

**Legal Strategies for Structuring and Establishing  
Pension and Benefit Plans**

**Paul F. Baston  
Partner  
Fraser Milner Casgrain LLP  
Toronto**

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## **INTRODUCTION**

It is very important to consider legal as well as design issues when establishing or amending a pension or benefit plan. It is self evident that the documentation should be in compliance with all legal requirements. However, it is critically important that issues beyond mere technical compliance be considered. Given the application of contract and trust law to pension and benefit plans by the courts, some provisions of the plans may not be able to be changed later if the ability to do so is not reserved in the first instance. In this paper I will endeavour to provide some examples of legal issues beyond technical compliance that those who draft pension and benefit plans should consider. The examples provided in this paper are situations that have been considered by the courts or regulators. However, they are examples only and are not necessarily exhaustive.

## **APPROACH TO DRAFTING**

It goes without saying that an employer who is establishing a pension or benefit plan should obtain appropriate professional advice. Depending on the nature of the plan, the advice may be provided by a lawyer, an actuary, an accountant or an insurance or investment advisor. The employer will look to these professionals to draft the plan so that it is in compliance with all technical legal requirements and provides the desired pensions/benefits. Although the employer is relying on these professionals, particularly with respect to technical compliance issues, it is important that the employer be an active participant in the drafting process.

Because the employer is typically the one to administer the plan, the employer should be comfortable with the plan terms and their meaning. An employer should not hesitate to ask for changes or clarifications of provisions which are not clear and understandable.

Furthermore, the technical requirements should be dealt with fully. The employer should insist on completeness in drafting. For example, the definition of spouse or common law partner is different from one province to the next. If a pension plan has members who are employed in more than one province, any differences in definition should be clearly spelled out in the plan text. It is not sufficient to state that the definition will comply with legislated requirements

without setting them out. A failure to do so will lead almost inevitably to an error in administration.

When drafting a pension or benefit plan it is vitally important that the drafting be done in anticipation of future events to the extent it is possible to do so. For example, a legal advisor can advise on specific court and regulatory decisions and suggest language to deal with the types of circumstances that arose in those cases, if it is possible to do so. This approach involves much more than mere technical compliance. It is also important to try and anticipate situations that may not yet have been considered by the courts or regulators. Essentially the process involves "brain storming" in which possible future events are anticipated and provided for. The process that I am trying to describe is a bit like that of will drafting where the draftsman must, for example, anticipate deaths which may not occur in the usual order (i.e. child predeceases parent).

#### AMBIGUOUS PLAN PROVISIONS - EMPLOYER VULNERABILITY

The contents of most pension and benefit plans are not negotiated. Most plans are drafted by or for the employer without input or comment from or by plan participants or their representatives. In this circumstance, if a term of the plan is ambiguous or unclear, it will be construed against the party who drafted the document, or oversaw the drafting, (i.e. the employer) if the portion under consideration could be read to favour either the employer or the participant. The rationale for this approach is that the person doing or controlling the drafting should get it right. If an employer fails to do so, it does so at its own risk. As a consequence of this doctrine, it is very important that plan terms be as clear and unambiguous as possible.

#### APPLICATION OF TRUST LAW

An employer should also be aware that the courts have adopted a very rigid, traditional approach to the application of trust law in pension cases unlike areas such as matrimonial law where the courts have been accused of being unduly creative. In pension cases the courts have found that some plan provisions cannot be altered after they are established except in very limited circumstances. Given the application of trust law to pension plans, employers must be very

mindful of trust law issues that may arise in the pension or other benefit plan. I will deal with specific examples of trust law issues later in this paper.

#### NEW PLAN VERSUS EXISTING PLAN

The issues for an employer who is establishing a new pension or benefit plan are very different from those of an employer who is amending an existing plan. Subject to limitations which may be imposed by law and which cannot be changed, in a new plan the employer has the ability to set the rules. For example, the employer can reserve the right to receive surplus if the plan is wound up, use excess assets to meet funding obligations while a plan is ongoing or pay plan expenses. On the other hand, where a plan is already in existence the employer may not necessarily have the right to make an amendment that affects the employer's rights and entitlements. Contract and, particularly, trust law issues must be considered in light of the existing plan and funding agreement language as well as the language in all predecessor documents. This consideration becomes even more complex if the plan has resulted from one or more plan mergers because the histories of the predecessor plans must also be considered.

