TAB 13

How to Advise Your Client When It Is in Financial Difficulty and Operates a Pension Plan for Employees

Fred Myers
Goodmans LLP

The Six-Minute Debtor-Creditor and Insolvency Lawyer 2011

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CONTINUING PROFESSIONAL DEVELOPMENT

How to Advise Your Client When It Is in Financial Difficulty and Operates a Pension Plan for Employees

Fred Myers
Joshua Hurwitz
Jesse Mighton[1]

In April of this year, the Ontario Court of Appeal released *Re Indalex Limited*[2] ("***Indalex***") and, to say the least, this decision generated tidal waves in the Ontario insolvency bar. *Indalex* surprised many insolvency and pension lawyers by recognizing a deemed trust for the *entire* wind-up deficiency of a pension plan and using the device of a remedial constructive trust to give pension plan deficiency claims priority over all other creditors including debtor-in-possession ("**DIP**") lenders in insolvency restructuring proceedings. *Indalex* also contains some troubling and puzzling commentary on the duties of corporate directors who administer defined benefit pension plans. The decision is subject to an application for leave to appeal to the Supreme Court of Canada. A factual overview of this decision is provided as the final section of this article for the benefit of those in search of a more detailed analysis of the litigation proceedings. Rather than dealing with an analysis of the legal issues in the case, the balance of this article will be forward-looking and consider what a debtor's lawyer should do if a debtor is in financial difficulty and operates a defined benefit pension plan.

There are five considerations that serve as a basic checklist for lawyers representing debtor companies in precarious financial situations that have a pension plan for their employees:

1) Is the plan a defined benefit pension plan?

2) If so, has the company paid all of its required contributions under the plan?

3) Does the plan have a going concern or solvency deficiency as identified in the most recent actuarial report?

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[1] The authors are with Goodmans LLP, counsel for Sun Indalex Finance LLC, an unsuccessful respondent in the appeal that is the subject matter of this paper.

[2] 2011 ONCA 265.

4) When is the company's next triennial report due?

5) What steps can directors of companies – who usually administer defined benefit pension plans – take to discharge their fiduciary duties owed to plan beneficiaries? How can directors avoid the liabilities identified and described in *Indalex*?

As a preliminary matter you need to determine if the financially distressed company operates a registered pension plan. Under the Ontario *Pension Benefits Act*[3] (the "***PBA***"), pension plans must be registered with the Financial Services Commission of Ontario.[4] A pension plan can be registered if documentation outlines the plan's design requirements and the conditions for employee's receipt of pension benefits.[5] Once registered, a pension plan receives a provincial registration number.[6]

THE FIVE CONSIDERATIONS

1. IS THE REGISTERED PENSION PLAN A DEFINED BENEFIT PENSION PLAN?

If the debtor operates a registered pension plan, what type of plan is it? A defined benefit plan, a defined contribution plan or a hybrid plan? A hybrid plan contains elements of both a defined benefit and a defined contribution plan.

Defined Benefit Pension Plans

A defined benefit pension plan is a plan whereby retirement benefits are determined by a formula – usually based on years of service and/or earnings. An example of this formula would be a plan where an employee's annual pension benefit equals the employee's average salary in the last 5 years of employment multiplied by a given percentage, multiplied by the employee's years of

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[3] *Pension Benefits Act*, R.S.O. 1990, c. P.8.

[4] *PBA*, *supra* s. 9(1). If a Reciprocal Agreement or regulation exempts the plan from Ontario registration, the plan need not be registered in Ontario.

[5] Ari N. Kaplan, *Pension Law* (Toronto: Irwin Law Inc., 2006) at 125.

