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Ontario Court of Appeal gives priority to pension plan wind-up deficits in CCAA proceedings

By Mary Picard and Jane Dietrich

On April 7, 2011, in *Indalex Limited (Re)*, 2011 ONCA 265 (*Re Indalex*), the Ontario Court of Appeal (the Court) held that in certain circumstances a pension plan wind-up deficit should be paid in priority to claims of secured creditors, including amounts outstanding under a court-approved debtor-in-possession facility (the DIP Facility).

In *Re Indalex* the debtor company sponsored two defined benefit registered pension plans. One was in the process of being wound-up at the time of the CCAA filing and the subsequent motion for a sale of assets and distribution. The other was not. That difference between the status of the two plans affected the Court's analysis, but the Court's conclusion was the same with respect to both plans: the deficit in both plans had priority over the super-priority status that was granted to the DIP Facility in the CCAA proceedings.

The *Re Indalex* decision is notable for a number of reasons.

The Pension Benefits Act deemed trust extends to the full amount of the wind-up deficit

With respect to the plan that was in the process of being wound-up at the time of the CCAA filing, the Court held that the deemed trust created by the *Pension Benefits Act* (Ontario) (the PBA) extends to the full amount of the wind-up deficit. The Court found that plan liabilities, including the wind-up deficit even though not yet due under the PBA, accrue as of the wind-up date and are

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deemed to be held, in trust, pursuant to section 57(4) of the PBA.

The PBA deemed trust may extend to plans that are not wound-up at the time of the CCAA filing

Lawyers for the members of the pension plan that was not in the process of being wound-up at the date of the CCAA filing argued that the deemed trust provisions of the PBA applied because it was inevitable that the plan would be wound-up. The Court noted that the opening words of the applicable PBA provision speak to "where a pension plan is wound up", and on its face suggest the deemed trust would not apply.

However, the Court stated that it was troubled that Indalex could rely on its own inaction to avoid the consequences of a wind-up. In its reasons, the Court held that it did not need to determine that specific question in this case. Rather, as explained below, the Court found that the deficit in the non-wound-up plan had priority over the claims of secured creditors as a result of Indalex's "breach of fiduciary duty" as plan administrator.

A wind-up deficit may have priority on the basis of "breach of fiduciary duty"

The Court provided a second reason for granting priority to the pension wind-up deficits, quite apart from the application of the PBA deemed trust, which is novel. The Court stated that the assets of a debtor company could be subject to a "constructive trust" at common law, as a remedy for the company's breach of its fiduciary duty as plan administrator.

It is well accepted in pension law that companies which administer pension plans have a fiduciary duty to act in the best interests of the pension plan's beneficiaries. Companies also have the right to act in the interests of their shareholders when they are required to make decisions about the pension plans. These two roles (which sometimes conflict) have been confirmed in pension cases outside the insolvency arena. This is sometimes referred to as the "two hats" dilemma.

Re Indalex appears to be the first occasion where a court has applied the fiduciary duty to act in the best interest of the pension plan beneficiaries in order to grant a super-priority to pension deficit claims.

The Court found that Indalex had breached its fiduciary duty by failing to try to fund the deficits in each of the pension plans. It was not sufficient for Indalex to simply make contributions to the plans when they were due under pension legislation. Indalex breached its fiduciary obligations, the Court said, by (a) taking steps which undermined the possibility of additional funding to the plans; (b) applying for CCAA protection without notice to the members of the plans; (c) obtaining a CCAA order that gave priority to the DIP lenders over "statutory trusts", without notice to the members of the plans; (d) seeking court orders approving the distribution of sale proceeds to the DIP lenders knowing that there would be insufficient monies to fund the plans' deficit; and (e) seeking a bankruptcy order to defeat the PBA deemed trust. The Court stated: "In short, Indalex did nothing to protect the best interests of the Plans' beneficiaries and, accordingly, was in breach of its fiduciary obligations as administrator."

The Court also stated that Indalex should have taken steps to address the conflict: the obligation to act in the interests of the shareholders versus the obligation to act in the best interests of the members of the pension plans. The Court did not suggest how Indalex could have addressed that conflict.

The Court determined that the appropriate remedy for Indalex's breach of its fiduciary duty was to apply the common-law equitable doctrine of "constructive trust" in order to grant priority to the pension deficit for both plans.

Questionable super-priority of DIP Facility

The Court also held that the super-priority given to the DIP Facility under previous court orders (even though the orders had not been appealed) was not effective in these circumstances. The order approving the DIP Facility contained the typical priority related language relied on by DIP lenders in most CCAA proceedings.

The Court stated that the CCAA court does have the authority to grant a super-priority charge to DIP lenders in CCAA proceeding and, under the doctrine of paramountcy, has the authority to override provincial legislation such as the PBA. However, in *Indalex*, the Court found nothing to suggest that the doctrine of paramountcy was considered at the time of the granting of the order which approved the DIP Facility. Rather, the Court noted that the PBA deemed trust was not specifically identified at the time the super-priority charge was granted to the DIP lender and there was nothing in evidence to suggest such a priority was necessary.

The Court held that to override the provincial deemed trust for pension deficits, Indalex should have specifically raised the issue of paramountcy, alerted the affected parties to the risks and put the affected parties in a position where they could have taken steps to protect their rights. In this regard, the Court took into consideration the lack of notice that was given to the pension plan beneficiaries of the proceedings.

Summary

The Court of Appeal appears to have focused on the 'equities' of this case and emphasized that the decision with respect to the DIP priority (or rather lack thereof) is unique to the facts of this case. In this respect, the Court made comments which appear to limit the effect of its decision by casting the contest not as one between a third party DIP lender and pension plan beneficiaries, but rather as an 'equitable' dispute between the pension plan beneficiaries and the principal secured creditor of Indalex's parent company (as Indalex's parent company was subrogated to the position of DIP lender as a result of payments made under its guarantee of the DIP Facility).

Regardless of the Court's attempts to emphasize the uniqueness of the circumstances of this case, this decision raises significant uncertainty with respect to a number of matters including (i) the priority of DIP financing; (ii) the priority of pension plan wind-up deficits with respect to secured creditors generally; (iii) duties of debtors (and directors) to deal with pension issues during a CCAA proceeding; (iv), the effect of a subsequent bankruptcy on either the deemed trust under the PBA or a 'constructive trust'; and (v) the application of the decision in the context of a receivership proceeding.

At this early stage it is not clear whether or not leave to appeal to the Supreme Court of Canada will be sought.

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