2500, 20 Queen Street West
Toronto, ON
Canada M5H 3S1
Tel. 416.595.8500
Fax. 416.595.8695
www.millerthomson.com

MILLER THOMSON LLP

Barristers & Solicitors, Patent & Trade-Mark Agents

TORONTO VANCOUVER CALGARY EDMONTON WATERLOO-WELLINGTON MARKHAM WHITEHORSE WASHINGTON, D.C.

Pension and Benefit Plans: Steering Clear of Soft Shoulders

by Brent K. Duguid
January 29, 2003

PENSION AND BENEFIT PLANS: STEERING CLEAR OF SOFT SHOULDERS
By Brent K. Duguid, Miller Thomson LLP

Introduction

In the context of transactions involving the sale of a business, pension and benefit issues can be quite complex due to the significant value of the assets and the liabilities associated with such pension and benefit plans. It is important for both the seller and buyer to understand such issues and identify potential liabilities at the early stages of the transaction so as to minimize or eliminate costly surprises or unexpected liabilities following the closing of the deal.

This paper will identify some of the pension and benefit liability issues that arise in the context of both a share and asset purchase transaction. In particular, I will address how such issues affect the structure of the transaction and outline various options available to the buyer and seller to limit their potential exposure to liability.

It is essential for buyer to conduct extensive due diligence to identify potential pension and benefit liability issues and for the parties to deal with such issues at the earliest opportunity in order to

(i) avoid unnecessary and costly surprises that may result in undue delays affecting the timing of the transaction;

(ii) to provide adequate time to assemble the necessary talent (pension lawyer, benefit consultants and actuaries) to properly identify all pension and benefit arrangements and quantify the liabilities associated with such programs;

(iii) determine a fair purchase price, or alternatively, to negotiate pricing adjustments for assumed or newly identified liabilities;

(iv) deal with potential compatibility issues arising between the buyer's pension and benefit programs and those of the seller (*applicable to both asset and share purchase*) and to assess the impact of such programs on the buyer's offer of employment to transferred employees (*asset purchase*)

(v) ensure that the transaction is effectively structured to isolate your client (buyer or seller) from unnecessary liability and risk

(vi) determine the scope and accuracy of potential representations and warranties in the purchase and sale agreement

Regulatory Framework

Pension plans are regulated by both federal and provincial legislation. All pension plans must be registered under the *Income Tax Act,*[1] ("ITA") in order to be accorded tax exempt status. The Canada and Customs Revenue Agency ("CCRA") is responsible for registering pension plans under the ITA, and for ensuring that they are administered in accordance with the ITA requirements. In addition to being registered under the ITA, pension plans must also be registered under either provincial or federal pension benefit standards legislation. Because pension standards legislation varies across provinces, even with respect to minimum benefits, plans with employees in more than one province or with employees who have been employed by the same employer in different provinces are subject to complex and varying legal, regulatory and administrative requirements.

For the purpose of this paper and discussing the requirements of pension standards legislation, my comments will generally be limited to the jurisdiction of Ontario and primarily the *Pension Benefits Act*[2] ("PBA").

---

[1] R.S.C. 1985, c. 1 (5^{th} supp), as amended.

[2] R.S.O. 1990, c.P.8, as amended.

Types of Pension Plans

It is essential to identify the type of pension plan being dealt with in order to properly assess the relevant pension issues in the context of the purchase and sale of a business. Registered pension plans can generally be classified as defined benefit plans, defined contribution plans (money purchase plans) or some hybrid/combination of these two types of plans.

(i) Defined Benefit Plans

The amount of the employee's pension benefit is specified in a defined benefit plan. If the defined benefit is determined by a formula referencing past earnings and years of service, then the plan can be further classified as a career average earnings, best average earnings or final average earnings. Where such benefits are defined by a fixed dollar amount for each month of year of service, then the defined benefit can be further classified as a flat benefit.

Although the pension benefit is specified under a defined benefit plan, the contribution obligation of the employer is not. The employer is responsible for funding the promised benefit regardless of the funded status of the plan. A defined benefit plan that also requires employee contributions is known as a "contributory" plan, however, the employer generally pays for the majority of the benefit. In addition to administering such plans in accordance with applicable pension standards legislation and the ITA, an employer who sponsors a defined benefit plan therefore also bears the financial risk of sufficiently funding the promised benefit.

(ii) Defined Contribution (Money Purchase) Plans)

A defined contribution plan differs from a defined benefit plan in that it is the contribution that is defined and not the benefit. The employer's obligation to contribute is limited to the amount specified or defined in the plan. Generally, the employer and employee's contribution is based on a fixed percentage of the employee's earnings. The amount of the employee's pension to be paid at retirement is unknown since it is dependent on the amount of contributions and investment returns earnings thereon accumulated with interest to the employee's retirement date. Under a defined contribution plan, it is the employee that generally bears the risk of inadequate financial returns and the risk that annuity prices may be high at retirement.

It is also possible for pension plans to provide both defined benefit and defined contribution funding characteristics. Such plans are commonly referred to a hybrid or combination plans.

Registered pension plans are pension arrangements which are registered under the ITA. Registered pension plans qualify for special tax treatment that generally permits employer contributions to be deducted for tax purposes and permits contributions and investment earnings thereon to accumulate on a tax deferred basis. Other tax assisted deferred income arrangements under the ITA include Registered Retirement Savings Plans ("RRSPs") and Deferred Profit Sharing Plans ("DPSPs").

