The Implications of *Indalex* on Restructuring in Canada

*Robert I. Thornton and Kirsten Thompson**

I. INTRODUCTION

In its recent decision in *Indalex*,[1] the Ontario Court of Appeal departed significantly from existing case law when it decided that pension plan deficiency claims can have priority over security held by debtor-in-possession ("DIP") lenders. The decision emphasized strict adherence to notice requirements, expanded deemed trust rights, examined potential conflicts of interest where a company acts as both employer and administrator of a pension plan and raised concerns that go far beyond the facts in the particular case. The holdings of the Ontario Court of Appeal in *Indalex* represent a material departure from the law as understood by counsel and other advisors to lenders, pension plan beneficiaries and administrators and court officers such as monitors operating within a *Companies' Creditors Arrangement Act* ("*CCAA*") proceeding.[2]

II. BACKGROUND

On April 3, 2009, Indalex Limited ("Indalex") and certain of its Canadian affiliates filed for creditor protection under the *CCAA*. FTI Consulting Canada ULC was appointed as monitor ("monitor"). Less than two weeks earlier, Indalex's parent company and its US based affiliates (collectively,

* Robert I. Thornton is a founding partner of Thornton Grout Finnigan in Toronto and Kirsten Thompson is a research and litigation lawyer with the firm.

1 *Re Indalex Limited,* 2011 ONCA 265, 104 OR (3d) 641 [*Indalex*].

2 *Companies' Creditors Arrangement Act*, RSC 1985, c C-36, as amended [*CCAA*].

"Indalex US") had sought Chapter 11 bankruptcy protection in the United States.[3]

On April 8, 2009, the Superior Court of Ontario (Commercial List) authorized Indalex to borrow funds pursuant to a DIP credit agreement among Indalex, Indalex US and a syndicate of lenders ("DIP lenders"). Indalex US guaranteed Indalex's obligation to repay the DIP lenders and this guarantee was a condition of the extension of credit.[4] Contained within the order was the usual provision granting a super-priority charge to the DIP lenders, providing that the DIP lenders' charge "shall rank in priority to all other security interests, *trusts*, liens, charges and encumbrances, *statutory or otherwise*" (emphasis added), other than the "Administration Charge" and the "Directors' Charge" (both defined in the initial court order).[5]

Indalex was also the sponsor and administrator of two registered defined benefit pension plans in Canada: the Retirement Plan for Salaried Employees of Indalex Limited and the Associated Companies (the "Salaried Plan") and the Retirement Plan for Executive Employees of Indalex Limited and Associated Companies (the "Executive Plan"). At the time of the *CCAA* filing, the Salaried Plan had been wound-up for over 2 years.[6] However, the Executive Plan was ongoing, albeit closed to new members.[7] Both the Salaried Plan and the Executive Plan (collectively, the "Plans") were underfunded even though Indalex had made all of the legislatively required contributions to both plans, including all current service contributions for both plans as well as wind-up payments for the Salaried Plan and special solvency payments for the Executive Plan.[8]

On July 20, 2009, Indalex sought approval of the sale of its assets on a going-concern basis as well as approval to distribute the sale proceeds to the DIP lenders.[9] The proposed distribution meant the deficiencies in the Plans would not be satisfied, resulting in a reduction to the amounts that would be paid to pension beneficiaries. As well, no payments would be made to any other

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3 Under the *Bankruptcy Code*, USC title 11.

4 *Re Indalex Limited*, Amended and Restated Initial Order (8 April 2009), Toronto CV-09-8122-00CL, Morawetz J at paras 33-37 (Ont Sup Ct [Comm List]), online: FTI Consulting: <http://cfcanada.fticonsulting.com/indalex/> [Amended and Restated Initial Order].

5 *Ibid* at para 45.

6 The wind-up was effective 21 December 2006.

7 On 10 March 2010 the Ontario Superintendent of Financial Services (the "Superintendent") issued a Notice of Proposal to wind-up the Executive Plan as of September 30, 2009.

8 As of 31 December 2008, the wind-up deficiency of the Salaried Plan was $1,795,600. The Executive Plan had an estimated wind-up deficiency of $3,200,000 as of 15 July 2009.

9 *Re Indalex Limited*, Approval and Vesting Order (20 July 2009), Toronto CV-09-8122-00CL, Campbell J (Ont Sup Ct [Comm List]), online: FTI Consulting: <http://cfcanada.fticonsulting.com/indalex/> [Approval and Vesting Order].

unsecured creditors. The United Steelworkers ("USW") and a group of retired executives (the "Former Executives"), beneficiaries of the Salaried Plan and the Executive Plan respectively, objected to the proposed distribution of sale proceeds. Both groups asserted a deemed trust claim over the sale proceeds in the amount of the deficiencies under the Plans. In addition, both groups claimed that, by failing to meet its obligations under the Plans and ignoring its responsibilities as plan administrator once the *CCAA* proceedings had commenced, Indalex had breached the fiduciary duty it owed to plan beneficiaries. The court approved the sale but the monitor retained $6.75 million of the sale proceeds in reserve (the "Reserve Fund"), an amount approximating the Plans' deficiencies.

When the sale closed on July 31, 2009, the proceeds were insufficient to repay the DIP lenders. The DIP lenders called on the guarantee for the amount of the shortfall, which was then paid by Indalex US[10] The USW and Former Executives brought motions returnable August 29, 2009 to determine their deemed trust claims. In response, Indalex brought a motion wherein it sought approval for a voluntary assignment into bankruptcy. This motion was to be heard contemporaneously with the motions of the USW and Former Executives.

On November 5, 2009 the Superintendent of Financial Services (the "Superintendent") appointed Morneau Sobeco LLP ("Morneau") as the administrator of the Plans.

A. *Commercial Court Decision*

On February 18, 2010, Justice Campbell of the Ontario Superior Court held that, under section 57(4) of the Ontario *Pension Benefits Act* ("*PBA*"),[11] no deemed trust over Indalex's assets arose in respect of either of the Plans. He ordered that the DIP lenders be paid the amounts held in the Reserve Fund. The pensioners and Plan beneficiaries were and remained unsecured creditors as of the date of the sale of Indalex's assets. This was consistent with prior case law and the general principle that, as unsecured creditors of the debtor, pension plan beneficiaries' claims rank behind those of secured lenders, including DIP lenders, having priority in a *CCAA* or bankruptcy proceeding.[12] Pursuant to the Approval and Vesting Order, Indalex US was fully subrogated to the rights of the DIP lenders.[13] The USW and the Former Executives appealed.

