THE INSOLVENCY INSTITUTE OF CANADA
TASK FORCE ON PENSION REFORM

REPORT

Industry Canada
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Attention: Mr. Roger Charland

Introduction

The Insolvency Institute of Canada ("**IIC**") Task Force on Pension Reform (the "**Task Force**") respectfully submits this report on behalf of the leading organization of insolvency professionals in Canada. A brief description of IIC is attached as Schedule **"A"** hereto.

This report has been prepared in response to your request for comments on the proposed changes to Canadian insolvency legislation and related acts, which have been set out in various bills, specifically Bill C-476, C-487, C-501, S-214 and S-216 that are currently on the agenda of the 40th Parliament (collectively, the "**Proposed Legislation**") and other initiatives currently in process relating to the treatment of pension and long term disability ("**LTD**") obligations in an insolvency context. The report is based upon the volunteer efforts of many members of the IIC who participated in a number of meetings organized by the Task Force, and the comments herein have been formally approved by the IIC.

For the purpose of this Report, we have grouped the concepts in the Proposed Legislation into the following three areas:

1. Changes to the *Bankruptcy and Insolvency Act* (the "**BIA**") and the *Companies' Creditors Arrangement Act* (the "**CCAA**") to provide super-priority status for unremitted pension amounts and any amount determined to meet the standards for solvency of the plan, as well as restrictions on the ability of the Court to approve BIA

proposals or CCAA plans unless provision is made for the payment of same (the "**Pension Proposal**");

2. Changes to the BIA to give super-priority status to employees' severance and termination pay in bankruptcy and receiverships (the "**Severance and Termination Pay Proposal**"); and

3. Changes to the BIA and the CCAA to: (i) require trustees and receivers to continue LTD benefits post-bankruptcy/receivership; (ii) provide super-priority status for unfunded health related and LTD obligations; and (iii) restrict the ability of the Court to approve BIA proposals or CCAA plans unless provision is made for the payment of same (the "**Health/LTD Proposal**").

It has been the objective of the Task Force to approach the formulation of these comments on a principled basis, to use our practical in-depth knowledge of business insolvencies and of the existing Canadian insolvency system to comment on the Proposed Legislation. It should be noted that the IIC in general, and the Task Force in particular, do not represent any special or other interests in advancing the submissions contained herein.

The Executive Summary of the Report is set out on the following pages, with the contents of the Report set out thereafter.

EXECUTIVE SUMMARY

Recent insolvency filings (particularly, Nortel) have focused concern on the impact of the insolvency on employees and the risk they face in respect of the insolvent companies' inability to pay pension, health or LTD obligations and/or termination/severance pay. There is no question that the impact on employees of these unpaid claims is significant.

Attempting to address the issues by protecting the employee claims through insolvency legislation reform presents (at least) one fundamental problem. Once the rules for the insolvency proceeding are set by the Proposed Legislation, every other person (whether they are lenders, investors, suppliers, etc.) involved in establishing relationships with debtor companies must, by necessity, modify their relationships to protect themselves in the event of an insolvency that is governed by the Proposed Legislation. For example, if a priority charge is created against the debtor company's assets, those who provide funds to solvent debtors (whether secured or unsecured) must take into account such priority claims when making decisions about funding the solvent entity. Although the impact of the priority charge is theoretical until an insolvency occurs, an insolvency event must be factored into making the appropriate assessment of the debtor's ability to repay the debt. Most operating lines are on a demand basis and/or have strict review provisions – which would undoubtedly be triggered by the imposition of priority charges. Moreover, the margining requirements and ability to impose additional discretionary reserves on the borrowing base will significantly curtail the availability of financing under existing facilities, even in the absence of a demand or termination of the facility.

As a result, amendments to the insolvency legislation to provide for priority charges or restrictions on restructuring will likely create material new impediments for access to funding. Even if the scope of claims protected by the priority charge were easily quantifiable (and, as we describe in more detail below, they are not), the impact would be significant. Where, as with the Proposed Legislation, the quantum of claims is both substantial and volatile, the prospect of creating priority claims is likely to deal a crippling blow to many companies' ability to access capital.

To what end? The yoke of these additional financial burdens will encumber all Canadian employers with defined benefit plans, but will be irrelevant to the employees of Canadian companies who do not become subject to insolvency proceedings. The Proposed Legislation will, without question, worsen the situation for the vast majority of solvent companies, while providing limited impact for the employees of the very small minority of companies that become insolvent. The risk is that the Proposed Legislation negatively impacts an already sensitive equilibrium and causes more insolvencies as a result of a tighter credit market. As importantly, the financial burden placed on Canadian employers will present material impediments to their ability to be competitive in a global marketplace – all of which will occur in what is currently a very sensitive stage of economic recovery for Canadian companies.

The fundamental conclusions of our report are that substantial reforms are required in Canada's pension law. Many of these reforms are being advanced in a non-insolvency context and it is more likely that employees will be more effectively assisted by the other measures taken to initiate wider reforms to protect pensioners, such as Bill C-9. Attempting to address the related issues in the context of business insolvencies, particularly through the Proposed Legislation, is commercially imprudent, ineffective and inappropriate (with the possible exception of unremitted pre-filing pension contributions – which are discussed below). We are of the view that the provisions of the Proposed Legislation will have a significant negative impact on access to capital in the business environment while doing little to address the economic and social policy goals of Canadians generally. Although much of the discussion in this Report regarding the Proposed Legislation relates to the Pension Proposal, the conclusions regarding the negative impact apply equally to the Severance and Termination Pay Proposal and the Health/LTD Proposal.

