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The Effect of Cross-Border M&A on Pension Plans: A Canadian Perspective

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Being able to navigate through the complicated pension landscape in Canada has become increasingly important with the surge in M&A activity in recent years and the phenomenal growth in cross-border transactions. These transactions therefore require a comprehensive understanding of the issues regarding pension and employee benefits. A lack of clarity in the case law, combined with minimal legislation and restrictive policies established by regulatory bodies, has created an uncertain legal environment in this area. And recent legal developments have made pension plan mergers in Canada even more complicated.

THE ANATOMY OF A TRANSACTION

Acquiring or disposing of pension plans and their associated liabilities in the context of an M&A transaction can have a significant effect on a company's financial statements as well as on employee morale and productivity. These transactions generally involve negotiations regarding representations and warranties, pre-purchase and post-purchase administration as well as the funding of pension arrangements.

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Share transactions are often relatively straightforward because the purchaser acquires the shares of the vendor company and the purchased entity can continue uninterrupted, but under new control. Therefore, a pre-existing pension plan would continue to be sponsored by the acquired company, and the purchaser would accept all of the vendor's pension liabilities and obligations, making due diligence extremely important.

Asset transactions tend to be more complicated than share transactions, with the purchaser acquiring some or all of the assets and employees of the vendor's business. An asset transaction does not automatically result in the assignment of the vendor's pension liabilities and assets to the purchaser. Absent any specific employment agreement covering key employees or collective agreements covering unionized employees that would require the purchaser to provide a successor plan, the vendor and purchaser have greater flexibility in determining whether or not to provide a successor pension plan to the affected employees.

Mergers involve the combination of two or more corporations into one legal entity with the rights and obligations of the merging companies continuing in the successor corporation. Pre-existing pension plans of the merging corporations are not automatically merged, and plans will generally continue separately. However, the successor corporation may decide that a pension plan merger is in the best interests of the corporation. In such situations, understanding the regulatory and legal framework for pension mergers becomes imperative to effecting the desired result.



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THE ANATOMY OF A PENSION PLAN MERGER

A pension plan “merger” describes a scenario in which two or more pension plans are amalgamated into a single plan through a transfer of pension plan assets. Thus, what is commonly referred to as a “plan merger” is actually an asset transfer. In the context of an M&A transaction, such a scenario may be in the best interests of the successor corporation as well as the plan members. Plan sponsors may be able to take advantage of the surplus in one plan to offset contributions to another. Additional synergies may be achieved through providing uniform pension benefits to all employees, reducing plan administration costs and streamlining regulatory compliance obligations. Moreover, plan governance may also benefit from a plan merger.

From plan members’ perspective, a merger is also preferable because most pension plans in Canada use years of service as part of their formulas to calculate employee entitlements. Therefore, when plans are not merged, the combined pension that a plan member collects will likely be reduced.

The benefits resulting from a merger of pension plans in certain scenarios are clear. That being said, to achieve these benefits, practitioners will need to go through a complex process involving a review of plan documents, legislation, regulatory policies and case law. Before a merger is effected, it is necessary to examine the language of the historical plan documents because this determines the parameters for the plan merger. Another layer of complexity is added when dealing with a plan impressed with a trust. In the seminal case of *Schmidt v. Air Products*, the court held that the power of revocation must be expressly reserved in order for amendments to be made to trust instruments. Whether the pension plan is open or closed will also determine the rights of beneficiaries and affect the administration of the plan.

The subject of plan mergers or asset transfers is not dealt with extensively in pension legislation. In fact, regulatory control over the merger process in most Canadian jurisdictions is derived from the regulator’s general authority to permit or deny approval for asset transfers. This is the case in Ontario, where the consent of the superintendent of financial services is required and will only be granted if the pension benefits of the members of the transferring plan are protected. Historically, pension plan mergers have received little attention from Canadian courts. However, several recent cases have drawn attention to this important area of law.^[FOOTNOTE 1] One of the most significant cases is discussed below.

‘AEGEON CANADA INC. v. ING CANADA INC.’

Aegeon Canada Inc. and Transamerica Life Canada had arranged to enter into a share purchase transaction with ING

Canada Inc. for the shares of NN Life Insurance Company of Canada. Under the agreement, ING had warranted that all required contributions had been made to the NN Life Pension Plan and that it was fully funded on a going-concern and solvency basis.