10 Indalex US paid the shortfall of approximately US $10.75 million: *Indalex, supra* note 1, at para 65.

11 *Pension Benefits Act*, RSO 1990, c P.8 (*PBA*).

12 As a result of the conclusion on the deemed trust provisions, the Campbell J found it unnecessary to deal with Indalex's bankruptcy motion: Approval and Vesting Order, *supra* note 9.

13 *Ibid* at para 14.

B. Court of Appeal Decision

On April 7, 2011, the Ontario Court of Appeal unanimously reversed the judgment of the Ontario Superior Court and ordered the monitor to make payments into each of the Plans in an amount sufficient to satisfy their respective deficiencies because, in these particular circumstances, the Plans' deficiencies should be paid in priority over security held by the secured DIP lenders. The Court of Appeal made a number of findings in other areas as well:

i. Deemed Trust Applies on Wind-Up of the Salaried Plan

The Ontario Court of Appeal expanded the scope of the deemed trust provision in section 57(4) of the *PBA* to include the entire wind-up deficiency. While section 57 of the *PBA* generally established a deemed trust for contributions that are "in arrears", the section 57(4) wind-up provisions were relevant because the Salaried Plan had been wound-up prior to Indalex entering *CCAA* protection and the Executive Plan was intended to be wound-up. This subsection provides that, when a pension plan is wound-up, an employer is deemed to hold in trust for the beneficiaries of the plan an amount "equal to the employer contributions accrued to the date of the wind-up but not yet due under the plan or regulations."[14]

The Court reasoned that when a pension plan is wound-up, members stop accruing benefits and thus all plan liabilities that could ever accrue are accrued as of the plan wind-up date. As such, the employer contributions accrued to the date of the wind-up include contributions that would become required to fund the entire wind-up deficiency. The Court held that the wind-up deficiency merely represented that which had already been "accrued" and it therefore fell within the scope of the section 57(4) deemed trust.[15]

In so holding, the Court of Appeal turned sharply away from the analysis in earlier cases which had limited the deemed trust to current service costs and known special payments accruing up to the wind-up date, without regard for any deficiency that arose as a result of the wind-up process itself.[16] Under this new interpretation, the section 57(4) deemed trust provisions applied to any and all amounts remaining to be paid in respect of a wind-up deficiency under the Salaried Plan.[17]

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14 *PBA*, *supra* note 11 at s 57(4).

15 *Indalex*, *supra* note 1 at para 101.

16 *Re Ivaco* (2005), 12 CBR (5th) 213, 47 CCPB 62, (Ont Sup Ct), aff'd (2006), 83 OR (3d) 108, 275 DLR (4th) 132, (CA) [*Ivaco*]; *Toronto-Dominion Bank v Usarco* (1991), 42 ETR 235 (available on WL Can), (Ont Ct (Gen Div)).

17 In this case, there were two annual payments outstanding in the Salaried Plan wind-up deficiency and both were found to be included in the deemed trust amount.

ii. Pension Wind-Up Deficiency Takes Precedence over Secured Lender

The Court of Appeal confirmed that the Ontario Superior Court did have authority to grant a super-priority charge to DIP lenders under the *CCAA* and that a *CCAA* judge can make an order granting a super-priority charge that overrides the deemed trust under the *PBA*.[18] However, the Court also held that, absent an express finding of federal paramountcy, valid provincial laws continue to apply in federally regulated bankruptcy and insolvency proceedings. The party seeking to rely on the paramountcy doctrine bears the onus of demonstrating that the federal and provincial laws are incompatible and that compliance with both is impossible or that applying the provincial law would frustrate the purpose of the federal law. In *Indalex*, the Court found there was no evidence that complying with both regimes would frustrate the *CCAA* proceeding or the efforts of Indalex to sell itself as a going-concern business.[19] As a result, the doctrine of paramountcy could not apply. The Court then went on to find that because the initial order, as amended, did not specifically identify that the DIP super-priority ranked ahead of the pension deemed trust, the employees' deemed trust claim must be honoured.

Acknowledging that this new status of the deemed trust could discourage DIP lenders from advancing funds, the Court commented that it wasn't that a finding of paramountcy could *never* be made but rather that such a determination should be made on the facts of each case and that the applicant needed to clearly raise the issue so that affected parties would be afforded the opportunity to protect their rights.

iii. No Deemed Trust over Deficiency in the Executive Plan

The Executive Plan fared differently, with the Court of Appeal declining to find that a deemed trust existed because this plan was not wound-up at the time Indalex entered into *CCAA* protection. The Court observed that the wind-up of a pension plan appeared to be a requirement for section 57(4) of the *PBA* to apply and concluded that because the Executive Plan had not been wound-up at the relevant time, no deemed trust could arise.[20] However, to address the apparent disparity between the treatment of beneficiaries under the Salaried

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18 *Indalex*, *supra* note 1 at para 176, citing *Re InterTAN Canada Ltd (Re)* (2009), 49 CBR (5th) 232 (available on CanLII), (Ont SC); *Century Services Ltd v Canada (Attorney General)*, 2010 SCC 60 at para 62, [2010] 3 SCR 379 [*Century Services*].

19 In fact, the Court noted that the evidence of the CEO of Indalex was that the company intended to comply with all applicable laws, including regulatory deemed trust requirements. See *Indalex* at paras 178–189.

20 *Indalex*, *supra* note 1 at para 110.

