

PROTECTING THE PENSION FUND

Report for the Ontario Expert Commission on Pensions

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EXECUTIVE SUMMARY – PROTECTING THE FUND

This Report assesses pension plan funding media and applicable law in Canada, the U.S. and the United Kingdom in order to describe the protection offered to the defined benefit pension fund. It describes the experience or problems with different forms of media and the extent to which each type is used.

Background

The context for the assessment of the protection offered by various media and legal rules is the risk or threats to the promised benefits provided through defined benefit pension plans. The promised benefits are the right to the payment of a specified sum of money for the rest of the employee's life following retirement. The first risk is an insolvency in which the employer will not be able to pay the promised benefit due to insufficient funds. Even if a separate fund has been set aside in the employer's accounts, other creditors will have a greater claim to the employer's assets including the amounts designated to pay pension benefits. Alternatively, when an employer is in financial distress, it can decide to use funds set aside for pension benefits to try to rescue the business. In either circumstance, there will be insufficient funds to pay the promised benefits. Funding media respond to these risks by providing a separate legal entity in which the fund set aside to pay the benefits can be deposited, protecting it from claims by the employer's creditors in an insolvency. These media include a trust fund, an insurance company group annuity contract, an insurance company deposit administration contract or a pension society. They can also protect against the employer using the funds when it is in financial distress if the funds can only be used to provide the promised benefits. They also serve to separate the investment risk to the fund – the risk that the investment of the fund's assets will not generate sufficient returns to pay the benefits – from the financial risks in the employer's business.

Pension funds originated in the realization by employers that the practice of funding the pension benefits from current revenues was generating demands on those revenues that were increasingly difficult to meet as employees aged and life spans increased in the first third of the twentieth century. Pre-funding the promise offered a means to recognize the

cost of the benefit when it was earned, ensure that the burden of providing the benefit was shared equitably between different generations of shareholders and add credibility to a benefit program that offered significant human resource management advantages to the employer.

Regulation Relating to Funding Methods

Income tax regulation offered an immediate deduction from taxable income for both employer and employee contributions to fund a pension plan, together with the opportunity to accumulate tax-free investment income in the fund. Taxes were only payable on the pension benefit received by the employee after retirement. In order to ensure a pension plan fulfilled the public policy purpose of offering these tax benefits by providing retirement income security for older citizens, regulations conditioning eligibility for the tax benefits were developed. The regulations required that legal title to the pension fund assets be transferred to a separate legal entity and that the employer's contributions to the fund be irrevocable. They also did not permit the employer to retroactively revoke the entire pension plan, but permitted the employer to terminate the plan, provided accrued benefits under the plan were fully funded to the date of termination. Thus, income tax regulation aimed at ensuring tax benefits were only being provided for contributions to pension funds that would provide pension benefits also had the effect of protecting pension funds from an employer's financial distress or insolvency.

Pension legislation also adopted the requirement that the fund be held in a separate legal entity. Pension plan regulation has as its goals to increase the protection offered by the private pension system by ensuring adequate funding standards, safeguarding against speculative investments and providing minimum standards for vesting of benefits during the members' working lives. In doing so, it gave plan members legally enforceable claims on the assets of the pension fund for amounts required to fund their benefits and clarified their status as the beneficiaries of the pension fund. However, the claims arising from mandatory vesting do not, in themselves, create a legal claim to pension fund assets in excess of the plan's current liabilities.

Surplus Use and Allocation

With the fund held in a separate legal entity and the legally enforceable claims of plan members for payments of benefits from the funds, the remaining issue arising in respect of funding media is the ownership and use of surplus assets in the pension fund. It is important to differentiate between two different concepts of surplus assets, those in an ongoing plan and those in a plan that has been terminated. In the former case, the surplus assets are an estimate that, if all of the variables concerning future economic trends used by a pension plan actuary in forecasting the future costs of future benefits behave as predicted, not all of the assets in the plan will be needed to pay those future benefits. Of course, a change in any variable will affect this forecast, and a subsequent forecast may find that there is no surplus, or that the plan is actually in a deficit position. The second concept of surplus refers to the calculation made when the pension plan is terminated. Since there will be no future accrual of benefits, there is no need to forecast future pension costs or investment performance, the calculation of the surplus is not an estimate and the existence of the surplus is not contingent on future economic performance.

The distinction between these two concepts of surplus is important in assessing the circumstances in which there is a dispute over the use or ownership of those assets. Except in circumstances in which the plan is terminated, partially terminated or proposed to be terminated, the disputes concerning the use of surplus involve the first concept, surplus assets in an ongoing plan. These include: extraction of surplus by an employer from an ongoing plan; funding contribution holidays; funding benefit improvements; funding deficits in other pension funds sponsored by the employer; and, funding new types of pension benefits. Where a plan is terminated, the issue is who is entitled to share in the surplus available for distribution and whether the plan members and pensioners can terminate a pension plan in order to obtain a distribution of the surplus in the plan.

Surplus in an Ongoing Plan

The problems of the competing claims concerning the legitimate use of excess assets in a pension fund are complex and multi-layered. They involve conflicting views of the implications of the defined benefit pension “bargain”, the allocation of the burdens of the

significant risks in such a bargain, and the proper distribution of the increases in income that can result from an increase in certain risks. Where surplus in an ongoing plan is an issue, the competing claims include the plan sponsor's interests in the continuation of a valuable human resource management benefit plan on a cost effective basis, the plan members interests in receiving the full benefit of past employer contributions as part of their compensation for past services rendered, the need to provide reasonable assurance that accrued benefits will continue to be fully funded, and the concerns of tax authorities about excessive contributions to tax-exempt funds. In balancing these claims both regulation and judicial pronouncements on the nature of a defined benefit plan have played a role, with the emphasis varying by jurisdiction. Except for the extraction of surplus in the U.S. and the use surplus in one plan to fund benefits accrued in another plan in Canada, the use of the trust as a funding medium has not played a significant role in questions about surplus use in an ongoing plan. Instead the role of regulatory requirements is central to the resolution of these issues. For example, in Ontario, any extraction of surplus by an employer from an ongoing plan must meet minimum standards with respect to the funding left in the plan following the withdrawal, and receive the unanimous consent of the plan members, pensioners and beneficiaries.

In the U.S., the pension legislation, ERISA, requires the plan's assets to be held in a trust in which the use of the assets for any purpose other than the provision of benefits to plan members is prohibited while the plan is ongoing. In Canada, where the surplus assets in a pension trust are to be distributed to plan members on termination, courts have held that their use to fund benefits accrued in the past for members of other plans sponsored by the employer is an impermissible revocation of a trust. However, the use of surplus assets to fund employer contribution holidays, either in respect of the original members of the plan, or for new employees whether hired directly or acquired by the employer through mergers with other entities, is permitted in all jurisdictions. Also permitted is the use of surplus to fund employer contribution holidays in respect of new types of pension benefits such as defined contribution pension plans, provided the benefits are being delivered as part of the same plan. Thus, where the regulation is permissive, courts have interpreted broad amending powers in a trust instrument and pension plan as including the power to make amendments accomplish these goals. This interpretation is based

primarily on the courts' views about the private pension system as a voluntary system in which an employer may terminate participation at any time and in which the choice of the benefits to be provided is left to the employer. Although recognizing the interests of employees in receiving the full benefit of past contributions, the courts have held that the retention of control by the employer over prospective benefit design and the utilization of surplus assets to fund benefits does not involve a trespass on the reasonable expectations of plan members in a defined benefit pension plan and recognizes legitimate employer interests in controlling its costs and utilizing the plan as a human resource asset for all of its employees.

Surplus in a Terminated Plan

Where the issue concerns the allocation of surplus assets on plan termination, however, differing considerations may apply. The employer's interests in the continuation of the plan for its benefit are no longer an issue, nor are the interests in controlling its costs and benefit design. The factors often cited as relevant are the employer's having taken the investment risk through its obligation to make additional contributions to fund accrued benefits and the employees' having foregone increased cash compensation for the contributions made by the employer.

The allocation of surplus between plan members and the plan sponsor is not determined by regulation in the U.S., the U.K. or Canada. Instead, each jurisdiction permits payment of this surplus to the plan sponsor, if the sponsor is otherwise entitled to receive the surplus. In Ontario, pension legislation interprets any document that did not expressly provide for surplus distribution to the employer before December 31, 1986 as requiring distribution to plan members. The choice of funding medium plays an important role in Canada with respect to the determination of entitlement. The same choice does not appear to be as determinative in the U.S. and U.K. In Canada, the use of a trust fund is a transfer of all the employer's interest in its pension contributions to the trustees for the benefit of the beneficiaries, unless the trust document permits the employer to revoke the trust. A broad power of amendment is not sufficient to amend the trust to obtain an interest in the surplus on termination after the trust is created. In contrast, if the funding medium is an

insurance contract, a broad power of amendment will enable the plan sponsor to amend the plan to receive surplus on termination.

However, in Ontario entitlement is only the first step. In order for a plan sponsor to obtain surplus on termination, it must obtain the consent of a prescribed percentage of plan members, pensioners and beneficiaries. Other jurisdictions provide for an arbitration of the issue, if a specified percentage of plan members object to a surplus sharing agreement. Thus in Canada, there has been an attempt to encourage a negotiated settlement by requiring consent, but such consent is not mandatory except in Ontario.

In the U.S., the distribution of excess assets to the plan sponsor from a pension trust is not considered be contrary to trust law, because under U.S. trust law, the reservation of a broad power of amendment by the settlor is considered to encompass the power to revoke the trust. In addition, courts interpreting ERISA's provisions have distinguished the distribution of excess assets on termination as a reversion of unused trust assets, not a revocation, and in some cases courts have held that the trust only applies to those assets needed to fully satisfy all liabilities, with any excess assets being returned to the employer on a resulting trust. Under U.S. law, strong, express wording prohibiting a reversion of any assets is required before an amendment permitting that reversion will be found invalid. None of the U.S. decisions appear to turn on the choice of funding medium.

