Update

Indalex Decision: Implications from a Pensions & Benefits Perspective

The Ontario Court of Appeal decision in *Indalex Limited (Re)* has created considerable uncertainty over the priority status afforded to pension plan wind-up deficits, particularly in insolvency proceedings involving the plan sponsor. Overturning the trial decision and despite prior jurisprudence to the contrary, Madam Justice Gillese, writing on behalf of the Court of Appeal, held that the entire amount that an employer is required to contribute to fund a pension plan wind up deficiency under the Ontario *Pension Benefits Act* (PBA) is subject to the deemed trust provisions of the PBA and, in the circumstances, the amount subject to the deemed trust should be paid in priority to outstanding secured creditor claims.

BACKGROUND

On April 3, 2009, Indalex Limited (Indalex) obtained creditor protection under the *Companies' Creditors Arrangement Act* (CCAA), a federal act that provides financially troubled corporations with temporary protection from creditors and a process through which they can restructure their affairs. The CCAA court issued an initial order that, among other things, gave Indalex temporary protection from its creditors in order to prepare a plan of arrangement. Shortly after this, the Court authorized Indalex to obtain debtor-in-possession (DIP) financing providing Indalex with loans to allow it to continue to operate its business during the restructuring period. The CCAA court ordered that the DIP lenders were to have a "super-priority" over existing debt, equity and other claims. The DIP loan was also guaranteed by Indalex U.S. FTI Consulting Canada ULC (the Monitor) was appointed to supervise the steps taken by Indalex while in CCAA proceedings, on behalf of all of the creditors.

Indalex brought a motion for the approval of the sale of its assets and the distribution of the sale proceeds to the DIP lenders. At the sale approval hearing, two groups of pension claimants opposed the sale, and claimed that Indalex assets equal to the funding deficiencies in two defined benefit pension plans sponsored and administered by Indalex (known as the "Executive Plan" and the "Salaried Plan") were deemed to be held in trust and should be remitted to the plans in priority to the DIP lenders. An amount in respect of the funding deficiencies was held back by the Monitor and retained in a reserve account pending resolution of these pension issues and the DIP lenders were paid the balance of the sale proceeds. Indalex U.S. paid the DIP lenders the amount outstanding

on the loan, pursuant to its guarantee. Indalex U.S. then claimed the portion of the sale proceeds held by the Monitor in the reserve account and the two groups of pension claimants argued that these moneys should be paid to the pension plans.

The pension claims were dismissed by the CCAA court, which found that, because (i) the Executive Plan had not yet been wound up, and (ii) no amounts were due to the wound up Salaried Plan at the time (all going concern and special payment contributions required by law had been made at that date), there was no deemed trust in respect of the plan deficiencies at the date of wind up. In this regard, the CCAA court found that the deemed trust under the PBA only extended to any outstanding special payments due or accrued at the relevant date, not to the full wind up deficit which could be amortized over five years. Since all such required contributions had been made and no amount was in default, the CCAA court concluded there was nothing to which the deemed trust could attach.

PBA deemed trust extends to the full wind up deficit

Responding to the CCAA court's finding that the deemed trust provisions in the PBA only apply to contributions accrued and due at the date of wind up, the Court of Appeal focused on the "grammatical and ordinary meaning" of subsection 57(4) of the PBA, stating that "s. 57(4) contemplates that all amounts owing to the pension plan on wind up are subject to the deemed trust, even if those amounts are not yet due under the plan or regulations."

Departing from prior jurisprudence thought to have settled the scope of the PBA deemed trust, the Court held that the deemed trust under subsection 57(4) extended to all amounts owing on plan wind up by virtue of section 75 of the PBA. Section 75 requires the employer of a wound up plan to pay into the pension fund an amount equal to the total of all payments due or accrued to the fund that have not yet been paid (s.75(1)(a)) plus any additional amounts relating to the shortfall between the value of certain benefits and the assets available to pay those benefits in respect of Ontario plan members (s. 75(1)(b)). Accordingly, the Court held that the deemed trust under subsection 57(4) extended to "all amounts owed by the employer on the wind up of its pension plan" under the PBA. The Court stated that the fact that employers are permitted to pay the pension shortfall over time (i.e., five years) under the regulations does not change the result under subsection 57(4).

Priority of deemed trust

Despite the fact that the super-priority DIP charge approved by the CCAA court specified that it ranked in priority over trusts, "statutory or otherwise," the Court of Appeal relied on what it saw as procedural shortcomings in the CCAA process in this case, and found that there was nothing in the CCAA court record to suggest that the issue of paramountcy should be invoked. As such, the Court held that the DIP charge did not have priority over the deemed trust. In particular, the Court noted that the documents before the CCAA court at the time the charge was granted did not "alert the

court to the issue or suggest that the PBA deemed trust would have to be overridden in order for Indalex to proceed with its DIP financing efforts." The Court also pointed to affidavit evidence before the CCAA court at the time these orders were sought, indicating that Indalex intended to comply with all applicable laws including "regulatory deemed trust requirements."

