SUPPLEMENTAL CHAPTER S3

Pensions, Insolvencies, Bankruptcies, and the Worker*

LEARNING OBJECTIVES

After reading this chapter, students will be able to:

- Identify the key areas of law applying to insolvent or bankrupt employers.
- Explain the similarities and differences between restructuring and bankruptcy and the four major procedures available.
- Identify the different options employees have for enforcing their rights to wages and pensions when an employer becomes insolvent.
- Describe the way in which insolvency laws prioritize creditors and the effect of this classification on different stakeholders.
- Describe defined benefit and defined contribution pension plans, and the advantages and disadvantages of each.
- Explain the "minimum standards" that pension legislation imposes on employers who sponsor pension plans.

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I. Introduction

This chapter considers the regulation of employees' rights and entitlements after their employment is terminated due to an employer's **insolvency** or when they have left the labour force altogether due to retirement. Both situations are concerned with the position of employees at a point in their life when they may be particularly vulnerable. This chapter begins with a discussion of one of the biggest events for an employer and its employees: an insolvency or a **bankruptcy**. When a company becomes insolvent or goes bankrupt, employees become creditors, like other stakeholders, to the company. Employees' entitlements, such as unpaid wages, pensions, and other benefits, become subject to a special insolvency process, and the result is that some entitlements become compromised or reduced. The insolvency process is particularly difficult for employees because they are a vulnerable group compared with other creditors of an insolvent company.

insolvency: A state in which the liabilities of a business are greater in value than the realizable value of its assets such that the business cannot or will not be able to meet its liabilities as they become due.

bankruptcy: A legal process that facilitates the treatment of a pension or company that can no longer pay its debts. *Bankrupt* is the name of the legal status of an entity that has declared bankruptcy.

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Retirement terminates the employment contract in an entirely different manner. Most employees aspire to retire at some point, and some employers offer post-employment benefits such as pensions to help provide income for former employees in retirement. For many decades, pension benefits were a key part of retaining employees, and pensions could make up 25 percent of an employee's total compensation. However, employees receive pension benefits only when they have retired. In this sense, pensions are an "after-labour-market" phenomenon. Although television commercials paint a glamorous picture of retirement, with smiling couples racing down the road in convertibles to make their golf tee time, retirement for many Canadians has become an increasingly stressful event. Lower employment income and lack of retirement savings leave many Canadians struggling to make ends meet.

Governments have enacted legislation that closely regulates pension benefits, bankruptcies, and insolvencies. Protecting workers is one objective of this legislation, but it is not the only one and, as we will see, sometimes the law favours other interests over those of workers.

II. Employee Claims in Insolvencies and Bankruptcies

It is an understatement to say that there is no joy in an insolvency. A business has reached a point at which it cannot meet its obligations, and it must either radically restructure or liquidate (sell) its assets and dissolve. Every stakeholder in the business is affected one way or another: suppliers lose a customer and may not have their outstanding bills paid, shareholders lose their investments, banks (sometimes) lose part of their loans, and employees (often) lose their jobs and everything that goes with a job, including important things like pensions and health care benefits. Target Canada's bankruptcy, described in Box 34.1, is among the highest profile insolvencies in Canada in recent years.

BOX 34.1 » TALKING WORK LAW

Target Canada Files for Bankruptcy

In early 2015, discount department store Target Canada announced that it was closing all 133 stores and liquidating its stock, less than two years after its Canadian launch. The closures meant the loss of 17,600 jobs, with labour experts suggesting that those laid-off workers faced grim prospects as they looked for new work.

> "I suspect they are feeling some anger and some very genuine fear," said Brock University labour expert Kendra Coulter, noting that many retail sector staff work only part-time hours.
>
> "Many of them will not be eligible for employment insurance and are facing a very scary future."
>
> Angella MacEwen, the senior economist at the Canadian Labour Congress, says it could take between six months to a year for the employees to find replacement work, particularly given the cyclical slowdown in the retail sector during the post-holiday season. …
>
> Target Canada's U.S. parent has set up a $70 million trust fund to cover employees' severance payments. The company said most workers will receive 16 weeks' pay.
>
> But Lee Harbinson, an employee at the discount retailer's Pickering Town Centre location, says it's not a real severance package, as many employees will still be working during those 16 weeks.*

Mass terminations of this type result in many thousands of job losses, and they can have profound effects on employees, their families, and their communities. It might even be said that the employees in this particular proceeding are comparably lucky: the US parent company of Target Canada agreed to pay some of the compensation employees were owed. In most proceedings, employees would have to wait months or, more likely, years in order to receive their entitlements, and even then might not receive all of them.

* F. Kopun, "Target to Start Liquidations in Two to Three Weeks," *Toronto Star*, January 19, 2015, http://www.thestar.com/business/2015/01/19/target-to-start-liquidations-in-two-to-three-weeks.html.

Some business stakeholders are able to protect themselves to some degree against insolvencies: for example, banks or other lenders can negotiate loan terms that give them significant advantages over other creditors of an insolvent business. Employees are a particularly vulnerable group in this respect, because they rarely (almost never) possess the bargaining power to negotiate the same kinds of protections in their individual contracts of employment or their collectively bargained contracts. Professor Ron Cuming (University of Saskatchewan) summarized it this way:

> Employees comprise the largest segment of those creditors of business organizations who have little capacity to protect themselves from the effects of insolvency of their debtors. This is due in large part to the fact that the circumstances surrounding the formation of employment contracts do not facilitate the use of protective measures. A prospective employee rarely has the bargaining power to demand some form of security interest in the property of an employer. … Even in the extremely unlikely event a security interest is given … there is no way to ensure that it would provide the desired protection for the employee. …
>
> Employees are disadvantaged in other respects. Unlike most other creditors, they have no capacity to assess the solvency of an employer or prospective employer. They do not have access to the private records of a business offering employment and generally do not have the knowledge or resources to get information from commercial sources upon which an assessment of the risk involved in giving credit to the business can be made. Further, employees do not have the capacity to spread the loss resulting from the non-payment over a large number of transactions. Nor can an employee "write off" non-payment of wages against other income.[1]

That is the predicament of employees who are creditors to a business. To this account we might add that losing employment can entail very significant financial and emotional hardship for workers, their families, and their communities. In single-industry towns, a major employer bankruptcy can literally end a way of life. This section will set out the basic legal rights and recourse employees have in an insolvency proceeding: however, the issues involved are far larger than can be covered here.[2]

A. Terminology: Bankruptcies, Insolvencies, Receiverships, and Liquidations

Insolvency law is chock full of special terms of art that can make it seem impenetrable to non-experts. Therefore, it is a good idea to discuss some key terms. Most people think of bankruptcy when they think of a failed business, but in fact a bankruptcy is only one way to deal with a business in financial distress. There are other ways to deal with businesses in some form of financial distress, and when discussed as a group, they are referred to as *insolvency proceedings* or *insolvencies*.