The U.K. cases reviewed all dealt with trust funds. Thus, there was no contrasting treatment to consider. The statutory regime provides for a distribution of surplus to the employer where all plan members benefits have been funded to the statutory maximum permitted. Certainly where the plan specifically prohibits the return of contributions or any amendments that would have the effect of allowing part of the assets to revert to the employer, the courts have held subsequent amendments to allow surplus to be paid to the employer to be invalid. None of the decisions appears to be based on the reasoning that because the contributions are held in trust and there is no express power of revocation, the employer may not receive surplus.

Extent of Use of Different Funding Media and Assessment of Levels of Litigation

Insofar as the use of funding media in different jurisdictions, trusts are the prevalent medium in all three jurisdictions, especially in larger plans. Between 1974 and 2006, the use of trusts in defined benefit pension plans in Canada has increased with the total membership in such plans increasing from 62.7% in 1974 to 76.8% in 2006. Data regarding reported pension dispute decisions in Canada was gathered to try and assess the level of litigation concerning surplus assets in Canada from 1980 – 2007. Once reports of the same dispute in different levels of courts and decisions that did not deal with the merits were eliminated, there were 111 decisions remaining. The percentage of the disputes in which a trust was involved seemed roughly comparable to the percentage of plans in Canada held in trust and there did not appear to be any overrepresentation of trust funds in pension surplus disputes.

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INTRODUCTION

The research mandate for this report requests an assessment of funding media and applicable law in various jurisdictions regarding the protection offered; experience or problems with different forms of media and the extent to which each type is used, if they are used. In order to accomplish this task, the report is divided into several sections. Section A looks at the risks or threats to pension funds that legal rules concerning funding media protect against. Section B analyzes and compares the legal rules in the U.S., Canada and the United Kingdom, including judicial interpretation of those rules, to attempt to assess differing levels of protection offered and to analyze how the various legal regimes treat the purposes and effects of segregation of assets in the pension plan. The issue of surplus distribution on plan termination and the use of surplus in an on-going plan are analyzed in each jurisdiction. An assessment of levels of litigation is attempted by gathering data about surplus use litigation in Canada from 1980 – 2007 and comparing the data as they relate to the overall levels of litigation during the period and any differences in litigation levels for different forms of funding media.

A. Background and Concepts

1. The Role of Funding in A Defined Benefit Pension System

a. Nature of the Pension Promise

Since the Second World War, employer-funded pension plans have become a major source of income stabilization for retired employees. A pension is a promise by an employer that when an employee ceases to work for the employer upon reaching a specified retirement age, that employee will receive regular payments from the employer until the employee dies. Because payment will not be made for years, perhaps decades after the employee begins to work, the promise is vulnerable to a number of developments which may undermine or destroy the value of the promise. Accordingly, various legal instruments have been used to try and increase the value of the promise and decrease the risk that might arise in an unregulated environment. These instruments

include the use of prescribed funding media, statutory requirements for regular contributions and mandatory professional advice in funding design.

Prior to the implementation of comprehensive pension legislation, pension promises were subject to a number of conditions that undermined their value. Paul Harbrecht provides a carefully researched glimpse into the sources of the impetus for modern pension legislation in his review of the private pension system in the United States at the end of the 1950's.¹ There were extremely lengthy vesting periods, the employers had discretion as to whether to terminate the trust and use some other method of funding prior to vesting, pension plan texts permitted employers to terminate or reduce promised benefits, and even pensions that were vested and being paid. In addition, there were few regulatory standards for funding and, as a result, many pension plans' liabilities were not adequately funded.² Employees who sought redress for under-funding of pension promises would be denied standing to raise claims concerning the pension fund because they only had a contingent interest in the fund until they became vested with a right to a pension.³

In Canada, income tax regulation implemented after World War II prohibited revocation of pension benefits once payments had commenced. Eileen Gillese reports that the majority of pension plans were typically funded through insurance contracts between an insurer and the employer. Employers had broad powers of amendment and employees had no legal rights with respect to the insurance contract under privity of contract doctrine, except for the non-revocation of pension benefits after payment commenced.⁴

b. Rationales for Pre-funding the Promise

Many employer-sponsored pension plans in the early years of the twentieth century were structured to pay benefits from current revenues. However, plans began to mature after World War I, with increasing numbers of pensioners and a greater number of active employees nearing retirement age. In these circumstances, it became clear that benefit

¹ Paul P. Harbrecht S.J., *Pension Funds and Economic Power* (New York: The Twentieth Century Fund, 1959) [hereinafter Paul Harbrecht, *Pension Funds*].

² Alicia H. Munnell, "ERISA - The First Decade: Was the Legislation Consistent with Other National Goals"? (1985) 19(1) *Michigan Journal of Law Reform* 51 [hereinafter Alicia Munnell, *ERISA – The First Decade*]

³ Paul Harbrecht, *Pension Funds*, supra, note 1 in Chapter 6.

⁴ Eileen E. Gillese, "Pension Plans and the Law of Trusts" (1996) 75 *Canadian Bar Review* 221 [hereinafter Eileen Gillese, *Pension Plans and Trusts*].

payments were increasing to a level that constituted a significant and growing drain on the employer's cash flow.⁵ Although employers faced no significant legal liability if they terminated an under-funded plan during the 1920's, the uncertainty over the value of the employer's pension promise eroded the rationales for implementation of pension plans by employers. Pension plans were a means of ensuring an employer retained the services of skilled employees, allowed an employer to remove aged employees to make room for more productive employees, and encouraged employees to make human capital investments in increased productivity in order to increase the value of the final pension benefit.⁶ Thus, employers faced the prospect of ever-increasing expenditures that fluctuated inversely with the income of the company and employees faced unacceptable levels of uncertainty about whether they would receive any benefits, let alone the level of benefit provided.

c. Risks Facing Non-segregated Pension Funds

The funding arrangements to deal with these issues evolved over a number of decades and culminated in the present system created by a combination of changes undertaken by employers and increasing regulation of the employer-sponsored pension plan. The funding options developed over time involve different risks to various stakeholders in the business. Jean-Jacques Gollier has provided a summary description of these options and the risks and divided them into internal (funding is internal to the company's books prior to payment of benefits) and external (funding involves payment to an outside agency prior to payment of benefits) mechanisms.⁷

The internal mechanisms include the pay-as-you-go system, outlined briefly above, in which the company pays benefits from its current assets from the point of retirement until death. Gollier points out that such a mechanism is considered very hazardous because: it does not make provision for future financial difficulties in the face of expected increases

⁵ Stephen A. Sass, *The Promise of Private Pensions: The First Hundred Years* (Cambridge: Harvard University Press, 1997) [hereinafter Stephen Sass, *Promise of Private Pensions*] at 56-62.

⁶ *Ibid.* see Chapter 3, "The Logic of Pension Expansion" at 38-55.

⁷ Jean-Jacques Gollier, "Private Pension Systems", in (OECD Working Party on Private Pensions ed) *Private Pension Systems and Policy Issues* 223 (2000) [hereinafter Jean-Jacques Gollier, *Private Pension Systems*] at 232-36.

in costs; shareholder dividends paid early in the scheme are artificially high because the cost of accrued benefits is not carried on the accounts, to the prejudice of future shareholders; and, both retired and current employees will lose everything in a bankruptcy. A second internal mechanism is setting aside reserves in the employer's books to cover the cost of pension benefits accruing as calculated by an actuary. Such a system changes the risks of the pay-as-you-go system as follows: the reserves assist in paying the increased costs when they arise, while still allowing the company to invest the funds in its operations in the (often lengthy) period until payment is required; investment returns on the reserves will be the return earned on the company's operations, but the interest amount credited to the reserve account will be the interest rate used to calculate the cost of the benefits; fairness is restored between generations of shareholders; and, the risk of losing all benefits remains the same for both retired and active employees, as their claims would rank last with other unsecured creditors. Of course, since all of the assets in the reserves are vested in the employer, there is a certain degree of investment risk that the employer will not generate sufficient return to equal the interest rate used to calculate the required amount of reserves, but such an eventuality will merely hasten an employer bankruptcy and need not be dealt with separately in an internal mechanism.

d. Third-party Custody as a Response to the Risks

One common external mechanism is what Gollier calls a self-administered pension fund. It involves transfers of the company's assets to a separate legal entity based on an actuarial calculation of the amounts necessary to fund the pension plan, taking into account the expected income from investment of the fund and the expected level of benefits to be paid. This method provides the advantages of the book reserve method set out above, while providing some protection against bankruptcy risk for retired and current employees. The protection is that because the fund is held by a separate legal entity, it is not subject to the claims by the bankrupt employer's creditors as it would be in an internal funding mechanism. However, such a mechanism does require additional expenses for legal, accounting, actuarial and investment management services.

In addition, the risks arising from the investment performance of the fund are now separate from the performance of the employer's business which can have positive and negative consequences for the security of the benefit. By separating the fund from its own operations, the employer can choose the level of risk to which to expose the assets and thus may earn higher returns on riskier investments over the risk-free rate of return. Of course, riskier investment strategies also carry with them an increased risk of losses and the employer's non-pension assets are available to fund the shortfall, which may raise the issue of fairness between generations of shareholders again. If the company is in financial difficulties at the time that the funding shortfall occurs, the current employees and retirees will face a reduction in their accrued benefits equal to the amount of the shortfall.

The second external mechanism is group insurance of pension benefits provided by an insurance company. In return for the payment by the employer (sometimes aided by contributions deducted from employees' wages) of premiums to the insurance company, the insurance company guarantees payment of the agreed-upon level of benefits to the employees on retirement. This guarantee is conditional on the re-computation of the premiums by the insurer for each year's benefits and the continued willingness of the employer to make those premium payments. All of the investment return risk is assumed by the insurer. The risks of such a mechanism are the potential increases in premiums and the potential that the insurance company will become bankrupt, which will leave current employees and retirees with a reduced or no benefit, depending on the outcomes of the bankruptcy proceeding. In most cases, the employer's obligation will have been fulfilled by entering into the insurance contract, and it will not be liable for any shortfall in the funds of the insurer.

