International Corporate Rescue

ChaseCambria
SOUTH SQUARE
Centre for Commercial Law
UCL LAWS

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2013 (6 issues)
Print or electronic access:
EUR 695.00 / USD 845.00 / GBP 495.00
VAT will be charged on online subscriptions.
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International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

ARTICLE

When Two Worlds Collide: The Supreme Court of Canada's Decision in *Re: Indalex*

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On 1 February 2013, the Supreme Court of Canada ('SCC') released its long-awaited decision in *Re Indalex Limited.*[1] The appeal sought to overturn the Ontario Court of Appeal's ruling that granted priority to beneficiaries of two pension plans over the rights of a party granted a super-priority charge by court order for loans that facilitated a restructuring under the Companies' Creditors Arrangement Act ('CCAA').[2] The Ontario Court of Appeal did so through the use of a statutory deemed trust and the imposition of a constructive trust for breach of a fiduciary duty by the insolvent company, as administrator of the pension plans.

The decision highlights a thorny problem that arises when provincial and federal laws intersect upon insolvency. In Canada, insolvency matters are within the exclusive jurisdiction of the federal parliament and are reflected in the CCAA and the Bankruptcy and Insolvency Act (Canada) (the 'BIA').[3] Property and civil rights, which encompass a myriad of legal interests, are within the exclusive jurisdiction of each province. This includes legislation governing (i) the creation, perfection and priority of security interests; and (ii) pension matters, for all employees and employers other than those relating solely to federally-regulated industries such as banking and aviation. Upon insolvency, conflicts can arise if application of the provincial legislation would produce a different result than that prescribed by the federal insolvency statutes.

Within that context, the SCC was asked to rule on the respective rights of stakeholders in an insolvency proceeding under the CCAA. Key aspects of the SCC decision are:

(a) the deemed trust under section 57(4) of the Pension Benefits Act (Ontario) ('PBA')[4] extends to the entire deficit in a wound-up pension plan, not just the unpaid contributions or special payments as at the date of wind-up (the 'Statutory Deemed Trust');

(b) based on section 30(7) of the Personal Property Security Act (Ontario) ('PPSA').[5] a Statutory Deemed Trust under the PBA has priority over (a) the interests of all secured creditors with respect to the inventory and accounts receivable of the company; and (b) all unsecured creditors;

(c) the Statutory Deemed Trust will be subordinate to the interests of a lender who is granted a super-priority charge by court order for debtor-in-possession ('DIP') financing pursuant to the CCAA, due to federal paramountcy over provincial statutes;

(d) Indalex breached its fiduciary duty to the plan beneficiaries by failing to take steps to address a conflict of interest between its corporate duties and its duty to the plan beneficiaries once such conflict arose during the insolvency proceedings; and

(e) the imposition of a constructive trust is inappropriate as it would give the plan members a benefit that they would not otherwise enjoy, is disproportionate to the breach and would have the effect of re-ordering priorities among creditors.

Facts and lower court decisions

Ontario Superior Court of Justice (Commercial List)

On 3 April 2009, Indalex Limited ('Indalex') and a number of its Canadian affiliates filed for creditor protection under the CCAA. Its American parent ('Indalex USA') had filed for creditor protection in the USA. On 8 April 2009, Indalex was authorised to borrow funds pursuant to a DIP financing agreement. The court order granted the DIP lenders a super-priority charge ranking in priority to all other 'security interests, trusts, liens, charges, and encumbrances, statutory or otherwise', other than the 'Administration Charge'

Notes

1 2013 SCC 6.
2 R.S.C. 1985, c. C-36.
3 R.S.C. 1985, c. B-3.
4 R.S.O. 1990, c. P-8.
5 R.S.O. 1990, c. P-10.

and the 'Directors' Charge'. Indalex USA guaranteed Indalex's obligation to repay the DIP financing.