It is important to note that *bankrupt* is a legal status, whereas *insolvency* is a financial condition. A company becomes insolvent when its assets do not or are not expected to meet its liabilities or its obligations as they become due. *Bankruptcy*, on the other hand, is a legal status declared by a court in which a person or a business entity loses its legal capacity to deal with its assets and a trustee in bankruptcy is appointed with a mandate to liquidate the assets and distribute the proceeds to creditors (among other things). An insolvent business need not become bankrupt. It may instead become subject to other forms of proceeding, with a view to restructuring the obligations of the business and the business itself so that it may continue as a going concern. A *restructuring* is a process in which the creditors of a business, under the supervision of a court, and with the assistance of an independent monitor of the business, develop a plan to reorganize or restructure a business so that it can continue to operate. Such a process typically involves altering (often reducing) the existing financial obligations of the business on the understanding that a business that survives will be more valuable to all creditors than one that is

terminated. Another form of proceeding is called a **receivership**, which is a procedure used by a creditor to enforce a security right it has in property owned by a business or person. A creditor may seek the appointment of a receiver, who takes possession of the asset and sells it to pay the outstanding debt. A receivership can be separate from or part of a bankruptcy process, or a bankruptcy process may result in a full **liquidation** of all the bankrupt company's assets.

B. Sources of Legal Authority

Box 34.2 summarizes the key legislation that governs insolvency and bankruptcy proceedings in Canada. The legal field is very complex, but we can provide a general overview of how the law deals with employee claims and interests in this brief chapter.

BOX 34.2 » TALKING WORK LAW

Statutes That Regulate Bankruptcies and Insolvencies in Canada

In Canada, three statutes govern insolvency proceedings: the federal *Companies' Creditors Arrangement Act* (CCAA), the federal *Bankruptcy and Insolvency Act* (BIA), and the *Personal Property Security Act* (PPSA) enacted in each province and territory (except Quebec).*

- *CCAA:* This Act is the main source of authority for most large-scale insolvencies in Canada. In order to bring a proceeding under this Act, a corporation must have at least $5 million of liabilities or claims against it or a group of affiliated corporations in aggregate. Although this Act was originally created to facilitate restructurings, due to its flexibility, over time it has come to be used for other types of proceedings, including liquidations and receiverships. A business itself triggers a proceeding under the Act. This use of the CCAA has sometimes been controversial, because it provides a way to avoid the (often stricter) rules in the BIA.
- *BIA:* This Act is the main source of authority for liquidation and reorganization of insolvent debtors on any scale, but it is typically used to reorganize smaller-scale debtors. In liquidations and receiverships, a third party is appointed as a trustee over the assets of the business to protect and preserve them or to oversee their liquidation and distribution.
- *PPSA:* These provincial and territorial statutes govern the priorities, rights, and obligations of a group of creditors (called *secured creditors*) to a business.

* In addition to these sources of authority, it is also possible under provincial rules of court to seek the appointment of a receiver to liquidate a business.

C. Types of Proceedings and Implications for Employees

Generally speaking, four types of insolvency proceedings occur under the statutes presented in Box 34.2: proposals in bankruptcy, bankruptcies, receiverships, and restructurings. Each of these insolvency proceedings is described below, and the legislation that governs them appears in brackets in the heading.

1. Proposals in Bankruptcy (BIA)

If an employer cannot pay its debts when they become due, it can seek to consult with its creditors on a proposal to restructure and pay off its debts. A proposal in bankruptcy is essentially a compromise between an employer and all of its creditors. Most proposals provide for the payment of less than the full debt, and creditors may accept it as preferable to a full bankruptcy. A proposal requires a majority vote of all creditors representing at least two-thirds of all claims

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receivership: The appointment of a receiver (a trustee in bankruptcy) by agreement or by a court order to take possession of an asset of a debtor and sell the asset to pay outstanding claims against the owner.

liquidation: A process in an insolvency, defined by Justice Pigeon as "the act or operation of winding-up the affairs of a firm or company by getting in the assets, settling with its debtors and creditors, and apportioning the amount of each partner's or shareholder's profit or loss, etc." (*Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd.* (1980), 108 DLR (3d) 257, [1980] 1 SCR 1182).

against the employer, and it must be approved by the court.[3] If it is not approved, the employer is deemed to become bankrupt. Most employees continue working during the proposal process, but may have to file a **proof of claim** with the **trustee in bankruptcy** overseeing the proceeding for claims or unpaid amounts that are owed to them. During the proposal process, a stay of proceedings is in effect, which is a court order that temporarily ceases creditors from enforcing their rights against an employer.

2. Bankruptcies (BIA)

If an employer is unable to pay its debts as they become due, a trustee in bankruptcy is appointed to administer the estate of the employer. The trustee's functions include a review of business activities for any fraudulent preference transactions, the disposal of assets, and the distribution of funds to creditors. Employees are deemed to be dismissed immediately upon a declaration of bankruptcy by the court, although a small number may be retained for a short period of time during the process of winding down the company. Under a BIA procedure, employees are required to file a proof of claim with the trustee for any amounts owed to them up to the date of dismissal, and they must file a claim under the *Wage Earner Protection Program Act* (WEPPA).[4]

The BIA contains a limited protection for employee claims, known as a "wage priority." Section 81.3 of the BIA creates a limited super-priority in a bankruptcy or a receivership in favour of employees for unpaid wage claims, up to a maximum of $2,000.

