcy Code and may be subject to sanctions, including the imposition of punitive damages. The extra territorial effect of the stay is recognised to apply to those who are subject to the jurisdiction of the US Bankruptcy Court, (in practice where they have assets within the jurisdiction of the US Court). In this case once the PPF and Trustee had filed their claims in the US bankruptcy, they became subject to the provisions of the automatic stay.

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## The Decision

The Third Circuit affirmed the earlier decisions of the Bankruptcy Court and the District Court that the police power exception to the automatic stay did not apply because neither PPF nor the Trustee is a “governmental unit” and the UK pension proceeding is not a “proceeding by a governmental unit.”

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## Comment

The automatic stay bars the Trustee and PPF from participating in the UK pension proceedings to determine liability for shortfalls in Nortel Networks UK pension plan’s funding with respect to the US Debtors. The Trustee and PPF did not challenge the extraterritorial application of the automatic stay. The Court notes in several parts of its ruling that TPR did not file claims against the US Debtors and was not a party in the US bankruptcy case or the appeals of the lower court decisions. It is unclear as to why the TPR did not participate.

The Third Circuit’s ruling may be read as suggesting, that if TPR itself had been a party in the case, it would have qualified as a governmental unit for the purposes of determining the applicability of the police power exception to the UK proceedings (see page 19 of the Opinion of the Court). Having said that, since the UK pension proceedings themselves were considered to fail the preliminary purpose and public policy test, even had the TPR participated, the outcome may not have been any different. The purpose of UK pension proceedings and the function of the TPR was held to be primarily to protect members of occupational and personal pension schemes and to reduce the risk of claims on the PPF. The Court noted that although the police power exception was not available to the Trustee and PPF, they are free to ask the Court for relief from the automatic stay to permit them to participate in the UK pension proceedings with respect to the US Debtors. It is unclear whether the Trustee or the PPF will seek further relief to allow participation in the UK pension proceedings.

The FSDs have been controversial across both sides of the Atlantic in the context of the companies in the Nortel Group. In relation to the group companies that are subject UK administration proceedings the Court of Appeal has held that the FSDs would rank in priority to other creditors, including those with the benefit of floating charge security and also ahead of ordinary unsecured creditors. That case is pending an appeal at the Supreme Court. ([See our bulletin 374](#) for more detail on that case.)

In relation to the US proceedings the standing of the FSD in the context of US Chapter 11 proceedings is now uncertain. The only other US case to have considered this issue, related to the Sea Containers Group (see *In re Sea Containers Ltd* No. 06-11156 (KJC),

2008 WL4296562) which ultimately settled before the cross border aspects fell to be decided. Whilst the PPF and the Trustee in this case gave assurances to the US Court that they were not seeking to enforce the FSDs, but simply wanted to quantify the pension liabilities – it was also suggested that the US Bankruptcy Court was itself capable of quantifying such liabilities under UK law within the context of the Chapter 11 proceedings. The US judge has indicated that the parties should try to resolve matters if they can, without recourse to further litigation. So we shall have to wait and see if there is any further US judicial insight is forthcoming on this important aspect of cross border insolvency law.