Unregistered Pension Arrangements

As a result of the severe limits and restrictions placed on the amount of available tax deferred savings for registered arrangements under the ITA, employers frequently establish unregistered pension arrangements to "top-up" pension benefits in excess of the ITA limits. Such arrangements are commonly referred to as Supplemental Executive Retirement Plans ("SERPs"). Although SERPs had traditionally be implemented for executives and senior management, the use of SERPs is now being commonly extended to all employees affected by the ITA limits.

Share PurchaseTransactions

Generally a share purchase is relatively more straightforward and simpler transaction as compared to an asset purchase. In a share transaction, the buyer purchases the shares of the seller's corporation and becomes the new owner of that corporation's business. Nothing essentially changes within the seller's corporation since all liabilities remain with that corporation following the sale of its shares to the buyer. From the employee's perspective, there is no fundamental change in their employment as a result of the ownership change. The buyer assumes all of the employer's pension responsibilities and liabilities, including responsibility for pre-purchase administration and for past pension service accruals of employees (and deferred vested employees and retirees). It is important to note however that if the seller is a "participating employer" in a large plan covering employees of the seller and its affiliates, it will no longer qualify for participation following the sale and the parties may wish to negotiate an appropriate transfer of assets from the plan.

In order for the buyer to protect themselves from financial responsibility for pre-purchase administration and the adequacy of funding of the seller's pension and benefit plans, the onus is on the buyer to uncover all of the relevant liability issues through effective due diligence and to negotiate extensive representations and warranties from the seller. It is common for the buyer to attempt to negotiate extensive representation and warranties and broad indemnification protection from the seller to isolate itself from any prior administration or funding abnormalities that occurred during the seller's watch.

The PBA and ITA imposes a number of statutory requirements and responsibilities on employers who sponsor pension plans. Breaches of these statutory requirements can result in significant fines and potential personal liability for directors and officers of the company. For example, an employer (or person) who is convicted of breaching the PBA or regulations thereunder may be liable for a fine of not more than $100,000 for a first conviction, and not more than $200,000 for each subsequent conviction[3]. Where the offense relates to the failure to submit or make contributions to the pension fund, the court may impose a penalty requiring the convicted employer (or person) to pay the amount equal to the shortfall into the pension fund.[4] In addition to statutory obligations, an employer who sponsors a pension plan also has fiduciary duties recognized by common law.

Breaches of the PBA could occur as the result of failing to administer the plan in accordance with the PBA or in accordance with the plan documents. For example, significant liability could result if a benefit was improperly calculated or eligible employees were denied enrolment in the plan. Perhaps the employer improperly withdrew surplus or transferred assets without regulatory approval, or improperly utilized contribution holidays to fund employer contribution requirements under the plan. A buyer should also be wary of any previous partial wind ups that may have been implemented by the seller in light of the decision of the Ontario Court of Appeal in *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)*[5]. In *Monsanto*, the court held that section 70(6) of the *PBA* imposes an obligation on employers who undertake a partial plan wind up to distribute a portion of the actuarial plan surplus to affected employees. The decision could have serious implications for employers who previously undertook partial wind-ups in the past and who did not distribute any surplus at that time. Between November

---

[3] PBA, ss 109 and 110.

[4] PBA, ss. 110(4)

1992 and November 1998, 156 partial wind-up reports were filed that did not contain any surplus distribution proposal. The Superintendent has taken the position that since such reports were never formally approved (nor refused), such cases can now be reopened and considered. The fallout of the Monsanto decision could be severe: employers who filed partial wind-up reports which are sitting in limbo at the Superintendent's office could be forced to contribute millions of dollars from their general revenues to prop up surplus in plans to the level as at the partial wind-up date. This will clearly have an impact on the company's bottomline in a challenging economic environment. Accelerated funding obligations may also cause problems with respect to solvency of some pension plans and may lead to the bankruptcy of some employers. The reopening of previous partial wind ups will also lead to prolonged and costly litigation between employers and employees over the issue of surplus entitlement.

Accordingly, a buyer should attempt to identify any potential liability that may arise if the seller participated in a previous partial wind-up and possibly seek an indemnity to address this uncertain and potentially costly liability.

In a share transaction, extensive due diligence is required so that the buyer fully understands and appreciates their inherited liabilities and funding obligations, and to allow the parties to negotiate appropriate purchase price adjustments.

Asset Purchase Transactions

Generally, in an asset purchase transaction, the buyer acquires all or part of the assets of the seller. The buyer can negotiate which particular assets and liabilities are to be acquired from the

---

[5] The decision was released by the Ontario Court of Appeal on November 22, 2002.

seller including pension assets and liabilities as well as employees ("transferred employees"), subject to the requirements of a collective agreement. As a matter of law, if the purchase agreement is silent on a particular asset or liability, then that asset or liability remains with the seller. In order for the seller to avoid wrongful and constructive dismissal claims, purchase agreements commonly require the buyer to provide pension and benefits to the transferred employees which are "no less favourable as", or "substantially similar" to the terms and conditions that are currently offered by the seller. From the buyer's perspective, due diligence is required to determine and assess the implications of acquiring the assets and liabilities associated with the seller's pension and benefit plans, the compatibility of the seller's benefit plans with those of the buyer and how to properly structure the transaction and any employment offers to transferred employees. In addition, depending on whether or not particular assets or liabilities are assumed by the buyer, the parties may wish to negotiate purchase price adjustments.

In some circumstances, the buyer may be bound under the terms of a collective agreement as a successor employer to maintain certain pension and benefit plans for employees of a specific bargaining unit.