The WEPPA establishes and regulates the federal government's Wage Earner Protection Program (WEPP), which provides limited protections to employees whose employer becomes bankrupt. A claim filed by an employee with the program is paid from the program rather than from the employer. The federal government becomes "subrogated" to the employee's claim against the employer's estate to the extent of the amount it paid; that is, the program steps into the shoes of the employee as the creditor in the bankruptcy proceedings.[5] Under the WEPPA, an employee may apply for wages owing and unpaid (including severance and termination pay owing) from the six-month period prior to the date of bankruptcy to a maximum of approximately $3,800 (calculated as the maximum weekly benefit for a four-week period under the *Employment Insurance Act* [see Chapter 30 for a discussion of how employment insurance benefits are calculated]). During the bankruptcy process, a stay of proceedings is in effect, which is a court order that temporarily prohibits creditors from enforcing their rights against an employer.

3. Receiverships (BIA, CCAA)

A secured creditor may wish to enforce a **security interest** against the assets of an employer by seeking to appoint a **receiver** to liquidate the employer's assets and be paid the amount due to it. A receiver may be appointed pursuant to a security agreement or by a court order. Part XI of the BIA contains provisions governing the appointment of receivers and the process for taking possession of assets and liquidating them. A receiver can be appointed either by the secured creditor (if the underlying security agreement between the secured creditor and the debtor provides such a right to the secured creditor) or by the court. In either case, the receiver takes control of the property of an employer, supervises liquidation proceedings, and remits the proceeds

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proof of claim: A form submitted by a creditor to an insolvent company claiming payment of a debt that is due.

trustee in bankruptcy: A person appointed by the court and granted legal authority to manage an insolvent or bankrupt business, including selling off the assets of the business and paying creditors with the proceeds.

security interest: A legal interest in an asset of a debtor's business that gives the creditor a right to seize and sell the asset in the event of non-payment of the debt.

receiver: A person appointed to sell assets that are subject to a secured interest in order to obtain funds to enable payment of the debt to the secured creditor. Receivers must be trustees in bankruptcy.

according to priorities established under the BIA. A stay of proceedings may be—but is not necessarily—put in place by the court, and if the employer is to wind down entirely, employees are usually dismissed immediately, unless, as with a bankruptcy, a small number are retained during the process. The WEPP is available in a receivership, and the BIA wage priorities also apply in a receivership.

4. Restructurings (CCAA)

A restructuring takes place under the authority of the CCAA, and the intent of this proceeding is to permit larger employers (with creditors' claims that total more than $5 million) to attempt a restructuring similar to a proposal in bankruptcy, but with far greater flexibility in (and fewer constraints on) the restructuring process itself. In a restructuring, employees typically continue to work, although some divisions of a business may be dissolved and their employees dismissed as a result. A stay of proceedings is granted by the court, while a "plan of arrangement" is negotiated and filed with the court. If this procedure fails, then there may be a claims process and a distribution of the assets of the employer. In that event, employees would file claims in the same way they would for a proposal in bankruptcy or a bankruptcy. A restructuring involves additional facets, including the appointment by the court of a "monitor" (akin to a trustee) to act as an independent third party to monitor the employer's operations and report to the court. The WEPP may become available under a restructuring if the restructuring process fails and the employer enters a bankruptcy process. A court may recognize the wage priorities included in a plan of arrangement, but outside of these amounts, the claims of employees are treated as unsecured claims.

D. Secured and Unsecured Creditors and Employee Claims

Very generally, all creditors' claims to an insolvent business's assets are divided into four basic types, which are prioritized as follows:

1. Super-priority claims
2. Secured claims
3. Preferred claims
4. General unsecured claims

The highest-ranking creditors are paid first from the funds of an insolvent business, while the lowest-ranking creditors are only paid if money is left over after the higher-ranking creditors have recovered their entitlements. With some exceptions (explained below), employees' claims to unpaid wages, benefits, and pensions usually rank near the bottom of the priorities list.

In a bankruptcy and a receivership, a very limited portion of the wages owed to employees on account is granted super-priority status.[6] Super-priority status is restricted to individual employee claims of up to $2,000 for due, but unpaid, wages (plus an additional $1,000 with respect to disbursements owing to travelling salespeople) for services rendered during the period beginning on the day that is six months prior to the "initial bankruptcy event." This limited super-priority claim ranks ahead of claims of all other creditors, with limited exceptions.[7] Similarly, a limited portion of the amounts owed to pension plans in bankruptcies (BIA, s. 81.5) and receiverships (BIA, s. 81.6)—in the form of current service costs (rather than any deficit in the plan itself)—is granted super-priority status in a bankruptcy and a receivership. Subject to these limited super-priorities, secured creditors are then paid in priority over all other creditors.

In the rare event that any of the insolvent employer's assets are not encumbered by a security interest, or that **secured creditors** have been paid out in full, the next parties to whom funds of

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secured creditor: A creditor that has a security interest in an asset of a business.

the insolvent can be distributed are **preferred creditors**. Preferred creditors are ranked before the general body of **unsecured creditors**, who share proportionately in the remainder of the employer's assets, if any. Accordingly, while some protection is given to pensioners and employees of insolvent companies, that protection does not come close to meeting the full obligations owing to employees in terms of wages, severance pay, and pension or other benefit obligations. As the Supreme Court of Canada noted in a recent decision: "Insolvency can trigger catastrophic consequences. Often, large claims of ordinary creditors are left unpaid. In insolvency situations, the promise of defined benefits made to employees during their employment is put at risk."[8]

Table 34.1 sets out the priority of certain employee and retiree claims under the BIA.

TABLE 34.1 The Priority of Employee and Retiree Claims Under the BIA

Claim	Priority	BIA Section
Wages	Claims of up to $2,000 ($3,000 for travelling salespeople) are super-priority; the remainder are unsecured	81.3, 81.4, 136
Termination Pay	Unsecured	136
Pensions*	Payments currently due to the plan are super-priority; the remainder are unsecured	81.5, 81.6, 136
Fringe Benefits	Unsecured	136

* Pension claims come in two types: current amounts owed to a pension fund to pay for benefits, called "current service costs," and amounts owed to a pension plan to pay for any unexpected deficit in the plan, called "special payments." Current service costs are a priority, but special payments are not. Special payments can be very large amounts—much larger than current service costs—and in some cases, are the largest unsecured claims on a bankrupt business.