Insurance companies have been offering another pension product known as the deposit administration contract. Under such an arrangement, the insurance company accepts contributions from the employer, invests them in investments and then pays out benefits as designated by the employer. In effect, it is a type of self-administered pension fund, with the insurer acting as the administrator of the separate fund, but offering no guarantee of investment performance or adequacy of the funds available. In such a case, the

employees and retirees will face the same risks as they would under the self-administered pension fund mechanism.

External mechanisms are the prevalent form of funding in the employer-sponsored pension plans in the countries in which particular interest was indicated by the Commission.⁸ This leaves the question, what are the remaining sources of risk in an externally funded defined benefit pension plan? They have been summarized as: default risk where the employer becomes insolvent and plan assets are insufficient; inflation risk, where benefits are calculated without any adjustment for erosion of purchasing power through inflation; and, intergenerational risk, where current members' contributions rise in response to the inadequate funding of current retirees' benefits.⁹

2. Consequences of Adopting Pre-funding and Third Party Custody

The elements of the policy response to bankruptcy (default) risk include: funding requirements to ensure pension assets meet or exceed benefit payments on wind-up; investment restrictions; disclosure requirements to ensure plan members are informed about the funded status of the plan in order to exert pressure on employers to accelerate contributions in the face of under funding; and, government-run termination insurance to protect some of the accrued benefits.¹⁰ In view of the Commission's request for separate reports on insurance against sponsor and plan failure and factors in insolvencies, this report will not be looking at these factors in detail, but only to the extent they impact on the central questions of this report's mandate.

Once pension funds have been insulated from the employer's creditors through their transfer to a third party, the remaining risk that the fund will be inadequate to pay the promised pension benefits arise from the funding policies of the sponsor and the investment policies of the pension fund. The funding policy of the sponsor must provide

⁸ *Ibid.* at 256, Table 5; neither the United States nor the United Kingdom used book reserves as a method of funding employer-sponsored pensions according to 1994 data assembled by Gollier.

⁹ Keith P. Ambachtsheer, *Pension Revolution: A Solution to the Pensions Crisis* (Hoboken: John Wiley & Sons, Inc., 2007) [hereinafter Keith Ambachtsheer, *Pension Revolution*] at 208.

¹⁰ James E. Pesando, "The Containment of Bankruptcy Risk in Private Pension Plans", in (OECD Working Party on Private Pensions ed) *Private Pension Systems and Policy Issues* 337 (2000) [hereinafter James E. Pesando, *Containment of Bankruptcy Risk*] at 338-39.

for contributions to the pension fund that are sufficient, when increases from investments are taken into account, to fund the expected benefit. The investment policy of the fund must be able to consistently meet or exceed the assumed rate of return for investments used in establishing the employer's funding policy. Implicit in both policies is an assumption of a certain degree of risk arising from the necessarily imprecise calculation of future events affecting the cost of benefits and from the choice of investments that will earn higher rates of return than risk-free investments.

Assuming that the Commission has requested reports on the effects of funding and investment policies and regulation of these factors on security of the benefits, this report will concentrate on the protection offered by various forms of funding media and rules relative to their custody of the pension fund. Insofar as the rights and obligations flowing from the differing forms of funding media in Ontario and other jurisdictions, please read below. An important point to make is that for all jurisdictions in which the Commission has expressed a particular interest, the rights and obligations concerning funding and investment policies are determined by legislation and regulation, rather than by the particular type of funding media chosen.

The use of "external funding mechanisms" mandated by the applicable legislation, as set out in the discussion of legal rules below has as its two primary functions the protection of the funds required to pay the pension benefits from the employer in times of financial distress and from the employer's creditors. Some of the types of funding media also involve a transfer of the risk of having to remedy a shortfall in assets available to pay promised benefits from the employer to another entity and thus separating the risk to the pension benefits from the solvency risk of the employer.¹¹

The legal issues surrounding pension funds held in external funding mechanisms concern the beneficial ownership of assets in a pension fund that appear to be in excess of the funds required to provide the promised benefits. The reason that funds may not be conclusively characterized as "excess" is that apparently slight changes in economic circumstances or in the assumptions used in standard actuarial practice can have

¹¹ Jean-Jacques Gollier, *Private Pension Systems*, *supra*, note 7 at 232-33.

exceedingly large adverse impacts on the funded status of on-going pension plans.¹² The risks of treating these plans as having excess assets was highlighted by the fact that a significant number of Canadian pension plan sponsors took contribution holidays (suspending any ongoing contributions to the plan and funding accruing benefits from existing plan assets instead) during the late 1990's and then saw plans become under funded as result of the poor market returns and decreased interest rates in the 2000-2002 period.¹³ From 2000 - 2003, a review of 79 corporations in the TSX large and mid-cap indexes found that the number of over funded plans declined from 57 to 16 and the number of under funded plan went from 22 to 63.¹⁴ However, it is not known whether or not these particular plans had taken contribution holidays prior to 2000. It is important to note that most pension Canadian regulatory schemes only require an actuarial valuation of the funded status of a pension plan be performed every three years.¹⁵

Over the past few years there are signs of recovery amongst pension funds with the Office of the Superintendent of Financial Institutions reporting that the percentage of federally regulated pension plans that were under funded on a solvency basis declined from 78% on December 31, 2005 to 51% on December 31, 2006.¹⁶ In its document "Funding Defined Benefit Pension Plans: Risk-Based Supervision in Ontario", the Financial Services Commission of Ontario (FSCO) reported that the median solvency

¹² One estimate suggests that over the 3 years ending in 2002, the collective financial condition of 68 large Canadian pension plans deteriorated by almost 30% due to a meager 1% per year return on investments and an increase of 10% per year of liabilities due to declines in long-term interest rates - Keith P. Ambachtsheer, 'Cleaning Up the Pension Mess: Why It Will Take More Than Money' (2004) in C.D. Howe Institute Backgrounder No. 78 <http://www.cdhowe.org/pdf/backgrounder_78.pdf> (accessed 28 March 2004) at 2; increases in life expectancy are not being predicted in mortality tables or actuarial ad hoc increases, creating a risk that assets will be insufficient to fund benefits calculated on shorter expected lives Sebastian Schich, 'Corporate Pension Fund Liabilities and Funding Gaps' (2005) 2005(1) *Financial Market Trends* 74-126
<http://masetto.sourceoecd.org/vl=4063441/cl=12/nw=1/rpsv/ij/oecdjournals/0378651x/v2005n1/s4/p74> (accessed 12 September 2007) at 106.

¹³ Jim Armstrong, 'What is the Funding Status of Corporate Defined-Benefit Pension Plans' (2004) 2004(June) *Financial System Review* <<http://www.bankofcanada.ca/en/fsr/index.html>> (accessed 1 October 2007) at 46.

¹⁴ *Ibid.* at 48, Table 1.

¹⁵ However, Quebec has recently enacted amendments to its pension legislation requiring at least a partial annual actuarial valuation which will come into effect on January 1, 2010, Bill 30, *An Act to amend the Supplemental Pension Plans Act, particularly with respect to funding and administration of pension plans*, S.Q. 2006, c. 42, s. 11.

¹⁶ Office of the Superintendent of Financial Institutions (Canada), 'Estimated Solvency Ratios' (2007) in PBSA Update 27 <http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=1847#5> (accessed 28/10/07).

ratio in plans registered in Ontario declined from 0.83 in 2004 to 0.81 in 2005. Again it is important to realize that for plans on a three year valuation cycle, the 2005 valuation represents the results from the 2002-05 period. FSCO was projecting an improvement in the median solvency ratio to 0.90 by December 31, 2006. FSCO reported that although returns on investments were strong in 2005, they were more than offset by continuing decline in long term bond yield rates and a decrease in the Canadian Institute of Actuaries interest rates for computing transfer values which increased the value of the liabilities in the plan. The sensitivity of pension arrangements to changes in economic factors affecting their valuation over relatively short period of time indicates that caution must be exercised in characterizing assets in the on-going plan as excess.

a. Assuring the Assuring the Appropriate Flow of Contributions

There are conflicting policy elements at work in pension funding regulation. In order to guard against under funding and provide maximum security for the promised benefits, pension policy makers might wish to design funding requirement that require or at least permit over funding to occur in order to avoid a plan termination while a plan was not fully funded. However, since pension plan contributions and investment income usually enjoy tax preferences, tax policy will want to restrict the use of these preferences by limiting over funding or seeking to eliminate it.¹⁷ As will be discussed in the sections dealing with the legal rules affecting funding, these differing policy concerns have led to pension regulation of minimum funding requirements, and tax regulation imposing maximum funding limits.

b. Funding Media

Trust

The trust is a method of transferring legal title to assets from the original owner (“the settlor”) to another (the “trustee”), for the benefit of a third party (the “beneficiary”). In order to create a trust, the settlor must manifest the intention to transfer the assets to the

¹⁷ Jean-Jacques Gollier, *Private Pension Systems*, *supra* note 7 at 339; C Pugh, 'Funding Rules and Actuarial Methods' (2006) *OECD Working Papers on Insurance and Private Pensions* (accessed 12/07/07) <doi:10.1787/274307371724> at 6.

trustee to be held for the benefit of a third party and the trustee must accept the property on those conditions. The identity of the property and the beneficiaries must be ascertainable. In Canada, transfer of the assets from the settlor to the trustee is presumptively irrevocable, unless the settlor has expressly reserved the right to revoke the trust and have the assets returned. The meaning of irrevocability in the context of a pension trust is one of the many aspects of trust law that have variable impacts across jurisdictions. However, a settlor may also be a beneficiary of a trust, but will not have any greater rights than other beneficiaries only by reason of having been the settlor.

