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EXPECT THE BEST

Court Creates Potential New Hurdle For Insolvent Companies That Sponsor Employee Pension Plans and Seek New Financing

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Originally published in *Commercial Litigation Update* (June 2011)

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Insolvent companies with under-funded employee pension plans that want to borrow money to keep operating and ultimately return to profitability may find it tougher to find new financing as a result of a recent Ontario Court of Appeal decision.

The Court ruled on April 7 that Indalex Limited (and certain affiliated companies), the second largest aluminum extrusion company in North America, which administered two pension plans, one for employees and the other for executives, was obliged to pay its pension obligations first and, only after that, to pay its secured creditors and other lenders.

The fact that Indalex was the administrator of the pension plans covering its executives and other employees was central to the Court's decision. In that decision, the Court left open the possibility that, on different facts, it might have decided differently.

The Indalex decision adds to case law regarding which creditors rank where in the effort to recapture what they are owed by borrowers that have company-sponsored pension plans. Herewith some background and comment on some of the ebb and flow in that case law.

Background

In recent years, both Air Canada and Stelco have undertaken significant, court supervised restructurings, in part due to underfunded pension obligations. These cases opened (some would say resurrected) the debate on how distressed companies provide for company-sponsored pension plans when so many other stakeholders are competing for an ever decreasing supply of money.

Tied to the more general issue of insufficient resources for stakeholders, pensions also provide a legal tension between *Ontario's provincial Pension Benefits Act* (PBA) and Canada's federal *Bankruptcy and Insolvency Act* (BIA).

Section 75 of the PBA requires that, prior to wind up, employers fund all amounts due, or accrued, that have not been paid and any additional amounts relating to the pension shortfall. Section 57 of the PBA creates a deemed trust for all employer contributions accrued to the date of the wind-up (including the wind-up deficiencies). Section 30 of Ontario's *Personal Property Security Act* (PPSA) confirms the priority of the deemed trusts under the Pension Benefits Act, at least as it pertains to provincial legislation. However, section 67 of the bankruptcy act states that, on bankruptcy, all but three very specific deemed trust claims (Canada Pension Plan, Employment Insurance, and Withholding Tax) are extinguished.

The receivership of Usarco Limited (an importer and supplier of copper wire) and the restructuring of Ivaco Inc (a steel products manufacturer). tackled the tension between these various pieces of legislation. Based on these decisions, the general belief was that, at law, the deemed trust provisions of the PBA (and confirmed by the PPSA) remained in force unless and until the debtor company became a bankrupt. On bankruptcy, the paramountcy of federal legislation dictated that section 67 of the BIA applied and that the deemed trust claims under the PBA were extinguished.

The Court of Appeal's decision in Indalex Limited has created uncertainty in these generally held beliefs.

The Indalex Decision – Motions Court

On April 3, 2009, Indalex Limited obtained court protection through an Initial Order pursuant to the *Companies' Creditors Arrangement Act*. At the time of this Initial Order, Indalex was a plan sponsor and administrator of two registered pension plans. Five days later, the Initial Order was amended permitting Indalex to obtain debtor-in- possession (DIP) financing,, which would rank in priority to virtually all other debts (including pension deficiencies). The DIP loan was to be used to finance Indalex's operations during the restructuring. On June 12, 2010, the DIP loan was increased (with court approval) to almost $30 million.

On July 20, 2010, Indalex sought an Order approving a sale of its assets to a third party and further sought an order distributing the proceeds of sale. The approval motion was granted. It was opposed, however, by two groups on the basis that it did not provide for the deemed trust claims pursuant to the PBA. The court ultimately approved the distribution but required the court-appointed Monitor to hold back $6.75 million pending argument on the deemed trust provisions of the PBA

The deemed trust argument was brought before the motions court on August 28, 2010. The Honourable Mr. Justice Morawetz dismissed the motion requiring payment of all deemed trust claims. The dismissal was in large part due to the fact that there were no payments "due" or "accruing due" as of the date of the Sale and Distribution Orders The learned motions judge acknowledged that there would have been a payment due on December 31, 2009, but reasoned that the stay of proceedings provided for in the Initial Order (as amended) made that payment no longer "due" or "accruing due".

The Court of Appeal Reverses the Motions Court

In reasons released April 7, 2011, the Court of Appeal allowed the appeal and ordered that all deemed trust claims under the PBA (including any wind up deficiencies) were payable and that the holdback be applied to these claims. Furthermore (and in spite of the provisions of the amended Initial Order, which was not appealed), the Court of Appeal ordered that the PBA payment be made in priority to the DIP loan.

In its reasons, the Court of Appeal stated that the PBA payment accrued on the date that the plans began to wind up. The fact that the PBA provides for these payments to be made over five years does not mean that they have not accrued immediately. Furthermore, the record before the court approving the DIP loan did not reference said loan as taking priority over the deemed trust provisions of the PBA. In fact, the Court of Appeal held that the materials made some suggestion to the contrary

Finally, the Court of Appeal also dismissed the argument that the motion was a collateral attack on the Order approving the DIP loan. This was decided on the Court of Appeal's belief that "the collateral attack rule does not apply in the circumstances of this case". This finding is based in part on the "flexible, judicially supervised reorganization process that allows for creative and effective decisions".

Indalex - What does it Mean?

On the surface, the Court of Appeal decision appears to give all pension payments, including wind up deficiencies where applicable, priority over secured creditors and any debtor-in-possession financings which a debtor may wish to obtain to assist in its restructuring.

Read broadly, the decision could raise serious concerns among lenders who might wish to lend to companies that sponsor employee pension plans. It could also make it all but impossible for these same financially-strapped companies to obtain debtor-in-possession financing, particularly if there were a wind up deficiency in their pension plans.

On a closer review of the Indalex decision, the Court of Appeal was concerned with three specific actions:

1) In Usarco and Ivaco, the prospect of their bankruptcies was already before the court. In Indalex, the idea of bankruptcy appears to have been brought in response to the motion that the PBA payment was a deemed trust claim that was in priority over the secured creditors and the DIP loan.

2) The motion to approve the DIP loan was brought forward on short notice to all stakeholders and without notice to the pension plan beneficiaries.

3) Indalex was the plan administrator of both its executive and general pension plans and, in this capacity, had a fiduciary obligation to the beneficiaries. In spite of these obligations, Indalex sought, and obtained, approval for the DIP loan, which effectively subordinated the rights of the plan beneficiaries to the DIP lender. This calls into question the company's obligations to all of its stakeholders versus its obligations to the plan beneficiaries and, as such, is a conflict of interest.

These three particular actions are facts specific to this case. In its decision, the Court of Appeal left open the possibility that, on different facts, it may have dismissed this appeal.

Conclusions

To sum up, in reviewing the Indalex decision, the most that can be said is that it created some uncertainty with respect to the priority of pension plan deficiencies in an insolvency proceeding.

As indicated earlier, this will likely have a chilling effect in the credit market (particularly where the debtor has company-sponsored pension plans).

This author believes, however, that the Court of Appeal has left the door open for a return to the priority scheme articulated in Usarco and Ivaco, providing certain procedural requirements are met

Blaney McMurty LLP understands that certain Indalex stakeholders have sought leave to appeal the Ontario Court of Appeal's decision to the Supreme Court of Canada. ■