

FTR Now

Ontario Court of Appeal Revisits Pension and Insolvency Principles: *Indalex*

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INTRODUCTION

On April 7, 2011, the Ontario Court of Appeal (the “Court”) released its decision in [Re Indalex Limited](#). In this decision, the Court considers and revisits fundamental and established Canadian pension and insolvency law principles, making this decision required reading for members of pension committees, human resources professionals involved in pension plan administration, and members of boards of directors who sponsor and administer pension plans.

While a successful appeal of this decision remains possible, employers who maintain defined benefit pension plans must be aware that:

- when an Ontario registered pension plan is wound up, the employer’s assets are now subject to a deemed trust equal to the entire wind up deficiency under the plan;
- if the employer is insolvent and under *Companies’ Creditors Arrangement Act* (“CCAA”) protection, pension deficiencies may have priority over all secured debt, whether the pension plan is wound up or ongoing;
- employers may have fiduciary obligations to plan beneficiaries relating to functions not previously identified as fiduciary in nature and for which they may be found liable. Employers should therefore review existing governance procedures related to funding and other plan related decisions in light of this decision.

In this *FTR Now*, we review the facts of the case, the Court’s decision and discuss the significant pension law implications for employers that administer defined benefit pension plans. Although the *Indalex* case arose in the context of pension plans registered in Ontario, most Canadian pension standards statutes contain provisions similar to those at issue in this case.

BACKGROUND

Indalex Limited (“Indalex”) and certain Canadian affiliates filed for creditor protection under the CCAA on April 3, 2009. FTI Consulting Canada ULC was appointed as monitor (“Monitor”). Indalex’s parent company and its U.S. based affiliates (collectively, “Indalex U.S.”) sought Chapter 11 bankruptcy protection in the United States a few days prior, on March 20, 2009.

On April 8, 2009, the Superior Court of Ontario (the “Commercial Court”) authorized Indalex to borrow funds pursuant to a debtor-in-possession credit agreement among Indalex, Indalex U.S. and a syndicate of lenders (“DIP lenders”).

The court order contained a “super-priority charge” provision which provided that the DIP lenders would rank in priority to all other creditors. Specifically, the order provided that the DIP lenders’ charge “shall rank in priority to all other security interests, trusts, liens, charges and encumbrances, statutory or otherwise”, other than the “Administration Charge” and the “Directors’ Charge” (both of these charges were defined in the initial court order). Indalex U.S. guaranteed Indalex’s obligation to repay the DIP lenders, and this guarantee was a condition of the extension of credit.

Indalex was the sponsor and administrator of two registered defined benefit pension plans in Canada: The Retirement Plan for Salaried Employees of Indalex Limited and the Associated Companies (the “Salaried Plan”) and the Retirement Plan for Executive Employees of Indalex Limited and Associated Companies (the “Executive Plan”). The Salaried Plan was wound up effective December 21, 2006, over 2 years prior to the CCAA filing.

In contrast, the Executive Plan was ongoing (albeit closed to new members) at the time of the CCAA filing. As outlined in further detail below, both the Salaried Plan and the Executive Plan (collectively, the “Plans”) were underfunded.

At a hearing on July 20, 2009, Indalex sought approval of the sale of its assets on a going-concern basis as well as the approval to distribute the sale proceeds to the DIP lenders. Under the terms of the sale, the purchaser assumed no responsibility for the Plans.

The proposed distribution of the sale proceeds would result in no additional monies to fund the deficiencies in the Plans as a result of which reductions to the pension benefits would be necessary. At the time, Indalex had made all of the legislatively required contributions to both plans. This included all current service contributions for both plans as well as wind up payments for the Salaried Plan and special solvency payments for the Executive Plan.

As of December 31, 2008, the wind up deficiency of the Salaried Plan was \$1,795,600. The Executive Plan had an estimated wind up deficiency of \$3,200,000 as of July 15, 2009.

The United Steelworkers (the “USW”) and a group of retired executives (the “Former Executives”), as beneficiaries of the Salaried Plan and the Executive Plan, respectively, objected to the proposed distribution of sale proceeds and asserted a deemed trust claim over the sale proceeds with regard to the deficiencies under the Plans. The USW and Former Executives also claimed that Indalex had breached the fiduciary duty owed to plan beneficiaries by failing to meet its obligations under the Plans and ignoring its responsibilities as plan administrator once the CCAA proceedings had commenced.

The court approved the sale of Indalex’s assets on a going-concern basis with the sale proceeds going to the Monitor. As a result of the USW and Former Executives’ claims, the Monitor retained \$6.75 million of the sale proceeds in reserve (the “Reserve Fund”), an amount representing the approximate value of the Plans’ deficiencies.