E. The Lingering Issue of Legacy Costs

Legacy costs represent a major issue for Canadian governments, employees, and employers, particularly industrial employers (e.g., auto sector, steel, and manufacturing employers). These costs are associated with pension plans and post-employment health care benefits that form the terms and conditions of employment, but are paid for sometimes long periods after the termination of employment. Legacy costs result from several factors, including the following:

- The design of the employer-centric benefits system in Canada, in which private employers provide a significant share of pension and health care benefits. Although in Canada certain health care benefits are publicly funded, extended health care, dental benefits, and life insurance (among others) are borne by employers and employees.
- The unexpectedly fast increase in the cost of these "fringe" benefits, which reflects longer life expectancy, the high rates of health care inflation, low interest rates, and changes in methods for accounting for these benefits (which, together, increase the accounting and actuarial costs of liabilities).

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preferred creditor: An unsecured creditor who is given preference over other unsecured creditors.

unsecured creditor: A creditor who does not have a secured interest in an asset of an insolvent debtor.

legacy costs: A term of art referring to the accumulated costs of post-employment pensions and benefits that are required to be paid by an employer. They are called "legacy" costs because they are payments for workers who have retired or left employment, and because many of these benefits have been eliminated for new workers.

- The increase of the proportional burden of these legacy costs among active employees, particularly where downsizing has shrunk the active workforce. This point is particularly significant when comparing the legacy costs of Canadian-based (or North American-based) industrial employers with those of emerging market industrial employers. The latter provide similar employer-centric benefits, but they have not yet encountered the **dependency ratio** problem because they entered the market more recently, which means that their legacy costs are lower.[9]

Legacy costs can be so large that they are among the largest costs of an employer who becomes insolvent. The treatment of legacy cost claims in an insolvency is important. If an employer does not pay for these claims, the result is the reduction or elimination of pensions and health care benefits at the very time when former employees need them most: in retirement or unemployment.

Legacy cost claims receive only limited protection in insolvency. As mentioned above, the BIA creates a very limited pension priority over assets of an employer and for limited amounts. However, legacy liabilities are typically much greater than these amounts and are referred to in pension legislation as *special payments*—payments required to ensure that enough assets are in a pension fund to pay all the benefits. For example, in the case of the Nortel insolvency—an ongoing process at the date of writing—it is expected that the unsecured claims of the Nortel pension plans' beneficiaries will not be paid in full, and as a result, pensions will be reduced. Most pensioners and their families cannot easily absorb a significant drop in income in retirement without making considerable sacrifices. Next, we will consider in more detail the risks pensioners face when their employers go out of business.

III. Pension Benefits

The first modern pensions in Canada were introduced in the early 20th century and thought of and treated as special gratuities paid by employers to long-service employees. They typically took the form of a paid-up **life annuity** that was granted on a discretionary basis by employers. In this outdated view, an employee had no right to the payment and little recourse if it was not granted or awarded as promised or expected. Over the 20th century, and particularly as trade unions began to represent more workers and bargain their terms and conditions of employment, pensions became a more standard term and condition of employment. The Supreme Court of Canada has referred to pensions as deferred compensation for employees' service.[10] As a result, employers developed standardized ways to make pensions available and to fund them. Eventually, governments wishing to encourage retirement savings developed tax incentives—in Canada, contained in the *Income Tax Act*—for employers to provide and for employees to participate in pension plans. These incentives continue to exist today.[11]

Pensions became one the four main pillars of government social policy following the Second World War (the other pillars being federal unemployment insurance and provincial welfare assistance programs, public health care, and public education). In Canada, pensions—or, more accurately, the retirement income system—are typically divided into four types: (1) public incomes in retirement funded out of tax revenues (i.e., Old Age Security and the Guaranteed Income Supplement);[12] (2) private individuals' savings;[13] (3) mandatory employment-related, government-administered pension plans (the Canada Pension Plan and, in Quebec, the Quebec Pension Plan);

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dependency ratio: The ratio of active employees to retired employees. It is used as a way to measure the relative cost of the current workforce as compared with the former workforce. A high dependency ratio means that there are more retired workers than current workers drawing resources from the business.

life annuity: A fixed-amount periodic payment (often monthly) to a person for life. Life annuities are the most common form of pension.

and (4) employer-centric pension plans funded out of contributions by employers and employees. This chapter will focus on the third and fourth categories, which are employment-related pension schemes.

A. The Canada Pension Plan

The Canada Pension Plan (CPP) was introduced in 1965 and was intended to provide a universal retirement income plan tied to employment earnings.[14] It is a mandatory plan for all employees and employers in Canada, and it is administered by two branches of the federal government: Employment and Social Development Canada and the Canada Revenue Agency. The objective of the CPP is to provide a basic, minimum income in retirement (after age 65, but as early as age 55), funded through contributions from employers and employees over their working lives. The amount of pension a retiree receives depends on the number of years of employment and the contributions made during those years: the maximum amount is 25 percent of the average industrial wage (about $1,065 per month in 2015), but the average benefit is only about 60 percent of the maximum.[15]

The CPP was not intended to provide 100 percent of a worker's income in retirement but was designed as a basic pension plan. It was hoped that individual employers would provide pension plans and that individual employees would save for retirement so that, added together, these three income sources would enable retirees to maintain their standard of living. The amount of retirement income needed to maintain the standard of living is sometimes called the **replacement rate**.[16]

B. Employer-Centric Pension Plans

The incidence of employer-sponsored pension plans has long waned in Canada (see Figure 34.1), and today it is common to speak about a looming crisis in retirement savings. As recently as 1977, just over 45 percent of the Canadian labour force participated in an employer-sponsored pension plan. By 2015, this figure had fallen to about 35 percent, and in the private sector, to just over 20 percent.[17] The loss of employer-sponsored pension plans is now considered an important policy problem, particularly for middle-income Canadian workers.[18]

1. Types of Pension Plans in the Workplace

Many different types of employer-centric pension plans exist, and new types of plans are continually being introduced. Historically and to the present day, most employees whose employers have a pension plan have a **defined benefit (DB)** pension plan. This type of plan defines the level of income a worker is promised to receive during retirement using a formula that is tied to years of service and earnings during employment. The key feature of this type of plan is a concrete promise of a certain level of retirement income, and it is up to the employer to provide a fund sufficient to pay that pension for the life of the retiree.