There are essentially four principal options available to a buyer that is purchasing the assets and assuming liabilities from the seller:

Option # 1: Buyer Offers No Pension Plan

The first option is that the buyer could elect not to offer a pension plan for transferred employees. Under this option, the seller will retain responsibility for its pension plan and the buyer will accordingly have no liability concerns with respect to such plan. Generally, the seller will strongly oppose this option since the seller may be ordered to wind-up the plan and be forced to prematurely address surplus and underfunding issues that arise as a result.

Pursuant to Section 69 (1)(f) of the PBA, the Superintendent by order may require the wind-up of a pension plan in whole or in part if:

> (f) All or part of the employer's business or all or part of the assets of the employer's business are sold, assigned or otherwise disposed of and the person who acquires the business or assets does not provide a pension plan for the members of the employer's pension plan who become employees of the person.

There are potentially significant costs associated with the wind-up of a pension plan. Under the deemed vesting provisions of section 73 of the PBA, individuals who do not have two years of plan membership automatically become vested in their pension entitlements under the terms of the plan. More significant is the liability associated with "grow in" rights under section 74 of the PBA[6]. The "grow-in" provision provides that on a full or partial plan wind-up, terminating members whose age and years of service total 55 or more are entitled to enhanced pension benefits which may result in increased fund liabilities and accelerated funding obligations of the employer.

Another potential cost for the seller involved in a partial wind-up may be the requirement to prematurely distribute surplus allocable to affected members as a result of the *Monsanto* decision as set out above.[7]

This option may not be satisfactory to the buyer in circumstances where a collective agreement requires the establishment of a successor plan.

---

[6] Only Ontario and Nova Scotia provide "grow-in" entitlements.

Option # 2: Future Service Option – Buyer Establishes New Plan With Seller Retaining Responsibility for Past Benefit Accrual

Under the future service option, the seller retains responsibility under its pension plan for all accrued liabilities for transferred employees for pre-purchase service and the buyer assumes liability for post-purchase pension benefits. The buyer will permit transferred employees to join an existing plan or a new plan sponsored by the buyer.

This type of transaction is governed by the sale of business provisions of section 80 of the PBA. Section 80 provides that a transferred employee who is a member of the seller's pension plan prior to closing is entitled to:

(i) the benefits provided under the seller's pension plan accrued to the closing date of the sale without further accrual;

(ii) credit in the buyer's pension plan for the period of employment in the seller's pension plan for the purpose of determining eligibility for membership in, or entitlement to benefits under, the buyer's pension plan (but not accrual of benefits);

(iii) credit in the seller's pension plan for the period of employment with the buyer for the purpose of determining eligibility to benefits under the seller's pension plan.

Furthermore, for the purposes of the PBA the employment of the seller's employees is deemed not to be terminated by reason of the transaction.

---

[7] Supra, note 6.

This option is favoured by both buyers and sellers who attempt to control and isolate their liabilities in relation to their respective employment periods for pre-purchase and post-purchase pension service, and also for its general simplicity from both a regulatory and drafting perspective. Since there is no transfer of assets or liabilities between the plans, there are no significant regulatory hurdles.

The future service option can create some employee relations problems and may result in a large initial unfunded liability as a result of the establishment by the buyer of a successor plan. Employees may not feel comfortable looking to two sources for their pension benefits since the pension promise has effectively been split between the buyer and seller. More importantly, if the seller's pension plan is a final average earnings plan, employees may suffer a hit to their overall benefit entitlement even if the buyer puts in place an identical plan for future service. The buyer's pension plan may seek to compensate the transferred employees for the fact that their benefit entitlements under the seller's plan is based on their salary strictly with the seller and does not factor any salary increases post-closing with the buyer by implementing a "wrap-around arrangement". Under this type of arrangement the buyer enhances pension benefits (subject to ITA limits) provided under the seller's plan by applying current final average earnings to years of employment with the seller but offsets liabilities under the buyer's plan by amounts payable under the seller's plan.

There are two noteworthy cases in respect of the residual liability that may be imposed on the seller even if the buyer establishes a successor plan in compliance with the PBA. In the decision of the Ontario Court of Appeal in *Gencorp Canada Inc. vs. Ontario* (Superintendent of

Pensions),[8] Gencorp Canada Inc. ("Gencorp") sold its tube and tire manufacturing business to General Tire of Canada Inc ("General Tire"). The pension arrangement negotiated by the parties resulted in future service liabilities for transferred employees being assumed by General Tire (Buyer) and with Gencorp (Seller) retaining responsibility for pre-purchase accrued pension liabilities. General Tire shutdown the tire plant it had purchased from Gencorp approximately four years after the sale. The Superintendent then ordered a partial wind-up of Gencorp plan pursuant to Section 69 of the PBA. In particular, section 69(1)(d) provides that the Superintendent may order a wind-up of a pension plan in whole or in part where "a significant number of members of the pension plan ceased to be employed by the employer as a result of the discontinuance of all or part of the business of the employer or as a result of the reorganization of the business of the employer."

The Court of Appeal upheld the finding of the Pension Commission of Ontario (now referred to as the Financial Services Commission of Ontario) that both General Tire and Gencorp qualified as an "employer" for the purposes of the PBA and therefore Gencorp could be subject to a section 69 wind-up order which covers both predecessor and successor employers. In other words, Gencorp continued to be the employer of the transferred employer for the purpose of the Gencorp's plan, and when the actual employment of the transferred employee was terminated by General Tire, by extension, their deemed employment with Gencorp was also terminated thereby triggering the wind-up of the plans.

---

[8] (1998), 39 OR (3d) 38.

As a result of the wind-up order issued by the Superintendent, the transferred employees became eligible for costly "grow-in" benefits under Section 74 of the PBA. The "grow-in" benefits in this case amounted to nearly $5 million dollars.