The sale closed on July 31, 2009, and the proceeds were insufficient to repay the DIP lenders. The DIP lenders called on the Guarantee for the amount of the shortfall, which was then paid by Indalex U.S. The USW and Former Executives brought motions to determine their deemed trust claims, which were set for hearing on August 28, 2009. Indalex then filed a bankruptcy motion, seeking to file a voluntary assignment into bankruptcy.

On November 5, 2009 the Superintendent of Financial Services (the “Superintendent”) appointed the actuarial firm Morneau Sobeco Limited Partnership (“Morneau”) as the administrator of the Plans. On March 10, 2010, the Superintendent issued a Notice of Proposal to wind up the Executive Plan as of September 30, 2009.

COMMERCIAL COURT: NO MONEY FOR PENSION PLANS (FEBRUARY 2010)

On February 18, 2010, Justice Campbell of the Commercial Court held that no deemed trust over Indalex’s assets arose either in respect of the Salaried Plan or the Executive Plan under section 57(4) of the Ontario *Pension Benefits Act* (“PBA”).

The Commercial Court ordered that the DIP lenders were entitled to be repaid the amounts held in the Reserve Fund. The pensioners and Plan beneficiaries remained unsecured creditors, as of the date of the sale of Indalex’s assets.

The Commercial Court’s decision was consistent with prior case law and the general principle that, as unsecured creditors, pension plan beneficiaries’ claims are behind those of secured lenders (including DIP lenders) in priority in a CCAA or bankruptcy proceeding. As a result of its conclusion on the deemed trust provisions, the Commercial Court found it unnecessary to deal with Indalex’s bankruptcy motion.

The USW and the Former Executives appealed the decision of the Commercial Court.

COURT OF APPEAL DECISION

On April 7, 2011, the Ontario Court of Appeal issued its unanimous decision and reversed the findings of Justice Campbell in the Commercial Court. The Court ordered the Monitor to make payments into each of the Salaried Plan and the Executive Plan in an amount sufficient to satisfy the deficiencies in each Plan.

The Court held that, in the particular circumstances, the Plans' deficiencies should be paid in priority over security held by the secured DIP lenders.

The outcome for each of the Salaried Plan and the Executive Plan was identical. However, as explained below, the reasoning that led to the outcome for each Plan was quite different.

1 . DEEMED TRUST APPLIES ON PLAN WIND UP OF INDALEX SALARIED PLAN

Justice Gillese, writing on behalf of the Court, expanded the scope of the deemed trust provision set out at section 57(4) of the *Pension Benefits Act* ("PBA") to include the entire wind up deficiency.

Section 57 of the *PBA* generally establishes a deemed trust over the employer's assets for contributions to a pension plan that are "in arrears". There were no payments in arrears in this case.

Section 57(4) of the *PBA* then goes on to provide that when a pension plan *is wound up* an employer is deemed to hold in trust for the beneficiaries of the plan an amount "equal to the employer contributions accrued to the date of the wind up but not yet due under the plan or regulation". In this case, wind up was highly relevant because the Salaried Plan had been wound up prior to Indalex entering CCAA protection and the Executive Plan, although technically ongoing, was intended to be wound up.

In interpreting the scope of section 57(4), the Court reasoned that when a pension plan is wound up, members stop accruing benefits. Therefore, all plan liabilities that could ever accrue are accrued as of the plan wind up date. On this basis, the Court viewed the employer contributions accrued to the date of the wind up as including any and all contributions that would become required to fund the entire wind up deficiency. The Court held that the wind up deficiency merely represents that which had already been "accrued", and it therefore falls within the scope of the subsection 57(4) deemed trust.

The Court declined to follow the analysis adopted in earlier cases which had limited the deemed trust to current service costs and known special payments accruing up to the wind up date, without regard for any deficiency that may arise as a result of the wind up process itself.

As a result of the Court's interpretation, the section 57(4) deemed trust provisions applied to any and all amounts remaining to be paid in respect of a wind up deficiency under the Salaried Plan. In this case, there were two annual payments remaining to be paid on account of the Salaried Plan wind up deficiency. Both were found to be included in the deemed trust amount.

2. PENSION WIND UP DEFICIENCY TAKES PRECEDENCE OVER SECURED LENDER

After concluding that a deemed trust over Indalex's assets existed with respect to the entire wind up deficiency in the Salaried Plan, the Court held that the super-priority given to the secured DIP lenders under previous court orders did not oust the deemed trust. As a result, the wind up deficiency took priority over the secured debt and had to be paid.

