Banking and Financial Services

Indalex: Supreme Court of Canada Decision Released

The Supreme Court of Canada ("SCC") recently released its much-anticipated decision in the Indalex Limited ("Indalex") proceedings under the *Companies' Creditors Arrangement Act* (the "CCAA Proceedings"). The decision is important for secured lenders in the context of an insolvency proceeding ("DIP Lenders") or outside of an insolvency proceeding ("secured lenders"). One of the main issues the SCC scrutinized was whether defined benefit pension plan wind-up deficiencies are subject to the deemed trust provided for by the *Pension Benefits Act* (Ontario) ("PBA") and the priority of the deemed trust in respect of a charge granted in favour of the DIP Lenders who funded Indalex's CCAA Proceedings ("DIP Financing").

SHORT SUMMARY

a. Implications for Lenders

In a 4-3 decision (with three separate written judgments), the SCC held that an employer's obligations for funding deficiencies that arise upon the wind-up of a defined benefit pension plan are included in the PBA deemed trust provisions and, as a result, enjoy priority over secured lenders. When providing financing to borrowers with defined benefit pension plans, secured lenders should carefully consider appropriate provisions in their credit agreements that set out, among other things, strict reporting obligations and on-going monitoring of the debtor's affairs.

DIP Lenders can take comfort in the SCC's unanimous (7-0) decision that a court-ordered super-priority charge securing advances to an insolvent debtor will have priority over the PBA deemed trust provisions.

b. Implications for Insolvency Practitioners

In situations where a company acts as pension plan administrator (the "Employer-Administrator"), it owes a fiduciary duty to the plan beneficiaries. The Employer-Administrator must take steps to avoid any conflicts of interest that may arise as a result of the insolvency proceedings of the debtor employer and quickly deal with any conflicts that do arise. Although the judges did not agree as to the steps the Employer-Administrator must take at various stages in order to avoid a conflict of interest, the SCC was unanimous in its assessment that any motions seeking approval of DIP Financing, and a super-priority charge in favour of DIP Lenders, must be on reasonable notice to pension plan beneficiaries. Further, steps must be taken by the employer to ensure that pension plan members are properly represented at hearings that directly affect their interests, including motions regarding the terms of DIP Financing.

FACTS

As is common in CCAA Proceedings, Indalex secured DIP Financing to enable it to continue operations during its restructuring process. The Ontario Superior Court of Justice (the "CCAA Court") issued an order approving the DIP Financing and as security for the advances granted to the DIP Lenders a charge that enjoyed priority over all other creditors. At the time of filing for CCAA Proceedings, Indalex was an administrator of two registered defined benefit pension plans, one for salaried employees (the "Salaried Plan") and another for executives (the "Executive Plan"). Both plans faced funding deficiencies. At the time of commencement of the CCAA Proceedings the Salaried Plan was being wound up, but the Executive Plan was not.

As part of the CCAA Proceedings, Indalex sold its business operations as a going-concern to SAPA Holding AB ("SAPA"). At closing, Indalex owed US$27 million to the DIP Lenders. A portion of the sale proceeds was paid to the DIP Lenders and $6.75 million was retained in reserve pending a determination of the pension plan members' rights. The payment of the sale proceeds to the DIP Lenders left a US$10 million shortfall, which amount was paid by Indalex's US parent pursuant to a guarantee.

The pension plan members brought a motion for a declaration that a deemed trust equal in amount to the unfunded pension liability was enforceable against the sale proceeds held in reserve and had priority over the DIP Lenders and the US parent guarantor. The deemed trust provisions set out in the PBA provide that certain amounts payable by an employer in respect of its pension plan obligations are deemed to be held in trust for the plan beneficiaries, and therefore enjoy priority over the employer's other creditors.

The CCAA Court dismissed the plan members' motion at first instance. On appeal, to the surprise of insolvency practitioners across the country, the Ontario Court of Appeal ("OCA") sided with the pension plan members and held that they were entitled to payment out of the sale proceeds in priority to the DIP Lenders.[1]

DEEMED TRUST AND PENSION WIND-UP DEFICIENCY

An employer's liability upon wind-up of a pension plan has two components. First, it must pay an amount equal to the total of all payments that are due or have accrued and that have not been paid into the pension fund (the "current service costs"). Second, the employer must pay all additional sums to the extent the assets of the pension fund are insufficient to cover the value of all immediately vested and accelerated benefits and grow-in benefits. This latter liability is known as the "wind-up deficiency".

Four of the SCC judges, comprising the majority on this issue, held that amounts payable in respect of any wind-up deficiency are included in the PBA deemed trust provisions. The issue was strictly one of statutory interpretation and came down to whether the wind-up deficiency could be considered "accrued to the date of wind-up". Utilizing grammar, statutory interpretation principles and legislative intent as their guide, the SCC's two main judgments differed in their findings in this regard with the majority holding that the wind-up deficiency was properly considered accrued before the date of wind-up.

Prior to the Indalex OCA decision, it had been generally understood in the banking and insolvency world that the PBA deemed trust provisions only extended to current service costs and did not extend to any wind-up deficiency. The SCC has now confirmed that any wind-up deficiency amounts payable by an employer are included in the statutory deemed trust and will have priority over secured lenders, at least outside of the context of DIP Lending in an insolvency proceeding.