The most significant effect of this decision is that it takes away any comfort that the seller may have had in their belief that actions of the buyer could not impact on the seller's retained liabilities. As the *Gencorp* decision revealed, the actions of the buyer could cause a partial wind-up of the seller's plan thereby triggering funding obligations or the necessity of dealing with complex surplus issues. The only source of protection for the seller could be a requirement in the purchase and sale agreement stipulating that the buyer not take any action within a specified period of time which could cause a full or partial wind-up of the seller's plan, coupled with an indemnity.

The Pension Commission of Ontario ("PCO") reached a different result however in *Allan vs. Massey Ferguson*[9]. In that case, the buyer acquired all of the pension assets and liabilities attributable to the transferred employees (including pre-purchase accrued benefits). At the time of the transfer, the plan was fully funded. The purchase agreement provided that the seller would not have any future liability in connection with the transferred employees. The buyer operated less than two years, was placed in receivership and the Superintendent ordered the wind-up of the buyer's plan. The buyer's plan had an unfunded liability of approximately of $8.5 million. The transferred employees claimed that the seller, as their former employer, was responsible for funding the shortfall in the buyer's plan. Specifically, the transferred employees argued that the

---

[9] Allan and the Superintendent of Pensions, PriceWaterhouse and Massey Ferguson Limited (June 18, 1992), PCO Bulletin vol 3, issue 2, (Oct. 1992) p 36.

seller remained an "employer" under the PBA and was therefore responsible for the funding requirements set out in section 75 which require an employer to contribute and pay for any unfunded liability on wind-up. The PCO rejected this argument and decided that the seller was not an "employer" within the scope of section 75, and therefore was not responsible for the unfunded liability.

The significance of *Gencorp* and *Allan* decisions is that the that a seller that retains liability for accrued pension benefits of transferred employees may suffer significant and unexpected financial liabilities caused by the future actions of the buyer. In such circumstances, the seller may seek an indemnity and a requirement in the purchase and sale agreement that the buyer maintain the successor pension plan indefinitely or not take any actions detrimental to the interests of the seller within a specified period of time. However, often wind-ups result from events beyond the employer's control or the buyer may not be solvent thereby rendering the indemnity useless.

Option #3 – Buyer Assumes All Rights and Obligations of Seller's Pension Plan

A third option would be for the buyer to assume all rights and obligations of the seller under the seller's pension plan. Responsibility for pre-purchase and post-purchase service of the transferred employees is assumed by the buyer. The buyer also assumes responsibility for any retired members and any deferred vested members of the seller's pension plan. This approach may be required to satisfy the terms of a collective agreement and is restricted to situations where all active employees who participate in the pension plan are part of the deal.

The advantage of this approach is the avoidance of regulatory intervention since there is simply a change in the plan's sponsorship and not a transfer of assets. This option may also be favoured by employees since their pension benefit is retained by one entity and therefore they do not have to look to separate employers to receive their pension payments.

Similar to the liabilities inherent in a share purchase, the buyer should conduct extensive due diligence and negotiate representation and warranties (and possibly an indemnity) with respect to pre-purchase administration and funding by the seller.

Option # 4 : Transfer of assets and liabilities "Carved out" of the Seller's Plan

The forth option is to carve out the assets and liabilities associated with the transferred employees from the seller's pension plan and transfer them to an existing or newly established pension plan sponsored by the buyer, subject to regulatory approval. The transfer application to be submitted for regulatory approval must be in accordance with the section 80 sale of business provisions of the PBA as well as Policy Statement No. 2 (FSCO Policy A700-200. In a carve out situation the seller and buyer need to reach a consensus on the nature of the assets to be transferred, the valuation of such assets and the actuarial assumptions to be used, and other administrations issues involving the investment of assets, payment of benefits, responsibility for administrative expenses, and receipt of contributions during the interim period pending document completion and regulatory approvals. In addition, the purchase and sale agreement should contain a contingency option in the event that the regulatory approval is not received as well as a dispute resolution mechanism to address such things as disagreements over asset values or actuarial assumptions.

Although there is no specific requirement to transfer surplus on an asset transfer, the parties may still prefer to negotiate a transfer of surplus from the seller's plan to the buyer's plan in connection to the liabilities of the transferred employees.

In this respect, one should consider the decision of the Ontario Superior Court of Justice in *Reichhold Limited vs. Wong*[10], in which the court was asked to determine whether or not employees who had previously been transferred to a successor pension plan had any legal interest or entitlement to participate in a proposed distribution of surplus in their former employer's plan. A number of employees left their employment with Reichhold Limited (the "Seller") when a division was sold to Neste Chemicals Inc. (the "Buyer"). At that time, there was a transfer of the pro rata shares of assets and liabilities, including then existing surplus, from the Seller's plan to the Buyer's plan with respect to the group of transferred employees. Six years later, the Seller wound-up the plan and negotiated a surplus sharing arrangement which did not include the transferred employees. The transferred employees objected on the basis that they had ongoing rights to assets and surplus of the Seller's pension plan and were entitled to participate the proposed surplus distribution.

In rejecting their argument, the court held that since all of the assets and liabilities relating to the transferred employees had been transferred to the Buyer's plan, these employees did not have any current benefit entitlement remaining under the Seller's plan. In other words, their rights in the Seller's plan had ended with the consummated transfer to the Buyer's plan. Section 80(2) of the PBA provides that a member does not continue to be entitled to any benefit under a former employer's pension plan "if the successor employer assumes responsibility for the accrued pension benefits of the employer's [seller's] pension plan". Accordingly, the transferred employees had no legal entitlement to any of the remaining assets of the seller's plan. The court concluded that an employer does not owe a continuing fiduciary duty to former employees where

[10] 47 OR (3d) 400.

all the assets and liabilities relating to those persons have been transferred properly and legally to a successor plan.