REPORT

Background on Pension Deficit Issues

The fundamental and deep-seated societal issues relating to pensions in Canada are a reflection of the concern that Canadians currently in the workforce are at risk of having insufficient income in their retirement years. In a pension context (excluding consideration of RRSP's and CPP), these concerns can be said to be tied almost exclusively to situations where the employee is a member of a defined benefit ("**DB**") plan, as opposed to defined contribution ("**DC**") plan. DC plans reflect a commitment by the employer only to make certain contributions to the pension plan. Assuming that those payments are made (a process which is easily monitored by employees or their representatives and other persons interested in the financial affairs of the employer), the expectation of the employee is limited to the maximization of the available funds in the DC plan. In this context, it is the employees who bear the risk of the investment decisions relative to the accumulated pension funds. On the other hand, DB plans carry with them a more significant series of complicated issues, employee expectations and risks that affect both the employee and the employer – through its guarantee of the level of payments that will be made to the employees in the future – as well as other stakeholders in the enterprise.

The commitment of employers in both DB and DC plans is, in a basic sense, similar – to make the contractually agreed payments to the plans out of their operational funding. Normal and current service payments are made in the ordinary course and for all practical purposes are part of payroll. Normal and current service payments also do not generally have a negative effect on the ability of an enterprise to fund its liquidity needs. Those costs are known to the employer and expected by its secured and unsecured lenders to be made – circumstances that can be confirmed by those parties with minimal due diligence. Similarly, with respect to special payments - those payments required as a result of the pension regulatory regime to gradually reduce an actuarially determined going concern or solvency deficiency in a DB Plan - once a determination has been made that "catch-up" payments are required, the quantum of the special payments is known to the employer and can be easily quantified with minimal due diligence by the employer's secured and unsecured lenders.

In contrast, lenders cannot easily quantify the amount of any final funding shortfall that is determined on an actuarial basis at the time of a winding up of the pension as a result of an insolvency of the employer. The amount of this final deficit in a DB plan is a result of a divergence between the values used in a complex calculation that is made from a series of estimates about future demographic trends, economic trends, assumed rates of return, discount rates and inflation and the actual experience in those economic factors. The estimation process is inherently imperfect. The actuarial valuation takes time to develop, is performed as of a specified date, and the amount of the deficit could change while it is being calculated, due to the passage of time and changes in market conditions. Considering the length of time over which the projections are made, all of the components in the actuarial valuation have a compounding effect and slight amendments to the input variables will have a significant impact.

Pension legislation addresses the uncertainty concerning the actuarial calculation through periodic checks of funding adequacy by requiring two actuarial valuations be conducted at specified intervals. The first check – the going-concern valuation – assesses the adequacy of the fund to pay future benefits assuming the employer will continue the business and plan indefinitely. It requires the actuary to estimate future events and conditions over lengthy periods. If the valuation determines that the current level of funding is inadequate, then pension legislation requires that any funding deficiency be liquidated by special payments made over a long-term period of several years.

The second check – the solvency valuation – assesses the adequacy of the pension fund by assuming that the plan will be immediately terminated. In this type of valuation, future benefits are not taken into consideration and only accrued liabilities are valued as liabilities. The ability of the fund to pay those accrued liabilities is determined using the current market value of the fund's assets, without regard for any future earnings or increases in value that are not incorporated into the current market price. If the value of the accrued liabilities exceeds the current market value of the fund's assets, then this funding deficiency must be liquidated by special payments made over a five year period (although recent and proposed legislative changes would allow a doubling of this period in certain circumstances).

Thus an employer with a DB pension plan who becomes insolvent may have some or all of the following obligations: the normal cost pension contributions; special payments for a going-concern funding deficiency; special payments for a solvency valuation deficiency; and/or, if the plan is terminated, the entire amount of any solvency deficiency. The issues become how should any payment obligation or deficit that has been determined to exist be treated in the insolvency proceeding and what are the implications for that treatment.

It is important to stress that, in any circumstance where the amount of a liability is being determined by an actuarial valuation, the frailties of the actuarial process and the resulting consequences are clearly understood. The "actuarial science" involves applying the mathematics of probability and statistics to define, analyse and resolve the financial implications of future events. Almost every component of the predictors is a variable, many of which are tied to economic factors that are both volatile and inherently unpredictable. The variables never perform in a straight line as assumed, whether they are related to estimating the liability side of the equation or the value of the pension fund to address the estimated liabilities. The implications of the volatility are material – even slight adjustments in assumptions regarding, inter alia, interest rates, mortality or market performance can result in very large changes to the resulting calculations of the liabilities, asset values and deficiencies.

Status of Pension Deficits

The BIA and the CCAA as they presently exist provide a measure of protection for unremitted normal or current service payments in the case of proposals or plans of arrangement (by making the payment of these amounts a precondition to the ratification of the proposal or plan by the Court) and in the case of bankruptcy (by creating a super priority secured status for these unremitted amounts).

