Federal priority trumps deemed trust, SCC rules

Pension beneficiaries of bankrupt company lose on appeal after 'empty decision'

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Lenders breathed a sigh of relief this month after the Supreme Court of Canada ruled that a debtor-in-possession (DIP) charge that is granted super-priority by a federal insolvency court prevails over the provincial deemed trusts that require companies to give priority to eliminating the deficits of any employee pension plans they are winding up.

However, lawyers say the court's Feb. 1 ruling in Sun Indalex Finance, LLC v. United Steelworkers [2013] S.C.J. No. 6 raises concerns as well for lenders, and employee pension plan sponsors and administrators.

D.J. Miller, of Toronto's Thornton Grout Finnigan, said the most significant aspect of the decision is the court's 4-3 holding that the deemed trust imposed by s. 57(4) of Ontario's Pension Benefits Act (PBA) extends to the entire deficit in a wound-up pension plan.

Miller noted that the holding will be of concern to lenders financing companies that are not insolvent. Such creditors may find that, under the PBA, their security ranks behind much larger pension liabilities than they anticipated when they provided the financing.

"There are approximately 1,800 defined benefit pension plans registered in Ontario, many of which have lenders to [their] company who are probably now looking at their loans to see how the Indalex decision may impact their lending decisions," said Miller, co-counsel to the intervener Insolvency Institute of Canada.

"At some point in time, each of those plans may be wound up, and the priority of the statutory deemed trust will come into play. It has certainly elevated the risk?--?[and] risk usually directly impacts both cost and availability of financing."

Miller predicted "it's a very significant issue for lenders, and I think it will actually have a negative impact over all for pension-plan beneficiaries."

The ruling certainly was a blow to the respondent pension plan members of Indalex, the Canadian aluminum extrusion manufacturer that became insolvent in 2009. The top court split 5-2 to allow the appeal of the trustee in bankruptcy for Indalex's parent company, Indalex U.S., and Sun Indalex Finance LLC, from a 2011 Ontario Court of Appeal decision in favour of the pension plan members (Indalex Ltd. (Re) [2011] O.J. No. 1621).

Indalex sought and received protection from its creditors, under the Companies Creditors Arrangement Act while it looked for someone to buy it as a going concern in 2009. The CCAA judge at the time granted the lenders who supplied Indalex with more than $24-million in DIP financing, a charge over Indalex's assets that took priority over all other creditors.

But when Indalex subsequently asked the court to approve its sale for $30-million, and to distribute the proceeds of sale to the DIP lenders, members of Indalex's two employee pension plans opposed the motions because their defined benefit pension plans had funding shortfalls. The plan members urged that the full amount of those deficiencies ($6.75 million of the sale proceeds were held in reserve pending the determination of their rights) were subject under the PBA to the statutory deemed trust for wound-up pension plans, and that this deemed trust took priority over all other creditors under s. 30(7) of the Personal Property Security Act (PPSA).

For their part, the DIP lenders (who were later replaced by Indalex U.S., after the American parent paid off their loans and became subrogated to the DIP claims) successfully argued that the super-priority of their federal DIP charge prevailed over the provincial deemed trust.

"The federal and provincial laws are inconsistent, as they give rise to different, and conflicting, orders of priority," Justice Marie Deschamps wrote for all seven judges. "As a result of the application of the doctrine of federal paramountcy, the DIP charge supersedes the deemed trust."

However, only five judges went on to allow the appeal from the Ontario Court of Appeal's imposition of a constructive trust on the company sale proceeds?--?to the extent of the pension wind-up deficiencies?--?in favour of the pension beneficiaries.

The majority ruled in appellants' favour, even though they agreed with dissenters Justices Louis LeBel and Rosalie Abella that Indalex, as the pension plan's administrator, breached its fiduciary obligations to plan members by not giving them reasonable notice that it was seeking court approval for the DIP financing (which would override their priority). Nor did it give the requisite notice when it sought court approval to sell itself, and to voluntarily enter into bankruptcy.

Yet, despite these breaches, the majority held that a constructive trust should not have been imposed below, because that remedy requires that the wrongdoer's acts gave rise to an identifiable asset that would be unjust for the wrongdoer to retain. Here, "there is no evidence to support the contention that Indalex's failure to meaningfully address conflicts of interest that arose during the CCAA proceedings resulted in any such asset," wrote Justice Thomas Cromwell.

In dissent, Justices LeBel and Abella argued that the "seriousness" of Indalex's breaches of duty "amply justified" the imposition of a constructive trust to the extent of the full pension deficiency.

Counsel for the respondent United Steelworkers, Darrell Brown of Toronto's Sack Goldblatt Mitchell, called the majority judgment "a pretty empty decision for plan beneficiaries."

"On the one hand," he said, "it does mean that they'll have independent representation probably [at the beginning of insolvency proceedings], either through an independent plan administrator or through representative counsel, and they will be involved early in the process. So there may be some possibility to influence the outcome in that way.

"But they're left with no legal remedy, and so, when push comes to shove, they're still at the back of the line."

Brown said the judgment works in tandem with the 2009 amendments to the CCAA which require notice. "It's important that the plan beneficiaries be at the table early, and hopefully that's one of the lasting effects of this."

Edward Sellers of Toronto's Osler said the court's suggestion that an employer that finds itself unable to meet its fiduciary obligations because of a conflict of interest should transfer administration of the plan to an independent pension administrator "may be fine in theory. But unfortunately, in practice, pension legislation may not allow for the replacement administrator to be appointed," Sellers said, adding that under the PBA, for example, a replacement can only be appointed where the pension plan is being wound up. He said the power to appoint a replacement administrator is more broadly expressed for federally regulated pension plans, "but I am not aware of a situation where the superintendent has appointed a replacement administrator where the debtor is a going concern."