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TO:
Mark Schaan
Director general, Marketplace Framework Policy Branch
Innovation, Science, and Economic Development Canada
235 Queen Street, 10th floor
Ottawa, Ontario K1A 0H5

22 January 2019

Dear Director Schaan,

Re: Employee and Pensioner Protection during Insolvency - Consultations

This letter is in response to the federal government's consultations and deliberations on the issue of employee and pensioner protection during insolvency. We focus on three substantive areas: pension plan governance and funding rules, insolvency law reform, and reform of the corporate law aimed at protection of employees, pensioners and others.

We applaud the federal government's announced commitment to take action to ensure all Canadians have economic security and a dignified retirement. Insolvency of employer debtor companies is one of the most financially devastating events in employees' lives. Older employees are frequently not able to find new employment, and even if they do, it is usually at lower levels of pay and benefits. Employees on long-term disability (LTD) benefits often lose their benefits and retirees face loss or substantial reduction of their pensions.

We support the 2018 amendments to the *Wage Earner Protection Program Act (WEPPA)*[1] that increase the amounts to $7,150 in 2019;[2] as well as the broadened coverage, for example, to periods prior to filing of a notice of intention to make a proposal pursuant to the *Bankruptcy and Insolvency Act (BIA)*,[3] as well as recognition of other proceedings where the court so orders, based on specified criteria.[4] These

[1] Bill 86, Budget Implementation Act, 2018, No 2, amending, among other statutes, *Wage Earner Protection Program Act,* SC 2005, c 47, s 1, as amended. Amendments in force 13 December 2018, SC 2018 c 27. The long title of the *WEPPA* was amended to: *An Act to establish a program to provide for payments to individuals in respect of wages owed to them by employers who are insolvent.* See also Wage Earner Protection Program Regulations SOR/2008-222, current to 12 December 2018, https://laws-lois.justice.gc.ca/eng/regulations/SOR-2008-222/FullText.html.
[2] The first increase, to $6,960 was for 2018, retroactive to 27 February 2018.
[3] *Bankruptcy and Insolvency Act*, RSC 1985, c B-3, as amended (*BIA*).
[4] There are also additional requirements with respect to the Crown's right of subrogation.

measures now cover a range of ways in which employer companies address insolvency, including receiverships, proposals and plans of arrangement and compromise.[5]

However, measures to date fall woefully short of protecting employees and retirees. While pension law falls within both federal and provincial jurisdiction, there are measures that the federal government could enact now to improve protections for employees, both abled and disabled, and pension beneficiaries. It could lead by example and also work with provincial and territorial governments on pension protection issues. Finally, it is worthwhile to consider the experience of other jurisdictions and their regulatory responses as potential best practices that could be adopted without the trauma of a major insolvency involving a federally-regulated pension plan.

The government reports that private sector defined benefit plan membership in Canada has fallen to 1.2 million workers in 2017.[6] Yet that is still more than one million workers that the government could act to protect.[7] In terms of corporate governance reform, while fewer than 1% of the 310,000 federally-registered companies are publicly-listed companies, they are some of Canada's most significant corporations. The TSX reports that in 2018, federally-registered corporations account for 86.9% of market value of all corporations listed on the TSX/ TSXV, representing a market value of 719.4 billion CAD.[8]

BACKGROUND RISKS ASSOCIATED WITH PENSIONS AND BENEFITS

The consultation document is focused on the third pillar of Canada's retirement income system (RIS) – employment-based pension systems and voluntary tax-assisted private retirement savings [most of which also arise from employment income]. The consultation is intended to address "company insolvencies [that] have raised concerns about the security of pension, wage and benefit entitlements for workers and retirees".

In order to effectively address these concerns, it is necessary to identify the sources of the risks to the security of these entitlements and how the Canadian insolvency regime affects the realization of these risks. Within the consultation document itself, certain factors are identified as having a negative impact: "changing demographic trends; the 2008 global economic downturn; and, low long-term interest rates". As the document acknowledges, the effect of these factors is most keenly felt in defined benefit (DB) pension plans' funded status.

However, these factors have a negative effect because of the fundamental vulnerability of DB plans, which is that the sufficiency of their funding depends on a continuing flow of sufficient contributions to the pension fund from current employees and the accuracy of the actuarial assumptions concerning events (employment levels, the rate of return on the investment of plan assets, the interest rates that will be used to calculate the value of liabilities when they are annuitized, and, the post-retirement life span of retirees and beneficiaries) occurring over a multi-decade time horizon. The plan's actuary must calculate the effect of these variables over many decades to determine the level of current contributions that are

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[5] Pursuant to the *Companies' Creditors Arrangement Act,* RSC 1985, c C-36, as amended.
[6] Canada government, "Consultation Document Enhancing Retirement Security for Canadians", 21 November 2018, at 1; http://www.ic.gc.ca/eic/site/116.nsf/eng/home.
[7] It also reports that about 7% of private pension plans in Canada are federally regulated, with the remainder being provincially regulated, *ibid.*
[8] Cited in Janis Sarra and Cynthia Williams, *Time to Act,* Response to questions posed by the Expert Panel on Sustainable Finance on Fiduciary Obligation and Effective Climate-related Financial Disclosures, January 2019. Data on file with author; with thanks to Cheryl Mascarenhas, Specialist, Market Intelligence, TMX Group.

needed to adequately fund the promised DB benefit. It seems almost inevitable that, despite the actuary's best efforts, one or more of these crucial variables will deviate from the values assumed in the calculation and that the contributions so-calculated will be inadequate. Thus, pension regulations require periodic recalculations and provide for amortized payments of any funding shortfall disclosed by the recalculation.