The lesson to be learned from the *Reichhold* case is that an asset transfer which does not include a corresponding transfer of surplus may result in transferred employees retaining contingent rights and interests in surplus of the seller's plan.

In the event the plan's liabilities exceed the plan's assets and is therefore underfunded, the buyer will be responsible for the transferred employee's unfunded liabilities and will want to negotiate a price adjustment.

Due to the complexity, regulatory intervention, and potential high costs, the carve-out option is usually the least favoured option for a buyer.

Pension asset transfers are increasingly being subjected to greater scrutiny and legal challenges by plan members. For example, in *Hinds et al v. Superintendent of Pensions et al* (Colgate-Palmolive Canada Inc.),[11] the Ontario Court of Appeal dismissed an application by a group of former Colgate Pension Plan members for a judicial review of the Superintendent's consent to a transfer of assets from the Javex Division of Bristol-Myers Squibb's Pension Plan to the Colgate Pension Plan. In 1990, Bristol-Myers sold its Javex business to Colgate-Palmolive and proposed to transfer the accrued pension liabilities for the Javex employees from the Bristol-Myers Plan to the Colgate Plan. The transfer application was approved by the Superintendent in 1995 but subsequently challenged by Colgate plan members who were concerned about the negative impact the transfer would have on the surplus accumulated in the Colgate plan. One of the principal questions posed by the appeal was whether the Superintendent had any duty to consider the interests of the members of the "importing" pension plan (the Colgate Plan) before approving the transfer. Specifically, should the Superintendent have required Colgate to give notice of the proposed transfer to the members of the Colgate Plan so that they would be afforded the opportunity to inform the Superintendent of their views on the proposed transfer. The Court of Appeal concluded that the provisions of the PBA which deal with asset transfers in the sale of business context only require the Superintendent to pay strict attention to the pension rights of members of the exporting pension plan (the Bristol-Myers Plan). However, the Court of Appeal opined that the rights of importing plan members would be considered when a request was made for an amendment of the Colgate Plan under s. 26 of the PBA to require the assumption of accrued liabilities transferred from the Bristol-Myers Plan. Pursuant to s. 26(1) of the PBA, the importing plan members receive notice of the proposed adverse amendment and they are able to make submissions concerning it at that time. It is not clear from the decision whether there are any potentially adverse implications for buyers and sellers who transfer pension liabilities on a less than fully funded basis. There is an incomplete aspect of the Court of Appeal decision, in that the transfer of pension assets and liabilities from the Bristol-Myers Plan was approved, and yet the Court of Appeal did not deal with the corresponding amendment of the Colgate Plan to assume these assets and liabilities.

However, in *Micallef et al. vs. Gainers Inc. et al.*[12] , a dispute arose as a result of insufficient pension assets being transferred from the seller's plan to the buyer's plan upon the sale of a

---

[11] (2002), 58 O.R. (3d) 367.

[12] 63 OR (2d) 687.

business. Shortly after the closing of the transaction, the Buyer became insolvent and made an assignment into bankruptcy. Since there was a significant unfunded liability in the buyer's plan, the transferred employees brought an action against the seller for the shortfall directly relating to insufficient asset transfer. The parties eventually settled the case out of court.

The "Value" of Surplus

Surplus is often an illusive and difficult concept to properly value in the context of a purchase and sale agreement. If the buyer assumes the seller's plan or if some of the surplus is transferred to the buyer's plan the seller will want to ensure that it is properly reflected in the purchase price. However, the buyer should be very cautious and conservative when assessing what the proper value is, and whether such surplus can in fact be utilized. When valuing surplus it is important to note that employers will be taxed on the receipt of plan surplus which further diminishes the value of surplus to the employer.

The PBA sets strict and rigid requirements with respect to the withdrawal of surplus by the employer[13]. In the context of an ongoing plan, unanimous consent of plan members is required in order to obtain the consent of the Superintendent to withdraw surplus. On a plan wind-up, surplus cannot be withdrawn without significant consent (usually two-thirds) of members or former members of the plan. As a result of this consent requirement, surplus sharing is quite common and an employer can rarely expect to receive 100% of the surplus. Another significant restriction is the requirement that the plan documents specifically provide for the employer's legal entitlement to withdraw the surplus, notwithstanding the fact that the requisite consents of

---

[13] See sections 78 and 79 of the PBA.

plan members have been obtained. However, it has been the historical practice of FSCO (formerly PCO) to approve surplus sharing arrangements between the employer and plan members where such arrangements have received significant support and approval of the plan members, and the current surplus provisions of the plan text provided for employer ownership despite the fact that past plan documents may have been unclear.

The decision of the Ontario Divisional Court in *Kent vs. TecSyn International Inc.*[14] creates a great amount of uncertainty with respect to the treatment of surplus in Ontario by calling into question FSCO's past practice of consenting to surplus withdrawal notwithstanding that the employer's entitlement might historically have been unclear. The court held that section 79(3)(b) of the PBA requires the plan to provide for payment of surplus to the employer on the windup of the pension plan in both the current and historical documentation. If that requirement is not strictly met, FSCO has no jurisdiction to consider the employer's application and therefore no jurisdiction to grant its consent. Accordingly, the TecSyn decision has effectively resulted in regulatory gridlock by requiring the employer to also establish clear legal entitlement to surplus in the plan document in order to withdraw surplus regardless of the level of consent of plan members.

