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WRONGFUL DISMISSAL DAMAGES

deductibility of pension benefits

In assessing damages for breach of contract, the innocent party should be placed in the same economic position that he or she would have been in had the contract been properly performed. This requires deduction from damages of avoided and avoidable losses. Joe Conforti reviews the recent decision of the Supreme Court of Canada, *IBM Canada Limited v. Waterman*, which holds that employee pension benefits are an exception to the rule and a type of payment that will generally not reduce severance or other wrongful dismissal damages. In so doing, the Court has set out a framework for deductibility of damages in the employment context. The decision also serves as a reminder that courts are very protective of employees and will not hesitate to treat employment relationships in a manner that is different from other commercial contracts, even applying exceptions to fundamental legal principles where fairness warrants.

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UNJUST DISMISSAL

radical change under Canada Labour Code?

Is an employee “unjustly dismissed” under the *Canada Labour Code* if reasonable notice of termination is paid? In the recent Federal Court decision in *Atomic Energy of Canada Limited v. Wilson*, the finding of an adjudicator that paying severance to an employee does not prevent a claim of unjust dismissal under section 240 of the *Canada Labour Code* was held to be unreasonable. As Eric Durnford and Amy Bradbury explain, the Court held that the adjudicator had misinterpreted and misapplied earlier decisions. Further, the payment of reasonable notice was a defence to a claim of unjust dismissal, provided there were no other circumstances that made the termination unjust, such as discrimination or retaliation.

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RESTRICTIVE COVENANTS

damages and fiduciary duties

In a previous issue of this journal, Bruce Grist wrote on the decision of the Alberta Court of Queen’s Bench in *Evans v. The Sports Corporation*. The Court held that Richard Evans breached his employment agreement by being in breach of the non-solicitation provision in it. In a follow-up article, the author discusses the Alberta Court of Appeal’s ruling in *Evans*, where the Court held that the non-solicitation clause was unenforceable but still upheld the damage award against Evans on the basis of a breach of Evans’ fiduciary obligations.

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WRONGFUL DISMISSAL DAMAGES

Deduction of Pension Benefits From Wrongful Dismissal Damages

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In assessing damages for breach of contract, the “compensation principle” mandates that the innocent party should be placed in the same economic position that he or she would have been in had the contract been properly performed. As a corollary, avoided and avoidable losses must be accounted for and deducted from damages.

The compensation principle applies equally to wrongful dismissal damages.¹

Over the years, the courts have struggled with whether various types of payments are deductible from severance or other wrongful dismissal damages. For example, should disability benefits be deducted? workers’ compensation benefits? employment insurance, Canada Pension Plan and other statutory payments? pension benefits on retirement?

A recent decision of the Supreme Court of Canada, *IBM Canada Limited v. Waterman*,² has established a framework for deductibility of damages in the employment context and, in so doing, has determined that employee pension benefits will generally not reduce wrongful dismissal damages.

A summary follows.

The Facts

Mr. Waterman, an employee of IBM for over 42 years, was dismissed for economic reasons. At the time of the dismissal, Mr. Waterman was 65-years old.

Mr. Waterman was a long-standing member of IBM’s defined benefit pension plan and, during the course of his employment, IBM contributed a percentage of his salary to the pension plan on his behalf. The pension plan guaranteed a level of pension benefits, which vested over time upon retirement. Pursuant to the pension plan, an employee who was entitled to retire with his full pension but had not yet reached the age of 71, could not receive both pension benefits and employment income from IBM at the same time; that situation changed at age 71, when all employees were required to start drawing pension benefits regardless of their employment status – that is, they could continue working with IBM or work elsewhere and earn employment income at the same time as they were receiving pension benefits.

By the date of his dismissal, Mr. Waterman was entitled to a full pension; his dismissal had no impact on the level of his pension benefits. Although Mr. Waterman had no desire to retire, in accordance with the pension plan, IBM advised Mr. Waterman that he would be treated as a retiree following his dismissal and that he “must” begin receiving his monthly pension on an unreduced basis.