One study by an experienced pension actuary for the Department of Finance estimated that that a pension plan that seeks to replace 50% of preretirement income by investing in fixed-income government bonds requires a contribution rate of 23.8% of salary; and the study went on to characterize the funding practices of most pension plans:

> Most of today's retirement plans, defined benefit and defined contribution alike, try to make good pensions affordable by investing 50% to 70% of the fund in risky assets thought to offer higher rates of return in the long term, albeit with commensurately higher risks. The objective is typically to increase the rate of return on the pension fund by about 2% net of fees and to use some combination of risk management, patience, fluctuating contribution rates (defined contribution plans), fluctuating benefits (defined benefit plans) or both (hybrid pension plans) to deliver an acceptable compromise between affordability and stability. Increasing the expected rate of return by 2% reduces the steady state contribution rate by about 40%.[9]

Thus this funding regime is not risk-free, but rather, a compromise between risk and cost where the risks are pro-cyclical with the insolvency risks facing the sponsoring employer: economic downturns exacerbate the insolvency risk and reduce the returns on pension fund investments; low long-term interest rates increase the value of pension liabilities, requiring larger employer payments to reduce the funding shortfall so-generated, thus reducing the employer's capacity to respond to its own insolvency risks; employer work-force reductions coupled with longer retiree life-spans may see employers' ability to respond to the increased cost of longer lives constrained by the much smaller contribution base of the reduced work-force; etc.

As inferred in the last sentence of the above quote from the Finance study, there are some factors exogenous to the pension-funding regime that can also impact the security of these benefits. An increase of the expected return is achieved by increasing the proportion of risky assets in which the fund is invested, leading actuarial practice to reduce contribution rates required to fund the expected benefits.[10] Most pension fund legislation permits employers to act as the plan's administrator. As such, the management retains and instructs the plan's actuary. Unfortunately, this authority can lead to a conflict between the interests of managers and the pension beneficiaries, as the assumptions used by an actuary to determine contribution levels may directly affect the corporation's profit and the level of profit-linked compensation received by certain managers by affecting the cost of pension contributions. In addition,

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[9] Malcolm Hamilton, 2009. "Investment and Longevity Risks." Retirement Savings Research Program. Ottawa: Department of Finance. http://www.fin.gc.ca/activty/pubs/pension/refbib/hamilton-eng.asp. Kenneth Ambachtscheer estimates the cost would be around 25% of salary in *Pension Revolution: A Solution to the Pension Crisis*, (John Wiley & Sons: Hoboken, N.J, 2007) at 66.

[10] Critics of this practice argue that there is no justification rooted in financial economics principles or research .for using differing costs for a fixed obligation based on what form of investment one makes. In their view, the practice of incorporating the equity premium into the cost calculations ignores the fact that the premium is the market price for the extra risk assumed by choosing equities over risk-free investments: see LN Bader and J Gold, "Reinventing Pension Actuarial Science", (2003) *Pension Forum* 14 (2): 1-39; J Exley, S Mehta, and A Smith, "Pension Funds: A Company Manager's View" in *The Great Controversy: Current Actuarial Practice in Light of Financial Economics*, edited by the Society of Actuaries, (2004) Schaumburg, IL: Society of Actuaries. http://www.soa.org/library/monographs/retirement-systems/the-great-controversy/2004/june/m-rs04-1-01.pdf.

the temptation to seek to reduce pension costs when the company is in financial distress is also a source of potential conflict. For those managers where shares form a portion of their compensation, the decision as to whether to expend company resources on dividends or share repurchase versus pension contributions may also be a source of such a conflict.

In view of these factors, the issue of enhancing the security of these benefits can be seen as three-fold:

1. Is there anything further that can and should be done with respect to pension funding rules?

2. Can further developments in insolvency legislation offer any additional security for these benefits?

3. Would corporate law amendments be effective in addressing some of the conflicts within the pension administration regime?

PENSION FUNDING RULES

The government may wish to consider the following potential changes to the federal pension rules, both of which arise from the recommendations of the 2008 Ontario Expert Commission on Pensions (OECP):

1. Adopting target-benefit plan rules, but only if appropriate joint governance arrangements are also mandated.

2. Facilitating the use of larger pension plans' investment expertise by smaller plans through appropriate pooling arrangements.

Both of these recommendations are elaborated in detail in the Ontario Expert Commission on Pensions (OECP) report[11] and in the Institute for Research on Public Policy Report #16 "Is Your Defined Benefit Pension Guaranteed? Funding Rules, Insolvency Law and Pension Insurance".[12] The options discussed in the consultation document are analyzed in the context of these suggestions and the factors affecting benefit security discussed above. The following is a brief summary of these suggestions:

Target-benefit plans

As noted above, a risk free investment strategy would require a significant proportion (24 -25%) of employee compensation in order to provide a 50% of final income benefit. The introduction of some equity investment would still require a significantly larger proportion of employee compensation than presently used for pension contributions (between 7.5 – 15%).[13] These calculations raise the specter of employees facing a steep decline in their take-home pay in order to secure their pension benefits fully. Putting aside the tax considerations that would arise with such contribution levels, would employees be

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[11] Harry Arthurs, *A Fine Balance: Safe Pensions, Affordable Plans, Fair Rules*, Report of the Ontario Expert Commission on Pensions. (Toronto: Queen's Printer for Ontario, 2008). http://www.fin.gov.on.ca/en/consultations/pension/report/Pensions_Report_Eng_web.pdf.

[12] Ronald Davis, "Is Your Defined Benefit Pension Guaranteed? Funding Rules, Insolvency Law and Pension Insurance" IRPP Study #16 (Montreal: IRPP, 2011) http://irpp.org/wp-content/uploads/assets/research/faces-of-aging/is-your-defined-benefit-pension-guaranteed/IRPP-Study-no16.pdf.

[13] Ambachtsheer, *supra* note 9 at 66-67 estimates between 10 and 15%, while Hamilton estimates between 7.5 and 15%, *supra*, note 9.

willing to accept such a reduction in pay in return for security of the benefits or would they wish to accept benefit reduction to maintain the current level of contributions? How would the factors involved in this decision be adequately communicated so that any such decision is fully informed?