As a result, the Court ordered the funding deficiency relating to the Salaried Plan to be paid out into the pension fund *in priority* to that of the DIP lenders' security rights. However, noting that the wind up of the pension plan appears to be a requirement for s. 57(4) of the PBA to be triggered, the Court chose not to decide whether the deemed trust provisions applied to the deficiency in the Executive Plan, which was not subject to wind up.

BREACH OF FIDUCIARY DUTY OF EMPLOYER/ADMINISTRATOR

To further support its findings regarding the PBA deemed trust on plan wind up and to deal with the issue of priority claims under the Executive Plan (which was not wound up), the Court of Appeal went on to consider Indalex's obligations as plan administrator and fiduciary. Indalex, like most employers providing an occupational pension plan for their employees, acts as both plan sponsor and plan administrator under the PBA. The Court noted the "two hats" theory, which suggests that when wearing its "administrator hat," the employer must act in the best interests of the plan members, but when donning its "sponsor hat," it may act in a self-interested manner focusing on the needs of the business enterprise. Finding that Indalex was in a conflict of interest with respect to these two roles in the context of dealing with pension issues under the CCAA proceedings, the Court of Appeal held that it could not resolve this conflict "by simply ignoring its role as administrator."

The Court did not seem to be moved by the fact that Indalex had actually made all of its statutorily required contributions for normal cost and special payments to the pension plans, and went on to find that Indalex, as plan administrator, had breached its fiduciary duty to plan beneficiaries.

> [W]hen Indalex commenced CCAA proceedings, it knew that the Plans were underfunded and that unless additional funds were put into the Plans, pensions would be reduced. 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 Plans' 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 Plans' 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 knew the purchaser was not taking over 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.

While the Court's sympathies were clearly with plan members, the legal analysis is unclear and raises problematic questions. What exactly was Indalex supposed to do in this situation? In this regard, it is worth noting that if the plan administrator had been an independent third party rather than Indalex, it would not have had any power to cause additional funding to be made to the pension plans. A third party administrator would not have funded the deficit, and it would not have the power to negotiate the terms of the DIP financing between Indalex and the DIP lenders or of the sale of the Indalex assets. The only thing it could do would be to ensure that plan beneficiaries had notice of various steps in the process.

Finding that Indalex breached its fiduciary obligations and that a deemed trust existed with respect to the deficiency in the Salaried Plan, the Court of Appeal concluded that the Monitor should be ordered to pay the amount of that deficiency ahead of any DIP loan recovery. The Court then went on to apply its conclusions with respect to the Salaried Plan to the Executive Plan as well — based on principles of equity. Side-stepping the statutory deemed trust issue, the Court ordered that the deficiency with respect to the Executive Plan be paid in priority to that of the DIP lenders' security rights based on the common law doctrine of constructive trust. In so doing, the Court gave surprisingly little weight to the fact that the potential for such conflicts of interest is inherent in most pension plan governance structures, and it is normally accepted that fiduciary obligations only arise during the performance of an employer's duties as plan administrator. It appears that most of the actions by Indalex that were of concern to the Court (as noted above) were actions in its role as employer/sponsor, and that Indalex was fully compliant with its administrative obligations.

PRACTICAL IMPLICATIONS

The implications of the *Indalex* decision for future CCAA proceedings will be significant.

- Lack of Certainty: Before providing financing in CCAA proceedings, lenders will want certainty that their interest in the company's property takes priority over other entities, including the pension funds. Although the Court appeared to try to confine the decision to the particular circumstances of the *Indalex* case, such certainty will be difficult to obtain in light of this decision. As a result, some companies may be driven to choose bankruptcy proceedings, where there continues to be more certainty with respect to the priority to be given to lenders.

- Importance of Procedures Followed: More attention will have to be paid to the process issues identified by the Court of Appeal (e.g., notice to plan members of the CCAA proceeding) in future CCAA proceedings. The process followed by Indalex and the representations made to the Court in Indalex's affidavit evidence were key facts that the Court used in determining that there was a breach of fiduciary duty and that a constructive trust should be applied to give plan members priority over the DIP lenders.

- Independent Administrators: Companies with underfunded plans that are undergoing a CCAA restructuring may wish to consider taking steps to avoid fiduciary duty issues, such as seeking to have an independent administrator appointed for the pension plan. For Ontario registered plans, this would likely require the approval of the Ontario Superintendent of Financial Services.

- Impact on Directors and Officers: Given the conflict of interest involved, and the lack of certainty over the Director and Officer charge in relation to pension plan deficit claims, can the directors and officers continue to act, or will this place pressure on them to resign sooner?

In addition to insolvency proceedings, the *Indalex* decision is going to affect the ongoing operations of Canadian companies with defined benefit plans.

- Lending and Borrowing: We are already seeing the decision have a significant impact on asset-based lending arrangements in the normal course, as lenders try to adjust their financing agreements in order to protect the value of their security.

- Pension Plan Governance: The Court of Appeal's position on the fiduciary duty of a plan administrator to secure some type of full funding potentially has far-reaching implications for all companies with respect to their pension plan funding decisions and governance processes, even companies that do not have any current risk of insolvency proceedings.

We understand that the secured creditors are seeking leave to appeal this decision to the Supreme Court of Canada. In the interim, however, lenders and borrowers – both inside and outside the insolvency context – should proceed with caution.

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