In cases involving bankruptcies or receiverships, subsections 81.5(1) and 81.6(1) of the BIA provide that where the bankrupt is an employer who participates in a prescribed pension plan, the following amounts are secured by security over all of the assets of the bankrupt employer (if they remain unpaid on the bankruptcy date):

- the sum of all contribution amounts deducted from employees' salaries, but not remitted to the pension plan fund;
- the "normal cost", which is defined by subsection 2(1) of the *Pension Benefits Standards Regulations,* 1985 (the "**PBSR**") as meaning the cost of benefits, excluding special payments, that are to accrue during a plan year as determined on the basis of a going concern valuation; and
- the sum of all contribution amounts owed by an employer to a DC pension plan.

Collectively hereinafter referred to as the "**Unremitted Pension Plan Contributions**".

The security granted by subsections 81.5(1) and 81.6(1) of the BIA is provided with priority pursuant to subsections 81.5(2) and 81.6(2) of the BIA, respectively, over every other claim, right, charge or security interest against the assets of the bankrupt or person subject to receivership (for ease of drafting, these will be hereinafter referred to as the "**bankrupt**"), regardless of when that other claim, right, charge or security interest arose except in respect of certain specified claims (e.g., the rights of unpaid suppliers to repossess goods, the rights of employees to security for unpaid wages and deemed trusts for payroll source deductions).

In cases involving proposals under the BIA or restructuring proceedings under the CCAA, subsections 60(1.5) and (1.6) of the BIA and subsections 6(6) and (7) of the CCAA provide that, where an employer participates in a prescribed pension plan for the benefit of its employees, the court will not approve a BIA proposal or a CCAA plan of compromise or arrangement unless:

(a) the BIA proposal or the CCAA plan of compromise or arrangement provides for the payment of Unremitted Pension Plan Contributions; or

(b) the relevant parties have entered into an agreement, approved by the relevant pension regulator, respecting the payment of these Unremitted Pension Plan Contributions.

These provisions effectively provide Unremitted Pension Plan Contributions with a preferential status, given that the BIA proposal and the CCAA plan of compromise or arrangement cannot be implemented unless they provide that the Unremitted Pension Plan Contributions will be fully paid or all the relevant parties agree otherwise.

Currently, Unfunded Pension Plan Liabilities (as defined below) are not afforded "super priority" nor preferential treatment rights under the BIA and the CCAA that rank ahead of secured creditors.

(a) Rationale for protection of unremitted payments

Comparing the insolvency law treatment of pension claims (and pension guarantee regimes) in Canada, the United States and the United Kingdom, the following policy rationale has been suggested for the protection of contribution arrears:

> Pension legislation in all three countries requires regular contributions be made to both defined contribution and defined benefit plans. Any contribution arrears will thus likely involve a deliberate decision by the employer to postpone or avoid remitting the contributions in order to use the funds to keep the business going. Such an action amounts to a preference in favour of the non-pension plan creditors that is contrary to the statutory obligations of the employer. Thus, granting contribution arrears claims a preference in the claims over remaining assets can be seen as an attempt to recognize that the non-payment may have been the result of preferences granted to other creditors while committing an offence. To the extent that insolvency law can serve to provide appropriate incentives to financially distressed employers and their creditors to comply with statutory obligations, granting a post-insolvency preference for those statutory obligations can provide such incentives. (Davis 2009, 145)

The rationale is consistent with that used in other areas of insolvency law that try to discourage distressed debtors from attempting to prefer some creditors over others through risk-shifting strategies, such as voidable preferences (Duggan and Telfer 2007). Additional policy justifications for priority treatment include the likelihood of assets being available because of the significantly lower order of magnitude of contribution arrears in comparison with the total shortfall in the pension fund and the support for the pension guarantee funds in the U.K and U.S (Davis 2009, 145). Similar rationales would apply to amending insolvency legislation to include special payment arrears in the statutory secured charge for pension contribution arrears. There is no difference in the type of deliberate and illegal behaviour involved in a decision to postpone or avoid remitting special payments and normal cost contributions. The only difference is the size of the contribution involved, and accordingly one might therefore conclude that there is no principled reason to distinguish the two types of arrears.

From the perspective of protecting the position of employees, it is noteworthy that plan members have no effective remedy in the event of a default in pension plan contributions (including normal cost and special payments). It is the provincial pension regulator that must take action in response to a default, but the pension regulator can only act after the default is reported or otherwise comes to its attention. Any delay in reporting the default or effective action by the pension regulator will likely prejudice the interests of plan members.

As a result of the foregoing, there are a number of factors supporting a reasonable manner of protection of all unremitted payments.

Though not currently protected, special payments could receive some measure of priority protection without impairing liquidity. Suggested provisions could include:

1. Special payments which have accrued up to the date of filing based upon an actuarial report existing at the time of the filing could receive similar priority protection as normal or current cost payments. Any special payment protection should only be based upon the actuarial report existing at the time of the filing. In St. Marys, the pre-filing report indicated a shortfall of less than $1 million, but the amounts jumped after filing to over $10 million. In Nortel the yearly increase for special payments post filing would have increased dramatically (probably by over $20 million per year during its restructuring) if Nortel had not been able to settle its pension and other benefits.

2. Unlike normal and current cost payments, the special payments priority should only attach to current assets. The current situation, which provides for a priority charge against all assets for normal and current costs is already problematic. Any further extension of the charge to special payments might well inhibit access to secured term lending (which is typically secured by a charge on fixed assets). Unlike asset-based and liquidity lenders, term lenders do not have control after the funds have been lent and they typically lack the ability to constantly monitor the borrower's performance in making the payments. Their primary recourse is to call the loan in default. Such a situation lends itself to the trigger of more early insolvencies. However, it is fair to

note that this potential consequence could be mitigated by limiting any priority charge for special payments to current assets.