Plan and those under the Executive Plan, the Court then turned to equitable principles and a consideration of fiduciary duties.

iv. Breach of Fiduciary Duty and Constructive Trust

The Court held that Indalex had breached the fiduciary obligations it owed to the Plans' beneficiaries as the administrator of each of the Plans, at paragraphs 138 and 139, as follows:

> [138] I turn next to the question of breach.
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> [139] As previously noted, when Indalex commenced *CCAA* proceedings, it knew that the Plans were underfunded and that unless additional funds were put into the Plans, pensions would be reduced. Indalex did nothing in the *CCAA* proceedings to fund the deficit in the underfunded Plans. It took no steps to protect the vested rights of the Plans' beneficiaries to continue to receive their full pension entitlements. In fact, Indalex took active steps which undermined the possibility of additional funding to the Plans. It applied for *CCAA* protection without notice to the Plans' beneficiaries. It obtained a *CCAA* order that gave priority to the DIP lenders over "statutory trusts" without notice to the Plans' beneficiaries. It sold its assets without making any provision for the Plans. It knew the purchaser was not taking over the Plans. It moved to obtain orders approving the sale and distributing the sale proceeds to the DIP lenders, knowing that no payment would be made to the underfunded Plans. And, Indalex US directed Indalex to bring its bankruptcy motion with the intention of defeating the deemed trust claims and ensuring that the Reserve Fund was transferred to it. In short, Indalex did nothing to protect the best interests of the Plans' beneficiaries and, accordingly, was in breach of its fiduciary obligations as administrator.[21]

As found by the Court of Appeal, the solution was to impress a constructive trust upon the portion of the Reserve Fund equal to the deficiencies in the Executive Plan. This levelled the field as between the two plans insofar as the pension deficiency in the Executive Plan would now also rise above the DIP lender's super-priority.

The *PBA* creates two distinct roles in relation to pension plans. The first role is that of the plan administrator, which carries out the operation and administration of the pension plan. Most of the legal duties in respect of the pension plan arise from this role, including the fiduciary duties owed to the

21 *Ibid* at paras 138–139.

pension plan beneficiaries.[22] These obligations arise both at common law and by the nature of section 22 of the *PBA*.[23]

The plan sponsor, the employer, is the other distinct role. The sponsor carries out non-administrative functions related to a pension plan; these functions include establishing the plan, amending the plan, winding-up the plan and funding the plan. In carrying out these functions, the plan sponsor/employer is entitled to act in its self-interest and has been held not to be in a fiduciary relationship to the beneficiaries of the plan.[24] Directors of a corporation owe a common law and statutory duty to act in the best interests of the corporation, not any particular stakeholder.[25] The *PBA* expressly permits an employer plan sponsor to fulfill the role of the plan administrator and clearly contemplates one corporation performing both roles.[26]

The Court found that Indalex, as administrator, failed to take steps to enforce its lien and charge against the assets of Indalex under section 57(5) of the *PBA*. The Court noted that its findings, however, were heavily fact-driven.

v. Nature of the Administrator Role

Finally, the Court noted Indalex's admitted uncertainty with respect to its own responsibilities as the administrator of the Executive plan following the commencement of the *CCAA* proceeding. In particular, the Court held that when it became impossible for Indalex to continue to function in the role of plan administrator, "it was incumbent on Indalex to take steps to address the con-

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22 *Burke v Hudson's Bay Co*, 2010 SCC 34, [2010] 2 SCR 273, at paras 39–41.

23 See for instance *Toronto (Metropolitan) Pension Plan (Trustee of) v Aetna Life Assurance Co of Canada* (1992), 98 DLR (4th) 582 (available on QL); *Hembruff v Ontario Municipal Employees Retirement Board* (2005), 78 OR (3d) 561, 260 DLR (4th) 161; *Anova Inc Employee Retirement Pension Plan v Manufacturers Life Insurance Co*, (1994) 121 DLR (4th) 162, 11 CCPB 67.

24 While the corporation must treat all stakeholders fairly when their interests conflict, the directors' ultimate duty is to act in the best interest of the corporation; see *BCE Inc v 1976 Debentureholders*, 2008 SCC 69 at paras 81 – 84, [2008] 3 SCR 560 [*BCE*].

25 At common law, *BCE* established that while directors may be well advised to consult with stakeholders and consider stakeholder views, directors owe fiduciary duties to the corporation and must act in its best interest. There is also a statutory bases for these duties. See for example *Canada Business Corporations Act*, RSC 1985, c C-44, s 122 (1); *Ontario Business Corporations Act*, RSO 1990, c B.16 s 134 (1).

26 *Indalex, supra* note 1 at paras 128–129, citing *Imperial Oil Ltd v Ontario (Superintendent of Pensions)* (1995), 18 CPPB 198 and its interpretation of sections 1 and 8 of the *PBA*.

flict."[27] The Court, however, offered no guidance on what steps would be sufficient or appropriate under the circumstances.

The Supreme Court of Canada granted leave to appeal the Ontario Court of Appeal decision on December 1, 2011 (see SCC File 34308).

III. KEY ISSUES

The key issues raised by the appellate decision in *Indalex* are:

- **uncertainty of priorities**: the decision grants priority to certain pension deficiency claims not previously considered to have priority under established lending and insolvency practices in Canada, as determined in accordance with previous court decisions;
- **conflicting public policy objectives**: the Ontario Court of Appeal's determination that there is a statutory priority for the entire deficit in an underfunded pension plan flies in the face of that concept being rejected by Parliament in enacting amendments to the *Bankruptcy and Insolvency Act* ("*BIA*")[28] and *CCAA* that granted only a limited priority to unpaid amounts owing to a pension plan and no priority for the entire deficit;
- **unachievable notice thresholds**: the notice requirements imposed by the Ontario Court of Appeal are unworkable in practice in respect of an insolvent company that needs to obtain super-priority DIP financing to stabilize a distressed business on an urgent basis;
- **uncertain application of equitable remedies**: the application of equitable remedies by an appellate court to alter statutory priorities among creditors creates uncertainty; and
- **inconsistent application of regimes**: there is a need for a consistent, harmonious application of both federal insolvency statutes, to avoid "statute shopping" and encourage the successful restructuring of insolvent businesses for the benefit of all stakeholders and the public.

27 *Indalex*, *ibid* at para 143.

28 *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [*BIA*].

A. *Legal Uncertainty*

i. Ordinary Course Lending

In Canada, secured loans providing operating financing to borrowers are usually secured by the granting of a security interest over the company's accounts receivable and inventory, in addition to other assets, of the borrowers and, in some cases, affiliated entities. One such form of financing is asset based lending ("ABL"), which is provided by banks and other credit granting financial institutions. ABL and other operating loans are a significant source of operating capital in the Canadian market.