The OECP recommended that target-benefit plan legislation be implemented in which contributions would be fixed, based on best estimates of the amounts necessary to fund the target benefits. These target benefits would be provided only if there were sufficient funding to do so. If a funding deficit arose, then both present and future benefits would be reduced to reflect that deficit, and the benefits could not be increased to the target level until full funding was restored.[14] Similar features are found in legislation for Multi-Employer Pension Plans (MEPP) and target-benefit plans have been legislated in some provincial jurisdictions. The Ontario Government has since proposed additional regulations relating to the funding framework for eligible multi-employer pension plans that provide target benefits.[15]

However, in order to make such plans effective, some changes in the regulation of pension plan governance would be necessary. The OECP recommended that representatives of the employer, active plan members and retirees jointly govern target-benefit plans. The commission justified this requirement on the grounds that it "should ensure that beneficiary interests will be considered in fixing the levels of employer contributions and target benefits, lend economic force to workers' demands that the sponsor/employer fund the plan at the proper level, and ensure that member representatives will have an effective voice in the plan's governance process".[16]

Implementing this type of plan, however, would remove an important, albeit somewhat uncertain, support for plan member benefits in the pension fund's claim on the sponsoring employer's assets to make up any shortfall in funding. As discussed above, this support might falter at the very moment that economic factors stress the funding of the pension plan, with the consequence of lower-than-promised benefits. In such circumstances — that is, sponsor insolvency — it would be hard to distinguish a defined benefit plan from a target-benefit plan, from the perspective of its effect on pension benefits. In the place of this uncertain "guarantee", a jointly governed target-benefit plan would allow plan members and sponsors to focus on a more fundamental factor influencing benefit security: the appropriate balance between risk and reward in investment policy — and on contribution levels consistent with that policy — from the outset of the plan, instead of becoming aware of the need for an appropriate balance only in the midst of a funding crisis.

Extending joint governance to all pension plans

Employer/sponsors of defined benefit pension plans are permitted to be the sole administrators of pension plans in many jurisdictions' pension legislation. As noted above, sole administration may leave plan members subject to conflicted decision-making by managers/directors. One recent court decision revealed conflicts of interest in the role of corporate director or officer and pension plan administrator.[17]

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[14] Arthurs, *supra,* note 11 at 182.

[15] The funding framework for eligible multi-employer pension plans that provide target benefits was announced by the government on 29 June 2017 and the proposed regulations on 4 April 2018; Ontario's Regulatory Registry, "Target-Benefit Multi-Employer Pension Plans: Description of Proposed Funding Framework"; https://www.ontariocanada.com/registry/showAttachment.do?postingId=27266&attachmentId=37884. Bill 177, the Stronger, Fairer, Ontario Act (Budget Measures), 2017, Royal Assent 17 December 2017. See also developments in Alberta and British Columbia.

[16] Arthurs, *supra,* note 11 at 182.

[17] *Sun Indalex Finance, LLC v United Steelworkers,* 2013 SCC 6 (SCC).

The directors may have fulfilled their fiduciary duty to the debtor company, but they placed the debtor in the position of failing to fulfill its obligations as plan administrator; yet the majority of the court concluded that a remedy was not available to plan members, rendering any protections within the pension legislation meaningless.[18] In addition, the sponsor's control of the choice of actuarial assumptions, asset allocation and investment policies involves conflicts of interest between managers on the one hand and plan members and shareholders on the other. The OECP suggested that the assumption justifying complete control by the sponsoring employer over pension plan governance has been challenged by the wide acceptance that plan members bear some risks in defined benefit pension plans because they "have forgone wages, made matching contributions or stand to lose if the plan falters or fails".[19]

Given such conflicts, one can argue that managers should not be the sole decision-makers when it comes to the allocation of assets. Since it is plan members and other stakeholders who will suffer the adverse effects of increasing the fund's asset-liability mismatch risk, some mechanism that permits them to be part of the decision-making process should be implemented. In order to obviate any conflicts that might arise between active employees potential conflicts over job creation investments and the desire of retirees for adequate investment income, retiree representation should be part of such a mechanism.

Such a mechanism should be complemented by changes to actuarial practices that make the degree of asset-liability mismatch risk carried on the fund's balance sheet transparent to all concerned, and that calculate required contributions based on the value of plan liabilities without regard to the plan's asset allocation policy — that is, with the same projected rates of return regardless of the investment vehicles chosen for the fund. These changes, along with joint plan governance, would provide the opportunity to assess and discuss the expected rate of return from any particular asset allocation from the perspective of different stakeholder groups.[20] Joint governance is not an unusual feature in pension plans, in Ontario 60% of all pension plan members and 70% of those in defined benefit plans are in plans in which member representatives participate in or control decision-making.[21] Québec mandates joint governance and Manitoba recently enacted joint governance for large pension plans.

FACILITATING THE USE OF LARGE PENSION FUND EXPERTISE BY SMALLER PLANS – POOLING

Although pension funds enjoy an advantage over mutual funds in their returns on investments because their costs are lower than those of individuals who invest through mutual funds, the costs of pension funds vary according to the size of the fund. Service providers might charge large pension funds — say, those with more than $10 billion in investments — as little as 0.28%, while charging smaller funds — say, those with only $10 million in investments — as much as 0.6% for the same services. In addition, large pension funds are able to hire expert staff to execute complex financial transactions, are better able to offer a diversified investment environment and can reduce administration costs per member by spreading fixed costs over a larger number of members. The OECP report recommended that small and

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[18] In a strongly worded dissert, two of the Justices, LeBel and Abella JJ held that they would have awarded a constructive trust remedy. *Ibid*. See Ronald B. Davis, "*Re Indalex:* Fiduciary Duty = Conflict Management or Conflict Avoidance?" *Annual Review of Insolvency Law, 2013* (Toronto: Carswell, 2014); "Time to Pay the Piper: Pension Risk Sharing, Intergenerational Equity and Dissonance with the Conceptual Paradigm of Insolvency Law in Canada"; Mark Zigler and Andrea McKinnon, "Long-term Disability and other Post-Employment Benefits in Insolvency Proceedings", in Janis Sarra, ed. *Annual Review of Insolvency Law, 2010* (Toronto: Carswell, 2011) and Jean-Daniel Breton, "Employee Protection in Insolvency proceedings, Reviewing the Performance and Setting the Objectives", in Janis Sarra, ed, *Annual Review of Insolvency Law, 2010* (Toronto: Carswell, 2011).