The seller may argue that even though the buyer may not be permitted to withdraw the surplus, value should be recognized for its use to fund employer contribution requirements in the form of a contribution holiday. However, the buyer must review both the current and historical plan documents and consider whether the documents support the taking of plan contribution holidays. If the seller has utilized contribution holidays but were not supported or authorized under the

---

[14] [2000] OJ No.1826.

terms of the plan document, the value of this potential "asset" for the buyer becomes an immediate liability. The buyer, when determining the proper value for surplus, should also recognize the tax treatment of employer contributions to a registered pension plan under the ITA. For example, employer contributions are tax deductible and therefore the value of any surplus for contribution holidays should be appropriately discounted.

Underfunded Plans

In the event that the pension plan of the seller is underfunded, the buyer will generally negotiate a reduction in the purchase price. To the extent the plan is in a deficit position on a going concern basis, Section 5 of Regulation 909 requires special payments to be made over a maximum period of 15 years to liquidate the liability. If there is a deficit on a solvency basis then the special payments required to liquidate the solvency deficiency must be made over a period not to exceed five years. However, as noted above, employer contributions to a registered pension plan are tax deductible.

In order to prop up an inherited or assumed underfunded plan, the buyer might consider merging the underfunded plan with another pension plan of the buyer that is in a surplus position, provided the incorporating documents support a merger.

Employers have frequently merged pension plans to utilize the surplus in one plan to offset required employer contributions to the underfunded plan. This principle was viewed by observers in the pension industry as settled as a result of the decision of the Ontario Court of Appeal in *Heilig v. Dominion Securities Pitfield*[15] and the Supreme Court of Canada in *Schmidt v.*

---

[15] (1989) 59 D.L.R. (9th) 394

Air Products of Canada Ltd.[16]. In particular, the court in *Heilig* held that there was nothing inherently objectionable about a merger of a pension plan that is in a surplus position with one that is not, even if the assets of the former plan are subject to a trust for the benefit of the members. However, the recent decision of the B.C. Court of Appeal in *Buschau v. Rogers Communications Inc.*[17] has created some uncertainty as to whether this position enunciated by the court in *Heilig* was still the law. In *Buschau*, the court stated that the trust impressed upon the original plan remained intact, notwithstanding that the assets were merged with other funds, and ordered that the employer to separately account for the surplus attributable to the transferred members. The decision created great uncertainty as to what were the implications of the requirement to separately account for the surplus and whether such surplus could be utilized to fund benefits for members other than the transferred members.

The decision of the Ontario Financial Services Tribunal in *National Steel Car*[18] released this past summer appears to indicate that the reasoning of the court in *Heilig* still prevails in Ontario. In concluding that there was nothing inherently objectionable about merging an underfunded plan with a plan that was in surplus, the Tribunal distinguished the *Buschau* decision by finding that the court simply required a separate accounting for the surplus attributable for transferred members in order to preserve their entitlement to surplus on plan termination. Accordingly, although the recent ruling by the Ontario Tribunal is welcome news, there is still some uncertainty in the law since *Buschau* was an appellant decision of the B.C Court of Appeal.

---

[16] [1994] 2 S.C.R. 611

[17] (2001), 59 D.L.R. (4th) 394

[18] The decision of the Financial Services Tribunal was released on May 31, 2002.

Liability for Tax Deferred and other Non-registered Plans

Although complex funding issues are generally restricted to defined benefit plans which therefore require a higher degree of due diligence and analysis, there are other potential risks and hidden liabilities inherent in defined contribution plans that a buyer should be made aware.

In the context of a defined contribution arrangement, an employer may in fact have greater fiduciary obligations and risks than a sponsor of a defined benefit plan. Since the employer is often involved in the essential parts of the investment decision process of the fund, the list of potential complaints by plan members alleging a breach of fiduciary duties resulting in investment losses or perceived insufficient investment gains is quite broad and may include such claims as: the inadequacy of investment choices either selected by the employer or offered to the employee; the failure to provide adequate disclosure and sufficient investment information to the employee in order for the employee to make an informed investment decision; or the employer providing erroneous investment advice to the employee. Such claims will become more common as a result of the decline in market performance and individual investment portfolios.

A buyer may seek to negotiate an indemnity from the seller with respect to pre-purchase administration of the defined contribution plan in order to protect itself from such claims from employees. Other considerations may apply where the buyer decides to move the investments to another funding agent or investment manager. For example, the liquidity of the investments must be considered since some employees may suffer a financial hit if they are required to liquidate a long-term investment prior to maturity.

In addition to dealing with registered pension plans, a buyer may also be confronted with complex issues involving Group RRSPs, DPSPs and SERPs. In the context of an asset purchase transaction, member accounts for Group RRSPs and DPSPs are generally transferable to similar type plans sponsored by the buyer.[19]

Group RRSP and DPSPs

A Group RRSP is essentially a collection of individual contracts under which the employer acts as an agent for the annuitant (employee) for certain purposes such as receiving contributions. Employee contributions are deductible within limits.[20] The employer contribution is technically part of the employee salary which he or she directs the employer to contribute on his or her behalf. The employee then receives a deduction.

Under a share transaction, the buyer may be liable and responsible for any previous commitments by the seller to improve employer contribution rates. In an asset transaction it is important for the buyer to obtain fresh written authorizations from each employee in order to properly deduct contributions from the employee's pay. Without such new authorizations, the buyer may be liable for unauthorized payroll deductions.