[6] *Ibid.* at 127.

service in the plan. In defined benefit plans, the benefit is determined prior to the start of the plan, and exists independent of the pension fund's investment performance. If pension fund investment returns fail to adequately finance the projected defined pension benefits, the deficit must be reconciled by either special contributions while the plan is ongoing or wind-up special payments after the plan has been terminated or wound up.[7]

Defined Contribution Pension Plans

A defined contribution pension plan has no defined formula for pre-determining pension benefits prior to the start of the plan. Unlike a defined benefit plan, the amount of the pension benefit payable is not guaranteed or defined in a defined contribution plan. Rather, the pension benefit payable is the amount that has been generated by employee and employer contributions as at the time of transfer, termination, or retirement. In a defined contribution pension plan, the employer contributes an amount to the pension fund – usually determined as a percentage of the employee's earnings – which is added to the employee's contribution (if required) and subsequently invested to gain a return. The accumulated contributions and the investment returns that are gained from the accumulated contributions are paid out to pensioners. There can be no deficit in a defined contribution plan since, by definition, there is no set level of benefits expected to be paid to pensioners. The plan simply pays out what it has earned.

Hybrid Pension Plans

A hybrid pension plan, as the name suggests, contains elements of both a defined benefit and defined contribution plan.

2. HAVE CONTRIBUTIONS BEEN PAID TO THE DEFINED BENEFIT PENSION PLAN OR THE HYBRID PLAN?

A pension plan must lay out the method of calculating plan contributions.[8] A pension plan is either contributory or non-contributory. In a contributory plan, both the employee and the employer make contributions to the plan. In a non-contributory plan, only the employer makes

[7] *PBA, supra* at ss. 57 and 75.

[8] *PBA, supra* at s. 10(1)(6).

contributions to the plan. Every pension plan must also acknowledge the employer's obligation to pay the normal cost/current service contributions and the special payment contributions under the plan.[9]

Normal Cost/Current Service Contributions

Normal cost contributions are employer contributions that are necessary to cover the plan's service costs. Normal cost contributions are determined in accordance with the actuarial methods and assumptions used in a "going-concern" valuation. That is, in valuing normal cost contributions, actuaries assume that a pension plan will continue to operate indefinitely in the future. Normal cost funding looks at the requirements to fund the plan to meet the future obligations to pensioners as they retire years down the road. Funding for normal cost is amortized over 15 years. Section 4(4)(3) of the *PBA Regulations* requires that amortized normal cost contributions be remitted monthly no later than thirty days after the month in which they were deducted.[10] As the debtor's lawyer, you need to know whether the debtor has paid its normal cost contributions pursuant to the *PBA Regulations*.

Solvency Funding

There is also a second method of pension plan valuation, which is a "solvency" valuation. Solvency funding assumes that a pension plan will be terminated on the date of valuation and tests whether the plan would have sufficient assets to meet its obligations if the plan were to terminate immediately. The immediate cessation of the plan will often produce different assumptions as to which benefits will be applicable to different employees. Moreover, payment of benefits *en masse* will commence far earlier in a plan termination than under the going concern assumption of indefinite continuation of the plan. Therefore a plan can be fully funded on a going concern basis and yet have a substantial deficit on a solvency basis.

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[9] *PBA Regulations*, R.R.O. 1990, Reg. 909 at ss. 4(1) and 4(2)(b) and (c).

[10] *Ibid.* at s.4(4)(3).

Special Payment Contributions

Special payments are required employer contributions to the pension plan to cover any "going-concern unfunded liabilities" or "solvency deficiencies."[11]

Going-Concern Unfunded Liabilities

A "going-concern unfunded liability" is determined by valuing the pension plan on a going concern basis. A "going-concern unfunded liability" is defined in s. 1(2) of the *PBA Regulations* as the amount by which going-concern liabilities (the present value of accrued benefits assuming that the plan will continue to operate) exceed going-concern assets (the value of assets, including accrued income and receivables) on the date of valuation.[12] If an actuarial report discloses a "going-concern unfunded liability," the employer is obliged to make monthly special payments over a 15 year period to fund the liability.[13]

Solvency Deficiency

A solvency deficiency arises when a plan's "solvency liabilities" – which are the aggregate value of the pension benefits in the plan if the plan had been wound up on the valuation date – exceed "solvency assets" – which are the market value of investments held by a plan plus any cash and receivables.[14] If an actuarial report discloses a solvency deficiency, the employer is obliged to make monthly special payments over a 5 year period to fund the solvency deficiency.[15]

Failure to Pay Required Contributions Is An Offense Under *PBA* s. 109

Under s. 56(1) of the *PBA,* the administrator of a pension plan – usually the employer – has a duty to ensure that all contributions are paid when due. Many businesses that are under financial pressure have a tendency to pay their other creditors before they pay required *PBA* contributions.