Mr. Waterman sued for wrongful dismissal. At trial, it was determined that the appropriate period of reasonable notice was 20 months (this was not an issue on appeal).

IBM’s position at trial and on appeal was that Mr. Waterman’s pension benefits should be deducted from the salary and benefits otherwise payable by IBM as damages during the period of reasonable notice; that is, Mr. Waterman was not entitled to both a full severance and full pension benefits. IBM made two main points:

- Firstly, if IBM had given Mr. Waterman proper working notice of his termination, then, in accordance with the terms of the pension plan, Mr. Waterman could not have received both employment income and pension benefits during the notice period; that is, he would receive only his regular wages. If damages for the full notice period were awarded to Mr. Waterman without deducting the pension benefits received by him during such period, Mr. Waterman would be placed in a better economic position than he would

¹ See, e.g., *Michaels v. Red Deer College*, [1976] 2 S.C.R. 324, at 330-332.

² [2013] S.C.C. 70 (“*Waterman*”).

have been in had IBM performed the contract. As such, a failure to deduct pension benefits would be at odds with the compensation principle.

- Secondly, deducting pension benefits is consistent with the precedent set by the 1997 decision of the Supreme Court of Canada, *Sylvester v. British Columbia*,³ which determined that disability benefits under an employer-funded disability insurance plan were deductible from wrongful dismissal damages. As the Court said in that case: “It makes no sense to pay damages based on the assumption that [the employee] would have worked in addition to disability benefits which arose solely because he could not work.”⁴

The Decision

The Court summarized the dilemma posed in *Waterman* as follows:⁵

It therefore seems clear, under the general rule of contract damages, that the pension benefits should be deducted. Otherwise, Mr. Waterman is in a better economic position than he would have been in had there been no breach of contract.

On closer study, however, the question raised on appeal is not as simple as that.

Following “closer study,” the Court rejected IBM’s arguments. Applying an exception to the compensation principle, in particular, that benefits received from “private insurance” are not deductible from damages for breach of contract, the Court determined that Mr. Waterman was entitled to his severance in full and without reduction on account of pension benefits. It did so fully appreciating that its ruling departed from the compensation principle, explaining that the principle “cannot be, and is not, applied strictly or inflexibly in a manner that is divorced from other considerations.”⁶

The Court recognized that the scope of the private insurance exception and the type of benefits that are encompassed by it are controversial. The exception has, in the past, been applied by analogy to a wide variety of

payments that do not originate in a contract of insurance – although the decisions are sometimes difficult to reconcile with each other and have been based on such disparate factors as whether the benefits were intended to be an “indemnity” for the particular loss caused by the breach of contract and whether the plaintiff had “contributed” to the entitlement to the benefit.⁷

The Court derived several broad conclusions from a review of the case law:⁸

(a) There is no single marker to sort which benefits fall within the private insurance exception.

(b) One widely accepted factor relates to the nature and purpose of the benefit. The more closely the benefit is, in nature and purpose, an indemnity against the loss of the type caused by the defendant’s breach, the stronger the case for deduction. The converse is also true.

(c) Whether the plaintiff has contributed to the benefit remains of relevant consideration, although the basis for this is debatable.

(d) In general, a benefit will not be deducted if it is not an indemnity for the loss caused by the breach and the plaintiff has contributed in order to obtain entitlement to it.

(e) There is room in the analysis of the deduction issue for broader policy consideration such as the desirability of equal treatment of those in similar situations, the possibility of providing incentives for socially desirable conduct, and the need for clearer rules that are easy to apply.

The Court stressed three critical factors in support of not deducting retirement benefits from wrongful dismissal damages and of its conclusion that pension benefits will generally fall within the private insurance exception:

1. *Pension benefits represent property rights.*

Pension benefits “bear many of the hallmarks of a property right.”⁹ As such, they should not easily be forfeited.

³ [1997] 2 S.C.R. 315 (“*Sylvester*”).

⁴ *Ibid.* at paragraph 17.

⁵ *Supra* note 2 at paragraphs 2-3.

⁶ *Ibid.* at paragraph 35.

⁷ *Ibid.* at paragraph 56.