3. Because of the magnitude of the special payments, any statutory provision that contemplates a priority charge or payment requirement must include a cap or maximum amount of charge/priority so as not to materially restrict liquidity needs. This "cap" should be determined after consultation in the legislative process with actuaries and other stakeholders.

4. In cases where operations continue after the initiation of the insolvency process, the termination of special payments accruing after the filing should be a matter of discretion, after consulting with the Monitor/trustee and obtaining court approval. It is critical to any restructuring process that there be flexibility in this process as, among other things, it directly impacts the availability of DIP funding. In Abitibi-Bowater, the company was authorized by the Court not to continue making the special payments during the restructuring. In Nortel, the company was authorized to continue to make these payments until an overall settlement was reached with the retirees, employees, Unions, pension regulators, noteholders and other stakeholders. The settlement was finally approved by the Court and leave to appeal by some dissenting disability retirees was dismissed.

(b) Protection for Pension Deficiencies other than Pre-filing Accruals

As set out above, an employer with a DB plan initiating insolvency proceedings may have a number of different statutorily prescribed normal cost and special payment obligations. In addition, the most recent actuarial valuation may have disclosed a funding deficiency that the special payments are supposed to liquidate. However, the total funding deficiency does not become an obligation until a decision is made to terminate the pension plan, either by the employer or pension regulator.

Differing policy considerations apply when considering the case for increasing the priority of the claim for the funding deficiency after all contribution arrears have been remitted. There are two main reasons why the policy considerations are different. First, a shortfall in a DB plan can arise without any wrongdoing or statutorily prescribed fault, or even any deficient management decisions on the part of the employer.

Second, the magnitude of pension shortfalls makes it less likely that the employer's assets could satisfy the claim in many insolvency proceedings. Any inability to fully pay the priority charge means all other creditors (unsecured or subordinate secured) would receive nothing on their claims.

In addition, the effect on credit markets should be considered, especially given the volatility of pension shortfalls that will make any credit granting decision uncertain because of the unknown dimensions and probability of the credit risk involved in the DB pension fund. This concern has been cited as being behind the decision not to change priorities for pension claims in insolvency proceedings in the U.K. Pensions Act (2004). (Stewart 2007, 22)

Thus, the option of changing priorities under insolvency law to address the problem of pension fund shortfalls lacks a compelling policy rationale. This appears to be recognized by a number of other countries – none of which create the type of super-priority charge for pension deficiency claims contemplated by the Pension Proposal[1].

More importantly, however, from a strictly Canadian perspective, the extension of such a significant priority charge as provided for in the Pension Proposal will present a critical and immediate negative impact on all operating companies that are employers with DB plans for a number of reasons, including:

(a) It will cause lenders to restrict credit, particularly working capital, to borrowers with DB pension plans whether or not they are in deficit. Already, many working capital facilities reserve (deduct from the borrowing base) an amount in respect of existing priority claims (a payroll cycle plus one cycle of pension contributions). Credit Agreements will now have to reserve for special payments and indeed, may need to start to reserve for special payments that may be required in the future given the potential for regulators to demand new solvency valuations from

[1] See attached table, which sets out a summary of the status of pension claims on bankruptcy in certain selected countries based on information from OECD publications listed in the table.

time to time. The impact of this will be to deprive pension plan sponsors of the same access to credit that non-sponsors enjoy if indeed it does not cause some lenders to restrict credit to only the most financially stable companies. Credit availability will decline and credit cost will increase in a significant way, putting Canadian companies at a competitive disadvantage to companies in other countries that do not have to give preferred creditor status to Unfunded Pension Plan Liabilities.

(b) Because of (a), there will be very major incentives to the few remaining private sector plan sponsors to convert their plans to DC or simply close them down altogether. Unionized operations (the bulk of surviving private sector DB plans) will be under further competitive pressure and there may be fewer options available to restructure, attract capital or otherwise take steps necessary to adapt or survive.

(c) The consequences of (a) must also be measured in the impact on the general economy, which is at risk of deteriorating if Canadian companies' competitiveness in the global marketplace is hindered by being subject to a more burdensome regime through the application of additional priority charges on their assets.

(d) The Pension Proposal will provide little to no benefit to pensioners or employees. As a result of successor employer rules and the immunity of collective bargaining agreements from restructuring, pension plans cannot be terminated without the active participation of the union in any event. As such, pension deficits have a *de facto* priority in that pension plans cannot be terminated to crystallize the deficit unless the union agrees. This already causes needless liquidations.

(e) If the Pension Proposal comes into effect, a wide array of creditors, such as banks and bondholders, would see their interests suddenly become subordinate to potentially substantial Unfunded Pension Plan Liabilities. Directly affecting that calculation are the currently changing International Financial Reporting Standards

(“**IFRS**”), which will likely impact pension plan accounting and create more volatility from quarter to quarter. This increased lending risk would likely have the effect of instantly depressing the value of the debt instruments, issued by such employers. Such corporate bonds are widely held by Canadians in their retirement savings portfolios and registered pension plans.