Indalex was the sponsor and administrator of two defined benefit pension plans registered in Ontario: a plan for salaried employees (the 'Salaried Plan') and a plan for executive employees (the 'Executive Plan'). The Salaried Plan was wound up in December 2006, well before the CCAA proceeding was commenced. At the time the CCAA proceeding was commenced, the Executive Plan was ongoing. Both plans were underfunded. The wind-up deficiency of the Salaried Plan was approximately CAD 1.8 million and the wind-up deficiency of the Executive Plan was approximately CAD 3.2 million.

In July 2009, a motion was brought by Indalex for approval of a sale of its assets on a going-concern basis. The pension plans were not being assumed by the purchaser, and the sale would not produce sufficient proceeds to pay any amounts owing under the pension plans. The United Steelworkers of America union on behalf of the Salaried Plan and a group of former executives on behalf of the Executive Plan objected to the sale and to the proposed distribution of the sale proceeds to the DIP lenders on the basis of a deemed trust in favour of the pension plan beneficiaries. They also claimed that Indalex had breached its fiduciary duty to the beneficiaries. The sale of assets was approved by the Court but the Monitor was instructed to hold CAD 6,750,000 of the sale proceeds in a reserve account, pending a further motion as to entitlement to same. This amount represented the combined deficiencies in the Salaried and Executive Plans at that time.

Following a motion to determine entitlement, on 18 February 2010, the Ontario Superior Court of Justice held that no deemed trust existed in favour of the Salaried or Executive Plans under the PBA, as all contributions had been paid by Indalex to the date of filing. The Court ordered that the DIP lenders were entitled to the sale proceeds held in reserve by the Monitor.[6] The beneficiaries under the Salaried and the Executive Plans appealed the decision to the Ontario Court of Appeal. At the time of the appeal Indalex USA had paid the DIP lenders under its guarantee, and by court order stood in the shoes of the DIP lenders as it relates to the priority of the DIP charge.

Ontario Court of Appeal

On 7 April 2011, the Ontario Court of Appeal released a unanimous decision reversing the lower court's decision.[7] The Court of Appeal held that, pursuant to section 57(4) of the PBA, a deemed trust existed over Indalex's assets for the entire deficit in the Salaried Plan that had been wound up. The Court of Appeal further held that, as the lower court did not expressly 'invoke' the doctrine of paramountcy in issuing Orders granting a super-priority charge in favour of the DIP lenders, such charge could not oust the Statutory Deemed Trust in favour of the beneficiaries of the Salaried Plan pursuant to the PBA.

Further, while the Court of Appeal acknowledged that the deemed trust provisions of the PBA did not apply to the Executive Plan as it had not been wound up prior to Indalex's CCAA filing, the Court found another way to ensure that the beneficiaries of the Executive Plan were made whole. This was through a finding that Indalex had breached its fiduciary duty to the plan beneficiaries by acting without regard to their interests in filing for CCAA protection, seeking DIP financing with a charge that purported to be in priority to their deemed trust, and taking various other steps that were in the company's best interest but allegedly not in the best interest of the plan beneficiaries. As a remedy for the finding of a breach of fiduciary duty, the Court of Appeal imposed a constructive trust over the assets of Indalex for the full amount of the deficit in its pension plans. As a result, the Court held that, regardless of whether a Statutory Deemed Trust applied to any deficit in Indalex's pension plans, a constructive trust attached to the funds held in reserve by the Monitor. Finally, the Court of Appeal found that the constructive trust in favour of the beneficiaries of the Salaried and Executive Plans trumped the DIP lender's superpriority over the assets of Indalex.

Several parties, including Indalex and the Monitor appealed the Court of Appeal's decision.

The SCC decision

The SCC decision addressed four main issues:

1. Does the deemed trust in section 57(4) of the PBA apply to the entire deficiency in a wound-up pension plan?
2. If so, does the deemed trust have priority over the DIP charge?
3. Did Indalex have fiduciary obligations to the pension plan members when making decisions in the insolvency proceedings and if so, did it breach its fiduciary obligations?
4. Did the Court of Appeal properly exercise its discretion in imposing a constructive trust to remedy the breach of fiduciary duty?

Notes

6 *Re Indalex Limited*, 2010 ONSC 1114.
7 2011 ONCA 265.