#### EMPLOYER VERSUS ADMINISTRATOR

When drafting a pension or benefit plan an employer should be careful to maintain the distinction between its role as employer and its role as administrator should it also act in that capacity. As administrator, particularly as administrator of a pension plan, the employer is acting as a fiduciary and must act in the best interest of plan participants. However, in its capacity as an employer, an employer is not charged with the same fiduciary obligations. This distinction was recognized by the Ontario Pension Commission in *Re Imperial Oil Ltd Retirement Plan (No. 2)* (August 3, 1995) reported in 18 C.C.P.B. 198. If it were, it could not take steps that would not be in the best interest of the plan members. For example, benefits could not be reduced in the future or a plan may not be able to be wound up if in taking such action the employer was acting as a fiduciary. A plan document should make this distinction clear. For example, it should be clear that plan amendment or termination would be effected by the employer in that capacity and not as the administrator of the plan. In that regard it would be helpful to have a separate definition for both the employer and the administrator, even though it

is the same party, with appropriate uses of the defined terms throughout the text so that the distinction is always preserved.

## CHOICE OF ADMINISTRATOR

In a jurisdiction where an employer who is creating a pension or benefit plan has the ability to determine who will be the administrator, the employer must turn its mind to the issues involved in this determination. On the assumption that the employer and administrator roles have been clearly set out and separated, it is important to focus on what the administrator does. For purposes of this discussion I will consider the role of the administrator under a defined benefit pension plan but a similar exercise should be undertaken for other benefit plans.

By way of example, the administrator oversees the investment of pension plan assets. In a defined benefit pension plan the employer is obligated to make up any shortfall if pension plan investments do not perform as well as assumed by the actuary in the actuarial reports or changes in interest rates or negative experience relative to other assumptions are experienced.

Conversely, plan language permitting, an employer may benefit from excess or "surplus" assets in a pension plan by utilizing such assets to satisfy obligations where the employer may otherwise have to make contributions (i.e. "contribution holidays") or pay expenses. In this circumstance the employer must decide whether it is prepared to give up control over the investment of assets because inappropriate decisions could have a devastating effect on funding obligations or deprive the employer from the opportunity to take contribution holidays.

The administrator will also construe provisions of the plan. These interpretations may well impact on plan costs and employer funding obligations. Again, the employer must decide whether it is prepared to relinquish this control.

With respect to both of the above examples, however, it should be reiterated that the administrator, whether or not it is the employer, has a fiduciary obligation to act in the best interest of the plan members while investing plan assets and interpreting its terms.

Consequently, an employer who assumes the role of administrator must be mindful of these

fiduciary obligations so that decisions are not made based on business policies without regard for such obligations.

## TYPE OF PLAN

Under this heading I will focus on pension plans.

An employer must decide whether the plan will provide defined benefits (benefit determined based on a formula using a percentage of earnings and years of service) or defined contributions (benefits determined by investment performance and the cost of annuities).

There are a number of factors which affect this decision. Some of these factors will be determinative. For example, it would be very unlikely if an employer with five employees were to introduce a defined benefit pension plan as it would be far too expensive to set up and administer for such a small group. In fact, in that circumstance, an employer might well choose to have a group registered retirement savings plan rather than a defined contribution pension plan but I will ignore that option for purposes of this discussion.

When choosing between a defined contribution and defined benefit pension plan cost is a major factor. A defined benefit pension plan is more expensive to administer. It is also more complex and more time is required on the employer's part to administer the plan. On the other hand, defined benefits provide an element of certainty and are attractive to employees who will remain with the employer for several years. Under a defined benefit pension plan the possibility of surplus arising exists so that an employer may anticipate reduced or eliminated funding obligations in the future. On the other hand, if a deficiency arises under the pension plan the employer may have to fund it.