[19] Arthurs, *supra*, note 11, at 155.

[20] Davis, *supra*, note 12, at 28, 29.

[21] Arthurs, *supra,* note 11 at 155.

medium-sized pension funds be permitted to take advantage of the benefits of large pension funds by entering into arrangements that would involve varying degrees of amalgamation from outright merger to purchase of investment services from large plans.[22] Ontario has recently announced amendments to its *Pension Benefits Act* to allow private-sector employers to more easily merge their single-employer pension plans with jointly sponsored pension plans to allow pooling of assets.[23]

The public policy basis for such an option, in addition to reducing the amount and size of claims on any guarantee scheme, is its welfare-enhancing effect on public finances. There are two aspects to this welfare enhancement. First, pension fund contributions and investment earnings receive significant tax benefits through the deferral of taxation on these amounts until they are paid to plan members as pension benefits. Inefficiency in the investment processes, however, can lead to reduced benefit payments and, therefore, lower tax receipts than would be the case if the investment process were more efficient. Second, lower benefits resulting from inefficient investment processes in an employer-sponsored pension plan could reduce plan members' income to a level at which they would not be subject to full cost recovery through taxation of their benefits under the publicly-funded Old Age Security program and Guaranteed Income Supplement program. Both of these potential effects should encourage intervention to produce the most economically efficient process for the investment of taxpayer-supported pension fund assets.

Individual self-managed accounts or annuities on plan termination – the pooling alternative

A similar argument would apply to our suggestion for an alteration to the proposal in the consultation document concerning the option to use lump sum transfers to locked-in "self-managed" accounts in place of annuity purchases on termination of underfunded pension plans, with the rationale that instead of locking in the losses in the underfunded plan through an annuity purchase, the individual could hope to recoup some of the loss through "future investment returns". An individual investor is in an even worse position than a small pension plan with respect to service provider fees and access to expertise that greatly weakens the rationale for such a change. A stronger option is to transfer the management of such funds to a large not-for-profit pension organization, such as the CPP Investment Board, with the market power and expertise to obtain the best investment fees and the returns from more complex financial products. In addition, such an organization may be able to obtain more favourable annuity rates, when the individual retires, obviating the concern about outliving these retirement savings. Such an arrangement would offer the best chance that some recoupment may occur before an annuity purchase on retirement.

Solvency relief accounts

While the option may have some merits, it would likely be most workable in the context of a jointly-governed target-benefit plan with the changes to actuarial practice described above. The first problem is that the calculation of various guardrails in the option remain in the hands of the actuary, unless the rules make very specific criteria for the calculation as to when a plan is in surplus, or when a payment will result in a deficit, criteria that regulators may be reluctant to specify. Also, unless the entire amount of the solvency special payment is due on calculation, it will just reproduce the current amortization regime,

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[22] *Ibid*, 183-87.

[23] Ontario Government, "Proposed Changes to Create Jobs and Reduce Regulatory Burden in Specific Sectors", 6 December 2018.

without any evidence that it effectively allows a plan to overcome a deficit, as long as the economic conditions that led to the deficit continue in place (such as persistently low long-term interest rates).

Before such an option were to be implemented, it might be advisable to obtain information about those employer insolvencies where solvency payments were being made or due in order to determine: were the solvency payments actually reducing the deficit as calculated at the last valuation as compared with the deficit on termination? If there was no substantial reduction, why was the amortization regime not having the desired effect?

If implemented, it will be important that the assets in such accounts be available to generate returns to the pension fund, since fundamentally, a deficit indicates that the amounts *that should have been invested in the past were not* and thus the projected investment earnings upon which the payment of future benefits were dependent *were not generated,* exacerbating the shortfall in the fund. Thus the earnings on the solvency relief fund are necessary to enhance the security of those future benefit payments, just as the earnings on the amounts that should have originally been contributed would have been used.

Such an option would be a useful alternative tool to benefit reduction in the case of a jointly governed target-benefit plan because the contribution rates would be the result of a reasonable consensus amongst decision-makers who are provided transparent costing information and are able to address the conflicts that might affect the decision in the absence of joint governance. If there is an unexpected, but temporary economic shock, a solvency relief fund may be acceptable to an employer faced with the task of reducing employee pension benefits.

Funding relief criteria

Clearly, this topic will become less relevant if jointly-governed target-benefit plans are adopted. Temporary or permanent benefit reductions are the default option, however, the employer is still subject to the obligation to make the fixed current contributions necessary under the plan. If an employer cannot make these contributions, irrespective of the funded status of the pension plan, granting funding relief could be tantamount to undermining the statutory priority given to these contributions in insolvency legislation. In this context, the constraints imposed on the employer's actions should be such as will protect that priority in all circumstances.

Benefit reduction clarity

If the intent of the legislation is that all benefits be paid on termination and the legislation is really not clear, then Parliament can certainly provide any needed clarity. The amendments proposed by sponsors seem designed to reduce the plan's liabilities used to calculate the solvency deficit, which is calculated on the basis that the plan has terminated on the date of the calculation. This approach will merely benefit the sponsor's bottom line, not the plan members whose pension income will suffer the same reduction where the plan is terminated with a shortfall irrespective of whether the indexation is paid or not.

In the context of the jointly-governed target-benefit plan, it may make sense to have a hierarchy of benefit reductions in the face of a shortfall in funding. Such a hierarchy would be subject to review for equitable treatment of all affected by the regulator.