⁸ *Ibid.* at paragraph 76.

⁹ *Ibid.* at paragraph 83.

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According to the Court, unlike other kinds of employment-related payments such as disability benefits or employment insurance, pension benefits are not an indemnity against wage loss. Rather, vested pension entitlements are a form of deferred compensation – “a form of retirement savings earned over the years of employment.”¹⁰ While the employer made all of the contributions to fund the pension plan, as far as the Court was concerned, such pension are “invariably found to be contributory.”¹¹

The Court accepted that a pension is the property of the employee that is earned through work and consists of a benefit that is part of the employee’s overall remuneration package. The pension is like a “nest egg,” RRSP or savings account, which IBM could not take advantage to offset any damages awarded for breach of contract. In this regard, Mr. Waterman could have transferred the value of his pension to another vehicle if he had left employment with IBM before reaching the age of 65 and his retirement savings would consequently have been out of reach; he should not be worse off by having been dismissed.

In short, there is a sense of unfairness in depriving an employee of earned compensation. As the Court concluded succinctly:¹²

In light of the contract of employment, would the parties have intended to use an employee’s vested pension entitlements to subsidize his wrongful dismissal? In my view, the answer must be no.

2. *Disability benefits are not akin to pension benefits.*

In *Sylvester*, wrongful dismissal damages were reduced by the amount of disability benefits paid during the notice period from an employer-funded plan where the employee had made no contribution in money or money’s worth in order to obtain the benefit.

The Court reviewed the nature of the disability benefits at issue in *Sylvester* and concluded that they were intended to be a substitute, that is, an indemnity, for wages paid during the period of reasonable notice.

This was clear from the terms of the disability plan in that the disability benefits would continue only for so long as the employee was unable to work due to illness or injury; it was not possible for the employee to receive both disability benefits and wages at the same time. Further, disability benefits were expressly to be reduced by other income received by the employee (such as other disability income, wage continuation plan benefits, pension payments, workers’ compensation benefits and salary from other employment). As such, the disability benefits at issue in *Sylvester* were “not freestanding entitlements – they were linked to and defined by the extent of actual income loss.”¹³

In contrast, pension benefits are not an indemnity for loss of income due to inability to work. Rather, as set out above, a pension plan is, in essence, a retirement savings vehicle to which the employee participants earn an absolute entitlement over time. Moreover, unlike the disability benefits in *Sylvester*, pension payments are not, in general, reduced by other income or benefits according to the terms of most pension plans. For example, in this case, Mr. Waterman could have retired, drawn his full pension, and drawn a full salary from another employer.

As such, according to the Court, *Sylvester* was not an applicable precedent.

3. *Broader policy concerns support not deducting pension benefits from severance.*

According to the Court, not deducting pension benefits promotes equal treatment of employees.

Under the pension plan at issue in *Waterman*, if deduction from severance were to be permitted, then employees who were eligible to receive their pension but had not yet reached 71 years of age could, by means of wrongful dismissal, be forced to retire and draw on their pension benefits. In contrast, other employees would not be similarly disadvantaged: a dismissed employee who was not entitled to his or her pension would receive either a deferred pension or its commuted value plus full damages for wrongful dismissal; and an employee over the age of 71 would receive both pension benefits and employment income. Deducting the benefits

¹⁰ Ibid. at paragraph 77.

¹¹ Ibid. at paragraph 68.

¹² Ibid. at paragraph 85.

¹³ Ibid. at paragraph 81.

only in the case of employees in Mr. Waterman's situation – pension-eligible but less than age 71 – therefore constitutes unequal treatment of pensionable employees.

Moreover, deduction of pension benefits provides an undesirable incentive for employers to dismiss fully vested and pensionable employees instead of others simply because it would be cheaper to do so following a deduction – or to use the Court's words, if the employees' retirement savings were used to “subsidize” their own dismissals.

The Court suggested that, if deemed desirable, the parties could specifically address the issue of deductibility by contract. That is, the employer and employee are always free to set out in the employment contract or in the pension plan that certain pension benefits or other payments may be deducted from amounts owing upon dismissal.