(f) In addition to these potential adverse effects on the credit market, in extreme cases the Proposed Legislation may cause plan sponsors to borrow to make immediate further contributions to fully fund their pension plans in order to get continued access to credit – the additional debt burden could put some employers out of business. Another unintentional consequence of a sudden increase in the total amount of secured debt carried by plan sponsors, is that it may trigger an event of default under existing financing agreements. In addition, lenders may refuse to take on the increased risk of offering new financing to distressed sponsors (in the form of either DIP or exit financing) which could accelerate bankruptcies.

(g) Lastly, if one assumes the correctness of the premise that the most significant components that create a pension funding deficit are market related (whether it is stocks/bonds performance or interest rate fluctuations), the creation of the priority charge has the direct effect of shifting <u>all</u> of the market risk’s impact onto the creditors of the employer. There is no compelling policy reason for such a drastic result.

Other Alternatives

Instead of focussing the discussion on legislative reform in an insolvency context, other options must be considered. One option is to institute a national system of pension benefit guarantees funded by premiums charged to employers who have DB pension plans. The other option is to attempt to address the policy objectives through legislative reform in pension and related matters without limiting the legislative initiative to an insolvency context. These options are not mutually exclusive.

(a) Pension Guarantee

A pension guarantee fund is probably the least urgent option, but we should recognize that there already have been taxpayer-funded *ad hoc* forms of pension guarantee through (a) government bailouts of various industries on the grounds of industrial policy and (b) the “loan” of funds to the Pension Benefits Guarantee Fund (“**PBGF**”) to cover the Nortel (and prior) deficits.

Although it is acknowledged that international experience shows that designing a premium structure that will make a guarantee fund sustainable without driving weaker employers/pension funds into insolvency is a significant hurdle, the size of the Canadian problem is significant. Mercers has estimated that the wind-up deficit for private sector Canadian DB plans is approximately $38 Billion as at December 31, 2009. If the Ontario PBGF provisions were to apply to all these plans, then the total "national PBGF" exposure would be approximately $15 Billion. The estimates are based on a combination of Mercer data and Stats Canada information. While not setting out a split between Ontario plans and those of other provinces/territories, it is believed that Ontario would be at least half of the total exposure.

There are other avenues that would likely prove more fruitful in terms of strengthening the security of the pension promise, many of which can be found in the Ontario Expert Commission on Pensions Report.[2] These include strengthening the existing funding rules, addressing the ambiguities and conflicts in the role of the pension actuary, increasing the economic efficiency of small and medium sized pension plans’ investment activities, and vastly improving the governance regime for pension plans. However, all of these actions lie within the legislative purview of the provinces, except for that portion of pension funds under the legislative authority of Parliament.

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[2] Arthurs, Harry W. 31/10 2008. *A Fine Balance: Safe Pensions, Affordable Plans, Fair Rules.* Report of the Ontario Expert Commission on Pensions. *Queen’s Printer for Ontario*. Ontario Ministry of Finance. 15/11/08 <http://www.fin.gov.on.ca/en/consultations/pensions/report/Pensions_Reort_Eng_web.pdf>

(b) Wider Reform

The Government has already taken significant steps to address certain of the concerns noted above through the passage of Bill C-9 (the *Jobs and Economic Growth Act*, which received Royal Assent on July 12, 2010). The Act provides for, among other things:

- the extension of the statutory deemed trust to include unpaid wind-up deficit amortization payments. This protects part of the Unfunded Pension Plan Liabilities;
- a distressed pension plan workout scheme to facilitate a negotiated funding arrangement; and
- plan sponsors to satisfy funding obligations with letters of credit.

If one believes the concept that pension reform is a problem that reflects a deeper societal issue that needs more than a mere insolvency legislation change, it would seem that employees' retirement income could be better protected by:

- Creating incentives to encourage employers to leave reasonable surpluses in a plan, rather than limit the contributions to the strict minimum available amount. This would require eliminating the natural aversion of employers to contribute any excess amount to the fund. This could be accomplished by relaxing the rules to make a pension surplus available to the employer, on termination or wind up of a plan, so that there is no perception that any fund invested in the pension plan is forever lost to the enterprise. However, care should be taken that such changes do not create incentives for employers to terminate plans in order to gain access to surplus amounts at some point when market conditions generate such a surplus.
- Allowing the pension plans to become overfunded, by eliminating the possibility of an enterprise taking a pension plan premium holiday when investment yields are high. The enterprise would always be required to contribute to the plan notwithstanding an over funding status. Conversely, to increase stability, the special payments required to be made upon an actuarial revaluation of the plan could be scaled over a longer period. This would provide some recognition of the fact that yields can be cyclical, creating plan surplus and deficits that are merely temporary. The amount of overfunding required could be linked to the degree of volatility in the plan's investments pursuant to some reasonable and pragmatic formula.
- A multi-employer type of solution that, to the greatest extent possible, allocates the funding burden fairly, without the spectre of a priority charge that could choke off funding availability at a time when the economy needs to grow.

- To explore whether to prescribe certain minimum requirements in terms of insurance and then allow for optional, additional coverage for those that want it. This model would balance the societal concern and risks by ensuring minimum coverage for vulnerable employees who need protection and may not be able to choose for themselves, while allowing others to obtain (and pay for) enhanced coverage, hopefully as part of an integrated retirement plan.