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[11] *Ibid.* at ss. 4(2)(c) and 5(1).

[12] *Ibid.* at s.1(2).

[13] *Ibid.* at ss. 4(2)(c), 4(4)(5), and 5(1)(b).

[14] *Ibid.* at s. 1.3.1.

[15] *Ibid.* at ss. 4(2)(c), 4(4)(5), and 5(1)(e).

Clients should be informed that this can be an unwise practice: a debtor **and its officers and directors** may be guilty of a strict liability offense under s. 109 of the *PBA* if contributions go unpaid. Remedies include civil compensation orders as well as quasi-criminal penalties.[16]

3. IS THERE A DEFICIENCY?

If the pension plan's most recent actuarial report shows that there is a deficiency in plan funding, then there is likely to be a deficiency when the pension plan is wound up if the debtor fails. The magnitude of the deficiency on wind-up is difficult to predict because pension valuations are highly sensitive to input variables. That is, actuaries' financial assumptions can have a large impact on whether or not a deficiency exists. This can pose a problem because financial assumptions may vary over a very brief time span. For instance, the Canadian Institute of Actuaries identifies the discount rate to calculate the present value of accrued benefits for retired plan and active plan members, estimated winding up expenses, mortality rates and retirement age as some of the major assumptions that actuaries make when performing a solvency valuation.[17] A slight change in any of these variables – for example, a slight change in interest rates – can have a large impact on the valuation of the plan.

Where there is a looming deficiency on the wind-up of a pension plan, *Indalex* posits that unsegregated assets of the debtor will be deemed to be held in trust to pay for the deficiency. Moreover, in *Indalex*, the directors were found to be acting in conflict of interest when they applied to put the company into protection under the *Companies' Creditors Arrangement Act*[18] (the "***CCAA***") and obtained DIP financing to see the company through a cash flow crisis without first providing notice to pensioners and without providing to the pensions some of the funds borrowed to keep the company afloat. Therefore, the existence of a deficit in a pension plan should sound a significant alarm to managers of a debtor who are thinking about taking steps to save the company. At minimum, the debtor should understand the magnitude and sensitivity of

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[16] *PBA, supra* at s. 109.

[17] Canadian Institute of Actuaries, "Canadian Institute of Actuaries Standards of Practice" (January 2008), online: <http://www.actuaries.ca/SOP_Doc/Complete/SOP_e_Complete.pdf at 1048>.

[18] R.S.C. 1985, c. c-36 as amended

the projected deficit to try to determine the extent of the problem as accurately as practicality allows.

4. WHEN IS THE NEXT REPORT DUE?

Next, you must determine when the pension plan's next valuation report is due. Valuation reports ensure that the parties and the regulator are aware of unfunded liabilities or solvency deficiencies. The *PBA Regulations* require that an actuary for a defined benefit plan prepare and certify a going-concern and solvency valuation every three years.[19] The *PBA Regulations* also require an annual valuation if the most recent valuation indicates that the ratio of solvency assets to solvency liabilities is less than 0.8; or, if the solvency liabilities exceed the solvency assets by more than $5,000,000 and the ratio of solvency assets to solvency liabilities is less than 0.9.[20] The administrator must file a triennial valuation within nine months of the valuation date.[21]

The key practical issue with a new report is that, by design, all of the numbers will change as assumptions change in each report and actual results for the past period are used and never precisely match the predicted results for that period.

Is the Pension Plan Being Wound-Up?

If a pension plan is being wound-up, reports must be filed more frequently. The *PBA* defines a "wind-up" as "the termination of a pension plan and the distribution of the assets of the pension fund."[22] If a financially distressed company winds-up its pension plan and the plan has a solvency deficiency prior to being wound-up, the solvency deficiency becomes a wind-up deficiency.[23] The debtor must then file a wind-up report disclosing the plan's wind-up deficiency.[24] Until the wind-up liability is fully funded by the debtor, the debtor must file annual

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[19] *PBA Regulations*, *supra* at s. 14(1).