Typically these loans require periodic reporting of the value of the assets that are pledged in support of the loan together with a statement of liabilities that represent potential priority payables of the borrower. These potential priority payables are deducted pursuant to a formula which generates the net credit availability for the company.

This structure allows the credit granting institution to ensure that there is sufficient collateral coverage such that its loans will be repaid even in the event of a liquidation. This structure, in turn, allows the institution to assess and price the credit and other risks accordingly. Prior to the decision of the Ontario Court of Appeal in this matter, the list of potential priority payables was well understood by the lending community and its borrowers and such list did not include any provision for the entire deficit that may exist or that may arise in future in a defined benefit pension plan upon wind-up. The effects of this decision on credit facilities and lending practices in Canada are far reaching but have three principle implications for credit markets:

i) Existing loans are currently outstanding on terms that may not allow for deduction of the wind-up deficiency as a priority payable in the calculation of available credit. The existing banking arrangements are based on an understanding of the law, including the Ontario Court of Appeal's 2006 decision in *Ivaco*, that held that a priority existed for actual arrears only and such arrears did not include unpaid past service contributions or special contributions. If the *Indalex* decision is upheld and *Ivaco* is no longer good law as it relates to priority for pension claims, it could have a material impact on lenders who have already advanced funds based on the law as it had previously been understood. As such, financial institutions may now be bearing risk within their existing loan portfolios that was not accounted for in their internal credit and pricing assessment at the time the loan was made and for which no remedy may be readily available under their existing contractual loan arrangements. In cases where the lender does have discretion to deduct a wind-up deficiency, there is uncertainty for both lenders and borrowers as to when this deduction should be made and for how much. These factors create uncertainty about existing credit availability in the Canadian marketplace.

ii) New credit facilities will need to account for the risk of a wind-up deficiency existing or arising in future, that may result in either or both of a reduction in immediately available liquidity and/or increased interest rates or fees due to the increased risk assumed by the lender. For reasons discussed below, the magnitude of the risk and the size of the potential deficit at any given time are difficult to quantify, unlike most other priority payables.

iii) Credit assessment, including credit rating of, among others, public companies, will be made more difficult, since identifying a pension plan wind-up deficiency is typically done every three years and can fluctuate greatly within that period. In addition, credit ratings of certain Canadian companies with underfunded defined benefit pension plans and that have lower credit ratings will likely be lowered further in the marketplace when the implications of this decision are fully understood. This negative adjustment will put further pressure on the availability or cost of credit to those companies and, in turn, will increase the risk passed on to creditors and other stakeholders of such companies, including pension plan beneficiaries.

The Court of Appeal's application of the deemed trust in this case is not limited to inventory and accounts receivable, as provided by section 30(7) of the *Personal Property Security Act* (Ontario) ("*PPSA*").[29] In addition, its scope extends to the entire deficit in a pension plan, which was not previously understood to be the case.[30] The statutory authority for such a proposition, with respect, is debatable, as discussed below.

One difficulty with the Ontario Court of Appeal's deemed trust priority argument is that the DIP charge, being a lien created by an order of a court, was likely not subject to the *PPSA*. In the decision of the Supreme Court in *Bank of Montreal v iTrade Finance Inc.* (released six weeks after *Indalex*) the Supreme Court held that, where rights resulted from a court order rather than from a transaction that in substance creates a security interest, the *PPSA* did not apply.[31] In *Indalex*, if the DIP charge was not subject to the *PPSA*, it could not be subordinated to the *PBA* deemed trust by virtue of section 30(7) of the *PPSA*.

29 *Personal Property Security Act*, RSO 1990, c P.10 [*PPSA*].

30 *Ivaco*, *supra* note 16.

31 *Bank of Montreal v iTrade Finance Inc*, 2011 SCC 26 at paras 61–67, [2011] 2 SCR 360 [*iTrade*]. In i*Trade*, the transaction-based security interest was held to have arisen by way of constructive trust or equitable lien.

Moreover, the mere creation of the DIP charge is not inconsistent with the existence of the *PBA* deemed trust. The statutory conflict that concerned the Ontario Court of Appeal therefore had to have been between the priority granted to the DIP charge by *CCAA* order and the priority held to have been given to the *PBA* deemed trust by operation of section 30(7) of the *PPSA*. If that conflict does not exist, then the Ontario Court of Appeal's demand that the Commercial Court had to have given an explicit paramountcy ruling to defeat the *PBA* deemed trust cannot be sustained.

Section 30(7) of the *PPSA* may not apply in future cases because the provision appears to conflict with the new pension provisions of section 6(6) of the *CCAA,* which came into effect after the date of the initial *CCAA* order in *Indalex*, and thus did not specifically apply to the *Indalex* proceedings. Section 6(6) of the *CCAA* prohibits a court from sanctioning a *CCAA* plan unless the plan ensures payment of certain amounts to pension plans. The language of section 6(6) largely mirrors the language of section 60 of the *BIA,* which imposes similar requirements when a court is approving a *BIA* proposal and also closely follows the language in sections 81.5 and 81.6 of the *BIA*, which create super-priority charges for certain pension claims in bankruptcy and receiverships. In all cases, the payment of unfunded pension deficits upon wind-up is *excluded* from the requirements. If, as the Ontario Court of Appeal in *Indalex* held, the *PBA* creates a deemed trust and lien for such amounts, the *PBA* is, arguably and on its face, now in conflict with the *CCAA* and the *CCAA* will automatically be paramount in a proceeding to which it applies, without any need for a court declaration to that effect.