For a variety of reasons, since about 1990, employers have been closing or eliminating DB pension plans and replacing them with **defined contribution (DC)** pension plans. A DC pension plan defines the level of contribution to a pension plan, but it does not promise any particular level of income in retirement. Instead, the amount of income in retirement is whatever has been

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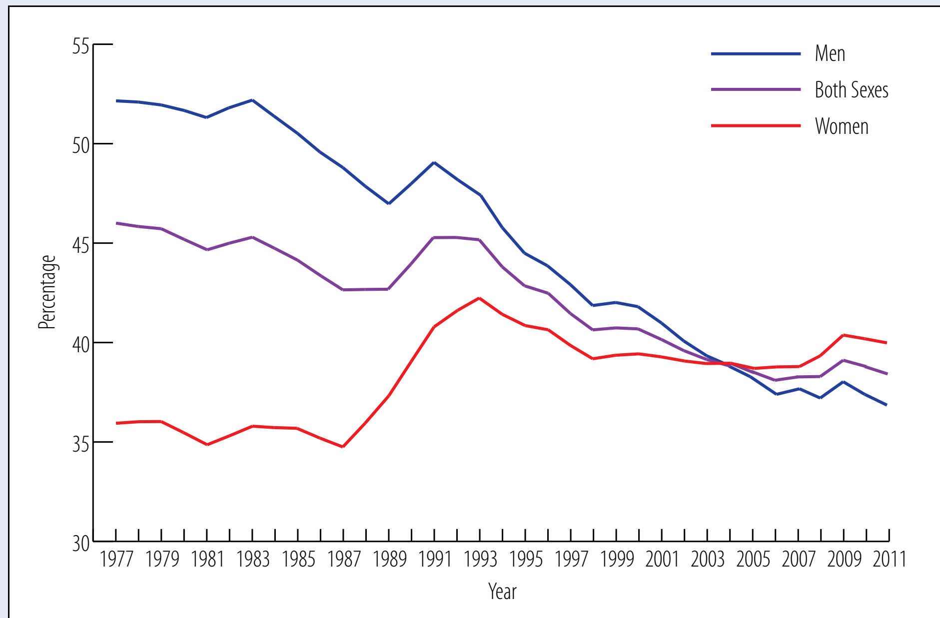
replacement rate: The amount of income in retirement measured as a fraction of the income earned prior to retirement. The most common replacement rate thought to provide for an adequate income in retirement is 70 percent (i.e., 70 percent of pre-retirement income).

defined benefit (DB): A pension plan that guarantees the recipient a predetermined, fixed payment amount on a periodic basis (usually monthly).

defined contribution (DC): A pension plan that requires a certain level of contributions into the plan but does not guarantee a specific level of benefits. Benefit levels are based on the amount of contributions and funds in the plan account.

FIGURE 34.1 Percentage of Employees with a Registered Pension Plan (RPP) Through Their Job, by Gender, 1977 to 2011



Source: M. Drolet and R. Morissette, *Insights on Canadian Society: New Facts on Pension Coverage in Canada* (Catalogue no. 75-006-X) (Ottawa: Statistics Canada, 2014), Chart 1, at 2.

accumulated by the employee in the plan or, more precisely, whatever level of retirement income those accumulated contributions will finance. With this plan, the contributions to the pension are certain, but the level of pension income is very uncertain.

Many variations exist on these two types of pension plans. "Hybrid plans" combine aspects of both benefits. "Target benefit plans" make defined benefit promises but permit the variation of defined benefit pension income, even if the plan member is already retired. Most recently, the federal government and some provinces have introduced still another form of pension plan, called a "pooled registered pension plan" (PRPP), which is a lot like a DC pension plan but differs in that employers are not required to contribute to it if they decide not to. PRPPs have many features of registered retirement savings plans (RRSPs), which, when they are provided by an employer to a group of employees, are called *group RRSPs*.[19]

The main issue for employees and employers is the difference in the way risks and rewards are allocated in DB and DC pension plans. As we have noted, in DB pension plans, employees have a secure, defined promise of a level of income in retirement. They can plan in advance and rely on this income, and they are protected from certain risks, such as investment losses or losing their pension if they live a long life. On the other hand, in DC pension plans, employees are exposed to risks and uncertainties. Contributions to pension plans are invested in capital markets, and if those markets fall in value, employee pensions fall. Moreover, if a retiree is lucky enough to live longer than the average, he or she could run out of retirement savings. These are significant risks and uncertainties, and for these reasons most employees prefer a DB pension plan, if their employer provides one.

The trend of employers closing DB pension plans and either replacing them with DC pension plans or providing no pension plan at all has been observed in most Organisation for Economic Co-operation and Development (OECD) countries. Eliminating pension plans has sometimes led to conflicts between employees and employers. It has also led to law reform and policy responses from governments, although to date, none have effectively "solved the problem" of providing adequate pensions to retired employees. In Canada, the conversion from DB to DC pension plans has on a number of occasions decreased the value of employee pensions, leading to lawsuits by employees against the employers and their actuarial consultants. However, to date, those lawsuits have been withdrawn or settled without a decision being issued.[20]

2. Regulatory Frameworks

As mentioned above, pensions were originally regulated through income tax legislation. This legislation provided an incentive to provide employer-centric pension plans, essentially permitting these plans to provide pensions on a tax-deferred basis. However, most income tax regulation of pensions concerns the minimum and maximum that may be contributed to and drawn from a pension plan, and does not directly address employee rights to a pension.

Recall that pensions were once thought of as gratuities, but as they became more standardized, they became terms of employment, especially where unions represented employees. Pension plans have always been complex and vulnerable to manipulation, particularly because they are very long-term promises or arrangements. Eventually, concerns over pensions led to the provincial regulation of employer-centric pensions through pension benefits statutes beginning in 1965 in Ontario and then over time across Canada.[21] This pension regulation has evolved significantly over the past five decades, and we provide an overview of its main features today.

a. Key Features of Employer-Centric Pension Regulation

Vesting is a cornerstone of pension regulation. Vesting is a legal concept that confers a form of property right in something that was previously limited to a contractual promise: if a pension (or any right to something) is vested, it cannot be unilaterally revoked without the consent of the employee (or the person with the right). Prior to the introduction of a vesting requirement for pension plans, employers could include terms in a pension plan that compelled an employee who left employment (say, to take another position) to lose all rights to his or her accrued pension. This loss could be a significant hardship on the employee, and many employees were not in a position (either lacking knowledge or lacking bargaining power) to avoid such terms. Today, employees who participate in a regulated employer-centric pension plan are "immediately vested" in their pension benefits: if they terminate their employment, they must be paid their pension following termination, have their pension transferred to a new employer, or be permitted to maintain a right to a pension with their old employer.[22]