Once the assets subject to the trust have been transferred to the trustee, they are held for the exclusive benefit of the beneficiaries pursuant to the terms of the trust. A trustee is legally obligated to carry out the terms of the trust and owes a duty of loyalty to the beneficiaries and a duty of care in carrying out the trusts.

Certain trusts are established for purposes, rather than individuals or groups of individuals. Only trusts established for charitable purposes will be treated as valid trusts. In addition, it is possible that the trust may not be able to be carried out either because there are additional assets that were not assigned to any beneficiaries or the beneficiaries no longer exist. In such circumstances, the assets will be returned to the settlor pursuant to the doctrine of a resulting trust in which the presumption is that the settlor implicitly intended that result when the transfer to the trustee occurred.

Insured Benefit

In this funding method, an employer enters into a contract with an insurer in which the insurer agrees to provide defined benefits to the employer's employees in return for the payment of certain premiums. These premiums can be funded by employer contributions alone or by both employer and employee contributions. The premium payments are then invested by the insurer along with its other funds, and the benefits are paid by the insurer from its own assets when they become due.

In this arrangement, the insurer bears the investment risk and the employee bears the insolvency risk of the insurer. The issue of excess assets does not arise in such an

arrangement unless the contract is one that allows the insurer's client to participate in favourable investment returns and/or experience that exceeds the actuarial assumptions used by the insurer in calculating the premiums, after allowing a margin for adverse circumstances.

Contracts may have their terms changed by agreement of the parties, subject to barriers to retroactive erosion of promised benefits when those benefits have vested – become legally enforceable claims – in any third party beneficiaries. Contracts can certainly be amended prospectively to affect future benefits.

Insurer as custodian/administrator

This form of insurance contract arose in response to the declining use of the fully insured group annuity form due to the availability of more flexible funding assumptions from pension actuaries advising self-administered pension funds. Pension actuaries were able to set funding targets that would allow lower current contributions for employers wishing to expand or higher current contributions where tax minimization was a consideration. In addition, the insurance industry used rates of return based on portfolios of fixed income securities, rather than equity returns, to set their premium rates.¹⁸

Insurance companies developed products in which the amounts contributed by the employer would be held and invested in accounts separate from the insurer's accounts used to fund its fully insured products. These separate accounts could be invested in equity or any other form of investment, with the employer, not the insurer, bearing the investment risk. If the separate account assets proved insufficient to fully fund the benefits, the employer or, if the employer was insolvent, the employees would bear that risk.¹⁹

This type of funding method has the same potential for apparent excess assets as the trust. Employers can choose the actuarial and investment return assumptions they wish and any positive deviation will generate an excess of assets over liabilities in the next actuarial

¹⁸ Stephen Sass, *Promise of Private Pensions*, *supra* note 5 at 161-64.

¹⁹ *Ibid.* at 164-68.

report. These types of plans would be subject to the same constraints on amendments as those described for fully insured pension contracts above.

Pension society

A pension society is a not-for-profit corporation to which pension contributions are paid. The corporation is then responsible for investment of the assets and payment of the benefits to pension plan members. There are typically no restraints on the investment policies of such a corporation and the only legal restriction on the use of the assets (aside from those imposed by pension legislation and income tax rules) is that the corporation be carried on without pecuniary gain for its members.

Government annuity

This funding mechanism was provided by the government of Canada. An employer could purchase a life annuity by paying the premium set by the government. Once the premium was paid, the annuity belonged to the employee, and therefore was immediately vested, even if the employee subsequently left the employer's service. This pension funding method enjoyed some popularity during the period from 1938 to 1948 due to very favourable interest rates in comparison to annuities purchased from private insurance companies. The government revised its interest rates in 1948 to reflect those prevalent in the insurance industry and over the next few decades the premium rates for government annuities became uncompetitive with those offered by insurers. In 1975 legislation ended the right to enter into any new annuity contracts.²⁰

c. Issues Leading to Litigation – Ownership and Use of Pension

Assets

Once the external funding mechanism is in place, what rights do the plan sponsor and the plan members have concerning the use of those assets? The answers to these questions

²⁰ Hart D. Clark, "The Development of the Retirement Income System in Canada", in (Task Force on Retirement Income Policy ed) *The Retirement Income System in Canada: Problems and Alternative Policies for Reform - Volume II (Appendices) Report of the Task Force on Retirement Income Policy to the Government of Canada* (1980) [hereinafter Hart D. Clark, *Retirement Income System Development*] at 1-2 – 1-3.

involve a complex analysis of the application of concepts from the law of employment, contract, trusts, equity, income tax and pension regulation. In this analysis decision-makers are invited to consider important public policy issues and the nature of the pension “bargain”.

Extraction by Sponsor

The plan sponsor may seek to recover those assets that exceed the value of the plan’s current or projected liabilities on the grounds that they constitute an overpayment by the sponsor of its obligation to provide the promised benefit to the plan members. An additional rationale for the claim to excess assets is the argument that such a claim is justified by the symmetrical obligation to make additional contributions to extinguish any funding deficit that can arise from the same factors that may create a surplus.²¹ These rationales can be contrasted with the rationale that employer contributions are deferred wages and that the bargain with the employer is over the cost of the promised benefit (calculated by the actuary) which forms part of the entire compensation package provided in return for the employee’s services.²² Indeed, the degree to which the ultimate cost of additional contributions or funding shortfalls is borne by an employer is called into question by evidence that there is a reduction in cash compensation when an employer is making additional contributions.²³ In addition, the burden of funding shortfalls is ultimately borne by plan members where the employer is insolvent and their benefits are reduced. However, as will be discussed below, the legal basis on which surplus claims are determined does not turn on acceptance of either rationale, but rather on the legal characterization of the funding media adopted for a particular plan.

Funding Contribution Holidays

²¹ The Association of Canadian Pension Management, 'Back From the Brink: Securing the Future of Defined Benefit Plans' (2005) <<http://www.acpm.com/docs/ACFD2B.pdf>> (accessed 15/09/07) at 9-11.

²² ²² Bernard Adell, "Pension Plan Surpluses and the Law: Finding a Path for Reform", in *Task Force on Inflation Protection for Employment Pension Plans Research Studies Volume 2* 211 (1988) [hereinafter Bernard Adell, *Path for Reform*] at 235-38.

²³ Douglas E. Hyatt and James E. Pesando, "The Distribution of Investment Risk in Defined Benefit Plans" (1996) 51(1) *Relations Industrielles* 136.

One of the obligations of plan sponsors under pension legislation is to make required contributions to the plan on a regular basis. In a defined benefit plan where the actuary has calculated that the plan's assets exceed the liabilities, actuarial practice and regulation permits the actuary to take the existence of excess assets into account in determining what contributions an employer must make to fund the normal cost of benefits accruing and of any special payments to extinguish past deficits.²⁴ This may mean that an actuary may determine that no further contributions are required to pay for these costs until the plan's assets no longer exceed its liabilities and the employer is relieved of its contribution obligations. Plan members may object on the grounds that their interests in the excess assets both as a means of providing security against economic shocks or employer insolvency and as assets purchased with their deferred wages is being eroded by this practice crediting them to extinguish the employer's obligation.

Funding Benefit Improvements from Surplus

Another issue which may be the source of litigation regarding the use of excess assets in the pension fund is their use to improve the benefits of some, but not all plan members and beneficiaries. This controversy may arise when a plan sponsor improves benefits for active employees or creates early retirement incentives such as pensions with more generous benefits over those previously provided for those retiring prior to the mandatory age of retirement. If the employer allocates excess funds already in the plan to fund the resulting increase in pension costs rather than increasing its contributions, plan members who did not benefit may object on the grounds that surplus is being used to inequitably benefit certain members and to further the employer's human resources management goals, rather than being equitably allocated for the benefit of all of the plan's members.

Funding Other Pension Funds Administered by Sponsor

Employers may be the plan sponsor of a number of different pension funds and plans that cover different classifications of their employees. Typically an employer may have one plan for its hourly paid employees and another for its salaried employees. Or an employer

²⁴ In Ontario, this practice is permitted under the regulations concerning the calculation of funding requirements, see text accompanying note 52, *infra*.

may have acquired a plan previously sponsored by another employer as a result of a merger or acquisition involving that other employer. If one or more plans have excess assets and others have a deficit in their funding, the employer may try to merge or amalgamate the plan's funds into a single fund covering all of the different employees and pensioners in its plans. To the extent that assets from one fund are to be used for the benefits of members of another fund, the members may object on the grounds that the assets in their fund are held for their benefit and the use of the funds to extinguish the employer's liability to fully fund the accrued benefits of another group of employees is illegitimate.

Funding "New" Types of Pension Benefits by Sponsor

An employer may decide to close a defined benefit plan to new entrants and offer new employees a pension plan with different, less costly benefits such as a defined contribution plan or a cash-balance plan. The issue arises whether any excess assets arising from the defined benefit plan can be used to fund the employer's obligations to contribute to the "new" plan.

Extraction by Plan Beneficiaries

This issue concerns the degree to which plan members can obtain access to the plan excess assets while the plan is ongoing. There are two components, both of which involve a wind-up of the plan. In the first component a plan has undergone a "partial wind-up" in which a significant number of plan members have been terminated from their employment. Plan members can have the assets representing the present value of their future pension benefits transferred to another pension plan or a registered retirement savings vehicle. They can also leave the assets in the sponsor's plan until they are eligible for a pension benefit. If there are any excess assets in the fund at the time of the partial wind-up, terminated plan members claim a payment of their proportion of the excess assets.

Secondly, where a plan is held in trust, trust law permits all of the trust's beneficiaries, if they are adults and capable of giving consent, to call on the trustee to deliver the trust

property to the beneficiaries, even where the terms of the trust call for some delay in the distribution of the property. This rule known as the Rule in *Saunders v. Vauthier*, and plan members, especially in a plan closed to new membership may wish to try to use the rule to terminate an on-going plan which has excess assets and few active members.

