

## Introduction

M&A transactions 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. In addition, recent legal developments have made pension plan mergers in Canada even more complicated.

Given this background, the purpose of this paper is to analyze the current state of the law regarding pension plan mergers in Canada, focusing on registered pension plans from an Ontario law perspective.<sup>1</sup>

## M&A in Canada

In 2007, 40% of all M&A transactions in Canada and 78% of total M&A value had an international component.<sup>2</sup> The United States remains Canada's largest cross-border M&A partner. Last year, 54% of Canada's 532 foreign acquisitions were in the United States, and 44% of the 246 foreign acquisitions of Canadian companies were made by U.S. companies.<sup>3</sup> With pension issues receiving an increasing level of scrutiny from market participants, added significance is accorded to knowing precisely what kind of pension assets and liabilities are involved in a transaction.

## Pension Plans in Canada

The federal and most provincial governments in Canada have enacted their own pension legislation. This creates a complex area of law, with overlapping multijurisdictional components. Key pieces of legislation in Ontario include the *Pension Benefits Act* (Ontario),<sup>4</sup> the federal *Pension Benefits Standards Act, 1985*<sup>5</sup> and the *Income Tax Act* (Canada).<sup>6</sup> Government pension regulators administer the legislation and publish policies and bulletins that provide guidance regarding matters of interpretation and regulatory consent. Additional sources of legal obligations are found in common law concepts such as contract law and trust law. This is especially relevant with respect to pension plan texts and funding agreements that form the basis of pension plan documentation. As a result of this extensive legal framework, pension plans in Canada are subject to stringent regulation by government authorities, with substantial and ongoing compliance requirements.

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<sup>1</sup> Forty-five percent of registered Canadian pension plans are located in Ontario. Source: Statistics Canada, online: Pension Plans in Canada: Key Tables [www.statcan.ca/english/freepub/74-508-XIE/74-508-XIE2004001.htm](http://www.statcan.ca/english/freepub/74-508-XIE/74-508-XIE2004001.htm).

<sup>2</sup> Crosbie & Company, "M&A Quarterly Report – Q4/07," online: [www.crosbieco.com/pdf/ma/MA\\_Q407.pdf](http://www.crosbieco.com/pdf/ma/MA_Q407.pdf).

<sup>3</sup> *Ibid.*

<sup>4</sup> *Pension Benefits Act*, R.S.O. 1990, c. P.8. [PBA].

<sup>5</sup> *Pension Benefits Standards Act, 1985*, R.S.O., 1985, c. 32. [PBSA].

<sup>6</sup> *Income Tax Act*, R.S.C. 1985, c. 1.

## 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. Negotiations over representations and warranties, pre-purchase and post-purchase administration, as well as over the funding of pension arrangements will take place between the purchaser and the vendor in all scenarios described below.

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.

## 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 by 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.

In certain scenarios, the benefits of pension plan mergers 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 in which the plan

merger may take place. Another layer of complexity is added when dealing with a plan impressed with a trust. In the seminal case of *Schmidt v. Air Products*,<sup>7</sup> 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.

Pension legislation does not deal extensively with the subject of plan mergers or asset transfers. 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, which requires the consent of the Superintendent of Financial Services who will give consent only if the pension benefits of the members of the transferring plan are protected.<sup>8</sup> Historically, Canadian courts have given little attention to pension plan mergers. However, several recent cases have drawn attention to this important area of law. Some of the more significant cases are 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 (NN Life 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 (Halifax 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. Pursuant to the PBA, NN Life had sought plan merger approval from the Pension Commission of Ontario (PCO), the precursor to the Financial Services Commission of Ontario (FSCO). The PCO subsequently required NN Life to provide an undertaking that all transferred assets and associated liabilities of the Halifax Plan would be maintained in an account separate from the NN Life Plan. NN Life abided by the terms of the undertaking, but for the purpose of determining whether it could take contribution holidays, NN Life 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 did not make any employer contributions to the NN Life Plan.

The issue in this case was whether ING breached the warranties discussed above.<sup>9</sup> 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 PCO, the Court held that there was no legal basis 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*, FSCO drafted a new policy statement regarding its approach to pension asset transfers. FSCO's position drastically restricts plan mergers between defined benefits plans unless the merger can be distinguished from the facts of *Transamerica*.