A second key feature of pension regulation today is the regulated, periodic pre-funding of pension plans. This feature is particularly important for DB pension plans, for which the employer (typically) has the sole responsibility of funding. Very generally, pension regulation in Canada requires that DB pension plans measure their pension promises (or liabilities) and their contributions plus investment income (or assets) every one or three years and report the "funded status" of the plan to regulators.[23] Some of the most significant pension conflicts and cases have arisen out of the funding of pension plans. In the late 1980s and throughout most of

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vesting: A legal term for an irrevocable right to a benefit. Vesting is a concept from property law that provides that a benefit (or property) may not be taken away or revoked or withdrawn by another person without the consent of the owner or beneficiary.

the 1990s, pension plans enjoyed extraordinary investment returns on assets (contributions not used to pay pensions were invested in portfolios of investments) and, as a result, they often developed assets in surplus to liabilities. In DB pension plans, especially those to which employees had also made contributions, the ownership and use of a pension plan surplus became hotly debated. Employers often claimed entitlement to the surplus in the plans when the plans were wound up. Or they argued that the surplus in a plan permitted them to stop making contributions into the plan (known as taking a "contribution holiday"). Employee beneficiaries under the plans argued that the surplus belonged to them, leading to a string of cases culminating with clarification from the Supreme Court of Canada in the case discussed in Box 34.3.[24]

BOX 34.3 » CASE LAW HIGHLIGHT

A Landmark Pension Case

Schmidt v. Air Products Canada Ltd.

[1994] 2 SCR 611, 115 DLR (4th) 631

Key Facts: Air Products Canada Ltd. merged two DB pension plans (the "Stearns plan" and the "Catalytic plan") and created a new DB pension plan. The employer used the surplus from the two prior plans to take a contribution holiday on the new plan. In 1988, the company sold off its assets and ceased to exist, and the new pension plan was terminated. The employer claimed that it was entitled to keep the surplus money left in the plan after all the plan members had been paid their entitlements, amounting to just over $9 million. The plan members (including Schmidt) brought an action claiming that the surplus money belonged to the former employees, and that the employer should also be ordered to pay out the money from the plan that it used to fund its contribution holiday (approximately $1.5 million) to the employees.

Issue: Does the employer have a unilateral right to appropriate or use surplus assets in a pension fund?

Decision: It depends. The Supreme Court of Canada found that the question of whether an employer can take a pension plan surplus depends on the application of a branch of the common law known as *trusts*. Briefly, a "trust" is a legal arrangement in which funds (or property) are transferred to a person who is tasked with administering or managing the funds for the benefit of another person. If a pension plan is created as a trust for the benefit of plan members (employees), then the employer could not claim entitlement to the surplus for itself.

The Catalytic plan was established in 1959 and included a clear intention to create a trust for the benefit of employees. The trust included not only the employee's contributions, but also any income earned, including any surplus. Therefore, the employer was not entitled to keep the surplus that can be traced to the Catalytic plan because those amounts were being held for the benefit of the employees. However, the employer was entitled to use the surplus in the plan to take a contribution holiday, since the pension plan permitted this.

The Stearns plan was not established as a trust for employees, and therefore trust law principles did not apply. Whether the employer could take the surplus from the plan upon the plan's termination and take a contribution holiday during the existence of the plan depends on the language of the pension plan contract. That contract clearly contemplated that the employer would be entitled to any surplus left in the plan, and that the employer was permitted to use a surplus in the ongoing plan to fund a contribution holiday. Therefore, the employer was entitled to keep the portion of the surplus traced to the Stearns plan.

The Supreme Court of Canada concluded its decision by calling on the government to enact legislation specifying who owns the surplus of an employee pension plan:

> The results in these appeals demonstrate the need for legislation. In both appeals the pension fund was created to benefit the employees. During the contribution holiday enjoyed by the employer they continued to pay into the pension fund. They had a real stake in the fund which was created for their benefit and funded in part by their contributions. It seems unfair that there should be a different result for these two groups of employees based only upon a finding that a trust was created in one case but not in the other. In my opinion there should be a legislative scheme set up for determining the proportion of the surplus which should be awarded to the employer and the employees. It could be based at least in part upon their contributions to the creation of the surplus. Principles of equity and fairness should encourage legislators to draft a scheme to provide for the equitable distribution of any surplus in pension plans that are terminated.

Since 2001, however, there have been two or three very significant financial crises and a period of historically low interest rates. In combination, these conditions have led many DB pension plans to become underfunded (or in deficit), and in the case of DC pension plans, the value of individual pension accounts has fallen significantly. These conditions have also led some employers to seek to reduce or eliminate pension benefits, convert DB pension plans to DC pension plans, make employees pay significantly more toward the overall cost of a DB pension plan, or a combination of all these measures. The result has been another series of ongoing legal cases in which the legality and, in some cases, constitutionality of these changes have been challenged by employees.[25]

Pension legislation covers a variety of other aspects of the design and administration of employer-centric pension plans. These "minimum standards" are deemed to be common terms that any pension plan includes, such as the maximum period of employment to qualify to join a pension plan, the forms of benefits to be provided, minimum funding rules, options on termination of employment, and terms in the event of marriage breakdown.[26]

Pension legislation also puts significant duties on the person, committee, or entity that administers a pension plan. The administrator has fiduciary duties by statute, including the duty to act in the best interests of beneficiaries (i.e., the employees and retirees) of the pension plan.[27] This standard of conduct is drawn primarily from the administration of trusts, and it is the highest standard of conduct that is known in law. For this reason, employers often make clear distinctions between their role as an employer, operating and negotiating at arm's length from employees, and their role as the administrator of a pension plan, acting in the best interests of employees and retirees. This has led to what the pension industry calls the "two-hat" problem, insofar as these two roles can conflict. Consider the circumstances of an insolvent employer who is faced with a similar fiduciary duty to one stakeholder (say, the corporation itself, or by extension, its shareholders) that directly conflicts with the fiduciary duty to employees and retirees as the administrator of a pension plan.[28] This issue was addressed in the Supreme Court of Canada decision reviewed in Box 34.4.