The problems of the competing claims concerning the legitimate use of excess assets in a pension fund are complex and multi-layered. They involve conflicting views of the implications of the defined benefit pension “bargain”, the allocation of the burdens of the significant risks in such a bargain, and the proper distribution of the increases in income that can result from an increase in certain risks.

B. Comparison of Legal Rules

1. Legal Rules Concerning Funding

The legal rules concerning funding cover a range of issues, including setting out the permissible types of funding media, adequacy of funding, ensuring timely transfer of contributions into the fund, imposing fiduciary and other duties on those controlling the fund, and regulating transfers of assets out of the fund. This section of the report concentrates on describing and comparing the sources of the rules regarding funding media rights and obligations. Both tax and pension regulations serve as sources of these rules.

a. The Intersection of Tax and Pension Regulation

Historically, in North America pension plans were originally regulated by the tax authorities as a result of changes to the taxation regime that gave such plans a tax preferred status.²⁵

²⁵ In Canada, employer contributions were exempted from income tax in 1919 and in 1928 pension trustees could elect to make their funds exempt from taxation and thus exempt employee contributions from taxation, in 1936 employer contributions were limited to \$300 per employee per year up to a maximum of 5% of payroll - Desmond Morton and Margaret E. McCallum, "Superannuation to Indexation: Employment Pensions in the Public and Private Section 1870 - 1970", in *Task Force on Inflation Protection for Employment Pension Plans Research Studies Volume 1 3* (1988) [hereinafter Desmond Morton and Margaret E. McCallum, *Employment Pensions*] at 17. In the U.S., pension payments and deferred annuity premiums were deductible as ordinary business expenses since income tax was introduced in 1913,

i. The U.S.

During the New Deal, additional U.S. tax regulation was initiated in the face of evidence that pension plans were being created to allow highly paid executives to avoid the new, higher levels of taxation on high-income earners and concerns that revocable pension arrangements would allow employers to recoup assets that had been permitted to accumulate tax-free.²⁶ Thus, by 1942 in the U.S. tax legislation had developed the fundamental shape of funding media for private pension plans. The funds had to be in the hands of an insurance company or an irrevocable trust for the exclusive benefit of a substantial majority of the employees and yearly contributions equal to the actuarially determined “normal cost” of the benefits accrued each year were required. The statutory language of irrevocability – that it be “impossible, prior to the satisfaction of all liabilities ... for any part of the [fund assets] to be used for or diverted to purposes other than the exclusive benefit of the employees” - permitted the employer to recover excess assets on termination of the plan.²⁷

The issue of the amount of tax expenditure applicable to employer-sponsored pension plans in the United States led to several taxation provisions which restricted the funding of the plans. First, in 1987, a new maximum funding formula based on the current accrued benefits, rather than the estimated liability of pension benefits was adopted, preventing employers from funding benefits based on expected salary increases for younger workers.²⁸ The new maximum meant that for plans with younger workers and few retirees, their maximum permitted funding was lower than an actuarial calculation of

contributions to pension funds separate from a corporation’s assets were deductible in 1918, and in 1921 assets in pension trusts established for the exclusive benefit of “some or all employees” were exempted from taxation Stephen Sass, *Promise of Private Pensions*, *supra*, note 5 at 102.

²⁶ These changes included: requiring irrevocability of pension trusts and restricting tax favoured status to funds placed in trusts or with insurance companies (1938); requiring plans include substantially all employees, requiring immediate funding of each year’s pension costs calculated using standard actuarial methods, and, and limiting the tax-free portion of contributions to extinguish past service liability to 10% of the total liability per year (1942) Stephen Sass, *Promise of Private Pensions*, *supra* note 5 at 104-109} and note 29, Chapter 5.

²⁷ Norman P. Stein, "Raiders of the Corporate Pension Plan: The Reversion of Excess Plan Assets to the Employer" (1986) 5 *American Journal of Tax Policy* 117 [hereinafter Norman Stein, *Raiders*] at 143-46.

²⁸ Sylvester J. Schieber, "The Evolution and Implications of Federal Pension Regulation", in (William G. Gale, John B. Shoven and Mark J. Warshawsky eds) *The Evolving Pension System: Trends, Effects and Proposals for Reform* 11 (2005) [hereinafter Sylvester J. Schieber, *Federal Pension Regulation*] at 33, referring to changes initiated in the Omnibus Budget Reconciliation Act of 1987.

the funding using projected salary increases, with a significant and growing disparity between the two calculations until workers reached age 55 and became eligible for retirement benefits. This meant that many employers found themselves with excess funding due to the new limits and had to take contribution holidays.²⁹ Funding levels of all plans in the U.S. did drop from 1987 to 1997, with at least one author suggesting that the funding limits and the limits on employers' access to excess assets both played a role.³⁰

During the 1980s the high interest rate, high stock market returns reduced the projected costs of future liabilities while increasing the value of pension plan assets. This environment created the perception that plans had excess assets and led some executives to try to use those assets for corporate finance, rather than borrowing at high interest rates. Some employers terminated their plans to obtain reversion of the excess assets, while others split plans between active and retired plan members, funding the active plan with the minimum required funding, purchasing annuities for the retired members and terminating that plan to obtain the excess assets.³¹ Between 1980 and 1985, 785 U.S. plans terminated and the sponsors obtained more than \$8 billion in surplus from these plans.³² In 1983, the U.S. IRS established guidelines for terminations and reversions of assets to employers requiring the purchase of annuities for all benefits and permitting reestablishment of plans after a reversion. Beginning in 1986, the Tax Code was amended to impose a 10 percent excise tax on the reversions. This tax was increased to 15 percent and finally, in 1990, to 50 percent (in addition to corporate income tax).³³

ii. Canada

²⁹ *Ibid.* at 38-40

³⁰ *Ibid.* at 42 – 43; the median funding ratios for all plans declined from 1.45 to 1.23 in this period.

³¹ *Ibid.* at 38-40.

³² Norman Stein, *Raiders*, *supra* note 27

³³ Richard A. Ippolito, "Comment on Clark and Schieber the Transition to Hybrid Pension Plans in the United States", in (William G. Gale, John B. Shoven and Mark J. Warshawsky eds) *Private Pensions and Public Policies* 43 (2004) [hereinafter Richard A. Ippolito, *Comment*]; the 50 percent tax is reduced to 20 percent in three situations: bankruptcy, transfer of employees to a replacement plan covering at least 95 percent of original plan members, or a pro rata increase in benefits for plan members of at least 20 percent of the reversion amount. When combined with corporate tax it amounts to 85 percent of the surplus.

The history of Canadian pension regulation begins with the Income War Tax Act, enacted in 1917. It was amended in 1919 to allow employee contributions to a pension fund or plan that were deducted by an employer to be free from taxation. The maximum amount of deductible contributions was \$300 per employer per year³⁴ Employer contributions were made deductible in 1941 amendments and in 1942, deductibility of both employer and employee contributions was made conditional on the pension plan being approved by the Minister of National Revenue.³⁵ Rules for such approvals were published by the Minister in 1947 and contained provisions concerning plan design, including “non-discrimination, coverage, vested rights of terminating members and the quality of investments”.³⁶ Between 1947 and 1959, when the vast majority of pension plans were created or registered, these rules also required that a pension plan trust had to provide for the distribution of any surplus to increase the benefits of employees on an equitable basis and there should be no reversion of assets to the employer.³⁷ One result of this requirement was that “executive” pension plans were funded using very conservative actuarial interest rate assumptions and the inevitable surplus would then be distributed to the executives in excess of the permitted limits for accumulation of tax-free pension benefits. Beginning in the 1970’s, Revenue Canada required new plans seeking registration contain a provision that any surplus in excess of the permitted benefits had to be paid to the employer in order to maintain their registered status.

Canadian tax regulation utilizes the power of the Minister to approve a pension plan for registration to impose non-legislated requirements as a condition of registration. Current registration requirements are contained in a Canada Customs and Revenue Information Circular. The Information Circular contains a number of provisions applicable to the funding of a registered pension plan. These include:

³⁴ Hart D. Clark, *Retirement Income System Development*, *supra* note 20 at 1-3.

³⁵ *Ibid.* at 1-4

³⁶ *Ibid.* at 1-4

³⁷ Donovan Waters, "The Use of Surpluses in Pension Plans Operating in Ontario", in *Task Force on Inflation Protection for Employment Pension Plans Research Studies Volume 2* 135 (1988) [hereinafter Donovan Waters, *Ontario Pension Surpluses*] at 147.

- a plan may only be funded by an insurance contract, a trust, a pension corporation, an arrangement administered by the federal or provincial government, or a combination of these methods;³⁸
- a plan funded by individual insurance contracts must provide for the contracts to be held in trust by at least two trustees or a corporate trustee;³⁹
- if the funding arrangement is a segregated fund or deposit administration contract with an insurance company, then in order to qualify as an insurance contract for registration, it must prohibit payment of any funds to an employer or non-participant except for return of surplus and payment of administrative costs, failing which it must be a trusteed plan;⁴⁰
- a maximum contribution and maximum benefit formula;⁴¹
- a prohibition on the payment of surplus to plan members on termination **if** such a payment would result in benefits to the member exceeding the maximum benefits permitted in the circular, and therefore the plan must contain language permitting a return of surplus to the employer on termination;⁴²

As one earlier commentator noted, federal taxation power over retirement saving has two goals: to encourage retirement savings on a financially sound basis through tax expenditure; and, to place restrictions on the amount of the expenditure for reasons of fiscal prudence and vertical equity.⁴³ The concern over ensuring that tax deferral does not exceed the limits extends to both terminated pension plans, above, and to on-going plans. The Information Circular declares that “excess surplus” exists when the actuarial valuation of the plan indicates that the plan is funded beyond the amount needed to fund 2 years current service costs. The employer must reduce this excess surplus through one

³⁸ *Employees' Pension Plans*, IC 72-13R8 (Revenue Canada 4/10, 2003), subsection 6(e).