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<sup>7</sup> [1994] 2 S.C.R. 611 [*Schmidt*].

<sup>8</sup> PBA, ss. 80(5) and 81(5).

<sup>9</sup> *Aegeon Canada Inc. v. ING Canada Inc.* (2003), 179 O.A.C. 196 [*Transamerica*].

### ***Baxter v. Ontario (Superintendent of Financial Services)***

The decision in *Baxter v. Ontario (Superintendent of Financial Services)* provided some welcome news for plan sponsors and employers contemplating plan mergers.<sup>10</sup> The National Steel Car Corporation Limited Pension Plan (Original Plan) was established in 1952. It covered both salaried and hourly employees, and expressly permitted plan mergers. In 1965, the Original Plan was split into a plan for salaried employees (Salaried Plan) and a plan for hourly employees (Hourly Plan). The Salaried Plan was subsequently amended in 1972 to provide that any surplus was to revert to National Steel Car Limited (NSC). In 1994, the funding structure of both plans was changed to a pension trust.

In 2000, NSC announced that it intended to merge the Salaried Plan, which was in surplus, with the Hourly Plan, which was in deficit. After NSC obtained the Superintendent's consent to this asset transfer, members of the Salaried Plan applied to the Financial Services Tribunal for a review of the decision. The Tribunal upheld FSCO's consent and the members appealed to the Ontario Divisional Court. Their argument was that the merger did not protect their benefits because the Salaried Plan surplus might be used to enable NSC to take contribution holidays despite the Hourly Plan's deficit. The Salaried Plan beneficiaries argued that their plan was subject to a trust prior to the amendment in 1994 and that the 1972 amendment permitting the reversion of surplus was invalid as a result. Finally, the beneficiaries of the Salaried Plan argued that *Transamerica* was binding on the Court.

In analyzing these arguments, the Court made a number of important points. First, the Court re-affirmed the trust law principle that in order for a trust to be created, there must be a clear intention to do so. Second, the Court held that, consistent with the finding in *Schmidt*, the beneficiaries of a plan have no rights in the surplus of a plan while the plan is ongoing. Finally, the Court clearly distinguished *Transamerica* on its facts because the plan in this case expressly permitted mergers, unlike the *Transamerica* plan. This is significant because it seemingly limits the scope of the *Transamerica* decision and suggests that a plan merger is not ruled out where one plan is in deficit and the other in surplus.

The *Baxter* decision confirms that FSCO's merger policy does not prohibit pension plan mergers outright and that nothing in general trust law prevents such mergers. The facts in *Baxter* were quite different from the predecessor cases because, unlike *Buschau* (see below), plan membership was not closed and, unlike *Transamerica*, there was no undertaking to keep plan assets separate. Therefore, plan sponsors should be aware that a situation with less favourable facts may not yield the same results. In spite of *Baxter*, FSCO's policy remains unchanged. This continues to add to the uncertainty regarding pension plan mergers in Ontario. However, in light of *Baxter*, it appears that a properly structured merger involving pension plans with permissive text language, whether involving trusts or not, stands a reasonably good chance of receiving approval, which will continue to be made on a case-by-case basis.

### ***Lennon v. Ontario (Superintendent of Financial Services)***

The decision in *Lennon v. Ontario (Superintendent of Financial Services)* also limits the application of *Transamerica*.<sup>11</sup> As a consequence of the amalgamation of Reliance Electric Limited and Rockwell Automation Canada Inc., Rockwell applied to the Superintendent to merge the Pension Plan for the Salaried and Management Employees of Reliance Electric Limited (Reliance Plan) and the Revised Retirement Plan for Employees of the Allen-Bradley Division of Rockwell International of Canada (Allen-Bradley Plan) to form the Pension Plan for Employees of Rockwell Automation Canada Inc. (Rockwell

<sup>10</sup> *Baxter v. Ontario (Superintendent of Financial Services)* (2004), 192 O.A.C. 293 [*Baxter*].

<sup>11</sup> *Lennon v. Ontario (Superintendent of Financial Services)* (2006), FST Decision No. P0051-1999-1, aff'd [2007] O.J. No. 4228 (Div. Ct.).

Plan), and transfer the assets from the pension fund for the Reliance Plan to the pension fund for the Rockwell Plan. At the time of the merger and asset transfer, both the Reliance Plan and the Allen-Bradley Plan were in surplus positions.