BOX 34.4 » CASE LAW HIGHLIGHT

The "Two-Hat" Problem

Sun Indalex Finance, LLC v. United Steelworkers

2013 SCC 6, [2013] 1 SCR 271

Key Facts: An insolvent Canadian employer (Sun Indalex) sought protection from its creditors and time to restructure under the CCAA (see Box 34.2). At that time, the employer's two pension plans, one for salaried employees and one for executives, both had deficits (i.e., not enough funds to pay the pensions promised). In order to keep the company operating, the employer requested an arrangement through which some secured creditors ("DIP lenders") would loan it money in exchange for giving those creditors priority over all other creditors, including the pension plan members.* The pension plan members were not consulted or informed of the request, which was approved by the CCAA court. Later, the company was sold, but the proceeds did not cover the loan or the pension shortfalls. A dispute arose as to who took priority in the distribution of the funds from the sale, the DIP lenders who were given first priority or the pension plan members. The pension plan members argued that the employer had a fiduciary duty to protect their interests since it was the administrator of the pension plan and that it had failed in that duty.

Issue: Did the employer breach its fiduciary duty to pension plan members by proposing in the CCAA proceeding to grant lenders a super-priority to sale proceeds over the entitlement of plan members to their pensions?

Decision: Yes. The Ontario *Pension Benefits Act* allows an employer to act as administrator of a pension plan and upon taking that role, the employer accepts a fiduciary duty to act in the interests of plan members. In this case, the employer

argued that when it requested that the DIP lenders be given priority over plan members as a condition of receiving a loan, it was wearing its "corporation hat" and not its "pension plan administrator hat"; it was acting to further the interests of the company by finding a solution that would allow it to survive. The Supreme Court of Canada rejected the "two-hat" argument. It ruled that section 22(4) of the *Pension Benefits Act* required a pension plan administrator to avoid putting itself into a conflict of interest between its interests and those of plan members: "An employer acting as plan administrator is not permitted to disregard its fiduciary obligations to plan members and favour the competing interests of the corporation on the basis that it is wearing a 'corporate hat.'"

In this case, the employer was in conflict between its duty to pension plan members and its corporate interest in obtaining a loan. That conflict led it to favour the DIP lenders over the pension plan members. In doing so, it breached its duty to the plan members. However, the harm caused by this breach of duty amounted to little more than the loss of the right of the pension plan members to be given notice to appear at the CCAA proceedings and make an argument against granting preferred priority to the lenders. But even if such argument had been made, the CCAA court would almost certainly have granted the proposal to give priority to the DIP lenders, since doing so was the only option available to keep the company alive. Therefore, no remedy was ordered against the employer, and the employees ended up losing about half the value of their pensions.†

* This type of financing is called a *debtor-in-possession (DIP) loan*, and it is a common tool in restructurings under the CCAA. DIP lenders agree to loan the money in exchange for super-priority claim status.

† See the discussion in "Supreme Court Rules Against Pensioners in Indalex Case," *CBC News*, February 1, 2013, http://www.cbc.ca/news/business/supreme-court-rules-against-pensioners-in-indalex-case-1.1362453.

IV. Chapter Summary

Employees and employers have traditionally sought to save for retirement through employer-sponsored pension plans. These benefits are important for workers to be able to retire and maintain a decent standard of living. Employer-sponsored pension plans are in decline in Canada, and one of the significant policy issues facing future workers, employers, governments, and unions is how to secure decent and affordable pensions. When a company becomes insolvent, everyone loses. Employees are particularly vulnerable in these circumstances: they lose their employment, and they are among the most vulnerable groups of creditors, competing with other creditors for the limited resources the employer has left.

QUESTIONS AND ISSUES FOR DISCUSSION

1. What is the difference between an insolvency and a bankruptcy?
2. Which stakeholders are most likely to be protected (or to be able to protect themselves) in an insolvency? Why are employees particularly vulnerable in an insolvency?
3. What arguments can you think of to provide employees a higher "priority" in a bankruptcy proceeding? What are the arguments against doing so?
4. What trends in employment may be contributing to the decline in employer-sponsored pension plans and the decline in the number of employees enrolled in pension plans in Canada?
5. What are *legacy costs*, and why are they important to employees and employers?
6. What are the main sources of regulation of employer-provided pension benefits?
7. What is *vesting*? Why is it important for benefits such as pensions to be paid after an employment relationship is over?

UPDATES

Go to www.emond.ca/lawofwork for links to news, author's blog posts, content updates, and other information related to the chapters in this text.