Another consideration is possible liability or maladministration. In a defined benefit context this kind of liability could arise in a number of ways. Benefits may be calculated improperly. Usually this can be adjusted within the plan without a suit against the employer personally. However, the wrongful taking of contribution holidays, an unauthorized withdrawal of surplus or

the improper charging of expenses to the plan has resulted in employer liability. Claims have also been asserted with respect to improper investment activity.

Although at first blush it would appear that there is less liability exposure under a defined contribution plan than a defined benefit plan, such is not necessarily the case. Issues around surplus and contribution holidays are not a concern under a defined contribution plan. Moreover, there are no complex benefit calculations and administration expenses are much less. However, the employer still may face liability with respect to the investment of the defined contribution accounts. Although in my experience it is not as frequent today as in times past, some employers control the investment of the employer (and member contributions, if applicable) in the defined contribution plan. Because pension benefits are directly affected by pension plan performance, poor investment results coupled with a less than perfect governance model could well lead to employer liability. In addition, employers need to be very sensitive to the particular situations of members. As a member nears retirement an employer who is directing the investment of defined contribution accounts should be increasingly sensitive to the need to preserve capital.

The other alternative of permitting the members to direct the investment of their accounts does not relieve the employer of potential liability. Issues will arise as to the investment options offered, the ability to change investments, education about investment choices and investment advice. An employer must grapple between the risk of offering too few choices or too many. If the ability to change choices is very limited the employer may be criticized for not permitting members to take action to protect their investments. There is also the concern of providing sufficient education about the nature of the investments and the approach to investing pension assets without straying over the line and providing investment advice concerning selection of investments which could easily lead to employer liability, even if the employer is an investment counsel. Governance models have been developed in the United States and are developing in Canada to try and address these liability issues and provide employers with guidance.

## **SPECIFIC EXAMPLES OF DRAFTING CONSIDERATIONS FROM CASES/REGULATORY DECISIONS**

### **SURPLUS/EXCESS ASSETS**

If an employer is creating a new pension plan then the matter of dealing with surplus is very important, particularly if a trust is used to hold the pension plan assets. Because it is a new plan the employer has the opportunity to deal with all entitlement issues, subject to the collective bargaining process if the work force is unionized. If surplus rights are not adequately dealt with at this stage, it may be impossible to change them later. If an employer wants to retain entitlement to surplus in the event that the pension plan is wound up then that entitlement should be clearly spelled out in the pension plan text and supported by the trust or other funding agreement. The employer may also wish to address the withdrawal of "excess assets" while a plan is on going. The Supreme Court of Canada has held that surplus does not exist in an on going plan and only arises/crystallizes at wind up (or perhaps partial wind up). (See *Schmidt v. Air Products of Canada Ltd.* (1994), 3 C.C.P.B.1.) However, again depending on the final outcome in the *Mosanto* case at the Supreme Court of Canada [*Monsanto Canada Inc. et al v. Superintendent of Financial Services et al* (2002), 62 O.R. (3<sup>rd</sup>) 305 (Ont. C. of A.)], it may be held that this common law principle is overridden by specific legislation so that for regulatory purposes in some jurisdictions surplus can exist in an ongoing plan. An employer may want to reserve rights to the maximum extent possible, subject to applicable law from time to time.

An employer would also want to make it clear that contribution holidays may be taken and the Supreme Court of Canada has assisted in the *Schmidt* decision concerning the language which will grant that right. However, in this area given subsequent court decisions in British Columbia [*Hockin v. Bank of British Columbia* (1995), 7 C.C.P.B.197 (B.C.C.A.)] and Quebec [*Châteauneuf c. TSCO of Canada Ltd.* (1995), 6 C.C.P.B.1 (Que. C.A.)] it is better to be repetitious and redundant about the employer's right to take contribution holidays so that there can be no doubt in construing intent.

Where an employer is looking at amending an existing plan, then as noted above, the employer should seek legal advice based on all predecessor plans and funding texts to determine what amendments are feasible.