PRIORITY OF THE DEEMED TRUST

The SCC held unanimously that the provincial deemed trust under the PBA did not have priority over the super-priority charge granted by the CCAA Court to the DIP Lenders. The SCC noted that court-ordered priority based on the CCAA has the same effect as a statutory priority and where the CCAA Court grants priority to a DIP charge that conflicts with provincial priority schemes, under the doctrine of paramountcy, the court-ordered DIP charge supercedes provincial deemed trusts. Presumably, this would apply equally to a DIP charge granted in respect of proposal proceedings commenced under the *Bankruptcy and Insolvency Act* (Canada).

1 A copy of the e-news bulletin issued by Heenan Blaikie LLP in respect of the OCA's decision can be found here.

BREACH OF FIDUCIARY DUTY AS EMPLOYER-ADMINISTRATOR

As is common practice for Ontario employers with defined-benefit pension plans, Indalex acted as each plans' administrator. In its capacity as Employer-Administrator, all parties agreed that Indalex owed a fiduciary duty to the plan members, which duty included avoiding conflicts of interest.

a. CCAA Proceedings

The SCC considered the actions taken by Indalex in contemplation of the CCAA Proceedings, whether such actions constituted a breach of Indalex's fiduciary duty as Employer-Administrator and set out the steps an Employer-Administrator should take to avoid such conflicts.

The majority of the SCC held that filing for protection under the CCAA did not give rise to any conflict of interest or duty on the part of Indalex. However, the SCC unanimously held that Indalex had a duty to provide the plan members with reasonable notice of the motion seeking approval of the DIP Financing, and the granting of a super-priority charge in favour of the DIP Lenders. Indalex breached this duty by not giving proper notice of the motion to the plan beneficiaries and not taking steps to ensure the beneficiaries were properly represented in the CCAA Proceedings. When an Employer-Administrator finds itself in a conflict, Justice Cromwell held that it must bring the conflict to the attention of the CCAA judge who may consider it appropriate to appoint an independent administrator or representative counsel. In effect, the SCC unanimously rejected the theory put forward by the appellants that the Employer-Administrator could continue to act as both the restructuring debtor and Employer-Administrator in such circumstances by "wearing two hats".

b. Bankruptcy Proceedings

At the same time that Indalex sought approval of the sale to SAPA, it applied to the CCAA Court to lift the stay of proceedings in order to file an assignment into bankruptcy. Three of the SCC judges held that this was not a breach of Indalex's fiduciary duty, two of the judges held that it was done with an intent to harm the interests of the pension plan members and was therefore a breach, and the remaining two judges did not comment on this issue.

CONSTRUCTIVE TRUST REMEDY

The OCA found that Indalex breached its fiduciary duty owed to the plan beneficiaries and in order to rectify the breach imposed a constructive trust over the sale proceeds held in reserve in favour of the beneficiaries. The majority of the SCC (5-2) held that the imposition of the constructive trust over the sale proceeds was inappropriate as the sale proceeds did not arise as a result of Indalex's breach of fiduciary duty. Justice Deschamps held that courts should not use equity to do what they wish Parliament had done through legislation.

DOCTRINE OF EQUITABLE SUBORDINATION

Out of the three judges that wrote reasons, Justice Deschamps was the only judge that considered the application of the doctrine of equitable subordination. American bankruptcy courts employ this doctrine to subordinate claims of prior ranking creditors in favour of subordinate claimants in circumstances where the prior-ranking claimants acting inequitably in respect of the subordinate creditors. Justice Deschamps noted that the SCC had previously left for future determination the operation of equitable subordination in Canada but that she declined to endorse it in the *Indalex* decision. She held there was no evidence that the DIP Lenders committed a wrong or engaged in inequitable conduct. As a result, it remains an open issue as to whether the doctrine of equitable subordination can be invoked in Canada.

SUMMARY

a. Important Takeaways

i. In circumstances where an employer seeks to wind-up a defined benefit pension plan, amounts payable by the employer in respect of any wind-up deficiency amount are included in the PBA deemed trust provisions and will have priority over secured lenders.

ii. Court-ordered super-priority charges securing DIP Financing will have priority over the PBA deemed trust provisions.

iii. Where an Employer-Administrator has commenced CCAA Proceedings, any motions seeking approval of DIP Financing and a super-priority charge in favour of DIP Lenders must be on reasonable notice to pension plan beneficiaries.

b. Remaining Uncertainties

i. Although three of the SCC judges held that an Employer-Administrator's decision to bring a motion seeking authorization to file an assignment in bankruptcy did not amount to a breach of its fiduciary duty, without a majority decision on this issue, the question as to whether filing for bankruptcy constitutes a breach of fiduciary duty remains an open issue.

ii. It is not clear whether the doctrine of equitable subordination could be invoked in different circumstances to subordinate the claims of prior-ranking secured creditors in favour of junior-ranking creditors.

iii. The SCC did not provide guidance as to steps that a secured lender should take to protect its interests in the event of a wind-up of a borrower's defined benefit pension plan. It may be prudent for secured lenders to evaluate the terms of credit agreements entered into with borrowers who maintain defined benefit pension plans to ensure their interests are protected in the event the borrower encounters financial difficulties.

If you have any questions about these issues, or any other aspects of the SCC's *Indalex* decision, please contact the Banking and Financial Services Practice Group at Heenan Blaikie.

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Heenan Blaikie acted as Canadian counsel to SAPA, the purchaser of the Canadian and US assets of Indalex

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