SUMMARY ON PENSION FUNDING AND GOVERNANCE

The risks to the security of employment-based retirement income arrangements are not fundamentally the result of insolvency regulation, although it may exacerbate them. They arise from the inception of defined benefit pension arrangements and must be addressed in that context initially. As one of the authors has said:

> [A]n important public policy dialogue that does not appear to have occurred is one with plan members and retirees about the trade-offs between asset-liability mismatch risk and the cost of their pension benefits. Instead, plan members and retirees are left with the reasonable, but unwarranted, belief that regulatory measures ensure full funding of their benefits. Actuarial and accounting practices have added to the reasonability of this belief by obscuring the volatility of asset and liability values through the averaging of losses and gains over several years and, as a result, by presenting a financial portrait of "likely gains" for pension funds that is much smoother than the more accurate picture of frequent and rapid shifts in asset and liability values. In fact, the weaknesses of the funding regime and the lack of transparency about the risks on pension balance sheets can lead to serious shortfalls in assets under certain market conditions.
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> In light of these problems, pension law reform should address the conflicts of interest both among stakeholders and between them and their professional advisors. Governance reform to expand the composition of governing bodies while providing standards for knowledge and understanding would advance this goal. Reform should also address inefficient pension arrangements by developing a mechanism that allows small and medium-sized pension funds to gain the advantages of scale and cost-effective professional expertise available to large funds. Finally, the relationship between cost and risk should be addressed by a process that clarifies the security of the pension promise as a function of both its cost and its choice of assets. Discussion of whether to adopt target-benefit pension plans in place of defined benefit plans would be a good place to address questions of governance, efficiency and the risks and cost of pension benefits."[24]

Decisions about future pension regulation will involve normative choices about how retirement savings should be accumulated, what governance structure offers the best combination of conflict management and expertise and the degree of intergenerational risk sharing that is appropriate in such arrangements. It may be appropriate that a dialogue on these issues be initiated by the federal government.

INSOLVENCY LAW REFORM

Insolvency law, however, has different policy goals than pension law. It is designed to provide for an orderly distribution of the value of the debtor's business among creditors of equal rank, and therefore offers limited opportunities to enhance the security of the pension promise. Insolvency law is premised on a zero-sum situation in which giving more to one creditor deprives another creditor of an equal amount. Thus, it requires a justification rooted in its policy objectives in order to change the scheme of distribution.

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[24] Davis, *supra*, note 12 at31

One way in which debtors and creditors could try to undercut this scheme is through financial transactions in the period prior to the formal insolvency proceeding that give a preference in payment to one creditor over other creditors. Recent amendments that give a statutory secured charge to the arrears of normal cost contributions can be justified on the grounds that evading a statutory duty to make the contributions gives the insolvent employer's other creditors a preference over pension plan members.

The 2008-2009 amendments to the *BIA* and the *Companies' Creditors Arrangement Act (CCAA)* were a helpful first step in protecting employees and retirees, but they did not go far enough. While we appreciate that any measures by the federal government need to balance to the interests of all stakeholders, consider potential effects on the cost of credit, and the impact on restructuring efforts, the sad reality is that employees are hugely disproportionately disadvantaged by firm insolvency and should be given special attention. While it is too late for some initiatives, given the chronic underfunding of pension funds, there are measures that the government could enact now to address some of the most egregious behaviour. Thus a similar policy justification to that for normal contribution arrears would justify a priority for arrears for the payment of special contributions, which are also subject to a regulatory timetable for their payment.

Adjust the incentive effects of interim financing

One of the greatest disadvantages for employees and retirees in insolvency proceedings is the use of the *CCAA* to liquidate companies and in some instances, move assets out of reach of Canadian creditors and shift economic activity to the United States.[25] In addition to the loss of employment, increasingly there are huge primed interim financing facilities that eat into the assets, to the significant disadvantage of employees, retirees and other direct creditors of the firm. Interim financiers charge huge up-front fees for the facility plus high interest rates that the courts approve on a priority basis over all other claims. These charges run into the millions and sometimes billions of dollars. While it is likely too late to "close the barn door" on this practice of using a restructuring statute to liquidate, there could be amendment to slow the practice of diverting resources in *CCAA* proceedings.

One effective option would be to amend the *CCAA* and the *BIA* proposal proceedings to restrict the grant of interim financing to a priority below the claims of employees and retirees, including wages, benefits, and pension wind-up deficits where the proceedings are liquidating proceedings, *ie*¸ there is little or no going-forward business in Canada. This recommendation would affect the availability of credit where the company is using restructuring tools to liquidate. But current credit decisions are having the effect of shifting the insolvency risk to pension plan members and retirees. Interim financiers would still be able to lend on a priority basis where there was an actual restructuring, but for liquidation, parties would be incentivized to either find going-concern solutions or to use the *BIA* liquidation procedures, where there is appropriate oversight of fees and costs. The amendments would also create a further incentive for directors and officers not to run up these amounts owing in the period prior to insolvency.

We recognize that debtor companies frequently claim they are attempting a restructuring in order to come within the criteria of the *CCAA,* while their intention from the outset or early in the proceeding is to liquidate. To recognize this practice, the court should be given express authority to allocate part of the interim financing to a priority below employee and pension claims where the proceeding ends in

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[25] For a discussion of the huge increase in liquidating *CCAA* proceedings, see Janis Sarra, , "The Oscillating Pendulum: Canada's Sesquicentennial and Finding the Equilibrium for Insolvency Law", in Janis P Sarra and Barbara Romaine, eds, *Annual Review of Insolvency Law 2016* (Toronto: Thomson Reuters, 2017).

liquidation. Interim financiers would have notice of this potential ranking at the time of granting financing, and it might enhance accountability of such financing in that the debtor company would have to seek approval of tranches of the financing at various points in the proceeding, with the priority based on whether there is a liquidation or restructuring.

Amend the provisions on shareholder dividends and managerial bonuses in the *BIA and CCAA*

Another effective strategy would be to amend the *BIA* and *CCAA* to restrict dividends and other payments to shareholders and restrict management compensation bonuses in the year prior to insolvency. Management compensation would be unaffected, it would be the bonus structure affected. The companion amendment would be to amend insolvency legislation to allow the trustee or monitor to recover all dividends or other payments made to equity investors and managerial compensation bonuses paid to corporate officers in the year prior to the initial date of bankruptcy, where there are any amounts outstanding on wages, benefits, pension payments or contributions or pension deficit at the point of proceedings commencing.