Another Ontario Court of Appeal decision, *Bulut v Brampton (City),* is often cited for the same proposition.[32] In *Bulut*, a court order had created a charge competing with existing personal property security; this order, however, differed from the one in the *Indalex* case because in *Bulut* there had been no declaration as to the charge's priority. In *Bulut,* the Ontario Court of Appeal ruled that when priorities cannot be determined by the *PPSA* or the *BIA*, the common-law rule recognizing the priority of the earlier charge applies unless (i) the rule is overridden by a statute that allows a new lien to arise despite existing security interests, or (ii) if misconduct of the party with first-in-time priority calls for an equitable re-ordering of the priorities. This proposition of law creates difficulties in the circumstances of *Indalex* because the common-law priority rule can only come into play if it is accepted that the *PPSA* section 30(7) priority rule does not apply. For this non-application of the *PPSA* to be true, then it must also be true that the *CCAA* order that created and conferred priority on the DIP charge was not in any way defective for lack of an explicit paramountcy ruling. It means that the analysis of the competing priorities

32 *Bulut v Brampton (City)* (2000), 48 OR (3d) 108, 185 DLR (4th) 278 [*Bulut*]. Note, however, that in this case, the point was not explicitly ruled on by the Court as counsel conceded the point.

between the DIP charge and the Salaried Plan's *PBA* deemed trust starts with the priorities as they are set out in the Initial order, with the DIP charge having priority despite the timing of its creation. The question, then, is reduced to whether there are equitable reasons for altering the priorities of the *CCAA* Order. The Ontario Court of Appeal decided there were, holding that, even if it was wrong in its deemed trust analysis, it would still reach the same result on equitable grounds.[33]

ii. Collateral for Derivatives

Concerns have also been raised regarding the impact of the Ontario Court of Appeal's decision on the future business and practices of the derivatives industry in Canada and the participation of Canadian entities in international markets. The concerns relate primarily to the priority claims that might be made against cash pledged as collateral and the potentially serious adverse effect that the decision could have on the ability of certain Canadian businesses and financial institutions to participate in the international derivatives market, where risk-free cash collateral is an important component of such transactions.[34] In a typical credit support arrangement for derivatives, the collateral is securities or cash. The charge that the secured party has is in the nature of a fixed charge.

It is an important point to note that, whether based on the statutory deemed trust or some constructive trust remedy, the priority discussed in the *Indalex* decision should not extend to securities. The statutory priority for the deemed trust conferred by the *PPSA* applies only over "accounts" and "inventory" and their proceeds. Cash collateral may be an "account", however, and the deemed trust could defeat a security interest in cash if the set-off under the creditor support arrangement is not effective.[35] An argument could be made that "accounts" under the *PPSA* is limited to accounts receivable and not the broader concept of any monetary obligation owing to the debtor such as would be applicable to the cash collateral account.

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33 This line of reasoning is explored further in Sam Babe, "*Indalex*: The Ontario Court of Appeal Extrudes the CCAA", online: (June 2011) Collateral Matters, Aird & Berlis LLP <http://www.airdberlis.com/Templates/Newsletters/newsletterFiles/200/June%202011%20Collateral%20Matters.pdf.>

34 Further discussion on this point can be found at Margaret Grottenthaler, "Does Re Indalex affect credit support priorities for derivatives and securities financing transactions?" (June 10, 2011), online: Stikeman Elliot LLP < http://www.canadianstructuredfinancelaw.com/2011/06/articles/derivatives/does-re-indalex-affect-credit-support-priorities-for-derivatives-and-securities-financing-transactions/>.

35 *Caisse populaire Desjardins de l'Est de Drummond v Canada*, 2009 SCC 29, [2009] 2 SCR 94.

A deemed trust may also be defeated by the facts of any particular case. First, the *CCAA* provides that no order made in the proceeding can have the effect of subordinating financial collateral for an eligible financial contract.[36] It should prevent a court from relying on any express or inherent *CCAA* jurisdiction to confer priority on the deemed trust in an initial order and prevent realization on the collateral. Second, if the collateral is held outside of Canada by a non-Canadian entity, the deemed trust claimants would have to assert the claim in a foreign jurisdiction, and foreign courts may be disinclined to grant such a claim.[37]

Finally, the statutory deemed trust under section 57(4) of the *PBA* only arises on wind-up and it is not uncommon for wind-up to occur after insolvency proceedings have commenced. By that time, a derivatives counterparty, not being subject to the normal insolvency stays, likely will have realized on its cash (or securities) collateral and the deemed trust or constructive trust can't attach to such property for that reason alone. In the post-*Indalex* world, where a pension plan wind-up occurs prior to an insolvency proceeding, the deemed trust could have priority over cash collateral. The potential application of the deemed trust to cash collateral will be disturbing to counterparties world-wide who are relying on cash collateral in Canada.

iii. Liquidity Contraction

In *Funding of Defined Benefit Pension Plans in Ontario Seventh Annual Report* (the "FSCO Report") released in March, 2011, the Financial Services Commission of Ontario ("FSCO") confirms that funding valuation reports prepared by an actuarial firm must generally be filed every three years on both a going concern and solvency basis.[38] If solvency concerns are indicated, annual filing of valuation reports is required until these concerns are eliminated.[39] The existence and quantum of a pension deficit is therefore determined through an actuarial calculation prepared once every three years, or at most, annually, and cannot accurately or practically be used on a monthly or similar basis for the purpose of calculating a company's current loan availability pursuant to ABL or other operating loan facilities. The deficiency in a pension plan is dependent on a variety of factors including the value of the assets and assumed interest rates, both of which vary with fluctuations in financial markets.

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36 *CCAA*, *supra* note 2 at section 34(11).

37 Note that this may be a particularly difficult claim to assert in those jurisdictions (such as the US) that apply the law of the depositary intermediary to priority issues.

38 Financial Services Commission of Ontario, *Funding of Defined Benefit Pension Plans in Ontario Seventh Annual Report: Overview and Selected Findings 2007-2010*, (March 2011) at 7 [FSCO Report].

