

Torys on Pension and Employment

P&E 2011-2
April 12, 2011

Ontario Court of Appeal Decision May Create Uncertainty for Insolvent Companies with Pension Deficiencies

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A ruling on April 7, 2011 by the Ontario Court of Appeal has resulted in deemed trust and unsecured breach of fiduciary duty claims in favour of pension beneficiaries being given priority ahead of court-ordered “super-priority” charges. The decision may significantly change the way in which debtor companies and their stakeholders approach insolvency proceedings involving pension deficits (whether actual or prospective) in light of the priorities given by the Court to the claims. The judgment, in *Re Indalex Limited*, also creates considerable uncertainty for companies and directors regarding the nature of their duties when a company that is the administrator of a pension plan is also planning to commence a formal insolvency proceeding.

Background

Indalex Limited (Indalex) was the Canadian subsidiary of a U.S.-based aluminum manufacturing company that had sought protection under the *Companies’ Creditors Arrangement Act* (CCAA). Indalex was also the sponsor and administrator of two underfunded pension plans in Canada, one for its former executives (Executive Plan) and one for its former salaried workers (Salaried Plan) (together, the Plans). The Salaried Plan was in the process of being wound up; the Executive Plan had been closed to new members, but was not yet subject to a windup (although Indalex had indicated that a windup of the Executive Plan was intended). All current service contributions had been made for each Plan, but each Plan was underfunded.

In proceedings commenced under the CCAA, debtor-in-possession (DIP) financing had been approved by the CCAA court, with Indalex’s U.S. parent (Indalex U.S.) acting as guarantor. As is customary in CCAA proceedings, a super-priority charge in favour of the DIP lenders was ordered by the court at the time that the DIP financing was approved. A few months after the DIP approval, Indalex sold its assets as a going concern and applied to the court for approval of a distribution of the sale proceeds to the DIP lenders. The Plans’ beneficiaries challenged the proposed distribution and the court ordered the CCAA Monitor to retain a portion of the sale proceeds equal to the amount representing the total underfunding of the Plans. Ultimately, the DIP lenders were repaid in full because, as guarantor, Indalex U.S. was required to cover the shortfall. As a result, Indalex U.S. had a subrogated claim against Indalex, and it sought to have the balance of the funds held by the Monitor released to it. Indalex U.S. argued that the DIP lenders’ super-priority claims, and therefore its subrogated claims, had priority over the Plans’ beneficiaries. The CCAA court found in favour of Indalex U.S. and dismissed the claims of the Plans’ beneficiaries, which decision was appealed.

Indalex is a contest over funds between Canadian pensioners and a U.S. corporation affiliated with the Canadian debtor found to have breached its fiduciary duties to

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pensioners. The importance of this factual context cannot be overstated (though it may well be said to have resulted in an unfortunate legal precedent).

The Decision

In overturning the ruling of the CCAA court, the Ontario Court of Appeal sided with the Plans' beneficiaries. Its unanimous ruling centred on three principal issues.

1. Deemed Trusts

The Court found that when a windup of an employer pension plan has been commenced, a deemed trust is created with respect to any deficiencies in the plan. By its interpretation of the Ontario *Pension Benefits Act* (PBA), the Court further declared that such a trust was not limited to amounts already due at the time of windup but was entitled to amounts set to become due over the life of the plan.

Although the Court elected not to determine the issue (and was itself skeptical of the argument), it suggested that even plans that are still active at the relevant time period (i.e., not being wound up, such as the Executive Plan in the present case) may be able to benefit from the deemed trust created under the PBA. The Court was troubled that companies that elected not to proceed with a windup could potentially avoid a deemed trust; however, as is discussed below, the Court found that courts may address this issue in the context of fiduciary duties and remedies for breach of these duties.

2. Fiduciary Duty

The Court also found that Indalex breached the common law and statute-based fiduciary obligations it owed to the Plans' beneficiaries. This was on the premise that, as the Plans' administrator, Indalex bore fiduciary duties not only to the company's shareholders but also to the Plans' beneficiaries. In this sense, Indalex was conflicted (though the Court did not clarify how this conflict should have been addressed) and could not assert its preferred role by seeking out the best interests of the corporation at the expense of the Plans' beneficiaries. The Court found that numerous steps taken by Indalex in the context of the CCAA were in conflict with its fiduciary duties as administrator of the Plans. Traditionally, a breach of fiduciary duty gives rise to an unsecured claim in favour of the party that has been wronged. In *Indalex*, the Court found that it had the jurisdiction to elevate a breach of fiduciary duty claim to have priority over all other creditors, including secured creditors, by means of finding a constructive trust over the sale proceeds to exist in favour of the Plan beneficiaries.

3. Collateral Attack

Finally, the Court found that the doctrine of collateral attack does not necessarily prevent a party in CCAA proceedings from challenging prior orders of the CCAA court, including prior court-ordered "super-priority" charges. The decision introduces considerable uncertainty for parties seeking to rely on the orders of the courts made in CCAA proceedings.

In *Indalex*, the Plans' beneficiaries challenged the priorities imposed by the original court order authorizing the DIP loan. Despite the extended period of time between initial DIP loan authorization and the subsequent assertion to the sale proceeds by the Plans' beneficiaries, the Court reasoned that this delay did not constitute a collateral attack on the original court order. Through somewhat tortured reasoning, the Court found the Plans' beneficiaries had proceeded promptly, with diligence and without attempting to circumvent any binding decision made against them. Similarly, the Court concluded that the original wording of the initial CCAA order did not purport to elevate the DIP financing charge ahead of the pension claims (though it left open that future CCAA orders might do so – these initial CCAA orders

apparently must expressly refer to pension deemed trust and breach of fiduciary duty claims and must also expressly consider and order paramourcy over provincial deemed trusts if they are to be effective).

Conclusion

The *Indalex* decision will, unless appealed, engender extensive discussion and consideration in pension and insolvency circles. Companies that act as pension plan administrators have new conflict concerns to struggle with, particularly as they endeavour to plan, commence and conduct a formal insolvency proceeding. (We may well see these companies abandon the role on the eve of insolvency filings or shortly after commencement, bringing in independent third parties to act as administrators.)

DIP lenders and other stakeholders face increased uncertainty over the integrity of initial court orders and their ability to rely on these orders (including the efficacy of court-ordered charges and the risk of collateral attack at a later date). Stakeholders may increasingly consider alternatives to CCAA (such as bankruptcy) if there are pension deficits. All stakeholders face increased risk of unsecured breach of fiduciary duty claims being asserted, with the prospect of an elevated priority being given to such claims.

We may even see creative deemed trust claims made in respect of pension plans not being wound up (as the Court suggested may be possible). There will undoubtedly be numerous changes to CCAA practice, including amendments to the form of CCAA orders, in an attempt to eliminate or contain the uncertainty and risks resulting from this decision.

What is perhaps most regrettable is that the risks and uncertainty resulting from the *Indalex* decision will negatively affect all stakeholders. Liquidation may be pursued rather than restructuring, and even where restructurings are commenced, clearly, the costs, complexities and time involved in insolvency proceedings when there are underfunded pensions have increased significantly. **1**