³⁹ *Loc. cit.*

⁴⁰ *Ibid.* subsection 6 (f)

⁴¹ *Ibid.* subsections 9(g) and (g.1)

⁴² *Ibid.* section 13.1.

⁴³ Robert Couzin, "Income Taxation and Retirement Savings", in *Task Force on Inflation Protection for Employment Pension Plans Research Studies Volume 1* 353 (1988) [hereinafter Robert Couzin, *Income Tax and Retirement Savings*] at 353-54.

or combination of: a refund to the employer; applying the excess to fund current and future pension costs; and/or an increase in benefits provided under the plan.⁴⁴

Thus, a review of the history of the regulation of pension plan funding through tax legislation shows a progression of differing policy concerns coinciding with the growth in the size and scope of employer-sponsored pension funds from a few, scattered benefit plans to the massive storehouses of capital accumulating tax-free that exist today. Early regulation focused on ensuring that the social policy behind the tax exemption – provision of genuine employee benefits to ameliorate poverty and destitution amongst the aged unemployed – was actually being put into practice by addressing issues such as vesting of benefits, irrevocability of contributions and prohibitions on recovery. Later regulation, while still concerned to ensure exemption for taxation was confined to a genuine pension plan, was more focused on ensuring that tax expenditures on pension funds were confined within the limits provided by the legislation as reflected in the Canadian provisions dealing with surplus distribution in terminated plans and surplus accumulation in ongoing plans. It should also be noted that in both the U.S. and Canada, other legislation specifically regulating pension plans, including their funding, had been implemented between 1965 and 1976. Thus, tax legislation no longer was the sole regulatory instrument affecting pension plan funding.

b. Canada – Pension Regulation

The regulatory scheme for employer-sponsored pensions in Canada is bound up with our federal constitution. Taxation matters are the subject of exclusive federal legislative competence and matters concerning employment are matters of property and civil rights which are within the exclusive legislative competence of the provincial governments. Indeed the Department of Revenue withdrew some of its more substantive early regulation of pension plan design in partial response to objections that pension plan design and the social policy objectives of such plans were more properly the subject of provincial regulation.⁴⁵

⁴⁴ *Employees' Pension Plans*, IC 72-13R8, *supra* note 38 section 39.

⁴⁵ Hart D. Clark, *Retirement Income System Development*, *supra*, note 34 at 1-5.

i. Ontario

Ontario's Pension Benefits Act ("PBA") was introduced in 1963.⁴⁶ It contains detailed provisions concerning the content of pension plans, minimum funding requirements, vesting of benefits, portability for vested benefits and termination of plans. It creates a regulator, the Superintendent of Pensions, and a regulatory body, the Financial Services Commission of Ontario (formerly the Pension Commission of Ontario). It must be read in the context of the rules regarding funding mechanisms already in place under the federal *Income Tax Act* and requirements for registration.

The PBA funding mechanism provisions begin with a requirement that the application for registration of a pension plan must include the mechanism for establishing and maintaining the pension fund.⁴⁷ The PBA only permits prescribed persons to be the trustees of a pension fund and in the applicable regulation limits the classes of those who may administer pension funds (in distinction from administering pension plans) to a government, an insurance company, a trust, funds administered under the federal *Government Annuities Act*, and/or any body assigned such a responsibility pursuant to a statute.⁴⁸ Thus, although an employer may be the administrator of the pension plan under the PBA, they cannot administer the pension fund.

The Act deals with the issue of a plan sponsor's access to pension fund assets in two different sections. One section prohibits any payments out of a pension fund to the employer without the consent of the Superintendent and requires an employer seeking payment out of surplus to give notice of the application to plan members, former members, beneficiaries and any trade union representing the members. Those receiving notice are entitled to make written representations to the Superintendent, and the Superintendent's decision is subject to a right of appeal to the Financial Services Tribunal and then to the Divisional Court.⁴⁹ An exception is provided for application for the return

⁴⁶ *Pension Benefits Act*, R.S.O. 1990, c. P.8 [hereinafter PBA, Ontario]

⁴⁷ *Ibid.* ss. 10(1) 10.

⁴⁸ *Ibid.* ss. 22(6) and Pension Benefits Act Regulation, R.R.O. 1990, Reg. 909 [hereinafter PBA Reg. Ontario], s. 54.

⁴⁹ PBA, Ontario s. 78.

of overpayments or reimbursement of sums paid by the employer that ought to have been paid by the fund that are made within a year of the payments.

The Superintendent may not consent to any surplus withdrawal by the employer unless reports show there is a surplus, the plan provides for the withdrawal of surplus by the employer or the Superintendent is otherwise satisfied the employer is entitled to withdraw surplus and the plan and employer comply with all other prescribed requirements for a surplus withdrawal.⁵⁰ In the case of a withdrawal from a continuing plan, there is an additional requirement that a specified amount of surplus be retained in the fund. In addition, there are provisions that require pension plans that do not provide for withdrawal of surplus to be construed as prohibiting withdrawal from a continuing plan and providing for distribution of that surplus amongst members, former members and beneficiaries on the wind-up of the plan.⁵¹

The remaining prescriptions concerning surplus utilization and withdrawals are in the provisions of the General Regulation under the PBA. It permits an employer to use actuarial gain to reduce contributions to the plan.⁵² The employer is also permitted to use surplus arising from a conversion of a defined benefit plan to a defined contribution plan to fund its contributions to the defined contribution plan.⁵³ However, any payment to an employer from surplus assets in a pension plan requires the consent of a specified percentage of the plan members, former members and beneficiaries in the case of a plan wind-up and unanimous consent in the case of an on-going plan.⁵⁴ The effect of these regulations and the requirement in the PBA to comply with all prescribed conditions is that employers wishing to withdraw surplus must come to an agreement with the plan's members, former members and beneficiaries concerning the distribution of surplus. The regulations requiring consent came into force in 1991 and were time limited. However, their regulatory life has been extended several times and they are now due to expire on December 31, 2009.

⁵⁰ *Ibid.* s. 79.

⁵¹ *Ibid.* ss. 79(2) & (4).

⁵² PBA Reg. Ontario s. 7(3).

⁵³ *Ibid.* s. 9

⁵⁴ *Ibid.* ss. 8 & 10.

ii. Other Canadian Jurisdictions

(a) Quebec

Quebec's Supplemental Pension Plans Act requires that every pension plan except for an insured plan have a pension fund constituted as a trust patrimony "appropriated mainly to the payment of the refunds and pension benefits to which the members and beneficiaries are entitled".⁵⁵ It nullifies any amendments to plans regarding the allocation of surplus on termination that are made after November 15, 1988 and requires an employer either reach an agreement with plan members and/or their representatives on the allocation of surplus. If 30% of the plan members and beneficiaries object to the plan the employer must submit the allocation decision to binding arbitration.⁵⁶ With respect to the use of surplus assets by the employer to take contribution holidays while the plan is on-going there are two separate regimes applicable to determining the issue. For all pension plans that came into existence after December 31, 2000 any use of surplus must be set out in the provisions of the plan.⁵⁷ For plans in existence as of that date, the employer has the option of obtaining consent for an amendment to the plan permitting contribution holidays from affected plan members and their representatives and the effect of such an amendment will be to preclude any legal proceedings challenging the legality of the contribution holidays.⁵⁸ If the employer does not exercise the confirmation amendment option, then the issue will be determined before the courts, if a contribution holiday is challenged by a plan member.

(b) Federal

⁵⁵ Supplemental Pension Plans Act, R.S.Q. c. R-15.1 [hereinafter SPPA, Quebec], s. 6.

⁵⁶ Regie des rentes du Quebec, 'Draft Agreement' (2006) in Allocation of Surplus <http://www.rrq.gouv.qc.ca/en/administrateur/terminer_regime/attribution_excedent_actif/projet_entente.htm> (accessed 29/10/07).

⁵⁷ SPPA, Quebec, s. 14, para. 17; though the percentages are similar to those in Ontario the assignment of the onus to object to plan members and beneficiaries has quite different implications than the onus on the employer in Ontario to obtain consent with the latter having the potential of being a much more expensive and time consuming process than the former.

⁵⁸ Regie des rentes du Quebec, 'Confirmation of an Employer's Right to Take a Contribution Holiday' (2005) *Supplemental Pension Plans Newsletter* <<http://www.rrq.gouv.qc.ca/NR/rdonlyres/DBB3E4C1-4BC0-418B-AE03-C18FE9682763/0/newsletter18.pdf>> (accessed 29/10/07); SPPA, Quebec s. 146.4 – 146.9.

Federal works and undertakings and other enterprises whose employment law falls under the legislative power of Parliament are subject to the Pension Benefits Standards Act if an employer provides a pension plan for its employees. It requires no particular type of funding mechanism and permits the employer to be the administrator of the pension fund.⁵⁹ The Act permits a refund of surplus assets to an employer, subject to the consent of the Superintendent of Financial Institutions, where the employer has an entitlement or a “claim” to the surplus or a part of it. An employer establishes a claim by obtaining consent to its proposed refund from at least two-thirds of members and former members of the plan as well as other prescribed persons. Where more than one-half but less than two-thirds of the members of these classes consent, the employer may, or in the case of a plan termination, must submit the proposal to final and binding arbitration.⁶⁰

One can see some similarities with the Ontario regulation, however, in Ontario the employer must obtain the requisite consent and establish an entitlement to the surplus, whereas under the Federal scheme, consent or entitlement are alternative routes allowing an employer to obtain access to surplus. Quebec’s scheme for compulsory arbitration in the absence of the requisite consent is a third alternative permitting employers to obtain surplus on plan termination.