1. Scope of the Deemed Trust

In a split ruling, a majority of the judges agreed with the Court of Appeal's finding that the Statutory Deemed Trust under the PBA applies to the entire deficit in a pension plan that had been wound up (the Salaried Plan). They also confirmed that the deemed trust does not apply to the estimated wind up deficit that may exist in a plan that has not been wound up (the Executive Plan). The majority of the judges were not persuaded that, since the wind-up deficiency is not finally quantified until after the effective date of wind-up and may change thereafter, the liability of an employer cannot be said to have accrued. As long as these liabilities are assessed as of the date of wind-up, the date when an exact calculation is determinable is irrelevant.

Unlike the Court of Appeal, which referred to the Statutory Deemed Trust attaching to the company's assets generally, the SCC referred to section 30(7) of the PPSA[8] to make it clear that it only extended to the company's inventory and accounts receivable.

2. Priority between the Deemed Trust and the DIP charge

While the SCC was divided on the scope of the Statutory Deemed Trust, all seven judges unanimously agreed that, by operation of the doctrine of federal paramountcy, the priority of any Statutory Deemed Trust does not supersede the super-priority status granted pursuant to a DIP charge under federal insolvency legislation.

The CCAA judge was found to have 'considered factors that were relevant to the remedial objective of the CCAA and had in fact demonstrated that the CCAA's purpose would be frustrated without the DIP charge.'[9] Further, compliance with provincial law in this instance would have required defiance of the order of the CCAA judge made under federal law. Given that the federal and provincial laws gave rise to conflicting orders of priority, the paramountcy doctrine applied to protect the super-priority status of the DIP charge over the Statutory Deemed Trust.

3. Breach of fiduciary duty

All seven judges of the SCC found that Indalex, as administrator of the pension plans, had a fiduciary duty to the pension plan members and had breached that duty. A conflict of interest arose between Indalex as corporate entity and in its capacity as administrator of the pension plans. For those judges who were part of the majority decision, the existence of the conflict of interest itself did not give rise to a breach of fiduciary duty – indeed the PBA expressly permits a company to act as plan administrator thereby acknowledging that there may be situations where a conflict may arise. The breach of fiduciary duty occurred due to Indalex's failure to properly address the conflict, once it had arisen.

Two judges held that, in seeking court approval for financing pursuant to which one creditor (the DIP lender) was granted priority over all other creditors including the plan beneficiaries, Indalex was expressly asking the CCAA court to override the plan members' interests. This step was not compatible with the administrator's duty to ensure that all plan contributions were paid. The administrator's duty to the plan members meant that it should have at least given the plan members prior notice of the motions that affected their interests, an opportunity to be represented by counsel to ensure that their interests were protected and a reasonable opportunity to present their arguments at various stages in the CCAA proceeding.

Three other judges forming part of the majority decision held that an employer / administrator who finds itself in a conflict of interest must bring the conflict to the attention of the CCAA judge. It is not enough to include the beneficiaries in the list of creditors; the judge must be made aware that the debtor, as an administrator of the plan is, or may be, in a conflict of interest. The SCC found that Indalex breached its fiduciary duties by failing to take steps to ensure that the pension plan members had the opportunity to be fully represented in the CCAA proceedings as if there had been an independent plan administrator appointed.

It is imperative for a company acting as administrator of its pension plans to ensure that plan beneficiaries receive prior notice, are represented by counsel and have an opportunity to make submissions on key steps taken in an insolvency proceeding in the same manner as would be available to them if a third party administrator was involved.

4. Constructive trust in response to breach of fiduciary duty

In a 5-2 split decision, a majority of the SCC held that it was an improper exercise of discretion for the Court of Appeal to have imposed a constructive trust in favour of the pension plan beneficiaries to remedy Indalex's breach of fiduciary duty. Notwithstanding the breach,

Notes

8 'Deemed trusts 30(7) – A security interest in an account or inventory and its proceeds is subordinate to the interest of a person who is the beneficiary of a deemed trust arising under the *Employment Standards Act* or under the *Pension Benefits Act*.'