The *BIA* currently allows a one year claw-back period where the dividend or other payment to shareholders occurred at a time when the corporation was insolvent or where payment rendered the corporation insolvent.[26] Yet this threshold test does not capture payouts to managers and equity investors when the company is approaching insolvency. The vast majority of companies know when they are in financial distress. Other than micro businesses, companies usually plan for insolvency proceedings over months, and sometimes years, often after negotiating forbearance and other measures with their secured creditors long before they file under the *BIA* or *CCAA.* Yet there is no prohibition during these periods on payments to shareholders or bonuses to managers, both of which detract from the value in the estate that would be available to all creditors, including employees. The current provisions encourage directors and officers to pay out value in the period leading up to insolvency to themselves and/or equity investors. The legislation as currently framed fails to align with existing provisions in insolvency legislation that provide a claw-back period in respect of non-arm's-length parties, such as the transfer at under-value or preference provisions.[27] Shareholders, by the nature of their equity holdings, and managers, by virtue of their employment, are not arm's-length.

For the companies that comply with their wage and pension obligations on an ongoing basis, there would be no downside for shareholders; and it would foster a governance change in that equity investors would likely seek assurances from directors and officers regarding the viability of the company on the payment of any dividends. It would be simple enough for companies to qualify dividend payments with a statement that the payment is subject to federal insolvency law, which specifies that any dividends in the year prior are subject to recall if, at the time of filing, there were any outstanding wage, benefit or pension payments. It would reduce the incentives of directors to pay out dividends where there are pension deficiencies and it would reduce some pressure by "impatient equity investors" on directors and officers to pay dividends when other legal obligations have not yet been met.

Consider enhancing the current priorities for wages, benefits and pensions

There are three ways in which the protection of employees and retirees could be enhanced in respect of priorities under insolvency legislation.

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[26] Section 101, *BIA.*

[27] Sections 95 (1)(b) and 96 (1)(b), *BIA.*

First would be to align the statutory priority for wage and benefit claims to align with the amounts payable under *WEPPA.* Payments under the *WEPPA* come out of consolidated revenues, and only $2,000 of that amount is recoverable through subrogation by the federal government under the priority provisions. It makes sense to align the priority amounts under the *BIA* with the *WEPPA* amounts, allowing the government to at least try to recover some of the value from the insolvent company. Canada ranks among the lowest of OECD countries in terms of the amount of priority it gives employee compensation during insolvency.

Second would be to clarify the current priority for wages and benefits in respect of LTD benefits under the *BIA* and coverage pursuant to *WEPPA*. Currently, wages up to $2,000 have a security over all current assets, subject to a couple of other priorities.[28] Sections 136(1), 81.3 and 81.4 of the *BIA* together provide the priority for wages, salaries, commissions, compensation or disbursements to employees. The statutory language appears to fold amounts owing into the definition of wages, and at least one judgment, *Ted Leroy Trucking,*[29] held that they should include LTD benefits: "In my view the definition of wages is broad enough to include holiday and overtime pay and all employee benefits [which included an LTD benefit] and entitlements (except for the specifically excluded severance and termination pay). Regardless of whether each of these items may be considered "wages" in the ordinary sense of the word, they are clearly "returns given by an employer to or for the benefit of the employee for services given by the employee".[30] Thus, they are properly viewed as compensation and should be considered "wages". So, if the LTD is provided through a mechanism of periodic third-party payments that fall within the six month prior to bankruptcy time period, they should be covered. Even if LTD benefits are covered under the *BIA* statutory priority, in order to qualify they must be "shoe-horned" into: (1) must be compensation for services rendered, (2) during the specific period, (3) up to a maximum amount.

However, the statutory definitions between the *BIA* and the *WEPPA* do not align, causing considerable confusion. The appellate court appears to conflate or confuse the statutory priority under the *BIA* and access to *WEPPA* benefits*.* Currently, *WEPPA* covers owed wages, vacation pay, termination pay or severance pay.[31] The government's website makes no mention of LTD benefits and both the government's *WEPPA* information advice centre and the Superintendent of Bankruptcy confirm that *WEPPA* does not cover LTD benefits, meaning that caselaw and public information do not align.[32] Yet the Court in *Ted Leroy Trucking* held that payments to third-party benefit providers would fall under the *WEPPA* definition of wages as "compensation for services provided". At best there is a lack of clarity, and at worst, LTD amounts are not covered. It would be helpful to offer clarity on this issue.

Recent cases have revealed that sick or disabled employees face reduction or complete loss of long-term health, insurance, and long-term disability coverage. LTD recipients are still current employees and payments owning to them should be protected at least to the same amount as other employees. Employees on LTD may have very little chance of recovery and usually cannot get another job to replace any lost income.[33] Disabled employees are also employees who are covered by other benefit

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[28] Sections 83.1(4) and 81.4(4), *BIA.*

[29] *Ted Leroy Trucking* 2009 BCSC 41, appeal dismissed 2010 BCCA 233.

[30] *Ibid.*

[31] Government of Canada, January 2019, https://www.canada.ca/en/employment-social-development/services/wage-earner-protection/employee/eligibility.html

[32] Wage Earner Protection Plan staff, telephone call 22 January 2019; OSB email correspondence, 22 January 2019.

[33] Janis Sarra, *Examining the Insolvency Toolkit,* Report of Public Hearings, Canadian Insolvency Foundation (Toronto: CIF, 2012). Janis P Sarra, *Rescue! The Companies' Creditors Arrangement Act,* 2nd ed (Toronto: Carswell, 2013).

plans/pension plans and may be entitled to severance pay, so potentially they will have other losses in addition to LTD benefits when their employer becomes insolvent.[34] They will be disproportionately affected by the loss of drug plans and similar benefits because their medication costs may be very high. It is very hard for disabled employees to find replacement insurance. In *Nortel Networks*, the value of health and insurance benefits was over $500 million, but there was just $80 million in the trust fund.[35] The value of the disability benefits alone was over $100 million.