[20] *Ibid.* at ss. 14(2)-(6).

[21] *Ibid.* at s. 14(10).

[22] *PBA*, *supra* at s. 1(1).

[23] Kaplan, *supra* at 543.

[24] *PBA Regulations*, *supra* at s. 30.

wind-up reports which disclose the deficiency. The pension plan's status will be reviewed annually by an actuary.[25]

5. AFTER *INDALEX*, HOW CAN DIRECTORS BEST PROTECT THEMSELVES?

Finally, if a financially distressed debtor operates a defined benefit plan with a solvency deficiency and there is a large risk that the company will be unable to fund the deficiency, how do the debtor's directors properly discharge their fiduciary duties to plan beneficiaries? What advice can counsel give to debtors facing pension plans with wind-up deficits and deemed trust?

The Importance of Communication

Without commenting on its correctness, *Indalex* says that in *CCAA* proceedings, corporate directors must contemporaneously wear both their corporate hat and their pension plan administrator hat at certain times.[26] In discharging their fiduciary duties while wearing their administrator hat, corporate directors are obliged to make certain communications to plan beneficiaries. The Court was critical of directors' failure to inform plan beneficiaries that Indalex had filed for *CCAA* protection.[27] The Court was also critical of directors' failure to inform plan beneficiaries of a *CCAA* order giving DIP lenders priority over pension plan beneficiaries and all other creditors.[28] These comments suggest that, as a lawyer representing a distressed debtor, you should be advising the directors of the debtor that they may be able to avoid liability if they communicate information concerning upcoming insolvency proceedings to pension plan beneficiaries. At the same time however, the directors will need securities law advice to ensure that they do not engage in selective disclosure. They will also need insolvency advice to avoid taking steps that would forearm creditors with an ability to launch pre-emptive strikes against the company's assets and undermine the use of restructuring statutes to obtain a stay of proceedings to prevent creditors from doing so. If this sounds impractical or impossible – especially if there

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[25] *Ibid.* at s. 32.

[26] *Indalex, supra.* at para 130.

[27] *Ibid.* at para 132.

[28] *Ibid.*

are a large number of pensioners spread across the country or the world – then we need all await the outcome of the proposed appeal in order to determine precisely how to advise our clients. in the interim, it is important to identify that issues exist and be very wary of proceeding.

Avoiding Conflicts of Interest

The Court's discussion of conflicts of interest in *Indalex* is troubling. The Court acknowledged that, the Supreme Court of Canada has held in cases such as *BCE Inc. v. 1976 Debentureholders*,[29] corporate directors must act in the best interests of the corporation and treat all stakeholders fairly where interests conflict.[30] However, in *Indalex*, the Court of Appeal stressed that corporate directors acting as pension plan administrators have a duty to act in the best interests of plan beneficiaries.[31] In *Indalex*, these two duties were said to be in conflict. The Court stated that when these two duties conflict, directors must "take steps to address the conflict."[32] The problem is that the Court did not explicitly state what "steps" directors should take. They suggested some impractical or unattainable options such as giving notice to pensioners as discussed above without describing the form or scope of such notice. The Court also hinted that perhaps some of the funds borrowed by way of DIP financing could have been paid toward the pension deficits by Indalex. But DIP financing is limited to funding new expenditures to keep a debtor alive during a funding crisis. Payment of pre-existing obligations would amount to a preference and would be unacceptable to not only the DIP lenders but also to all other creditors whose claims are being stayed during the *CCAA* proceeding. The Court did not identify how either going into *CCAA* or obtaining DIP financing could be said to prejudice pensioners, so it is difficult to articulate the nature of the conflict of interest or the steps that can be taken to protect oneself from such a finding. One is left with the feeling that directors *may* be able to avoid a conflict of interest if they resign as plan administrators prior to insolvency proceedings (the Court infers that *Indalex* should have taken "formal steps through the

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[29] [2008] 3 S.C.R. 560.

[30] *Indalex, supra* at para 129.