(c) **British Columbia**

In British Columbia, arbitration is available with respect to an employer contribution holiday, the allocation of surplus on winding up, or the payment of surplus to an employer.⁶¹ A matter will be referred to arbitration if a trade union representing plan members seeks a referral or at least 20% of the plan members, former members and beneficiaries dispute the proposed action.⁶² This gives the employer in British Columbia the option of an obtaining an agreement or arbitration, if at least twenty per cent of the plan members and beneficiaries object to the surplus going to the employer.

⁵⁹ Pension Benefits Standards Act, 1985 S.C. 1985 c. 32 (2nd Supp) [hereinafter PBSA, Can.] s. 7.4(1).

⁶⁰ *Ibid.* s. 9.2

⁶¹ Pension Benefits Standards Act, R.S.B.C. 1996, c. 352, s. 62.

⁶² *Ibid.* s. 62(2).

The ability of any of the parties to reach an agreement concerning surplus distribution is dependent on the legal rights which they bring to the negotiating table. These rights arise from the decisions of the courts interpreting the plan documents to determine which party has been given the right to surplus in the plan.

c. Trusts, Contracts and Establishing Claims to Surplus

These legislative and regulatory provisions do not directly establish the legal rights to any excess assets in the pension plan. In Ontario it is a requirement that the plan documentation contain language expressly providing for payment of surplus to the employer as a pre-condition to the Superintendent's consent and a failure to include such language will be construed as entitling plan members and other beneficiaries to a surplus distribution on wind-up. However, the legislation does not establish the legal validity of any claims to surplus assets based on current plan language.⁶³ That task has been left to the courts, which assess the claims based on the history of the plan's documents. The essential question is whether the language in current documents assigning the right to surplus to the employer creates an enforceable right. In order to assess this question, courts in Canada have had to resort to a historical analysis of the pension plan's constating documents to both determine the type of rights originally created and the effect of any power of amendment contained in those documents on those rights.

In this historical analysis, the choice of external funding mechanism has different consequences for an employer who did not expressly reserve the right to surplus on plan wind-up when the plan was created. As noted above, initially tax regulation required that reversion of assets to the employer be prohibited and plans may have contained such language or the plan may not have contained any provisions dealing with surplus withdrawal by the employer. The essential question when a plan is being wound up is whether any language giving the employer a right to surplus on termination is whether that language was inserted in the plan after its creation by a valid amendment to the plan.

The importance of the type of funding vehicle to the legal analysis of this question was clearly established in the *Schmidt v. Air Products* decision of the Supreme Court of

⁶³ Eileen Gillese, *Pension Plans and Trusts*, *supra* note 4 at 228.

Canada.⁶⁴ The case involved two pension plans which had been terminated by the sponsoring employer. One plan was held pursuant to a trust, while the other first an annuity contract with an insurance company and then the funds were held in a deposit administration contract with another insurance company.

i. Surplus on Plan Termination

The Supreme Court of Canada held that where a pension plan is subject to a trust, the pension fund is presumptively held for the exclusive benefit of the employee-beneficiaries. Mr. Justice Cory, writing for the majority, found that a pension trust is a transfer of property, and in view of the dynamics of the employment relationship concerning pension plans, it would be inequitable to grant the employer the power to take the funds back by a subsequent amendment. He wrote:

One of the most fundamental characteristics of a trust is that it involves a transfer of property. ...

The judgment of the B.C. Court of Appeal in *Hockin*, if followed to its logical conclusion, would mean that the presence of an unlimited power of amendment in a trust agreement entitles a settlor to maintain complete control over the administration of the trust and the trust property. That result is inconsistent with the fundamental concept of a trust, and cannot, in my opinion, be sustained without extremely clear and explicit language. A general amending power should not endow a settlor with the ability to revoke the trust. This is especially so when it is remembered that consideration was given by the employee beneficiaries in exchange for the creation of the trust. In the case of pension plans, employees not only contribute to the fund, in addition, they almost invariably agree to accept lower wages and fewer employment benefits in exchange for the employer's agreeing to set up the pension trust in their favour. The wording of the pension plan and trust instrument are usually drawn up by the employer. The employees as a rule must rely upon the good faith of the employer to ensure that the terms of the specific trust arrangement will be fair. It would, I think, be inequitable to accept the proposition that a broad amending power inserted unilaterally by the employer carries with it the right to revoke the trust. The employer who wishes to undertake a restricted transfer of assets must make those restrictions explicit. Moreover,

⁶⁴ *Schmidt v. Air Products of Canada Ltd.* (1994) 115 D.L.R. (4th) 631 (Supreme Court of Canada); *vary'g* (1992) 89 D.L.R. (4th) 762 (Alta. C.A.), *aff'g* (1992) 66 D.L.R. (4th) 230 (Alta. Q.B.) ('*Schmidt v. Air Products*').

amendment means change, not cancellation, which the word "revocation" connotes.⁶⁵

This reasoning can be contrasted with the majority's reasoning concerning an amendment to the other Air Products plan, which was funded through a contract. At issue was an amendment which changed a clause giving the employer the discretion to distribute the surplus to the plan members or retaining it for itself to one that designated the employer as the one to receive surplus on termination. Instead of focusing on the contribution to the pension fund as an irrevocable "transfer" which could not be revoked by a subsequent amendment, the court reviewed the amending clause in the plan and concluded that the amendment was within the power granted by the clause. Justice Cory wrote:

In my opinion, the 1983 amendment of the pension plan was within the limits of this power of amendment. The amendment does not violate s. 14.1(a), because at the time it was enacted it did not reduce any "then existing" interest of the employees. Under the prior plans, the employees had no interest in the surplus remaining upon termination until such time as the company exercised its discretion to give them an interest. The removal of a mere potential interest in the funds was within the company's amending power.

Nor do I think that the amendment violated the limitation on the amending power contained in s. 14.1(b). I agree with Moore C.J.Q.B. that this restriction on amendment was in the nature of a general protection of the benefits and rights of the plan participants and that it must be read in the light of other provisions dealing with specific rights including the treatment of surplus. He considered that two particular provisions in the 1977 plan overrode any conflict with the more general terms of the amendment power. I agree. This was also true of the corresponding provisions in the 1970 plan. The relevant 1970 clauses are that part of s. 14.1(c) which gives the employer a discretion as to the allocation of surplus, and:

13.2 No part of the fund shall be used for or diverted to purposes other than for the exclusive benefit of Participants and their beneficiaries. No Participant, retired Participant, survivor or beneficiary under the Plan, or any other person, shall have any interest in or right to any part of the earnings of the fund, or any rights in or to or under

⁶⁵ *Ibid.* at 659.

such Fund or any part of the assets thereof, except and to the extent expressly provided in this Plan.

The amending power contained in s. 14.1(b) must therefore be read in light of the fact that the employee rights under the plan are limited by s. 13.2 (and indeed throughout the plan) to the benefits defined in the plan, as well as by the stipulation that the company has the right to distribute surplus as it chooses. The 1970 plan does not deal with the issue of whether the reversion of surplus to the company is inconsistent with the non-diversion and exclusive benefit clauses contained in s. 13.2. I do not think it is. The prohibition on diversion of funds and the exclusive benefit clause applied from the outset only in respect of the defined benefits to which the employees were contractually entitled. They did not apply to the distribution of a plan surplus. The revamped version of s. 13.2, which appeared as s. 13.4 in the 1977 plan, and upon which Moore C.J.Q.B. based his conclusion, clarified this point but did not change the substance of the original provisions.⁶⁶

Thus in the case of a pension fund held in a contractual arrangement, a general power of amendment should be sufficient to allow the employer to amend the contract to receive any surplus on termination of the pension fund, even where the plan was originally silent concerning the distribution of surplus.⁶⁷ However, the fact a plan was funded through an insurance contract is not entirely determinative, because the contract itself could be held in trust for the exclusive benefit of the employees, and in such circumstances, the trust reasoning applied in *Schmidt v. Air Products, supra* would apply and plan members and beneficiaries would be entitled to the surplus in the plan on termination.⁶⁸

ii. Contribution Holidays Funded from Surplus

The use of the trust does not have the same restrictive effect on the employer's ability to use surplus in an ongoing plan, however. In *Schmidt v. Air Products, supra* the employer had taken contribution holidays in the years leading up to the termination of the pension plan. The court relied on the contingent nature of any surplus in an on-going defined benefit pension plan in distinguishing the use of such a surplus to take a contribution

⁶⁶ *Ibid.* at 678-79.

⁶⁷ *Howitt v. Howden Group Canada Ltd.*, (1999) 170 D.L.R. (4th) 423 (Ont. C.A.) ('Howitt v. Howden').

⁶⁸ ⁶⁸ *Bathgate v. National Hockey League Pension Society*, (1994) 110 D.L.R. (4th) 609 (Ont. C.A.); affirming 98 D.L.R. (4th) 326 (Ont. Ct. (Gen. Div.)), *leave to appeal to SCC refused*, 114 D.L.R. (4th) vii (SCC) ('Bathgate v. NHL'); *LeHave Equipment Ltd. v. Nova Scotia (Supt. of Pensions)*, (1994) 121 D.L.R. (4th) 67 (N.S.C.A.) ('Lehave v. Nova Scotia').

holiday from a transfer of surplus assets out of the fund on termination. Justice Cory wrote:

Once funds are contributed to the pension plan they are "accrued benefits" of the employees. However, the benefits are of two distinct types. Employees are first entitled to the defined benefits provided under the plan. This is an amount fixed according to a formula. The other benefit to which the employees may be entitled is the surplus remaining upon termination. This amount is never certain during the continuation of the plan. Rather, the surplus exists only on paper. It results from actuarial calculations and is a function of the assumptions used by the actuary. Employees can claim no entitlement to surplus in an ongoing plan because it is not definite. The right to any surplus is crystallized only when the surplus becomes ascertainable upon termination of the plan. Therefore, the taking of a contribution holiday represents neither an encroachment upon the trust nor a reduction of accrued benefits.

Similar reasoning explains why I cannot accept the proposition that an employer entitled to take a contribution holiday must also be entitled to recover surplus on termination.