Comments and Conclusion

The Court has now clarified the general rule: vested pension benefits are not to be deducted from wrongful dismissal damages. This rule, to the advantage of pension-eligible employees, obviously provides certainty.

Some comments:

- The practical result of *Waterman* may be quite limited as employers can avoid its application simply by providing working notice of termination to pension-eligible employees. In this way, the issue of deduction from wrongful dismissal damages does not arise since there is no payment in lieu of notice or severance and the terms of the pension plan will govern. In effect, the employee is put to an election: he or she can continue working throughout the notice period – receiving full salary and benefits with pension benefits to commence after employment – or retire and receive pension benefits immediately but without severance. In this regard, it is germane to note that, in Ontario, no statutory severance pay is owing to an employee who, on having his or her employment severed, retires and receives an actuarially unreduced pension benefit that reflects any service credits that the employee would have been expected to earn in the normal course of events for the

purposes of the pension plan had the employment not been severed.¹⁴

- Although *Sylvester* determined that disability benefits during the notice period should be deducted from wrongful dismissal damages, many courts have since limited the practical impact of *Sylvester* by noting that, in that case, the disability plan was wholly employer-funded and the employee made no contributions to it. Distinguishing *Sylvester*, therefore, courts have refused to deduct disability benefits from wrongful dismissal damages if the employee made a contribution, no matter how minimal or indirect, to the disability plan.¹⁵ *Waterman* minimizes the import of this distinction:¹⁶

While the cases from this Court have referred to whether the plaintiff has directly or indirectly contributed to the benefit, there were strong arguments against giving this consideration much weight as an explanation of why particular benefits should or should not be deducted. ... As a matter of logic, it does not seem right to say that deducting the benefits deprives the plaintiff of the contributions made to gain entitlement to those benefits – whether deducted from damages or not, the plaintiff receives the benefits.

Put another way, regardless of wrongful dismissal damages and whether or not the employee has contributed to the disability plan, the employee has received what he or she has paid for upon receipt of the disability benefits. As a result, unless otherwise provided for in the plan documents, based on the reasoning in *Waterman*, disability benefits should be deducted from severance awards.

- The Court's decision was obviously influenced by the fact that Mr. Waterman had no choice but to commence his pension at the same time he was wrongfully dismissed; this explains the reluctance of the Court to have an employee “subsidize” his own severance package. It is unclear

¹⁴ *Employment Standards Act, 2000*, O. Reg. 288/01 (Termination and Severance of Employment), section 9(1)(3).

¹⁵ See, e.g., *Sills v. Children's Aid Society of the City of Belleville*, 2001 CanLII 8524 (Ont. C.A.).

¹⁶ *Supra* note 2 at paragraph 67.

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whether the result would be any different if the employee could have deferred commencement of his pension but chose to commence it in any event, for example, on a reduced basis. Given the reasoning of the Court – even reduced pension benefits are a form of deferred compensation and retirement savings and not intended as an “indemnity for wage loss” due to unemployment – the result should be the same and there should be no deduction for wrongful dismissal damages.

- The Court has left open the possibility for employers expressly to provide for a result contrary to *Waterman* in an employment contract or in the pension plan – that is, to permit deductibility of pension benefits in the case of a wrongful dismissal. The interpretation and enforceability of such a provision remains to be seen but, it should be emphasized, it must be clearly drafted with legal advice and in compliance with the pension legislation and other applicable laws.

- *Waterman* expressly applies to both defined benefit and defined contribution pension plans. Its rationale also applies to supplemental pensions and, potentially, other deferred compensation arrangements. As such, it is important to keep in mind the deductibility of any such benefits from severance or other wrongful dismissal damages and, if a result different from *Waterman* is desired, to include it in the plan documentation.

The result reached in *Waterman* is consistent with existing law. Its reasoning and the framework established by the Supreme Court of Canada serve as a reminder that courts are very protective of employees and will not hesitate to treat employment relationships in a manner that is different from other commercial contracts, even applying exceptions to fundamental legal principles where fairness warrants.