MILLER THOMSON LLP

Barristers & Solicitors, Patent & Trade-Mark Agents

LABOUR AND EMPLOYMENT COMMUNIQUÉ

June 3, 2004

A publication of Miller Thomson LLP's Labour & Employment Practice Group

PENSION FUNDING CHALLENGES

Brent K. Duguid
Toronto
Tel. 416.595.8624
bduguid@millerthomson.ca

One cannot pick up a newspaper without reading about another crisis involving pension plan funding deficits and corporate restructuring. Underfunding of defined benefits ("DB") pension plans in Canada reached $225 billion in 2003 as companies are being forced to contribute billions in additional cash to prop up underfunded plans. For example, a recent study of S & P/TSX companies found that DB plan contributions jumped by close to $2.4 billion last year to $4.5 billion. After years of healthy surpluses that were utilized to subsidize the funding of company contributions or improve benefits, companies are quickly realizing how expensive DB plans can be.

In addition, debilitating pension deficits are also a primary reason why some large Canadian companies like Algoma Steel Inc., Air Canada and most recently Stelco Inc. have sought protection from creditors under the Companies Creditors Arrangement Act ("CCAA").

In the highly publicized saga involving Air Canada, one of the predominate issues in the restructuring was what to do with the estimated solvency deficit of $1.3 billion for the pension plans. Recently, Stelco Inc. filed for CCAA protection with a pension plan deficit of $1.25 billion, more than five time the estimated losses of $225 million for the company in 2003.

While many DB pension plans face massive deficits, pension plan members are generally protected as long as their employer remains solvent. Canadian pension standards legislation prohibits the reduction of accrued pension benefits and the employer usually bears the burden of increased contributions (rather than the plan members) and funding to address shortfalls. In Ontario, members on DB plans have further protection in the form of the Pension Benefit Guarantee Fund ("PBGF"), which is a statutory pension insurance scheme administered by Ontario's Superintendent of Financial Services. The PBGF was designed to protect DB plan members should their plans be wound up with insufficient assets, through a bankruptcy or liquidation. It is funded by a levy on employers. In general, it pays out no more than $1,000 per person in pension benefits. In the Stelco situation, the PBGF would cover approximately $773 million of Stelco's pension liability. Unfortunately, the PBGF has only $222 million in assets and therefore a $500 million contingency for pension deficits was announced by the new Liberal Government at the end of 2003.

Members of multi-employer pension plans ("MEPPs") are not afforded the same protection. Many MEPPs are less securely funded than DB pension plans, partly as a result of ambiguous and unique funding regulations applicable only to MEPPs in jurisdictions like Ontario. It is legally permissible to reduce accrued benefits in a MEPP if there are insufficient assets to provide the promised benefits in most Canadian provinces (except Quebec). However two factors often influence boards of trustees to shelter the problems in MEPPs and postpone the inevitable reduction of benefits that is all but certain to occur. The first is the unfavourable and negative plan member reaction associated with

Note:

This *Communiqué* is provided as an information service and is a summary of current legal issues of concern to the Labour & Employment Industry. *Communiqués* are not meant as legal opinions and readers are cautioned not to act on information provided in this *Communiqué* without seeking specific legal advice with respect to their unique circumstances. Your comments and suggestions are most welcome. Please direct them to: bduguid@millerthomson.ca

reducing previously promised pension benefits. Secondly, participating employers involved with the MEEP are often reluctant to throw in additional cash above the contribution amounts specified in the collective agreement.

The Road Ahead

There are a number of fundamental issues and implications resulting from the spiraling funding crisis:

As the true cost of expensive DB plans become more evident for companies, the trend away from such plans to defined contribution or other capital accumulation plan arrangements will continue. In addition, companies may seek to reduce costs through various plan design changes such as reductions to early retirement incentives, eliminating ad hoc improvements or increased contributions for plan members.

Regulatory changes may be on the horizon, however, in light of the PBGF's funding shortfall, companies should not expect assistance in the form of an across the board relaxing of solvency and funding requirements. Unless the PBGF magically disappears through the implementation of CAPSA's Model Law proposals, companies should expect to see a significant rise in PBGF premiums.

Several influential industry leaders have identified a number of shortcomings involving generally accepted actuarial, accounting and investment principles and practices. Increased transparency will force companies to identify pension fund investment losses and funding deficits in their financial statements on a much more expedited basis. Poor investment returns and stock volatility have some pundits theoretically questioning whether equities are too risky for DB plans and that greater asset diversification in bond related products are required. Companies may be wondering whether they were sold a defective product in implementing a DB plan that was based on an inflated estimated return on assets and other assumptions, and now must ante-up in the form of additional and unanticipated company contributions that have a direct impact on the company's bottom line.

Uncertainty regarding the treatment of surplus may dissuade some companies from contributing too much extra cash if they may not be able to utilize any surplus in the future (see the Monsanto saga).

While effective plan governance and greater diligence in oversight may assist some plan sponsors in tackling the funding crisis, more fundamental changes to the foundation of pension plan design may be necessary.

ABOUT THE AUTHOR:

Brent Duguid is a member of our Labour and Employment Group and leads the pension and benefit practice at Miller Thomson LLP.

Our Labour and Employment Practice Group is dedicated to providing comprehensive and integrated legal services, and advises management in all aspects of labour relations and employment law. For more information about our Group, visit our website at www.millerthomson.com or contact:

Miller Thomson LLP
2500 – 20 Queen Street West
Toronto, ON M5H 3S1

416.595.8500
416.595.8695 (fax)

This newsletter is provided as an information service to our clients and is a summary of current legal issues. These articles are not meant as legal opinions and readers are cautioned not to act on information provided in this newsletter without seeking specific legal advice with respect to their unique circumstances. Miller Thomson LLP uses your contact information to send you information on legal topics that may be of interest to you. It does not share your personal information outside the firm, except with subcontractors who have agreed to abide by its privacy policy and other rules.