39 *Ibid.*

The FSCO Report also indicates that, of the 1,506 registered defined benefit pension plans in Ontario that are reviewed in the FSCO Report, more than 1,250 have deficits.[40] When viewed in terms of aggregate dollars, the FSCO Report indicates that the aggregate deficit of these plans on a solvency basis is approximately $26.9 billion.[41] As noted in the FSCO Report, this number represents the aggregate level of under-funding for defined benefit pension plans registered in Ontario, exclusive of seven large public sector plans and certain other excluded plans. When viewed in terms of the aggregate *wind-up* funding shortfall taking into account all obligations under the plan, it translates into an aggregate wind-up funding deficit of $40.9 billion.[42]

What is not known is the extent to which those companies having deficits in their defined benefit pension plans in Ontario are relying on financing provided by operating and ABL lenders. However, if the uncertainty arising from this decision causes lenders to those companies to remove the aggregate amount of the wind-up deficiency from their existing loan availability calculations, this could result in the potential disappearance of an enormous amount, potentially billions of dollars, of liquidity in Ontario alone. A similar contraction in available liquidity could likely be predicted in every province that has similar deemed trust provisions under their pension legislation, which includes all provinces except Prince Edward Island. Similar issues are also likely to apply to federally regulated pension plans.

iv. Lending in CCAA Proceedings

Indalex has also created uncertainty for lenders considering whether to advance financing to an insolvent company to permit it to restructure, as an alternative to immediate bankruptcy. The ability of a lender to rely on a super-priority charge granted pursuant to a court order made in a *CCAA* proceeding has been called into question as a result of the decision. At a minimum, such reliance is now qualified by the necessity for certain findings to be made by the presiding judge and additional notice and service requirements being complied with that are impractical, as discussed below. The combined effect is likely to challenge or frustrate the ability of a debtor to obtain DIP financing and the much-needed stability that comes from ensuring adequate liquidity through the restructuring process that is provided by such financing.

Lenders to an insolvent company that advance new funds upon the strength of a court order under the *CCAA* and in reliance on section 142 of the

40 *Ibid* at 9.

41 *Ibid* at 22.

42 *Ibid.*

Courts of Justice Act (Ontario) may lose priority for such funds.[43] These additional risks that a lender must assume will at least result in a higher cost of borrowing and/or a decrease of availability of funding for insolvent companies seeking to restructure. To the extent that restructurings are made more difficult or more costly, all stakeholders suffer. In many cases, the absence of such financing would preclude an orderly restructuring and could force a debtor to liquidate.

Another consequence flowing from the uncertainty regarding the absolute priority of DIP loans in *CCAA* proceedings in Canada will be felt in cross-border restructurings. Unless clear priority for DIP loans is re-established in Canada, it is likely that insolvent companies with operations in both the US and Canada will file primary restructuring cases under Chapter 11 of the US *Bankruptcy Code*, where DIP lending priority is an established certainty, with only ancillary proceedings in Canada, including for Canadian subsidiaries. In practical terms, it means that primary decision-making for the restructuring of cross-border enterprises having operations in Canada will occur outside of Canada, applying US law.

It is not uncommon for various companies within a corporate group to file jointly administered proceedings, for members of that corporate group to provide cross-guarantees for each others' obligations, for DIP loans to be made on the basis of cross-guarantees and security and for DIP loans to be advanced by related parties. In some cases, solvent related parties are the only available source of new financing for a distressed company. Loans advanced to, or guaranteed by, related parties, potentially resulting in a subrogated position to an original third-party DIP lender, are no less in need of a court ordered super-priority charge to secure such financing, without which restructuring may not be possible.

The *Indalex* decision suggests that the priority question can be addressed by clearer and more explicit priority language being drafted into *CCAA* orders pertaining to DIP financing than currently exists under the model orders prescribed by the Ontario court. However, to grant such an order, a *CCAA* court must find that the recognition of the pension deemed trust would frustrate the purpose of the *CCAA* proceeding and therefore explicitly invoke the federal paramountcy of the *CCAA* to grant a super-priority charge. This will necessitate providing evidence in DIP financing motions that the financing will not be made available without the ability to trump the pension deemed trust. It may be difficult to do under recent *CCAA* amendments dealing with DIP financing and the definition of "secured creditor" under the *CCAA*. *Indalex* seems to suggest that any motion to approve the DIP priority must be on notice to the affected pension beneficiaries. Giving such notice will be problematic to the point of

43 *Courts of Justice Act*, RSO 1990, c C.43 at section 142 offers protection to those who take action under a court order: "A person is not liable for any act done in good faith in accordance with an order or process of a court in Ontario."

impossibility, particularly if funding is needed on the first day, as is often the case. More discussion of the notice requirements follows below.

v. Administrators of Pension Plans

This decision has created uncertainty for companies that act as plan sponsor and administrator of a defined benefit pension plan, as permitted by the *PBA*. Prior to this decision it had been understood, based on existing jurisprudence, that a corporation could fulfill its fiduciary obligations as administrator of the plan and at the same time carry out its functions as plan sponsor and employer.[44] There now exists uncertainty as to whether such roles and duties are irreconcilable if the company becomes insolvent. This presents an additional challenge, as a company cannot immediately or easily divest itself of its duties as plan administrator and any such change would require regulatory approval. The *PBA* and other Canadian pension standards legislation limit who can fulfill the function of the administrator to the employer and certain other entities, including member representative committees. None of the qualifying entities is a third party provider to whom the corporate administrator has simply contracted out its administrator duties. Therefore, simply "opting out" of the administrator role may be neither achievable nor desirable, depending on the circumstances.

The administrator is permitted to delegate certain tasks and/or to employ agents to assist in the administration of the pension plan. Neither displaces the administrator role nor relieves the administrator of its fiduciary obligations to pension plan beneficiaries. At a minimum, careful attention to the administrator's disclosure and other obligations is necessary during a formal insolvency or any period where financial stability may be in question.

Finally, in certain circumstances, the Superintendent has the authority to appoint an administrator to assume responsibility for the pension plan – an authority that is similar to the authority that exists in most Canadian jurisdictions.[45] It is the understanding of the authors that these circumstances have not included situations where a board of directors simply elects to cease acting as the administrator.

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44 This dual role is referred to as the "two hats" dilemma. See Eileen E Gillese, "The Fiduciary Liability of the Employer as Pension Plan Administrator – Pension and Other Benefit Funds: Who is a Fiducary?" (Toronto: the Canadian Institute, 18 November 1996, pp 1-25); *Morneau Sobeco Ltd Partnership v Aon Consulting Inc*, 2008 ONCA 196, 291 DLR (4th) 314; *René Langlois c. Denis N Roy et al*, 2006 QCCS 297, 55 CCPB 17; and *Réjean Coutu c. Denis N Roy et al*, 2006 QCCS 298 (available on CanLII).

45 *PBA*, *supra* note 11, s 71.