[31] *Ibid.*

[32] *Ibid.* at para 143.

Superintendent, plan amendment, the courts, or some combination thereof" to transfer the role of plan administrator to a "suitable person"[33]). Directors could attempt to appoint an independent administrator to administer the pension plan. For instance, directors could request that the pension regulator act as independent administrator. However, there is no obligation on the regulator to agree to fill the role of independent administrator. Moreover, there are no provisions that ensure succession or speak to a unilateral and effective resignation by a company as administrator absent the approval of the regulator.[34]

Bill 120

Bill 120 may make it easier for corporate directors to resign as plan administrators. Under Bill 120, s.8 of the *PBA* is amended and in "prescribed circumstances" the Superintendent may terminate a plan administrator's appointment and appoint a new plan administrator if the Superintendent deems it to be "reasonable."[35] Moreover, in "prescribed circumstances" the Superintendent may act as plan administrator.[36]

Filing for Bankruptcy To Defeat a *PBA* Deemed Trust

Speaking for the Court in *Indalex*, Madame Justice Gillese stated that it is "*inappropriate* for a *CCAA* applicant with a fiduciary duty to pension plan beneficiaries to seek to avoid those obligations to the benefit of a related party by invoking bankruptcy proceedings when no other creditor seeks to do so."[37] Justice Gillese's statement is difficult to reconcile with case law which acknowledges that a debtor may file for bankruptcy to re-order priorities. As recently as last year the Supreme Court of Canada recognized the propriety of using bankruptcy laws to re-order priorities among creditors, although some creditors may suffer and others may benefit by doing

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[33] *Ibid.* at para 135.

[34] Bills 120 and 236 – containing amendments to the *PBA* – may make this option more viable.

[35] Bill 120, *supra* at s. 2(2)(1.1).

[36] *Ibid.* As at the time of the drafting of this paper, these sections have yet to be proclaimed in force.

[37] *Indalex, supra* at para 183.

so.[38] It is the federal law of Canada that the priorities in a bankruptcy are determined under the *Bankruptcy and Insolvency Act* and this does not include recognition of provincially created deemed trusts. It is difficult to provide advice as to how a debtor should act to preserve and enhance its chances of successful restructuring or to fairly distribute its assets if unsuccessful where use of the system prescribed by law can be found to be amount breach of fiduciary duties to one subset of stakeholder interests.

CONCLUSION

To sum up, as a lawyer representing a debtor in financial distress, you should determine:

1. If the company operates a registered defined benefit pension plan;
2. Whether contributions have been paid to the plan;
3. Whether the plan has a solvency deficiency and the extent of the deficit;
4. When the pension plan's next triennial report is due;
5. If directors have adequately protected themselves by
    a) appropriately communicating with plan beneficiaries;
    b) *attempting* to resign as plan administrator and *attempting* to appoint an independent administrator; and
    c) carefully considering whether they should assign a company into bankruptcy solely to defeat a deemed trust.

Ultimately, despite the Court's attempt to highlight the uniqueness of the facts in *Indalex*, the decision creates significant uncertainties. These uncertainties are not limited to the insolvency arena: institutional lenders are now struggling with how to grant secured loans where future pension deficits can arise without fault and in unpredictable *quanta* that can take priority over

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[38] *Century Services Inc. v. Attorney General of Canada et al.*, [2010] 3 S.C.R. 379.

valid prior secured interests. Legal counsel are well advised to tread carefully, be aware that the existence of a defined benefit pension plan is a red flag, and to conduct due diligence with expert financial assistance as the situation requires and the client allows.

The Facts of *Indalex*

Indalex Limited is a Canadian wholly-owned subsidiary of an American group of companies involved in the business of aluminum extrusion. At its Toronto facility, Indalex Limited produced aluminum extrusion billets, the sale of which accounted for roughly one-third of the Indalex group of companies' total sales.

Indalex Limited provided two separate pension plans, of which the company was both the sponsor and the administrator. The executive plan is a defined benefit plan available to some 18 former executive employees of the company. The salaried plan is a hybrid plan. As of December 2006, Indalex Limited initiated the wind-up of its salaried plan. Significantly for the outcome of this litigation, the executive plan was not in the process of being wound-up when the company initiated *CCAA* proceedings in early April, 2009.