## EXPENSES

Plan expenses have become another thorny issue. Once more the courts have applied principles of trust law to hold that a broad amendment power, even the power to amend a municipal by-law, is not sufficient to permit an employer to change the rules about who is responsible for the payment of plan expenses. [*Markle et al. v. The City of Toronto and CIBC Mellon Global Securities Services Company* (Ont. C. of A. - February 3, 2003)] The ability to charge plan expenses to the pension fund should be clearly set out in the pension plan text (or municipal by-law) and the trust agreement should not contain any provisions that may be inconsistent with that intent. Given the approaches of the courts in these matters it is better to be as explicit as possible and redundant if necessary.

An employer with an existing plan who wants to change the rules with respect to payment of plan expenses must tread carefully and go through the same kind of exercise as would have to be undertaken if changes were made to surplus entitlement provisions to see what predecessor language provides.

## AMENDMENTS

The authority to make amendments is also complicated by the intertwining of contract and trust law. An employer should endeavour to have amendment language which gives the broadest possible authority to make amendments and changes to the plan. Although it is generally accepted that amendments are changes to a pension plan, there have been assertions from time to time that an amendment must be an "improvement". Consequently, the amendment authority should be made clear that applies to any changes or modifications. Again appropriate legal advice will help in this area. However, as noted above, a broad power of amendment may not be sufficient to permit certain changes if restrictions flow from a trust agreement. The trust agreement should provide for a broad power of amendment and reinforce the employer's rights

with respect to the payment of expenses as well as surplus entitlement. It should be clear that the employer is also a beneficiary of the trust. Because the court will be compelled to respect the terms of the trust agreement (on the assumption that there is no legal impediment to putting them in place in the first instance) it is important that the terms of the trust agreement be as clear as possible.

The ability to make amendments, including reduction or elimination of benefits, is very crucial in the area of post-retirement health and welfare benefits, particularly as these become increasingly expensive to provide. It is critical that an employer clearly reserve the right to reduce or terminate such benefits before an individual retires because a failure to do so before retirement will mean that that obligation may not be able to be changed after retirement. This type of concern relates to other post-retirement benefits. It should be made clear before the employment relationship terminates that these benefits may be changed or eliminated by the former employer after the employment relationship ceases.

## PLAN MERGERS

This is another thorny area. There have been recent examples where the courts have intervened to effectively set aside mergers so that two separate plans continue to co-exist within the "merged" plan resulting in uncertainty concerning surplus use or ownership. [See *Aegon Canada Inc. and Transamerica Life Canada v. Ing Canada Inc.* (Ont. S.C.J. January 23, 2003 and *Buschau v. Rogers Communications Inc.* (2001), 83 B.C.L.R. (3<sup>rd</sup>) 261 (B.C. C. of A.)]. The rationale for this is once more found in trust law and the requirement that restrictions imposed on the original plan under trust law must continue in the merged plan. Again, if there is an existing plan which is saddled with historic trust law problems, there may be little that can be done. However, if a new plan is being established consideration should be given to providing for more than just the authority to merge with another pension plan. Consideration should be given to seeing how far the plan and trust agreement can deal with the treatment of the plan assets if a merger occurs.

## MEMBERSHIP

There have been recent examples where the closure of the class of plan members (no new entrants will be permitted) have lead either to liability claims where the plan membership has been reopened or to the successful termination of the pension plan with the consent of members and the court. (See *Buschau v. Rogers Communications Inc.* (2002), 30 C.C.P.B. 167 (B.C.S.C) and *Buschau v. Rogers Communications Inc.* (B.C.S.C.), May 1, 2003.) As a result of these cases employers should be very careful to avoid closing a plan to new members, even if there is no immediate intention to add new members. If an employer chooses not to add new members at a later date it is necessary to reserve the right to add new members in the future, at the discretion of the employer, to preclude the class closure argument. Again this result may be more easily achieved with a new plan and may or may not be achievable by way of an amendment to an existing plan, depending upon its history. It is also important in this instance to consider granting express amendment authority dealing with this issue and the reserved right to reopen a class at a later date that is reinforced by the trust agreement.