9 *Supra* note 1 at para 58.

the facts of the case did not give rise to a situation where that remedy was appropriate and it amounted to a re-ordering of priorities. Further, the plan members were ultimately able to take advantage of the procedural protections that were the subject of that breach and to impose a constructive trust in favour of the beneficiaries would place them in a better position than they would have been in if the breach had not occurred.

Impact of the SCC decision

The most significant aspect of the decision is the confirmation of the Court of Appeal's finding that the Statutory Deemed Trust extends to the entire deficit in a wound-up pension plan. In *Indalex*, the full impact of that finding was not in issue, as the appeal dealt only with the rights of a DIP lender that had advanced funds after the commencement of the CCAA filing. As the DIP lender's charge was protected by applying the doctrine of paramountcy in a federal insolvency proceeding, priority was resolved in favour of the DIP lender. The result provides no comfort to lenders who advance funds to a company *prior to* the commencement of a CCAA proceeding and who hold security over inventory and accounts receivable.

The CCAA expressly prohibits a DIP charge from securing pre-filing (existing) advances made by a lender. Accordingly, existing advances will not obtain the benefit of a finding of paramountcy in protecting their priority over other interests including a Statutory Deemed Trust, as they are created under and governed by provincial legislation. While bankruptcy may still defeat the Statutory Deemed Trust while preserving a properly perfected security interest in favour of a lender, that is certainly a blunt tool to ensure that a secured lender's priority position is maintained. In addition to not always being desirable, it may not always be possible for a secured creditor to force a bankruptcy for a number of reasons. Furthermore, various legal arguments could be advanced on behalf of pension plan beneficiaries that create continuing uncertainty as to the effect of bankruptcy on the statutory deemed trust protected by the PPSA.

Justice Cromwell, writing on behalf of three judges who did not agree with the majority that the Statutory Deemed Trust included the entire deficit, identified the following concerns that would exist if that occurred (as it now does as a result of the majority decision):

> 'A deemed trust of that nature [covering the entire deficit] might give rise to considerable uncertainty on the part of other creditors and potential lenders. This uncertainty might not only complicate creditors' rights, but it might also affect the availability of funds from lenders. The wind-up liability is potentially large and, while the business is ongoing, the extent of the liability is unknown and unknowable for up to five years. Its amount may, as the facts of this case disclose, fluctuate dramatically during this time. A liability of this nature could make it very difficult to assess the creditworthiness of a borrower and make an appropriate apportionment of payment among creditors extremely difficult.'[10]

Put another way, it creates considerable uncertainty for lenders who make financing available to companies with defined benefit pension plans. Uncertainty increases risk, and risk is managed by lenders primarily through pricing and whether funds will continue to be made available and on what terms. In accepting that no DIP lender would agree to rank behind a pension deficit in advancing new funds to an insolvent company, Justice Deschamps (writing for the majority on the issue of paramountcy) stated the following:

> 'Given that there was no alternative for a going-concern solution, it is difficult to accept the Court of Appeal's sweeping intimation that the DIP lenders would have accepted that their claim ranked below claims resulting from the deemed trust .... The harsh reality is that lending is governed by the commercial imperatives of the lenders, not by the interests of the plan members or the policy considerations that lead provincial governments to legislate in favour of pension fund beneficiaries.'[11]

However, Justice Deschamps also formed the majority with three other judges in upholding the Statutory Deemed Trust as covering the entire deficit in a wound-up plan, notwithstanding the resulting effect on non-DIP lenders. Time will tell if her statements in relation to DIP lenders will apply to ordinary course (non-DIP) lenders who are equally well-placed to exercise their 'commercial imperatives' in determining whether, and on what terms, they will continue to lend to companies with defined benefit pension plans.

Options do exist for companies acting as administrator of their pension plans and for lenders who provide financing to Canadian companies with defined benefit pension plans that may be wound up at a future date. However, these options require a thorough understanding of the implications of the SCC's decision and the ways in which the existing risks can be mitigated and managed.

D.J. Miller would like to thank Michael Shakra, articling student at Thornton Grout Finnigan LLP, for his assistance in preparing this article.

Notes

10 *Ibid.* at para 176.
11 *Ibid.* at para 59.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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