The Superintendent consented to the transfer of assets under the PBA. However, the members of the Reliance Plan requested a hearing before the Financial Services Tribunal (FST) regarding the Superintendent's consent to the transfer of assets from the Reliance Plan to the Allen-Bradley Plan.

The FST considered whether the Reliance Plan was established pursuant to a trust and whether the Reliance Plan permitted mergers. The FST held that the Reliance Plan was subject to a trust. The FST also held that the trust document was to be read together with the plan to determine whether there were any impediments to asset transfer and plan merger. The FST determined that plan mergers were implicitly permissible due to the broad amending powers reserved by the plan sponsor and in light of the fact that the Reliance Plan was not closed to new members or new participating employers. The FST distinguished *Lennon* from *Transamerica* on the grounds that (i) the plan at issue in *Transamerica* was in surplus, whereas the other merging plan was in deficit; (ii) the plan at issue in *Transamerica* was closed to new members; (iii) the plan at issue in *Transamerica* required that its assets be kept separate and apart from those of the other merging plan; and (iv) the permissibility of the merger was not directly at issue in *Transamerica*.

The applicants also contended that the Superintendent failed to properly protect their rights to benefits – namely, rights to actuarial surplus on plan windup because the Superintendent did not investigate surplus entitlement when reviewing the application for plan merger. The FST ruled that the PBA does not require the Superintendent to refuse to approve a transfer that does not protect members' interest in surplus because surplus is neither a "pension benefit" nor an "other benefit" requiring protection under the PBA. *Lennon* thus implies that plan members have no interest in actuarial surplus while a pension plan is ongoing and that surplus ownership is not to be taken into account at the time of merger.

The members of the Reliance Plan appealed the decision of the FST to the Divisional Court on the basis that the FST erred in refusing to set aside the Superintendent's consent to the transfer of assets. The Divisional Court noted that the central question facing both the Superintendent and the FST was whether the plan and trust documents, reasonably interpreted, permitted the merger of the plans. In its analysis, the Divisional Court reiterated that general principles of trust law do not impede merger of pension plans. Actuarial surplus can be used for contribution holidays while a plan is ongoing, and this use is not a revocation unless the terms of the trust prohibit it.

The Divisional Court dismissed the appeal, holding that the decision of the FST was reasonable. It concluded that the merger and use of the actuarial surplus from the Reliance Plan to fund contribution holidays for the merged Rockwell Plan was not a revocation of trust because (i) nothing in the original Reliance Plan text precluded a merger with another plan; (ii) subsection 7(3) of the PBA Regulation expressly permits the use of actuarial surplus to fund contribution holidays; (iii) neither the Reliance Plan nor the Rockwell plan was closed to new members; (iv) Rockwell was entitled to take contribution holidays with respect to new members; and (v) neither the Reliance Plan documents nor the Rockwell Plan documents prohibited the use of trust funds to fund obligations relating to new beneficiaries of the plan.

### ***Buschau v. Rogers Cablesystems Inc.***

In 1980, Rogers Cablesystems Inc. (Rogers) acquired Premier Cablevision Ltd. and began to administer the Premier Communications Ltd. Pension Plan (Premier Plan). This plan was established in January 1974 and funded pursuant to a trust agreement, which included the following provisions pertinent to this case: (i) money from the Premier Plan was to be used for the "exclusive benefit" of the Premier Plan beneficiaries; (ii) no amendment was permitted to the Premier Plan that would derogate from this right; and (iii) any surplus was to be used to provide enhanced benefits to Premier Plan members.

Under Rogers' administration, a new section was added to the Premier Plan text specifying that any surplus was to be returned to Rogers upon termination of the Premier Plan. By 1984, the Premier Plan had been in surplus for a number of years and Rogers began taking contribution holidays. This continued until 1992, when Rogers decided to merge the Premier Plan with four other plans, three of which were in deficit, to form an amalgamated plan (RCI Plan). The RCI Plan provided that all surplus was to revert to Rogers.