## PURCHASE OF ANNUITIES

In a relatively recent case upon the failure of a life insurance company, from whom an annuity had been purchased, to provide a pension benefit to a retired member, it was held that the member could make a claim against the pension fund for pension payments going forward because the pension promise continued notwithstanding the annuity purchase and the purchase was not requested by the pensioner. In *McLaughlin v. Ultramar Ltd.* (1999), 20 C.C.P.B. 305 (Ont. C. of A.) the pension plan provided for the purchase of annuities to provide pension benefits but did not state that the purchase of such annuities would relieve the pension fund of responsibility to provide the pension benefit. The court stated that if such a relieving provision were contained in the plan its decision may have been different. As a consequence employers should look at the language dealing with the purchase of annuities and ensure that such purchase would clearly relieve the plan of responsibility to provide the benefit. Because the comment of the court was not necessary to reach its decision, it is possible that another court will come to a different decision. However, placing such a provision in the pension plan at least provides whatever protection that may be available.

## DEFINITION OF EARNINGS

Great care should be taken in defining the types of earnings that are to be recognized for pension accrual purposes in a pension plan, particularly where an employer has a complex compensation program that includes bonuses and other benefits. Unless an employer is going to include everything that is reportable in a T-4 or T-4A, care should be taken to spell out precisely what will be recognized to avoid future arguments. For example, is overtime to be included? Are some bonuses to be included and others not? As in most areas of drafting, the more certainty the better.

## MAXIMUM PENSION LIMITS

This is a relatively minor point but still worthy of mention. As readers will be aware, the limits imposed under the *Income Tax Act* (Canada) ("ITA") on the maximum dollar amounts that can be paid from a defined benefit pension plan or contributed to a defined contribution pension plan are being increased. An employer has a choice. If the employer wants to permit benefits to be paid up to these maxima that are in force from time to time, then the plan language should be amended to refer not only to a specific dollar amount but also such higher amounts as may be permitted from time to time under the ITA. Some plans just refer to the specific dollar limit and an increase in permissible benefit levels under the ITA would not apply to that plan unless it is amended. In circumstances where an employer has "top up" plan, often unfunded, that provides supplementary pension payments so that a pensioner receives a payment in total equal to the pension to which the individual would have been entitled if this ITA limit did not apply, it is important for both the employer and the pensioner to recognize increases in the ITA limits under the registered pension plan. A failure to do so will result in less being paid from the registered plan than may be paid from that vehicle and more from the unfunded plan, an undesirable result for employer and pensioner.

## COMMUNICATIONS

The area of employee communications is fraught with potential problems. Communications can range from statements of benefits to summary plan descriptions. The problems arise when the information communicated is inaccurate or potentially misleading. The miscommunication can even arise upon termination of employment such as in *Allison v. Noranda Inc.* (2002), 28 C.C.P.B.1 (N.B. C. of A.) where the former employee is encouraged to obtain independent advice and does so. There is no absolute protection for an employer in this area. However, there are two things that an employer should always do. The first is to ensure to the greatest extent possible that the information being communicated is clear, concise and accurate. The second is that, where provisions of a pension or benefit plan text are being summarized, it is clear that the text itself will govern if there is any difference between what is being summarized and what the text actually provides. The insertion of such a provision will not guarantee that an employer will be relieved from responsibility for miscommunication, but it provides the court with an opportunity to find in favour of the employer in situations where it appears that the employee is trying to take advantage of loose or inaccurate drafting. What the court will focus on is whether an individual has relied honestly to his or her detriment on the information that has been provided and made a decision which has cost implications for that individual which may not have been made if the information had been communicated correctly.

## CONCLUSION

It is important that great care be taken in the drafting of original texts, amendments and supporting documents for pension and benefit plans. Appropriate professional advice should be sought concerning technical and legal issues but the employer should also be an active participant in the process. If the appropriate care is taken and future events anticipated, to the extent that it is possible to do so based on past experience and possible future issues, then potential problems in administration and liabilities resulting therefrom will be significantly reduced.