A DPSP is an arrangement under which employer contributions are generally calculated as a percentage of profits but can be calculated on another basis as long as they are paid "out of profits". Employee contributions are not permitted in such plans. In an asset purchase transaction, the buyer should confirm whether it has sufficient profits or earnings in order to meet any contribution requirements should it decide to replicate the terms of the seller's DPSP in a plan established by the buyer.

---

[19] The Rules in this regard are set out in Sections 146, 146.3, and 147 of the ITA.

[20] Subsection 146(5) of the ITA.

Supplementary Executive Retirement Plans

Supplemental Executive Retirement Plans ("SERPS) are designed to provide pension benefits in excess of what may be paid from a registered pension plan as a result of the limits imposed by the Income Tax Act, on such plans. SERPS have traditionally been reserved for senior management and executives to provide retirement benefits in excess of those permitted by tax shelter retirement savings vehicles. However, as a result of the income tax restrictions and rising salaries, a number of employers are extending the use of a SERP to their general workforce in order to secure adequate retirement income for their employees.

A SERP is traditionally designed to wrap around the employer's registered plan to augment the income replacement ratio for employees who are affected by the tax limits on registered benefits. For example, its simplest form, a SERP will provide the benefit that would be payable under the registered plan but for the CCRA limits, minus the benefits actually payable under the registered plan.

It is essential for the buyer to determine the existence of SERPS during their due diligence review since the financial obligations on an employer can be quite significant. This task may be complicated by the fact that such arrangements may not be well documented and readily ascertainable, particularly where the SERP is unfunded. However, recent changes to accounting standards now require the employer to set aside a book reserve in their financial statements to indicate the SERP liability. In addition, the buyer should carefully review whether there are any change of control provisions within the SERP that may trigger additional liabilities or require the full funding of the plan.

It is also important for the buyer to identify the funding status for such arrangements. Many SERPs are unfunded and employers utilize a "pay-as-you-go" funding system in which SERP payments are made out of the company's general revenue when they become due. Such unfunded arrangements provide little security or protection for employees should the employer become insolvent. For example, in *Re Confederation Life Insurance Company*[21], executives who were entitled to a top-up pension were treated as unsecured creditors upon the failure of their employer Confederation Life. A SERP can also be funded by transferring cash or other assets to a custodian or trustee to establish a fund to meet the SERP obligations. This arrangement will generally be considered a retirement compensation arrangement ("RCA") under the ITA.[22] Under the RCA tax rules, there is a 50% refundable tax on all contributions made to the arrangement and on any investment income earned in the trust. The refundable tax is refunded to the employer, without interest, when benefits are paid out the plan. SERPs can also be secured through the use of letters of credit or insurance.

Accordingly, the buyer should through the due diligence process, determine the funding status for such arrangements, identify any triggering events that may accelerate SERP obligations or funding requirements, and obtain copies of any contracts, agreements or correspondence which outline the terms and nature of the promise.

The decision of *Emery versus Royal v. Oak Mines* [23] offers a cautionary tale highlighting the significance of corporate disclosure in respect of SERPs in the context of a corporate transaction.

---

[21] (1997), 14 CCPB 1 (Ont. C.A.)

[22] ITA, sections 207.5 and 248.

[23] (1995) 11CCPB 175 (Ontario General Division).

Falconbridge Limited ("Falconbridge") entered into a share purchase agreement with Pamour Inc. ("Pamour") in which Pamour acquired Falconbridge's controlling interest in a subsidiary. Pamour subsequently amalgamated along with a number of companies to create Royal Oak Mines Inc. ("Royal Oak"). Following the transaction but prior to the amalgamation, Mr. Emery, the then de facto Chief Executive Officer of the acquired subsidiary, was terminated. The issue before the court was not whether Mr. Emery was entitled to a supplemental pension benefit but rather which party (Falconbridge or Royal Oak) was responsible for providing this benefit.

The terms of the supplemental pension benefit, which was established pursuant to a letter written on behalf of Falconbridge, provided Mr. Emery with an amount representing the difference between the contractual pension benefit and the maximum amount allowable by CCRA. The court held that the terms of the letter and undertaking were not enforceable against Royal Oak for the following reasons:

(i) the letter did not form part of the benefits package disclosed to Pamour as part of the due diligence exercise;

(ii) the letter was not disclosed to the board of directors of the acquired subsidiary;

(iii) the financial statements of Falconbridge did not include information relating to the supplemental pension benefit;

(iv) the share purchase agreement did not specifically reference supplementary plan and its unfunded obligation; and

(v) Pamour had strongly expressed reservations and caution about accepting any form of unfunded future liability flowing from Falconbridge.

In conclusion, the court held that the supplemental pension benefit was neither addressed nor contemplated by the parties within the context of negotiations of the share purchase agreement. As a result, Falconbridge retained this benefit liability notwithstanding they had sold the business in exchange for the employing question.

Accordingly, the seller should be certain that they make full disclosure of all benefit obligations including supplementary pension benefits to the buyer to avoid being stuck with these commitments.

Change of Control Provisions

The buyer should confirm the existence of any written or verbal promises made by the seller to executives or employees relating to additional compensation to be paid in the event that the company is sold. Change of control provisions may be stand alone promises or may also be added as features of regular benefit programs, and when triggered may result in (i) earlier vesting or entitlement to benefits, (ii) financial obligations to fully fund any unfunded or unsecured benefits; or (iii) benefit improvement or "parachute payments". Change of control provisions are commonly "triggered" upon acquisition of control by a new shareholder or by the sale of a significant portion of the employer's assets. Accordingly, the buyer in both a share or asset purchase transaction should carefully review the seller's pension and benefit programs to determine the existence and impact of any change of control provisions.