NOTES AND REFERENCES

1. R.C.C. Cuming, *Enhanced Enforcement of Wage Claims Under Canadian Bankruptcy and Receivership Law* (Ottawa: Corporate Law Policy Directorate, Industry Canada, 1998), at 1.
2. The quotation associated with supra note 1 comes from a full-length book devoted only to employee claims in insolvencies, and even this book does not address the full scope of the challenges facing employees in this predicament.
3. Proposals are governed by part III of the *Bankruptcy and Insolvency Act*, RSC, 1985, c. B-3; voting requirements appear in s. 54.1 of the Act.
4. *Wage Earner Protection Program Act*, SC 2005, c. 47, s. 1 ("WEPPA"). See a description of the program at Service Canada, "Wage Earner Protection Program," http://www.servicecanada.gc.ca/eng/sc/wepp/index.shtml.
5. WEPPA, supra note 4, s. 36.
6. *Bankruptcy and Insolvency Act*, supra note 3, s. 81.3 (bankruptcy) and s. 81.4 (receivership).
7. The exceptions are unpaid suppliers (the "30-day goods rule"); farmers, fishermen, and aquaculturists; employee source deductions in bankruptcy (income tax, CPP, employment insurance); and funeral expenses and expenses for the administration of the estate of the employer.
8. *Sun Indalex Finance, LLC v. United Steelworkers*, 2013 SCC 6, [2013] 1 SCR 271, at para. 1 (per Deschamps and Moldaver JJ).
9. See S. Archer, "Origins and Prospects for Employee Life and Health Trusts in Canada" (2015) 34 *Estates, Trusts and Pensions Journal* 315.
10. *IBM Canada Limited v. Waterman*, 2013 SCC 70, [2013] 3 SCR 985, at para. 4.
11. The income tax system encourages retirement savings by making contributions to a registered pension plan deductible from current income and by making investment income on those contributions tax exempt (tax is paid on income received from a registered pension plan when it is withdrawn during retirement, likely at a level that is lower than employment income). This "tax expenditure" is estimated to cost the government $8 to $12 billion per year in forgone tax revenues, depending on the method of calculation, and, as such, it constitutes a major government program to incentivize people to save for retirement. The primary sections of the *Income Tax Act* on registered pension plans are ss. 5, 6, and 144-48. Also see s. 8500 of the *Income Tax Regulations*.
12. These public programs are "anti-poverty programs" as much as programs designed to provide retirement income. See the discussion of Old Age Security benefits at Service Canada, "Old Age Security," http://www.servicecanada.gc.ca/eng/services/pensions/oas/index.shtml.
13. Most individual saving occurs voluntarily and is not necessarily tied to employment.
14. *Canada Pension Plan*, RSC 1985, c. C-8.
15. In 2014, the prescribed employee contribution rate was 4.95 percent of a salaried worker's gross employment income between $3,500 and $51,100, up to a maximum contribution of $2,356.20. The employer matches the employee contribution, effectively doubling the contributions of the employee. Self-employed workers must pay both halves of the contribution, or 9.9 percent of pensionable income, when filing their income tax return. The average benefit is lower because employees have gaps in employment and do not always accrue the maximum benefit available.
16. The replacement rate normally cited is 70 percent of pre-retirement income (on an after-tax basis). After about 2000, a debate emerged as to the proper replacement rate target. Some took the position that 70 percent was too high and tried to establish that retirees could live on less, and, as a result, did not need to save as much during their employment years.
17. Statistics Canada, "Percentage of Labour Force and Employees Covered by a Registered Pension Plan (RPP)" (table), http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/labor26a-eng.ht. This decline has been slow and steady since about 1977, and it fairly closely tracks the decline in union density in the Canadian labour force.
18. M. Wolfson, "Projecting the Adequacy of Canadians' Retirement Incomes," *IRPP Study* No. 17, April 2011, http://irpp.org/wp-content/uploads/2014/05/Wolfson-No17.pdf; and B. Baldwin, *Research Study on the Canadian Retirement Income System* (Toronto: Ministry of Finance, 2009). Canadian anti-poverty programs (such as the Old Age Supplement and the Guaranteed Income Supplement) ensure that very low income retirees have a basic income. Very high income earners tend to have adequate savings in retirement through private individual savings as well as pension plans. It is middle-income Canadians—very roughly, those who earn between $30,000 and $100,000 during their working lives—who are thought to be at risk of undersaving for retirement and having to lower their standard of living in retirement.

19. For a critique of these plans and their capacity to respond to the "savings crisis," see S. Archer, "First Time Tragedy … Pooled Registered Pension Plans" (2012) Q1 *International Pension Lawyer*.
20. See, e.g., *Dawson v. Tolko Industries Ltd.*, 2010 BCSC 346; and *Weldon v. Teck Metals Ltd.*, 2013 BCCA 358.
21. *Pension Benefits Standards Act*, RSBC 1996, c. 352; *Employment Pension Plans Act*, SA 2012, c. E-8.1; *The Pension Benefits Act, 1992*, SS 1992, c. P-6.001; *The Pension Benefits Act*, CCSM c. P32; *Pension Benefits Act*, RSO 1990, c. P-8; *Supplemental Pension Plans Act*, CQLR c. R-15.1; *Pension Benefits Act, 1997*, SNL 1996, c. P-4.01; *Pension Benefits Act*, SNB 1987, c. P-5.1; *Pension Benefits Act*, SNS 2011, c. 41; and *Pension Benefits Standards Act, 1985*, RSC 1985, c. 32 (2nd Supp.).
22. For example, in Ontario immediate vesting is achieved through ss. 14 and 35-38 of the *Pension Benefits Act*, which requires a benefit to be paid to a member upon certain events and prohibits changes to a pension that take away earned or accrued benefits.
23. These two bases for measuring the health or funded status of a pension plan are known as "going concern" funding, which assumes that a plan will continue into the future, and "solvency" funding, which assumes that a plan discontinues. The different measurements can produce very different cost implications for employers and employees. The funding rules for pension plans in Ontario are set out in RRO 1990, Reg. 909 to the *Pension Benefits Act*, particularly ss. 4-6 and 13-14.
24. See *Schmidt v. Air Products Canada Ltd.*, [1994] 2 SCR 611; *Re Reevie et al. and Montreal Trust Co. of Canada et al.* (1986), 25 DLR (4th) 312 (Ont. CA); aff'g. (1984), 10 DLR (4th) 287 (Ont. H. Ct. J.); and *Bathgate v. National Hockey League Pension Society* (1992), 98 DLR (4th) 326 (Ont. Ct. (Gen. Div.)); aff'd. (1994), 110 DLR (4th) 609 (Ont. CA). Cases since *Schmidt* have explored and more recently limited or modified the application of trust principles in the context of pension plans. See, e.g., *Sutherland v. Hudson's Bay Company*, 2011 ONCA 606; *Markle v. Toronto (City of)* (2003), 223 DLR (4th) 459 (Ont. CA); *Aegon Canada Inc. v. ING Canada Inc.*, 2003 CanLII 22441; *Professional Institute of the Public Service of Canada v. Canada (Attorney General)*, 2012 SCC 71, [2012] 3 SCR 660; and *Nolan v. Kerry (Canada) Inc.*, 2009 SCC 39, [2009] 2 SCR 678.
25. See, e.g., *Pension Coalition et al v. PNB et al.*, 2014 NBQB 248.
26. For example, in the Ontario *Pension Benefits Act*, supra note 21, see the sections that regulate administration (ss. 18-22); record-keeping and disclosure (ss. 25-30); membership minimum standards (ss. 21-34); contributions to plans and funding (ss. 55-62, and ss. 4-6 of Reg. 909); prohibitions on seizure or assignment of pension moneys (ss. 63-67); division of pensions on marriage breakdown (ss. 67.2-67.6); and distribution of surplus assets (ss. 77.1-77.10).
27. For example, in the Ontario *Pension Benefits Act*, supra note 21, ss. 22(1)-(2) impose a fiduciary standard of conduct on administrators of pension plans: "The administrator of a pension plan shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person. The administrator of a pension plan shall use in the administration of the pension plan and in the administration and investment of the pension fund all relevant knowledge and skill that the administrator possesses or, by reason of the administrator's profession, business or calling, ought to possess."
28. *Sun Indalex Finance, LLC v. United Steelworkers*, supra note 8. Note that the case also decided important issues relating to the scope of a statutory "deemed trust" provision in the Ontario *Pension Benefits Act* and with a doctrine of federal supremacy when provincial and federal statutes conflict.