Treatment of Canadian Retirement Plans in M&A Transactions

Goodmans LLP

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Overview

The treatment of Canadian retirement plans in M&A transactions depends on a number of factors, including the type of plan, the deal structure and the province of plan registration. Unlike the Employee Retirement Income Security Act of 1974 ("ERISA"), Canadian employment and pension legislation is distinct in each province with oversight by separate regulators.

Below we explore considerations relevant in the acquisition of a Canadian business that sponsors or administers a retirement plan.

Type of Retirement Plan

There are several vehicles in Canada that an employer may establish to assist employees in saving for retirement. For the purposes of treatment in a transaction, there are two broad types: registered pension plans and capital accumulation plans.

Registered Pension Plans

In Canada, a "registered pension plan" is a defined legislative term for a pension plan that is registered with the regulator and subject to provincial minimum standards legislation. Similar to the US, there are two broad types of Canadian registered pension plans ("**RPP**"): defined benefit ("**DB**") and defined contribution ("**DC**"). A DB plan provides an ongoing monthly payment to the member starting at his or her retirement. While members may be required to contribute, the ultimate obligation to fund the plan and pay the pension benefit to members falls on the employer. A DC plan provides a set contribution rate for the employer and the employee to pay into the plan. The employer and employee contributions are deposited into the member's DC account, held by the plan, and accumulate investment earnings until the member's retirement date. There is no promised benefit amount at retirement, but the member gains access to the lump sum amount in his or her DC account for use as retirement income.

Unlike the US, Canadian RPPs do not have discrimination or coverage testing. Provincial pension legislation sets the statutory minimum benefits, while the *Income Tax Act* (Canada) establishes the maximums. RPPs must submit annual filings with both the CRA and the applicable pension regulator. In Ontario, the provincial pension regulator is the Financial Services Regulatory Authority of Ontario ("**FSRA**") and the pension legislation is the *Pension Benefits Act* (Ontario).

Capital Accumulation Plans

A capital accumulation plan ("**CAP**") is designed like a DC plan, with a set employer and employee contribution rate and no promised benefit amount at retirement. The term CAP includes group retirement savings plans, such as individual retirement accounts or Roth IRA accounts in the US, or registered retirement savings plans, deferred profit sharing plans or tax-free savings accounts in Canada. The main differences between a CAP and a DC plan are that provincial pension legislation does not apply to a CAP, different tax rules apply to CAPs, and there are no required filings outside of limited tax filings with the CRA.

Deal Structure

Deal structure plays an important role in the treatment of a retirement plan. It is useful to review the considerations associated with the type of transaction for the purchase, sale or merger of the business.

Share Sale

In a share sale, the buyer acquires the shares of the target company. For the target company employees, there is no change in employer, plan or administrator. The terms of their employment, including pension and benefit entitlements, remain the same. Typically, unless terminated or merged with the buyer's plan, the target company's retirement plans will continue as an active plan for the target company employees. Therefore, conducting thorough diligence on the employee benefit plans is important for the buyer.

Asset Sale

In an asset sale, the buyer acquires assets of the target company, typically including some or all of the employees. The buyer may negotiate with the seller regarding which, if any, retirement plans will be acquired. The assets and corresponding liabilities for benefits accrued prior to the closing date may remain with the seller or transfer to the buyer, as negotiated.

Where employees are transferred to the buyer in any province other than Quebec, the seller formally terminates the employment relationship and the buyer makes an offer of employment to employees. If an employee accepts the buyer's offer, the buyer becomes the new employer. While there is no legislative requirement for the buyer to provide any replacement employee benefit plans, this is typically negotiated as part of the transaction. In Canada, if the buyer does not offer terms, conditions and remuneration (including pension and benefits) to the target company's employees that are substantially similar to those received from the target company prior to closing, an employee who does not accept the buyer's offer may have a claim for constructive dismissal. It is therefore important to conduct proper diligence on the seller's benefit plans, whether the plans are assumed or employees join a replacement plan.