In 1995, a number of the beneficiaries of the Premier Plan commenced an action against Rogers, claiming a return of all withdrawn surplus and funding from contribution holidays.<sup>12</sup> This group claimed that they should be able to unilaterally terminate the plan pursuant to the rule in *Saunders v. Vautier*,<sup>13</sup> in which it was held that beneficiaries who together are entitled to all the rights of beneficial ownership in the trust property may, if they are of full capacity, call for the extinguishment of the trust, notwithstanding the settlor's expressed wishes.

The British Columbia Court of Appeal held that members of the closed Premier Plan could terminate the trust and force a distribution of surplus according to the rule in *Saunders*, but the Supreme Court of Canada held that the rule in *Saunders* could not be invoked to terminate the trust because this trust law principle could not be readily applied in the complex context of registered pension plans. The SCC held that the PBSA, which sets out a comprehensive legislative scheme dealing with plan termination and distribution of surplus assets, provides recourse for plan members and should displace the trust law rule. More specifically, the SCC recognized that pension trusts cannot be terminated without considering the legislation governing a particular pension plan and the plan itself.

The SCC decision that the rule in *Saunders* was not applicable to the *Buschau* facts represented an easing of the strict application of trust law principles in the pension context and confirms that pension trusts are different from traditional trusts. Equally important is the deference shown to the pension legislation, especially recognizing that the mechanisms established in the PBSA for dealing with issues such as plan termination and distribution of surplus assets take precedence over trust law rules, and that these mechanisms should be used to manage these issues. The *Buschau* decision halted the recent trend of pension decisions in favour of employees and represents a victory for pension plan administrators.

### 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 unique 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 section 409A of the *U.S. Internal Revenue Code*,<sup>14</sup> which regulates pension entitlements and other deferred compensation arrangements. These provisions were added to the Code under the *American Jobs Creation Act of 2004*<sup>15</sup> 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.

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<sup>12</sup> *Buschau v. Rogers Cablesystems Inc.*, [2006] 1 S.C.R. 973 [*Buschau*].

<sup>13</sup> (1841) 49 E.R. 282 (U.K. Ch. Ct.) [*Saunders*].

<sup>14</sup> U.S.C. Title 26 [Code].

<sup>15</sup> Pub. Law No. 108-357, 118 Stat. 1418 [*Jobs Creation Act*].

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 non-qualified 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). This law was the U.S. Congress's response to compensation abuses coming to light in the wake of highly public corporate scandals.

Accordingly, failure to comply with section 409A brings with it harsh penalties to the non-complying taxpayer, including (i) inclusion of all deferred compensation amounts in gross income back to the time of deferral; (ii) calculation of interest at the underpayment rate plus 1 percent; and (iii) assessment of an additional 20 percent tax.<sup>16</sup> 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 non-compliance and would be well-advised to identify these individuals, identify all deferred compensation arrangements and proactively resolve the situation.

More generally, parties who are negotiating pension mergers would find it extremely helpful to retain counsel 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.

### Future Trends

The 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. This uncertainty, delay and/or refusal to permit the transfer of assets and liabilities on sale-of-business transactions and plan mergers does not benefit plan sponsors or plan members. Given the importance of pension plans to both the employer and the plan beneficiaries, it is crucial that Canadian governments and regulators step in to provide consistent direction on how these transactions may be effected without resorting to the judicial system.

*Baxter* and *Lennon* are welcome news to pension plan sponsors who feared that pension plan mergers would be virtually prohibited by *Transamerica*. However, while that decision clearly demonstrates that plan mergers are possible, each decision will turn on its own facts, making it impossible to state that this case has paved the way for all plan mergers. *Transamerica* and FSCO's asset transfer policy will continue to significantly restrict the ability of plan sponsors to merge pension plans.

As has become evident, pension plan mergers in Ontario are neither straightforward nor routine. Pension mergers and asset transfers are case-specific. Thus, it is important for parties who are approaching any pension plan merger in Canada, to focus on the original plan text and any subsequent amendments to determine whether a merger would be prohibited. Plan sponsors must be well-prepared

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<sup>16</sup> Code, *supra* note 14 at § 409A.

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. As Canada's level of international trade and investment continues to grow, cross-border M&A will grow along with it to encompass not only the United States, Canada's traditional main trading partner, but other countries as well. Pension plan mergers do not lend themselves to easy answers and multinational transactions involving pension plan mergers will continue to require effective counsel with the proper mix of regulatory expertise and transaction experience. **T**