The Court acknowledged that in the context of a CCAA, the Commercial Court has the authority to grant a super-priority charge to DIP lenders in CCAA proceedings, and that a CCAA judge can make an order granting a super-priority charge that has the effect of overriding the deemed trust under the *PBA*.

However, the Court found that valid provincial laws continue to apply in federally regulated bankruptcy and insolvency

proceedings, absent an express finding of federal paramountcy. The onus is on the party relying on the paramountcy doctrine to demonstrate that the federal and provincial laws are incompatible by establishing either that compliance with both is impossible, or applying the provincial law would frustrate the purpose of the federal law.

In this case, there was no evidence that complying with both regimes would frustrate the CCAA proceeding or Indalex's efforts to sell itself as a going-concern business. On the contrary, the evidence before the Court in the affidavit of the CEO of Indalex was that Indalex intended to comply with all applicable laws, including regulatory deemed trust requirements.

The Court found that despite the Commercial Court's approval of the order that had granted a super-priority to DIP lenders over secured claims, including statutory trusts, the employees' deemed trust claim must be honoured. The initial order, as amended, did not specifically identify that the DIP super-priority ranked ahead of the pension deemed trust.

While alive to the possibility that the recognition of the deemed trust would cause DIP lenders to be unwilling to advance funds for CCAA proceedings in the future, the Court noted that the conclusion in this case does not mean that a finding of paramountcy can never be made. Rather, the determination must be made on a case-by-case basis, and the employer/applicant must clearly raise the issue in order for the affected parties to be able to protect their rights.

3. NO DEEMED TRUST OVER DEFICIENCY IN ONGOING PLAN (EXECUTIVE PLAN)

The Court declined to find that a deemed trust existed in respect of the Executive Plan because the Executive Plan was not wound up at the time Indalex entered into CCAA protection.

Justice Gillese noted that the wind up of a pension plan appears to be a requirement for s. 57(4) to apply and concluded that "...if that is so, no deemed trust could arise unless and until a plan wind up occurred. As has been noted, the Executive Plan had not been wound up at the relevant time" [para. 110].

The Court did, however, make specific note of the fact that it would be a triumph of form over substance if a deemed trust did not extend to the deficiency in the Executive Plan. In light of the Court's ultimate conclusion that the assets were to be distributed to the plan beneficiaries in any event, the Court found it unnecessary to decide whether the deemed trust applied to the deficiency in the Executive Plan and declined to do so.

One of the troubling aspects of the Court's decision is that it leaves open the question of whether the scope of the deemed trust under the *PBA* might be expanded further in a future decision to include a deficiency under an ongoing pension plan.

To address the apparent disparity between the treatment of beneficiaries under the Salaried Plan and those under the Executive Plan, the Court turned to equitable principles and a breach of fiduciary duty finding.

4. BREACH OF FIDUCIARY DUTY AND CONSTRUCTIVE TRUST

The Court's rulings on breach of fiduciary duty are far reaching and will affect established principles of pension plan governance. In this regard, it should be noted that these findings relate to the Plans, but do not extend to the members' supplemental pension benefits which Indalex had terminated during the CCAA proceeding.

Briefly, the Court held that Indalex had breached the fiduciary obligations it owed to the Plans' beneficiaries as the administrator of each of the Plans. The remedy for the breach of fiduciary duty was to impress a constructive trust upon the portion of the Reserve Fund equalling the deficiencies in the Plans. The result was that, like the Salaried Plan, the pension deficiency in the Executive Plan "trumped" the DIP lender's super-priority over Indalex's assets.

The essential finding that Indalex, acting as plan administrator, breached its fiduciary duties to the Plans' beneficiaries is stated as follows:

I turn next to the question of breach [of fiduciary duty].

Indalex did nothing in the CCAA proceedings to fund the deficit in the underfunded Plans. It took no steps to protect the vested rights of the Plan's beneficiaries to continue to receive their full pension entitlements. In fact, Indalex took active steps which undermined the possibility of additional funding to the Plans. It applied for CCAA protection without notice to the Plan's beneficiaries. It obtained a CCAA order that gave priority to the DIP lenders over "statutory trusts" without notice to the Plans' beneficiaries. It sold its assets without making any provision for the Plans. It moved to obtain orders approving the sale and distributing the sale proceeds to the DIP lenders, knowing that no payment would be made to the underfunded Plans. And, Indalex U.S. directed Indalex to bring its bankruptcy motion with the intention of defeating the deemed trust claims and ensuring that the Reserve Fund was transferred to it. In short, Indalex did nothing to protect the best interests of the Plans' beneficiaries and, accordingly, was in breach of its fiduciary obligations as administrator.[para. 138]

The above findings must be placed within the context of long-standing and well established jurisprudence and a statutory framework that assigns fiduciary responsibility to the tasks related to administering a pension plan and pension fund but, until now, has not assigned fiduciary duties to the other functions of the plan sponsor (including amending or winding up a pension plan and funding a pension plan).