If a target company's retirement plan is assumed by the buyer or the assets of the plan in respect of prior benefits are included, the buyer must make requisite filings with the provincial pension regulator. For RPPs, the asset transfer process requires the submission of an application for approval from the applicable provincial pension regulator. In Ontario, FSRA must consent to any transfer of the pension assets, which will not occur until after the transaction closes. As CAPs are not provincially regulated, assets can be transferred between such plans at the plan sponsor's direction without regulator consent.

If a replacement plan is established or made available to transferring employees, the type of plan does not need to be a mirror plan, but will typically provide substantially similar benefits to mitigate the possibility of an employee claim of constructive dismissal. Whether a RPP or a CAP, if the buyer provides a replacement plan to transferring employees, the accrual of benefits for future service under the replacement plan will begin on and after the closing date of the transaction, but as a successor employer the buyer must recognize past service with the predecessor employer for eligibility purposes.

When an employee is transferred as part of an asset transaction, the buyer will become the successor employer in accordance with provincial employment legislation. As well, the transferring employee will retain any entitlements accrued prior to closing in the predecessor employer's plans.

Consideration should also be given to employees who are not actively working at the time of the closing. Employees on leave, disability or temporary layoff may be considered active for pension and benefit purposes, and the parties must agree on whether those employees will transfer from the seller to the buyer. Typically, offers of employment made to employees on leave will be conditional on their ability to return to active work within a certain amount of time after the closing date.

The treatment of unionized employees is subject to a collective bargaining agreement ("CBA"), negotiated between the employer and the union. As a matter of law in Canada, the CBA will continue to apply to unionized employees after closing, when employed by the buyer. Even in an asset deal, the buyer will assume all obligations under the current CBA. Consequently, the same employee benefits promised in the CBA must also be provided by the buyer. It is important to conduct proper diligence on any CBA applicable to transferring employees to understand the employer's obligations.

Regulatory Considerations

In assessing a retirement plan, it is important to recognize the ongoing compliance requirements under provincial and tax legislation.

Funding

The funding requirements are different for DB and DC plans. The employer contributions required in DC plans and CAPs are typically expressed as a percentage of employee earnings and are determined in accordance with the plan design, set by the employer. There is no variability in contributions, unless the employer changes the plan design. Employee contributions are remitted directly from source and paid to the custodian, while employer contributions are made on a monthly basis. Employer contributions required in DB plans are more variable.

An actuarial report, prepared every year or every three years, depending on the plan's solvency and province of registration, will establish the contributions made to the plan. Similar to the case in the US, an underfunded DB pension plan can be a source of risk for a buyer. However, in Canada, several provinces have enacted legislation to ease funding requirements of pension plan sponsors and require a pension plan only to fund 85% of its liabilities on a solvency basis before any special payments are made. The funded status of a pension plan may impact the purchase price, and should be understood as a part of due diligence.

Governance

In addition to ongoing funding obligations, the administrator of a registered pension plan has documentation, record keeping and disclosure obligations. Annual filings in respect of DB and DC plans must be made with the pension regulator within prescribed timelines. In addition, certain provinces have enacted requirements for governance documentation, such as a statement of investment policies and procedures ("**SIPP**"), funding policy, and governance policy. In Ontario, the SIPP and any amendments to the SIPP must be filed with FSRA. Some provincial regulators have introduced administrative monetary penalties for non-compliance and late filings.

CAPs are not regulated by provincial legislation and are not required to make the same filings as registered pension plans. However, regulators, administrators, courts and other governing bodies expect a retirement plan administrator adhere to guidelines established by the Canadian Association of Pension Supervisory Authorities ("**CAPSA**"). CAPSA has published nine guidelines and numerous other publications that provide the framework for administration of a retirement plan, including DB funding, DC plans, and CAPs. While there is no penalty for non-compliance with the guidelines, any non-compliance can result in a potential liability for a retirement plan in a dispute with a member or an audit by the regulator.

For information on the treatment of Canadian retirement plans in M&A transactions, please contact any member of our Employment, Pensions and Executive Compensation Group.

The discussion in this Guide is confined to the laws of the province of Ontario, as well as the federal laws of Canada that apply in Ontario as of January 1, 2023. Because the laws and policies of governments and regulatory authorities change, some of the information may not be accurate after that date. This Guide provides general information only and should not be relied upon as legal advice.

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