If the LTD income benefits are insured with an outside insurance company, the least serious of potential scenarios, there are sometimes issues with employees who are in the process of qualifying for LTD.[36] While the debtor company may still have to deal with all of the other issues, such as benefits, severance pay, *etc.* for these employees, the employees should at least be guaranteed their income benefits. To the extent that the disabled employees are not able to collect from the trust, they are thrown back into the insolvency process to attempt to collect the rest of their claims as unsecured creditors. At the other end of the spectrum is where the disability payments are "pay as you go". They are self-insured and there is no separate trust fund or pool of money to fund these benefits. In this case, the disabled employees' rights are limited to making a claim in the insolvency proceeding. Even though disabled employees are technically considered to be active employees, there is no special protection for them under wage earner protection laws or the *BIA.* Therefore, they must claim as unsecured creditors.[37]

Third would be an amendment to expand the current statutory super-priority to include unfunded pension liabilities to be paid ahead of the claims of secured creditors, including pension deficit funding to a specified cap, such as $50,000 per beneficiary. The current priority of pension contributions was an important initial step a decade ago. However, the insolvencies that have occurred in the past ten years illustrate that the protection is not sufficient, as discussed above. While this additional priority is likely to be opposed by companies and creditors as sounding the death knell on financing, the reality is that financing is currently being given and priced on the basis that debtor companies do not need to meet their pension promise. There is no doubt that a significant amount of super-priority on a capped-basis would affect the cost of credit considerably, as well as the assessment of insolvency, but that pricing and grant of credit would be more realistic and would better protect pension benefits on insolvency.

The objectors to a priority argue, without empirical evidence, that a super-priority of even a few thousand will seriously affect credit availability; what they are essentially saying is that lenders do not want to grant financing where companies are meeting their statutory pension obligations, and that companies might be pushed into insolvency when they are meeting their statutory pension commitments instead of continuing to get financing if they violate pension law in the period prior to insolvency. In balancing interests, the government should be concerned with the relative impacts of priority ranking on affected stakeholders. Secured creditors are better able to price debt investment and to hedge against loses than are pensioners. Employees and retirees cannot easily diversity their risk, nor do they have any bargaining power to negotiate a price for their employment that accounts for the employer's failure to meet the promised benefits. At the very least, there should be a super-priority for special contribution solvency payments due in the period covered.

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[34] Sarra, *Rescue, ibid* at 384-5.

[35] *Re Nortel Networks Corp*, 2009 CarswellOnt 3583 (Ont. S.C.J. [Commercial List]) at paras 1, 5, 7, affirmed 2009 CarswellOnt 7383 (Ont CA), leave to appeal refused 2010 CarswellOnt 1760, 2010 CarswellOnt 1761 (SCC). For a discussion, see Sarra, *Rescue, ibid* at 386-8.

[36] Sarra, Toolkit, *supra* note 33.

[37] *Re Nortel, supra* note 35.

An expanded priority for wages, benefits and pension payments would also assist in supporting current "hardship payments" orders. These orders are where the court approves an interim payout to employees or retirees for hardship reasons; however, the courts have held that they will do so only where there has been hardship and where there is strong evidence that the assets support payment of the claims in the final resolution of the proceeding.[38] The higher priorities discussed above would make greater numbers of employees eligible for interim hardship payments pending resolution of the insolvency proceeding.

Good faith negotiations

It seems counter-initiative that anyone would not support good faith in insolvency proceedings, but that sentiment continues to exist, notwithstanding developments in the common law that are increasingly recognizing the need for good faith dealings in commercial law.[39] The Supreme Court of Canada has already been very clear that good faith is one of the baseline considerations of the court when it is determining whether or not to exercise its authority in insolvency proceedings.[40] Canadian insolvency legislation already imposes an affirmative duty to act in good faith on the debtor company.[41] It should be extended to creditors and any other parties to an insolvency proceeding. An important counter-argument to objectors to a good faith obligation is that: access to the court-supervised procedure must carry with it responsibilities for creditors, just as it does for debtors. Creditors, having received the benefits of the statutory framework and the supervision of the court, are no longer purely private contracting parties. Arguably, with the benefit of the stay that prohibits a race to the assets, protection of the hierarchy of claims and other protections of insolvency legislation come responsibilities. All parties to an insolvency proceeding should be explicitly required to act in good faith if they expect the full benefit of remedies under insolvency law and contract law to which they may entitled.[42]

CORPORATE GOVERENCE ISSUES

Restrictions on payments to equity investors

The government has posed the question of whether dividend payments, share redemptions and executive compensation packages could be restricted under the *Canada Business Corporations Act (CBCA)* in cases where a company has a large pension deficit.

We recommend amending the *CBCA* and other federal corporate-registration statutes to restrict the payment of dividends, share redemptions and bonuses and other executive compensation benefits where there is a pension deficit. This restriction would be a helpful additional protection in the *CBCA*, and the government could extend those protections to all federally-registered companies, including, for example, companies registered pursuant to the *Bank Act* and the *Insurance Companies Act.* Placing limits on the payout of executive compensation bonus packages would more appropriately align managerial incentives with the public policy goals of meeting statutory requirements to adequately fund pension plans. It would

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[38] *Re Nortel Networks Corp*, 2009 CarswellOnt 3583, 55 CBR (5th) 68 (Ont SCJ [Commercial List]), affirmed 2009 CarswellOnt 7383, 59 CBR (5th) 23 (Ont CA), leave to appeal refused 2010 CarswellOnt 1760, 2010 CarswellOnt 1761 (S.C.C.). Ronald B Davis, "Doomed to Repeat History? Retiree Benefits and the Reform of Canada's Insolvency Laws", in *Annual Review of Insolvency Law, 2004* (Carswell, 2005) 199-242.

[39] *Bhasin v. Hrynew*, 2014 SCC 71.

[40] *Century Services Inc v Canada (Attorney General),* 2010 SCC 60, [2010] 3 SCR 379.

[41] *CCAA,* ss 11.02(3) and 33(3); *BIA,* ss 50(12), 50.4(9), 50.4(11) and 65.12(2).

[42] For a discussion, see Janis Sarra, "*La bonne foi est une considération de base*— Requiring Nothing Less than Good Faith in Insolvency Law Proceedings", in *Annual Review of Insolvency Law 2014* (Toronto: Carswell, 2015).

also assist in insolvency workouts because corporate officers could not use payment of bonuses and other benefits as holdout bargaining chips in exchange for being retained to guide the company through the insolvency. Amendments to the *CBCA* would complement the suggested amendments to the *BIA*, discussed above.