- Reviewing the practice/requirements put in place in connection with the termination of pension plans to purchase annuities with the employee's distribution. If the plan is terminated at the bottom of the economic cycle, a process of committing employees to purchase annuities puts them into an annuity at the bottom of market thereby exasperating the situation. This is a difficult scenario, amplified by the lack of a vibrant market in Canada for annuities. It may be more appropriate to allow employees to have the option of taking funds out and putting them into new DC plans that would allow them to ride the market cycle rather than freezing them at bottom.

- Policy makers should not ignore the needs of the large number of Canadians who do not have access to pensions. Strategies could include further material enhancements to the RRSP and TFSA regimes.

Health/LTD obligations

Bill C-487 proposes to amend the BIA and the CCAA such that priority for payment (ahead of secured creditors) would be given in both bankruptcy and restructurings for the actuarial value of: (1) the income replacement portion of LTD benefits until the recipients reach the age of 65; (2) health care benefits and pension accruals for employees who were receiving LTD benefits until the recipients reach the age of 65; and (3) five years worth of health care benefits for all other employees. Bill S-216 proposes to amend the BIA and CCAA such that, in bankruptcy or receivership, the actuarial value of LTD benefits and health-related benefits owed to LTD recipients would be given priority for payment ahead of unsecured creditors and that, in restructurings, such amounts would be given priority for payment ahead of secured creditors.

The issue of terminating health related/LTD benefits arises where the business is being carried on in some form or other through a receivership or CCAA proceeding and the employer/interim lender (colloquially, "DIP lender") wishes to terminate benefits to retirees or to everyone. If the benefits are insured through group policies there is usually a short period during which individuals may convert their benefits into individual policies. Where LTD benefits are provided through an insurance policy, those employees in receipt of the benefits when the employer becomes insolvent should not have their benefits affected by the termination of the insurance policy. However, continued receipt of other benefits such as life insurance, supplementary health and dental coverage is dependent on the continued payment of policy premiums. If the employer's LTD program is self-funded, then it can be directly affected by the employer's insolvency. The issue is one of termination of an "executory" contract during the receivership or CCAA. The conditions for court approval of a disclaimer in the context of the CCAA are:

> 32(4) In deciding whether to make the order, the court is to consider, among other things:
>
> (a) whether the monitor approved the proposed disclaimer or resiliation;
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> (b) whether the disclaimer or resiliation would enhance the prospects of a viable compromise or arrangement being made in respect of the company; and
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> (c) whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.

By way of contrast, we note the criteria and procedure adopted by the U.S. in s.1114 of the Bankruptcy Code regarding retiree medical benefits could be adapted to our system and would be preferable to an abrupt cut-off occasioned by the filing of an application under the CCAA. The procedure is as follows:

> "… s.1114 sets out conditions that must be met in order to successfully apply to the court for an order modifying or rejecting the obligation to pay vested retiree health benefits. It begins by prohibiting an employer from failing to pay or modifying retiree benefits unless a court has ordered the modification of the benefits or an agreement on modification has been reached with the retirees' authorized representative. Before the employer can apply to the court for an order modifying retirees' vested benefits, it must comply with similar procedural requirements to s.1113, i.e., it must make a proposal to the retirees' representative after providing that representative with information about the proposal and why it is necessary to the employer's restructuring. The employer must negotiate the modification in good faith with the retirees' representative and may only go to court if the

proposal is rejected without cause. Once at court, the employer must show that the modifications are necessary and that all affected parties are treated fairly and equitably."[3]

Thus, rather than merely having to show that disclaimer enhances the prospect of the restructuring, employers would have to make a reasonable offer of compromise, negotiate in good faith and then demonstrate both necessity and fair and equitable treatment before they could modify or terminate the benefits. This is conceptually close to the actual experience in the Nortel proceeding.

> "In the United States Senate Committee report on the legislation enacting s.1114 of the U.S. *Bankruptcy Code*, the impetus for the legislative initiatives was described as follows:
>
>> This bill recognizes the conflict between the interests of all other unsecured creditors in a Chapter 11 proceeding and the special problems associated with the cut-off of health and insurance benefits to retirees. The special treatment accorded retiree benefit payments is appropriate because of the hardship imposed on elderly recipients when such benefits are suddenly curtailed. However, this bill addresses the needs of retirees within context of the traditional structure of the Bankruptcy Code. The broader issues associated with retiree benefits remain to be addressed by other committees of appropriate jurisdiction.

Thus, it would appear that the legislators wanted to provide some balance in the relationship between vested retiree benefit claimants and all other unsecured creditors that recognized the hardship imposed on retirees when they are denied access to medical insurance."[4]

> "… although the immediate impact of cancellation of health insurance may not be as devastating as that experienced by a U.S. retiree, the impact on a Canadian retiree will still be substantial, given the role of private sector financing in both the overall expenditures and those on prescription drugs. The potential that serious health effects may follow from delay in obtaining medication or other types of privately-funded

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[3] A fuller description of the US procedure and the rationale for choosing this over the current standard in respect of the termination of medical benefits is found in "Doomed to Repeat History" Retiree Benefits and the Reform of Canada's Insolvency Laws", *Annual Review of Insolvency Law – 2004,* 199.