Specifically, the *PBA* and other Canadian pension standards legislation contemplates two separate and distinct roles in relation to a pension plan. Most of the legal obligations that arise in respect of a pension plan relate to its operation and administration. These legal obligations are to be performed by the plan administrator. When carrying out the administration of the pension plan, the administrator owes fiduciary duties to the pension plan beneficiaries.

Administration of a pension plan includes investing the assets of the plan, the payment of benefits, overseeing the preparation of actuarial valuations and compliance with member disclosure and other statutory requirements.

The non-administration (non-fiduciary) functions related to a pension plan include establishing the plan, amending the plan, winding up the plan, and making contributions to (or funding) the plan. In carrying out these functions, the plan sponsor (employer) is entitled to act in its own self-interest and is not held to a fiduciary standard of care.

The *PBA* expressly permits an employer plan sponsor to fulfill the role of the plan administrator. Therefore, the legislative framework contemplates a single corporation carrying out both functions and wearing "two hats".

The Indalex decision may suggest a heightened responsibility for the employer administrator where it is in financial difficulty and there is a risk that a deficiency in a pension plan will not be funded as a result. According to the Court of Appeal, for example, in the context of a CCAA proceeding, this would include ensuring there is adequate notice to pension plan beneficiaries of proceedings that will prejudice their ability to rely upon deemed trust provisions in pension standards legislation.

In addition, on the facts of this case, the Court found that Indalex, as administrator, failed to take steps to enforce its lien and charge against the Indalex's assets under section 57(5) of the *PBA*.

5. NATURE OF THE ADMINISTRATOR ROLE

Finally, the Court noted Indalex's admitted uncertainty with respect to its own responsibilities as the administrator of the plan following the commencement of the CCAA proceeding. In particular, the Court held that when it became impossible for Indalex to continue to function in the role of plan administrator, "it was incumbent on Indalex to take steps to address the conflict" [para. 143].

The Court did not elaborate on what steps would be sufficient or appropriate under the circumstances.

The *PBA*, and other Canadian pension standards legislation, limits who can fulfill the function of the administrator to the

employer and certain other entities, including member representative committees. None of the qualifying entities is a third party provider to whom the corporation administrator has simply contracted out its administrator duties. Therefore, simply “opting out” of the administrator role may be neither achievable nor desirable, depending on the circumstances.

The administrator is permitted to delegate certain tasks and/or to employ agents to assist in the administration of the pension plan. Neither delegation nor the employment of agents displaces the administrator role nor relieves the administrator of its fiduciary obligations to pension plan beneficiaries. At a minimum, careful attention to the administrator’s disclosure and other obligations is necessary during a formal insolvency, or any period where financial stability may be in question.

Finally, in certain circumstances, the Superintendent has the authority to appoint an administrator to assume responsibility for the pension plan – an authority that is similar to the authority that exists in most Canadian jurisdictions. To date, these circumstances have not included situations where a board of directors simply elects to cease acting as the administrator.

Any plan sponsor facing financial difficulty will need to closely consider this aspect of the *Indalex* decision and the potential options available. In particular, employers must carefully consider the effect that an administrator appointed by a pension regulator may have on: (1) the corporation’s ability to restructure without undue delay; (2) the long term viability of the pension plan in question, if it is not being wound up; and (3) the amount that will ultimately remain available to be paid to the plan beneficiaries in the particular circumstances.

CONCLUSION

While this decision arises in the context of a formal insolvency proceeding, its implications for pension plan governance generally (outside of insolvency proceedings) are potentially far reaching and should be reviewed carefully by board members, pension committees and others involved in pension plan administration.

In the context of *CCAA* proceedings, this decision is nothing short of a radical game changer. Any employer in or contemplating a *CCAA* filing will require advice and guidance on addressing pension plan funding issues and governance in order to avoid the *Indalex* result.

It is our understanding that leave to appeal to the Supreme Court of Canada is being sought. We will continue to monitor this case and provide updates on its progress.

To discuss how this decision affects your business and your pension plan, please contact any member of the [Pension & Benefits Practice Group](#).

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