Enhance fiduciary obligation and codify existing common law

Another important way that employee and pension protection could be enhanced would be to amend the fiduciary obligation provisions of the *CBCA* to clarify that these stakeholders merit consideration when directors and officers are acting in the best interests of the corporation. We recommend amending the *CBCA* to require directors and officers to "consider" environmental, social and governance (ESG) factors with a view to the corporation's best interest.[43] Directors and officers may conclude that ESG factors *are* or *are not* factors posing a material risk or opportunity to the corporation. Corporate stakeholders would be confident that such factors have been considered by directors and officers if there were a clear statutory obligation to do so. Such an amendment would align with developments in the UK and European Union. The duty of directors and officers under section 172 of the UK *Companies Act* has been modified to create a duty on directors to act to promote the success of the company by considering the interests of multiple stakeholders, including: the likely consequences of any decision in the long term, the interests of the company's employees, relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment.[44] Publicly-traded companies must now explain how they are managing issues such as environmental performance, human rights, social and community involvement and diversity and must report on certain statistics such as CO_2 emissions.[45]

Second, amend the *CBCA* to require directors and officers to address material ESG factors, an obligation that arises only where ESG factors are material to the best interests of the corporation. One option for wording, taken from federal environmental legislation, is that directors and officers are to "take all reasonable care" to address material ESG issues, which would place a reasonableness standard on these obligations.[46]

Third, we recommend codifying the common law in a new section 122(2) of the *CBCA,* enacting specific wording based on Canadian judgments that directors and officers may consider the interest of multiple stakeholders in making decisions, including employees and pensioners. The Supreme Court of Canada has held that directors and officers are to act with a view to the best interests of the corporation, "having regard to all relevant considerations, including, but not confined to, the need to treat affected stakeholders in a fair manner, commensurate with the corporation's duties as a responsible corporate citizen".[47] This amendment would create greater certainty and transparency for all stakeholders and would encourage directors' oversight of the corporation with a view to long-term sustainability without fear of their decisions being attacked by equity investors seeking short-term returns to the detriment of the company's longer term solvency. Directors' good faith decisions would be protected by the defence

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[43] For a detailed discussion, see Janis Sarra and Cynthia Williams, *Time to Act, supra,* note 8.
[44] Section 172(1), *Companies Act* (UK).
[45] See also London Stock Exchange, "Revealing the Full Picture, Your guide to ESG reporting: Guidance for issuers on the integration of ESG into investor reporting and communication" (2018), at 19; online (pdf): LSEG < https://www.lseg.com/sites/default/files/content/images/Green_Finance/ESG/2018/February/LSEG_ESG_report_January_2018.pdf >.
[46] For a detailed discussion, see Janis Sarra and Cynthia Williams, *Time to Act, supra,* note 8.
[47] *BCE Inc v 1976 Debentureholders*, 2008 SCC 69 at para 66, [2008] 3 SCR 560.

under section 123(5) the *CBCA* that already serves duly diligent directors well. The Supreme Court of Canada has held that the defences of good faith and acting on a prudent and reasonable basis are very strong, even in the face of less than full information. The amendments would enhance corporate governance and encourage corporate boards to engage in oversight and undertake strategic planning in the interests of the long-term sustainability of the corporation, in turn benefiting employees and other stakeholders.

Increase corporate disclosure

The current *CBCA* corporate disclosure requirements should be enhanced. At a minimum, amend the *CBCA* to require corporations to report on policies that pertain to the interests of workers and pensioners, and require directors to promote the company's success for the benefit of all its stakeholders, including pensioners and employees. More effective, and to align with developments internationally, the federal government should consider amending the *CBCA* to expressly require directors and officers to disclose their consideration of, and actions to, address material ESG factors, as discussed immediately above.

After a pension plan is registered, it must have actuarial reports concerning its funded status prepared and submitted to the regulator at least every three years or when changes are made that change the contributions required and/or the plan's liabilities.[48] If these reports disclose that additional liabilities have been created or existing liabilities have been increased, then the employer must make additional special contributions calculated by an actuary as sufficient to pay-off these liabilities over a five to fifteen year time frame.[49] These provisions provide a stream of contributions into the pension fund or insurance company that are required to be sufficient to fund the benefits provided. As noted in the pension funding section above, we are recommending that actuarial practice be amended so that a transparent picture of the relationship between pension costs and benefits be presented irrespective of the assets held. This calculation should also form part of the enhanced disclosure requirements.

Courts have held that provincial legislation creating deemed trusts over certain funds is ineffective in creating a trust over those funds for the purposes of the *BIA* unless the funds are also the subject of a trust at common law.[50] In circumstances such as pension contributions, courts often rely on the failure to hold the specific funds separate from other assets of the debtor corporation as having destroyed the certainty of subject matter necessary for a valid common law trust.

CONCLUSION

As the federal government considers how to better protect employees and pensioners from the devasting economic effects of insolvency, it has some real challenges to meet. The above recommendations are meant to be practical, as well as possible in terms of constitutional authority, and more than justifiable in terms of public policy protecting the public interest and the economic security of vulnerable Canadians.

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[48] Ronald B Davis, "Restructuring Proceedings and Pension Fund Deficits: A Question of Risk and Reward", in J Sarra, ed, *Annual Review of Insolvency Law*, *2003* (Toronto: Carswell, 2004) at 29–65, citing *PBA* Reg, RRO 1990, Reg 909, ss 14(1) & 3(1).
[49] *Ibid,* citing Reg. (Ont), s 5(1).
[50] *Re IBL Industries Ltd* (1991), 2 OR (3d) 140 (Ont Bktcy); see also, *Edmonton Pipe Industry Pension Plan Trust Fund (Trustees of) v 350914 Alberta Ltd*, 2000 CarswellAlta 484, [2000] AJ No 583 (Alta CA), leave to appeal refused 2001 CarswellAlta 57, 2001 CarswellAlta 58, [2000] SCCA 408 (SCC).

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