Where an employer is also the pension plan administrator, as is almost always the case with single employer plans in Ontario, it is difficult to see how such an employer can implement a *CCAA* restructuring without being held to then have breached its fiduciary duties to pension plan beneficiaries as plan administrator. While the Court of Appeal did hold that the decision to commence a *CCAA* proceeding fell outside of the administration of the pension plan and did not necessarily engage the right of the pension plan beneficiaries, the Court did recite the factors it considered in finding that a breach of fiduciary duty on the part of the administrator had, in fact, occurred: doing nothing in the *CCAA* proceedings to fund the deficit in underfunded plans; taking no steps to protect the vested rights of the plan beneficiaries to continue to receive their full pension entitlements including funding of special payments; applying for *CCAA* protection and obtaining a *CCAA* order that provided the super-priority charge in favour of its DIP lender without notice to the plan beneficiaries; selling assets without making any provision for the plans; doing nothing to protect the best interests of the plan beneficiaries; and, in short, ignoring its role as pension plan administrator.

On the other hand, if a debtor attempts to fund a plan deficiency in preference to its other creditors, that action will likely be attacked as not only being a fraudulent preference but possibly also as oppressive conduct. Insolvency law requires that the debtor preserve the *status quo* standing of all creditors at the date of filing so that no one creditor can obtain a "leg up" over other creditors of the same class. As of the *CCAA* filing date, any deficit in an ongoing pension plan was generally understood to be an unsecured claim that should share *pro rata* with all other unsecured creditors as of the filing date. Accordingly, a *CCAA* debtor should not engage in actions that prefer one pre-filing unsecured creditor over another – yet, this decision suggests that if the *CCAA* debtor does *not* attempt to engage in such conduct it will be seen as being in breach of its fiduciary duties as plan administrator. Furthermore, even if a debtor wished to have someone independent appointed as the plan administrator just prior to or shortly after a *CCAA* filing, it would be very difficult to do so. As such, debtors, and particularly their directors, have now been placed in a legally precarious, even impossible, position.[46]

Another unintended result of the *Indalex* decision is that it is likely that various stakeholders in a *CCAA* proceeding will now try to elevate their claims to claims for breach of fiduciary duty in an attempt to gain priority over other creditors. As breach of fiduciary duty claims are heavily fact driven, courts may reasonably expect that their time will be increasingly occupied with adjudicating such claims and considering multitudinous invitations to find new fiduciary obligations.

46 For further discussion, see Robin Schwill, "*Re Indalex Limited* 2011 ONCA 265 Case Comment" (May 2011), 26:4 Ontario Bar Association Insolvency News.

B. *Departure from Legislative Mandate*

The recent amendments to the *BIA* and *CCAA* were made by Parliament after extensive public consultation and public hearings. It was thought by many practitioners in the area that those amendments settled the priority to be granted to claims in respect of pension plans on the insolvency of the plan sponsor and the ability of the court to grant super-priority charges to facilitate restructurings pursuant to federal insolvency legislation. Certain groups had lobbied for priority to be given for pension deficits over all other creditors, including secured lenders. This request for priority status for pension deficits was not granted by Parliament despite their requests.[47] Rather, priority for pension claims in insolvency was limited to unpaid normal cost contributions and did not extend to pension plan solvency or wind-up deficits.[48]

The Ontario Court of Appeal's decision holds that the entire deficit owing upon wind-up of a defined benefit pension plan may be supported by a deemed trust and that such deemed trust, absent a bankruptcy, has a priority even over a lender holding a super-priority charge. In doing so, the decision has introduced uncertainty in the critically sensitive area of priorities, notwithstanding the recently enacted legislative amendments. The decision is a significant step away from the Court of Appeal's recent decision in *Ivaco* and the Supreme Court of Canada decision in *Century Services*. Under the *BIA*, the priority of many statutory deemed trusts is reversed on a bankruptcy, and *Ivaco* and *Century Services* provided a straight transition from a sale under the *CCAA* to a distribution under the *BIA* following a voluntary filing. *Indalex* could potentially reopen the argument that insolvent companies acting as pension plan administrators cannot file voluntary proceedings under the *BIA* without risk of breaching their fiduciary duties.

C. *Notice Requirements*

Indalex suggests that before any super-priority financing is approved as part of a *CCAA* restructuring, prior notice to pension plan beneficiaries should be given, where priority over the deemed trust is sought, and those beneficiaries should have input into the process whereby the court is asked to grant such relief.

This requirement creates significant practical challenges to debtor companies, DIP financiers and their counsel. First, where pension plan beneficiaries

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47 Senate, Standing Senate Committee on Banking, Trade and Commerce, *Debtors and Creditors Sharing the Burden: A Review of the* Bankruptcy Insolvency Act *and the* Companies' Creditors Arrangement Act (November 2003) at 96–99 (Chair: Hon Richard H Kroft) ["Senate Report"].

48 *CCAA*, *supra* note 2, section 6; *BIA*, *supra* note 28, section 81.5.

are not organized as a cohesive group with a commonality of interests (e.g., where there is no union), attempts to organize plan beneficiaries, such as by way of obtaining a representative counsel to look after their interests, would take time and require public disclosure. DIP financing is an emergency life line of liquidity that a business requires when all other sources of financing may no longer be available to it. Prior notice to any large, unorganized stakeholder group, including pension beneficiaries, would be tantamount to giving notice to the world, particularly when dealing with public companies where such selective disclosure would be improper and could contravene securities laws. It would allow other stakeholders an opportunity to advance their own agenda through pre-emptive strikes—a "race to the swift"—contrary to a cornerstone principle of the *CCAA*, which is that the *status quo* is to be maintained among stakeholders from the outset.

D. Constructive Trust to Alter Creditor Priorities in Insolvency

The ordinary rule in insolvency proceedings is that all unsecured creditors share rateably in any available proceeds. In *Indalex*, the Ontario Court of Appeal imposed a constructive trust for the benefit of one unsecured creditor group (Executive Plan beneficiaries) thereby giving them, in effect, a priority claim over other creditors, including a guarantor who had become lawfully subrogated to the secured position of the DIP lender. A practical consequence of the Ontario Court of Appeal's retroactive use of the constructive trust is that it increases the uncertainty associated with priorities in an insolvency.