Multi-jurisdictional Issues

Identifying potential liability issues are made more complex as a result of significant differences between each province. One case which highlights the differences between provinces is recent decision of the Quebec Court of Appeal in *Canadian Steel Foundries Ltd. c .Hawker Siddeley Canada Inc.*[24] The decision illustrates the perils of assuming that pension transfer arrangements that are acceptable elsewhere in Canada will necessarily work in Quebec as well. The parties to transaction agreed to transfer past service assets and liabilities from the seller's pension plan to the buyer's pension plan. The agreement did not contemplate or contain any provisions dealing with surplus in the plans.. However, there was in fact a significant amount of surplus in the seller's plan relating to the transferred employees. The parties however failed to recognize the unique provisions of the *Quebec Supplemental Pensions Act*[25] that requires the transfer of a pro rata share of surplus as part of the asset transfer application. Accordingly, the court concluded that the seller was responsible for funding the short fall and therefore was required to transfer an additional amount representing a portion of surplus.

Benefit Plan Issues

On a share transaction, the employment relationship for the employees remains virtually unchanged since the buyer assumes any existing employment obligations. However, in an asset purchase transaction, the buyer has some discretion as to the level of benefits, if any, it will provide to the transferred employees. This freedom may be compromised by the existence of a collective agreement which requires that the successor employer provide identical or similar benefits to the transferred employees. In addition, even in the absence of a collective agreement, the seller may require that the buyer hire all of the employees engaged in the business on "substantially similar" or "no less favourable in the aggregate" employment terms currently

---

[24] (2001) 30 CCPB 73.

[25] R.S.Q., c. R-15.1

offered by the seller in order to minimize or avoid claims of wrongful or constructive dismissal, or statutory based claims for termination and severance pay[26].

If a buyer decides to offer similar terms for employment to the transferred employees, there are a number of other considerations that the buyer should consider such as: (i) the compatibility of the buyer's existing benefit programs with those offered by the seller (ii) whether the seller's benefit programs are consistent with the buyer's overall compensation strategy or business philosophy, and (iii) the cost and administrative complexity of implementing such benefits.

In a share transaction, it is important for the buyer to determine how the benefit programs are funded. Generally, benefit programs are either fully insured under an insurance contract with the employer's liability limited to paying premiums. It is quite common for long term disability ("LTD") and group life insurance to be fully insured through an insurance carrier. Alternatively, an employer may decide to self-insure such benefits through an administration services only contract ("ASO") in which the insurance company merely adjudicates claims and acts as the paying agent, and the employer bears the risk and financial obligation to fully fund the entire benefit cost, subject to any "stop-loss" coverage limiting such liability in the event of a catastrophic claim. ASO contracts have become increasingly popular for larger employees who provide medical and dental benefits.

An asset purchase agreement is usually structured so that the transferred employee retain benefit coverage under the seller's plans to the date of closing and thereafter are enrolled in the buyer's plan. Alternatively, the parties may agree for the seller to provide interim or transitional

---

[26] See the *Employment Standards Act,* 2000, S.O. 2000, c.41.

coverage in order to allow the buyer time to establish or modify existing plans. During this interim period, it is common for the buyer to reimburse the seller for the cost of continued coverage. If the plan is fully insured, that cost would simply be the premium. However, if the benefit plan operates on an ASO basis, the cost could be significant and may lead to complications and disputes unless the parties addressed the matter in the agreement.

When dealing with medical and dental claims, the parties generally agree to have the seller responsible under the terms of the seller's plan for claims incurred prior to closing .However, disputes may arise between the parties as to when a claim was "incurred" and therefore should be clarified in the purchase and sale agreement.

In dealing with employees who are on LTD on the closing date, the parties generally agree that the liability and responsibility for such LTD employees remains with the seller. However, the buyer may agree to employ such individuals should they return to full active service within a specified time period. In addition, there may be employees who are on short term disability ("STD") who may never return to work and expect to be switched over to LTD. Obviously, the buyer will be reluctant to take on the potential liability for such employees after closing and therefore may have to negotiate on a case by case basis with the seller the terms in which the buyer is willing to employ the STD employee.

Post Retirement Benefits

Employers frequently provide employees who retire from employment with post–retirement benefits which generally include life insurance and medical/dental coverage. Due to escalating drug costs and cutbacks by governments in coverage under provincial health care plans, the provision of post-retirement benefits is quickly becoming a huge liability for employers. Accordingly, it is important for the buyer to identify the existence of such programs and to calculate the potential liability of providing such coverage. Recent changes to accounting rules now require companies to account for such benefits on an accrual basis on their financial statements. The buyer should also be aware of the potential difficulties of containing such costs. The Supreme Court of Canada in Dayco (Canada) Ltd. v. CAW[27], held that retiree benefits vest at the time of retirement and cannot be reduced or eliminated unless the employer has specifically reserved the right to amend the plans.

Conclusion

Pension and benefits liability issues that arise in the context of the purchase and sale of a business can be quite significant. Accordingly, it is highly recommended that the parties conduct thorough due diligence to assess their potential risks and responsibilities and to turn their attention to such issues at the early stages of the transaction. I have attempted to identify some of the potential liability issues and the options available to parties in dealing with pension and benefit plans in the context of a share or asset purchase. While some risk may be alleviated

---

[27] Dayco (Canada Limited v. The National Automobile, Aerospace and Agriculture Implement Workers Union of Canada, [1993] 2 S.C.R. 230.

through the negotiation of strong representations and warranties and an indemnity, exposure to liability cannot always be completely avoided.