[4] *Ibid.* at 231-32.

medical equipment or treatment remains an important factor in evaluating the hardship that may follow termination of retiree medical benefits."[5]

"A second reason to intervene in the process of disclaiming retiree benefits has its roots in the retirees' unusual strategic disadvantage in restructuring proceedings, resulting from the particulars of their executory contract with the employer. These particulars leave them practically unable to take steps to protect themselves while they are still employed and vulnerable to undue pressure in any insolvency negotiations."[6]

For these reasons the risk to employees relating to the non-payment of health related or LTD benefits should be mitigated by a more stringent different disclaimer procedure. Protection for fair treatment in the disclaimer process balances the restructuring requirements of the insolvent employer with the unfortunate (but sometimes necessary) consequences to the employee. It also recognizes that, in Canada, the mitigating effects of the disclaimer are more likely to be offered by access to public health programs (an area where, regardless of recent U.S. reforms, Canadian residents/employees have greater benefits available to them) than in the U.S. Simply providing a priority claim for these speculative amounts will, for the reasons noted above relating to Pension Deficits, also lead to a restriction on the availability of credit.

It is worth noting that one unintended consequence of the Health/LTD Proposal and the resultant situation of tighter access to capital is that employers may have no alternative but to reduce or eliminate the types of voluntarily provided employee benefits (such as LTD benefits).

Termination Pay

Similar conclusions can be reached with respect to the Proposed Legislation concepts of giving termination and severance pay a super-priority charge over working capital lenders. It should be noted that:

(a) Severance and termination are not concepts that are inherently quantifiable. The existing super-priority for wages is a capped amount of $2,000 per employee (with an additional amount for certain expenses). As a result, lenders understand how to quantify any reserve when making their credit decisions. Termination and

[5] *Ibid.* at 233.
[6] *Ibid.* at 234.

severance pay are not defined terms – they include the greater of statutory *Employment Standards Act* amounts (which vary by Province) or common law/contractual severance. The latter are not ascertainable by a lender in advance with any degree of certainty (the "one month per year" rule of thumb is no more than that) and "reasonable notice" is a standard which varies from employee to employee and case to case. Where there is a large employee base, the calculated entitlements will be massive and grow constantly with the seniority of the workforce. In addition, the larger the workforce the greater the uncertainty in the calculation.

(b) Severance and termination pay are different from wages in that they are payable to employees without regard to loss – the employee who gains new employment immediately has the same entitlement as the employee who enters the ranks of the long-term unemployed.

(c) In addition to the negative effect that a super-priority will have on working capital credit for all plan sponsors, a priority for termination and severance will see reserves against borrowing base for all employers increase dramatically as lenders take a conservative view of what the amount of the super priority might be. As the amounts can be highly material (an individual's entitlement may be up to 12-18 months' salary in severance/termination pay based on the cases), the impact on lending could be catastrophic.

Summary

While it cannot be disputed that substantial reforms are required in Canada's pension law, attempting to address the protection of pension and related employee benefit issues in the context of business insolvencies, particularly through the Proposed Legislation, is both ineffective and inappropriate. While the Proposed Legislation initially appears to be aimed at protecting the interests of Canadian employees - a laudable goal - a more detailed analysis reveals that most of the provisions of the Proposed Legislation will have a significant negative impact on access to capital in the business environment while doing little to address the economic and social policy goals of Canadians generally. The Proposed Legislation will also impair, in a significant way, the ability of insolvent companies to undertake a restructuring in an attempt to continue operations. One of the most significant aspects of protecting employee-related obligations in the context of a restructuring is that the employer's business be provided with a reasonable opportunity to continue as a going concern. Creating roadblocks to that objective, through priority charges for employee related claims or mandatory (but difficult to value) criteria for a restructuring, will create both financial difficulty for employers that are already struggling and significant impediments to their ability to restructure.

All of which is respectfully submitted on behalf of the Insolvency Institute of Canada and the members of the IIC Task Force. We would be pleased to discuss with you any questions or comments you may have.

August 31, 2010

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The Insolvency Institute of Canada/L'institut d'insolvabilité du Canada

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The Institute has sponsored and supported public conferences on insolvency related topics and publishes papers that are delivered at its Annual General Meetings. The Institute has provided Insolvency Institute Fellowships for post-graduate studies in insolvency related subjects at leading Canadian universities and has commissioned research projects on important issues in Canada's insolvency and restructuring system. Through The Insolvency Institute's/Judicial Liaison Council, the Institute has established links with Canada's leading bankruptcy and insolvency judges. The Institute, in association with one of Canada's leading publishers, makes its collection of insolvency cases and materials available electronically.

The Institute, through its members, brings a wealth of judgment and experience to its activities and projects and is becoming increasingly recognized as the most authoritative multidisciplinary insolvency organization in Canada.

August, 2010

STATUS OF PENSION CLAIMS ON BANKRUPTCY IN SELECTED COUNTRIES[7]

Country	Predominant Occupational Pension Arrangement	Status of Pension Claims on Bankruptcy	Pension Fund Guarantee Schemes
Australia	• Defined contribution pension plans	• Pension contributions due but not paid are given priority over unsecured debts but rank behind secured creditors, liquidation expenses and unpaid wages	• No pension fund guarantee scheme
Canada	• Defined benefit/defined contribution pension plans	• Contributions due but not paid to pension funds have a preferred status • Pension deficit is treated as an unsecured debt.	• The Pension Benefit Guarantee Fund (Ontario) guarantees pension benefits in the event of plan sponsor's bankruptcy (only up to certain limits)
Denmark	• Defined contribution pension plans	N/A	• No pension fund guarantee scheme
Finland	• Mandatory defined benefit arrangement	N/A	• There is a joint and collective guarantee system for certain plans • The government guarantees all or part of the benefits under other plans
France	• Limited number of occupational pension plans due to generous	N/A	• No pension fund guarantee scheme

[7] Information appearing in this table has been derived from the OECD publications listed at the end of the table. Please note that the table only provides a high level summary of the OECD publications. For a more detailed description please refer to the actual publications.