Both of Indalex's pension plans experienced actuarially determined funding shortages, which is not uncommon for defined benefit plans in the current economic environment. As a result of these shortages, Indalex was obliged to make periodic special payments pursuant to its funding obligations under the *PBA*. At of the time of its *CCAA* proceedings, Indalex was up-to-date in all of its required payment obligations.

Indalex filed for bankruptcy protection under the *CCAA* in Toronto and its US parent and affiliates filed for protection under Chapter 11 of the *US Bankruptcy Code* at the same time. On April 8, 2009, following the imposition of a stay of proceedings against Indalex under the *CCAA*, the Courts in Canada and the US approved request by all of the debtors to borrow funds needed to pay for goods and services to enable them to remain in business pending a joint restructuring effort (a "DIP" loan). Indalex's obligation to repay this loan was guaranteed by its parent company, Indalex US, and, as is standard in this type of distressed debtor situation, the Court approved a super-priority charge in favour of the DIP lenders. By the terms of this charge, the

DIP lenders were to be paid from the proceeds of the sale of Indalex's assets as a going concern in priority to all other secured creditors, trusts, liens, charges and encumbrances.

This DIP loan was subsequently amended in June 2010 to allow Indalex to borrow further funds from the same group of DIP lenders. The motion was brought on an urgent basis that was accepted by the Court. Only short notice therefore was provided to pensioners' representatives.

At this point, parties interested in the pension plan wrote a letter to Indalex reserving their rights pursuant to the deemed trust provisions under the *PBA*. Indalex did not reply to this letter – an act that was subsequently interpreted by the Court of Appeal as a deliberate snubbing of what the Court construed to be the company's fiduciary obligations.

Ultimately Indalex sold its assets in a Court-approved cross-border sale that preserved the bulk of the jobs of Canadian employees. The DIP loan was repaid by Indalex US under its guarantee of the DIP borrowings and it was subrogated to the super-priority rights of the original DIP lenders. Representatives of the pensioners applied for payment of the pension deficiencies from the sale proceeds in priority to the DIP lenders' super-priority charge. The US trustee in bankruptcy of the Indalex US parent and the secured creditor of the US bankrupt estate sought to recover on their subrogated super-priority DIP charge ahead of claims of all other creditors including pensioners. Indalex sought to assign itself into bankruptcy to distribute its proceeds in accordance with the federal scheme of distribution that does not recognize deemed trusts under the provincial law (if the pensioners' deficiencies were entitled to a deemed trust under the *PBA*).

The Court of Appeal reached four conclusions in its decision:

1. Pensioners under the salaried plan were entitled to a deemed trust for the full pension deficit because a winding-up process had begun for that plan under the *PBA*. Prior decisions had limited the amount of the deemed trust to contributions that remained outstanding at the time that the winding-up had begun;

2. In addition, Indalex owed a fiduciary duty to all of the pension beneficiaries which it breached by failing to give better notice, failing to obtain benefits for the pension beneficiaries in the DIP and sale negotiations, and in seeking to bankrupt the company to defeat the deemed trust in favour of the pensioners of the salaried plan;

3. As a result of the breaches of duty, the proceeds from the sale of Indalex's assets as a going concern were held as a constructive trust for the benefit of the pension beneficiaries; and

4. The paramountcy of the DIP charge under the *CCAA* was avoided because in granting the super-priority the Court did not make express reference to the invocation of the doctrine of paramountcy and federal priority under the bankruptcy law could be avoided by the imposition of a constructive trust.

As a result of what the Court perceived to be a breach of its fiduciary duty, Indalex was ordered to pay the proceeds of its asset sale to the pension beneficiaries in priority of the court-approved DIP charge. In other words, after funds were advanced by a foreign bankruptcy estate in reliance on a Canadian DIP charge, the DIP charge was subordinated to the claims of the pension beneficiaries. It remains to be seen whether foreign courts will allow their bankruptcy debtors to issues guarantees of Canadian debtors' DIP facilities in future.