The Ontario Court of Appeal's analysis relied on the Supreme Court of Canada's decision in *Soulos v Korkontzilas*.[49] In *Soulos*, the Supreme Court held that the equitable remedy of constructive trust, previously available only in situations of unjust enrichment where monetary damages were insufficient, could be applied to cases where an equitable duty had been breached. The Court of Appeal in *Indalex* found that, as administrator of the Plans, Indalex had a fiduciary duty both under the *PBA* and at common law.

Soulos set out a four-part test that had to be met before a court would impose a constructive trust. Among other things, the test requires that the assets over which the trust may be imposed must have resulted from the same activities in which the defendant breached its duties. In *Indalex*, the Court of Appeal concluded this requirement had been satisfied because the sale proceeds resulted from Indalex's conduct of the *CCAA* proceedings, the same proceedings in which Indalex breached its duties as administrator. The Court of Appeal drew a straight line from the sale proceeds, concluding they arose from the marketing, auctioning and negotiation activities by Indalex and the monitor that led to the

49 *Soulos v Korkontzilas*, [1997] 2 SCR 217, 146 DLR (4th) 214.

sale. This reasoning is unsatisfying, however, because the various activities were each approved by the court supervising the insolvency proceeding.[50] The beneficiaries of the Salaried Plan, represented by counsel at that point, did not raise any objections to the approval of the bidding procedure. The Superior Court, despite hearing opposition from the Executive Plan beneficiaries, nonetheless declared the sale to be "commercially reasonable and in the best interest of [Indalex] and its stakeholders."[51] It is difficult to see how Indalex's conduct could be considered so egregious that it should give rise to a constructive trust.

An unintended but probable consequence of this remedy being available in an insolvency situation will be the promotion of litigation by special interest groups who hope to advance the cause of one particular creditor group at the expense of other. Such efforts will add to the already significant challenge of trying to garner support and build consensus around a plan of arrangement, will add to the cost of restructuring proceedings and will likely result in further delays.

E. Consistency between Liquidating CCAA and Bankruptcy

Occasionally, at some point during a *CCAA* proceeding, it is determined that the assets and operations should be sold such that the debtor company will no longer carry on business. There are many reasons why this process continues to be undertaken pursuant to the *CCAA* rather than through a bankruptcy pursuant to the *BIA*. The most common reason for continuing the *CCAA* proceeding is to permit the debtor company to continue in possession and control of its assets to facilitate a sale of its business operations on a "going concern" basis to a new purchaser in order to maximize the recovery. This strategy is beneficial for employees, suppliers, customers and other stakeholders and generally provides greater value than can be obtained through a piecemeal sale of assets or a liquidation by a receiver or a bankruptcy trustee. Effecting a liquidation pursuant to the *CCAA* provides the benefit of optionality to the company, its creditors and other stakeholders in keeping all possible options open rather than proceeding immediately to liquidation through bankruptcy.

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50 In fact, the activities were approved on two separate occasions. See *Re Indalex Limited*, Bidding Procedure Order (2 July 2009), Toronto CV-09-8122-00CL, Morawetz J (Ont Sup Ct [Comm List]), online: FTI Consulting: <http://cfcanada.fticonsulting.com/indalex/>; *Re Indalex Limited*, Order re Marketing Process & Stay Extension (22 April 2009) , Toronto CV-09-8122-00CL, Morawetz J, 2009 CarswellOnt 9099 (Ont Sup Ct [Comm List]), online: FTI Consulting: <http://cfcanada.fticonsulting.com/indalex/>; and Approval and Vesting Order, *supra* note 9.

51 Approval and Vesting Order, *ibid* at para 2.

The *CCAA* is also useful in facilitating cross-border restructurings where proceedings for some entities within a related corporate group are commenced under Chapter 11 of the US *Bankruptcy Code*. The flexibility of the *CCAA* allows for greater coordination of proceedings than would occur in a bankruptcy, including coordinating sales efforts involving integrated cross-border businesses.

In a liquidating *CCAA*, that is, one in which no plan of arrangement is put forward, an order is usually sought within the *CCAA* proceeding approving the distribution of proceeds to various stakeholders in accordance with their legal entitlements. A determination of their legal entitlements is made by reference to the scheme of distribution established pursuant to the *BIA*. If the distribution to creditors in a bankruptcy under the *BIA* and on a distribution motion within a liquidating *CCAA* produced different results, it would encourage parties to choose one result over the other and could lead to costly disputes between creditor groups. A more desirable result is to have both federal insolvency statutes interpreted and implemented in a consistent and harmonious manner.

The Court's conclusion that it is impermissible to attempt to deal with priority issues by bankrupting a *CCAA* debtor once the assets have been sold, on the facts as they were in *Indalex*, creates further uncertainty. Previously, it had been understood that debtors were able to convert *CCAA* proceedings into bankruptcies to alter priorities. This reliance is now in question if the bankruptcy is preceded by a *CCAA* filing, as is often the case, and if a defined benefit pension deficit exists where the debtor company is also the plan sponsor.

IV. CONCLUSION

Companies that are insolvent are usually facing unprecedented business and legal challenges. For the directors and senior management of such companies, those challenges may be greater than any they have previously faced. It has also been recognized that the restructuring of companies, rather than their liquidation in a bankruptcy, usually offers a better return for the many stakeholders of the corporate enterprise, including not only creditors, but particularly employees and pensioners. To that end, for many years, practitioners in the area, the bench and legislators have worked to recognize the importance of emergency financing, in the form of DIP loans, to be available to stabilize insolvent businesses and enhance the prospect for a successful restructuring. These efforts started with early cases that invoked the inherent jurisdiction of the court, evolved to the identification of a statutory jurisdiction within the *CCAA* and, ultimately, were codified in the amendments to the *CCAA* in 2009.

Despite many suggestions in the judgment in *Indalex* that it should be confined to its own facts, the unfortunate, and perhaps unintended, consequences of the decision reach far beyond the case. As a matter of law and practice, the decision reversed the trend of previous efforts to make the rules associated with DIP lending more certain. DIP financing, as a result of *Indalex*, undoubtedly will become more challenging to obtain and the position of the directing minds of insolvent enterprises will face even greater hurdles than they faced prior to this decision.