Country	Predominant Occupational Pension Arrangement	Status of Pension Claims on Bankruptcy	Pension Fund Guarantee Schemes
	state pension schemes • Occupational plans are mainly insured or savings plans		
Germany	• Defined benefit pension plans	• Pension obligations are treated as unsecured debts	Upon bankruptcy, the Pension Guarantee Fund (“PSVaG”) takes on obligations of plan sponsor (up to a certain level) and purchases annuities. About 2/3 of pension liabilities are covered by the PSVaG. The other third is held by insurers and “Pensionskassen” (these funds are being supervised as insurance funds and are subject to stringent solvency standards).
Ireland	• Defined benefit pension plans	• Unpaid pension contributions (up to certain limits) are given priority over floating secured creditors and unsecured creditors but rank behind fixed secured creditors and liquidation expenses	• Payment may be made out of the Social Insurance Fund in respect of unpaid contributions
Italy	• Severance pay or “Trattamento di Fine Rapporto” (“TFR”) (i.e. lump sum paid to an employee on termination of employment) • Defined contribution pension	• Salary owed to employees (incl. TFR) has priority over unsecured debts • Same priority status for contributions to public pension	• Protection Fund for unpaid contributions

Country	Predominant Occupational Pension Arrangement	Status of Pension Claims on Bankruptcy	Pension Fund Guarantee Schemes
	plans	schemes and other forms of social protection (theoretically includes contributions to employer-sponsored plans)	
Japan	• Severance pay • Defined benefit pension plans ("employee pension funds" or "EPFs" are large DB plans; there are also other types of DB arrangements)	• Severance pay ranks behind secured creditors but ahead of other preferential claims • Employer contributions to EPFs rank behind wages/taxes but ahead of unsecured creditors • Contributions to other pension arrangements are unsecured debts	• Pension guarantee program covers a portion of the pension benefits accrued by members of EPFs only
Korea	• Severance pay • Defined benefit pension plans	• Severance pay (up to certain limits) and contributions to defined benefits rank ahead of secured creditors	• No pension fund guarantee scheme
Netherlands	• Defined benefit pension plans	• Contributions to pension arrangements are unsecured debts (preferential status for unpaid contributions under consideration)	• No pension fund guarantee scheme but a special fund can pay contributions owed by sponsor (up to a maximum of one year of unpaid contributions)
Norway	• Mandatory defined benefit pension plans		• No pension fund guarantee scheme

Country	Predominant Occupational Pension Arrangement	Status of Pension Claims on Bankruptcy	Pension Fund Guarantee Schemes
Poland	• Mandatory defined contribution pension plans (with a guaranteed minimum rate of return)	N/A	• A guarantee fund covers the deficit of a pension fund (i.e. where the rate of return is below the minimum rate) in case of bankruptcy
Portugal	• Defined benefit pension plans	• No priority or preferential status for pension-related claims	• No pension fund guarantee scheme
Spain	• Defined contribution pension plans	N/A	• No pension fund guarantee scheme
Sweden	• Defined contribution pension plans	• Contributions to pension funds which are not covered under the pension guarantee scheme rank behind secured creditors and liquidation expenses but ahead of unsecured creditors	• Pension Guarantee Mutual Insurance Company (only covers plans for white-collar workers)
Switzerland	• Mandatory defined benefit pension plans and hybrid plans	• Preferential treatment with respect to the portion of entitlements which is not covered by the guarantee fund	• There is a guarantee fund which covers any shortfall up to a certain limit in case of bankruptcy

Country	Predominant Occupational Pension Arrangement	Status of Pension Claims on Bankruptcy	Pension Fund Guarantee Schemes
United Kingdom	• Defined benefit pension plans	• Preferential status for unpaid contributions (the government ranks as the preferred creditor if it paid those contributions to the pension fund)	• National Insurance Fund can pay employee contributions deducted as well as contributions owed by sponsor (up to certain limits) • Pension Protection Fund provides compensation to members of eligible defined benefit plans in case of shortfalls
United States	• A significant number of plans continue to have defined benefit obligations; a strong trend has been observed where employers either replace the DB plan with a DC plan or close the DB plan to new entrants	• No priority or preferential status for pension-related claims	• Pension Benefit Guarantee Corporation offers some protection of defined benefits if employer is unable to fund the plan

Sources:

1. *Protecting Pensions: Policy Analysis and Examples from OECD Countries*, OECD, 2007 [Note: The OECD's report on priority pension claims in case of bankruptcy found that pension claims, (unlike wages), do not always receive priority over other creditors. Difficulties with providing such status come from problems with changing bankruptcy laws and potential impacts on the capital markets. The OECD's report concludes that priority rights should be given to unpaid and due contributions and care should be taken that pension beneficiaries be treated at least as well as other creditors in any bankruptcy or restructuring process (e.g. ensuring their representation on creditor committees).]

2. *Complementary and Private Pensions throughout the World 2008*, ISSA/IOPS/OECD, 2008

3. *OECD Private Pensions Outlook 2008*, OECD, 2009

4. *Pensions at a Glance – Retirement-Income Systems in OECD countries*, OECD, 2009