The NN Life Plan was the product of a merger between a Halifax Life Insurance Company of Canada pension plan and NN Life pension plan. The Halifax Plan was impressed with a trust stipulating that no amendment to the trust could authorize the use of trust funds for anything other than the “exclusive benefit” of the plan beneficiaries. Under Ontario’s Pension Benefits Act, NN Life had sought plan merger approval from the pensions regulator. The regulator subsequently required NN Life to maintain all transferred assets and associated liabilities of the Halifax Plan in an account separate from the NN Life Plan. NN Life abided by this requirement, but for the purpose of determining whether it could take contribution holidays, it treated the two plans as one. For a number of years, the Halifax Plan was in surplus and the NN Life plan was in deficit. On the basis of the combined accounting, NN Life made no employer contributions to the NN Life Plan.

The issue in this case, commonly known as *Transamerica*, was whether ING breached the warranties discussed above. ^[FOOTNOTE 2] The Court of Appeal held that the terms of the trust prevented any part of the fund from being diverted for any purpose other than for the exclusive benefit of the Halifax Plan beneficiaries. Moreover, as a result of both the trust instrument and NN Life’s undertaking to the authorities, the court held that no legal basis existed for NN Life to consider the Halifax Plan surplus when determining its funding obligations for employees who were not members of the Halifax Plan. As a result, ING had, indeed, breached certain warranties under the share purchase agreement.

In response to *Transamerica*, the pension regulator created new policies regarding pension asset transfers. This policy drastically restricts plan mergers between defined benefits plans unless the merger can be distinguished from the facts of *Transamerica*.

CROSS-BORDER CONSIDERATIONS

In a cross-border transaction, counsel is generally retained in all relevant jurisdictions. Differences in the law in each jurisdiction require local expertise and a specific understanding of national statutory and regulatory regimes. In Ontario, the uncertain landscape regarding pension plan mergers underscores the necessity of such an approach.

Other cross-border considerations may arise in the context of an M&A transaction. In particular, plan sponsors must be made aware of §409A of the U.S. Internal Revenue Code, which regulates pension entitlements and other deferred compensation arrangements. These provisions were added to the code under the

American Jobs Creation Act of 2004 and cast a wide net by virtue of the fact that U.S. citizens are subject to tax on their worldwide income, regardless of residency.

The extraterritorial nature of these provisions means that they ensnare Canadian pension plans that count U.S. citizens among their beneficiaries. In the context of a merged pension plan, the successor plan administrator will have to ensure compliance by determining the status of beneficiaries from the original pension plans. Otherwise, participation by U.S. citizens in Canadian plans may result in certain prescribed penalties discussed below.

The Jobs Creation Act is designed to make deferred compensation arrangements transparent and regulate the timing of such compensation. It requires members of nonqualified deferred compensation plans to elect, the year prior to beginning to receive deferred compensation, the date when they will receive payments and the form those payments will take (e.g., lump sum, monthly, annually).

Accordingly, failure to comply with §409A brings with it harsh penalties to the noncomplying taxpayer, including:

1. Inclusion of all deferred compensation amounts in gross income back to the time of deferral;
2. Calculation of interest at the underpayment rate plus 1 percent; and
3. Assessment of an additional 20 percent tax.

As a cross-border issue, this is significant for the individual U.S. taxpayer. Nevertheless, plan sponsors will want to be aware of the consequences of noncompliance and would be well advised to identify these individuals, identify all deferred compensation arrangements and proactively resolve the situation.

FUTURE TRENDS

Transamerica and the other recent cases dealing with pension mergers and asset transfers in Canada have left a significant number of questions for companies wishing to reorganize their pension structures.

Although the *Transamerica* decision clearly demonstrates that plan mergers are possible, it has become evident that pension plan mergers in Ontario are neither straightforward nor routine. Pension mergers and asset transfers are case-specific.

Plan sponsors must be well prepared to demonstrate on a case-by-case basis that *Transamerica* and the regulator's asset transfer policy have no application to their asset transfer. In some cases, this may entail a legal review of the plan's historical language to assess whether the issues and the kind of language noted in *Transamerica* are present. This is especially important when dealing with a pension plan that is subject to a trust.

Pension plan mergers remain a significant consideration in cross-border M&A transactions and do not lend themselves to easy answers. Parties who are negotiating pension mergers would find it extremely helpful to retain counsel with the proper mix of regulatory expertise and transaction experience as early in the process as possible. Anticipating potential problems at an early date provides the necessary time to make the changes required to gain plan merger approval.

The significant differences between pension regimes around the world mean that a one-size-fits-all approach to this area of law is not possible.

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::::FOOTNOTES::::

FN1 Schmidt v. Air Products; Baxter v. Ontario (Superintendent of Financial Services); Lennon v. Ontario (Superintendent of Financial Services); Buschau v. Rogers Cablesystems Inc.

FN2 Aegeon Canada Inc. v. ING Canada Inc. (2003), 179 O.A.C. 196.