While a plan which takes the form of a trust is in operation, the surplus is an actuarial surplus. Neither the employer nor the employees have a specific interest in this amount, since it only exists on paper, although the employee beneficiaries have an equitable interest in the total assets of the fund while it is in existence. When the plan is terminated, the actuarial surplus becomes an actual surplus and vests in the employee beneficiaries. The distinction between actual and actuarial surplus means that there is no inconsistency between the entitlement of the employer to contribution holidays and the disentitlement of the employer to recovery of the surplus on termination. The former relies on actuarial surplus, the latter on actual surplus."⁶⁹

However, the employer may not take a contribution holiday unless its contribution obligation is to contribute those sums an actuary considers necessary to fund the benefits. Since the actuary will take into account that the plan's assets exceed its liabilities in determining what additional contributions are required, an employer may not be required to make contributions until there are no longer excess assets in the plan.⁷⁰ However, where the plan is "one which specifically mandates regular contribution on a specified

⁶⁹ Schmidt v. Air Products, *supra* note 64 at 665-66.

⁷⁰ *Ibid.* at 672.

basis which would leave an actuary no discretion to employ the standard actuarial practice of considering existing surplus”, then a contribution holiday is not permitted.⁷¹

The status of the pension fund as a trust does have some bearing on the courts’ resolution of some of the other issues that were canvassed above concerning use of surplus in an ongoing plan.

iii. Use of Surplus to Fund Other Plans

In *Buschau v. Rogers Cablesystems Inc.* (“*Buschau No. 1*”), the British Columbia Court of Appeal was dealing with a claim by the plan members of the Premier pension plan, one of four pension plans that Rogers had “merged”, that the merger had not affected their rights to surplus on termination in their original plan, and could not allow the plan sponsor to use any of that surplus to fund benefits for plan members in the other four plans.⁷² The original Premier plan was a trust that had provided that any excess assets on termination would be distributed among plan members. After the merger of the plans, the plan text provided that any excess funds on termination were to go to the plan sponsor and that the employer could take contribution holidays in respect of all the members covered by the merged plan. At the time of the merger, Premier plan’s trust fund had a substantial surplus, but some of the other plans’ funds were in deficit.

The Court of Appeal held that the merger of the plans could not result in the merger of trust funds because the plan sponsor was obligated to account for those funds separately, even where they had commingled the funds with those of other plans.⁷³ The Premier plan trust was thus only available to pay benefits to the members of the plan and subject to their rights to any surplus existing at termination, and not to fund the contributions required for other plan members’ benefits.

The Ontario Court of Appeal followed similar reasoning in finding a plan sponsor had breached its warranty to the purchaser of the sponsor’s business that its pension plan was

⁷¹ *Ibid.* at 672-73; *Trent University Faculty Association v. Trent University Board of Governors*, (1997) 99 D.L.R. (4th) 451 (Ont. C.A.) (“*Trent Faculty Association v. Trent University*”).

⁷² *Buschau v. Rogers Cablesystems Inc.*, [2001] BCJ No. 50 (B.C.C.A.) (“*Buschau No. 1*”).

⁷³ *Ibid.* paras. 65-69.

fully funded.⁷⁴ The assets of the Halifax plan trust had been transferred to the NN pension plan sponsored by the employer. After the transfer, the employer used the substantial surplus in the Halifax plan to justify contribution holidays with respect to benefits accruing for NN plan members. The court held that the employer could not call upon the assets of the Halifax pension trust to satisfy its NN pension liabilities and therefore, any surplus in the Halifax trust could not be applied to “cross-subsidize” the existing deficit in the NN Plan.⁷⁵

Thus, at least where plan surpluses held in trust are being used to fund pre-existing deficits for members of other plans, Canadian courts have used trust reasoning and a definition of the beneficiaries of the trust to restrict plan sponsors use of the assets in the plan to fund benefits accrued under another plan. The class of beneficiaries in these cases is restricted to those employees employed up until the point of the merger or amalgamation. This definition may be somewhat context specific, because in the *Buschau No. 1* case, the employer had closed the plan to new employees⁷⁶, and in *Aegon, supra* at the time of the transfer the employer had given the regulator an undertaking to account for the Halifax trust fund separately.

iv. Funding New Types of Benefits

In cases where the context and plan language was somewhat different, the courts have permitted employers to use contribution holidays using existing plan surplus by characterizing the transactions involved as analogous to the addition of new plan members in the ordinary course of business. *Nolan v. Ontario (Superintendent of Financial Services)*, was an appeal concerning whether an employer, after adding a defined contribution plan to the existing defined benefit plan and making the defined contribution plan mandatory for all new employees, could take a contribution holiday in

⁷⁴ *Aegon Canada Inc. v. ING Canada Inc.*, [2003] O.J. No. 4755 (Ont. C.A.) ('Aegon v. ING').

⁷⁵ *Ibid.* at para. 8-12.

⁷⁶ It is important to note that much of the reasoning in 2001 BCCA 16, *Buschau v. Rogers Cablesystems Inc.*, [2001] BCJ No. 50 (B.C.C.A.) ('Buschau No. 1'), *supra* note 72 by the British Columbia Court of Appeal regarding the sponsor's ability to use the surplus in other plans was premised on the ability of plan members to use the Rule in *Saunders v. Vauthier* to collapse the trust, a premise that has been overruled by the Supreme Court of Canada in [2006] S.C.J. No. 28, *Buschau v. Rogers Communications Inc.*, [2006] 1 S.C.R. 973 (SCC) ('Buschau No. 2').

respect of its defined contribution section of the plan using the accrued surplus in the defined benefit plan.⁷⁷ The Ontario Court of Appeal held that the employer could do so because there was nothing in the plan documentation that limited its ability to amend the plan to create a new category of plan member and that it was not a revocation of the trust to amend the trust to make the new plan member a beneficiary of the trust. It held that the plan was designed to provide benefits to all full-time employees of the employer and that all full-time employees would become members of the plan and beneficiaries of the trust fund. *Aegon, supra* was distinguished on the grounds that it involved two pre-existing plans and if the Halifax trust assets had not been segregated, its members' rights would have been diminished by the addition of a new category of beneficiaries not contemplated when the Halifax trust was created.⁷⁸

This reasoning has been extended to a situation in which the surplus from a closed defined benefit plan is being used to pay contributions to members of a pre-existing defined contribution plan, where those payments are restricted to contributions on a "going-forward" basis.⁷⁹ After closing a defined benefit plan for its Simpson's employees that had a significant surplus, the Hudson's Bay Company re-opened the plan to include several thousand members of its Zellers and K-Mart defined contribution plans. These new members had the employers' contributions due under the defined contribution plan paid from the surplus accrued in the defined benefit plan from the date they were added after the HBC plan was amended. The Ontario Superior Court of Justice held that plan amendments had to be for the exclusive benefit of the plan members. However, the class of plan members included any potential members based on the broad definition of the employees eligible to become members in the plan documents. As employees of the subsidiaries of the plan sponsor, Zellers and K-Mart employees were entitled to become members and benefit from the use of the trust fund. In reaching this conclusion, the court adopted an interpretive stance rooted in the expectations regarding the future at the inception of the plan and noted that pension plans necessarily contemplate the potential

⁷⁷ *Nolan v. Ontario (Superintendent of Financial Services)*, [2007] O.J. No. 2176 (Ont. C.A.) ('Nolan v. Ontario') also known as *Kerry (Canada) v. Nolan*.

⁷⁸ *Ibid.* at paras. 93-113.

⁷⁹ *Sutherland v. Hudson's Bay Co.*, [2007] O.J. No. 2979 (O.S.C.J.) ('Sutherland v. Hudson's Bay').

that new employees may become members, whether as new hires or because of corporate mergers and acquisitions.

As set out in the rest of this report, there are certain parallels in the reasoning of the courts in this case and *Nolan v. Ontario*, *supra* with the decision of the U.S. Supreme Court in *Jacobson v. Hughes Aircraft*, *infra* and the U.K. Chancery Division in *Barclay's Bank v. Barclay's Pension Trustees*, *infra*. They will be analyzed further in section 2 of the Report, but it seems clear that although the presence of a trust will have a significant impact on the ability of a plan sponsor to obtain any surplus in the plan on termination in Canada, it does not seem to have as great an impact on the ability of the sponsor to utilize the surplus to meet its funding obligations in an on-going plan. One remaining area where there may be some differences is in respect of plan mergers.

v. Extraction by Plan Beneficiaries

Plan members in the Premier Pension Plan discussed in *Buschau No. 1*, *supra* sought to use the common law trust doctrine known as the Rule in *Saunders v. Vauthier* to terminate the Premier pension trust and obtain a distribution of the surplus assets in the trust to the beneficiaries. If all of the beneficiaries, both vested and contingent, of a trust are adults and capable of giving their consent, then under the Rule, they may compel a trustee to terminate the trust and distribute its assets to them. Provinces have enacted trust variation legislation that empowers the courts to give consent to such a termination on behalf of minors, incapacitated adults or unborn beneficiaries if they are convinced it is in their best interests.⁸⁰

The plan members were successful in the British Columbia Court of Appeal, however, the Supreme Court of Canada held that the common law rule had no application to a pension trust governed by the federal Pension Benefits Standards Act because the legislation provided a complete code for pension plan terminations.⁸¹ The majority held that there was no provision for the termination of a pension fund by plan members in the legislation, only for termination by the plan sponsor, subject to the legislated procedure

⁸⁰ The Trusts and Settlements Variation Act, R.S.B.C. 1996, c. 463 is one such act.

⁸¹ *Buschau v. Rogers Communications Inc.*, [2006] 1 S.C.R. 973 (SCC) ('Buschau No. 2').

for such terminations. They also suggested that the Superintendent of Financial Institutions could order the plan terminated on the grounds that no contributions had been made since 1984 and the plan was closed to new members.⁸² However, the Superintendent of Financial Institutions refused the plan members' request to terminate the plan and granted the plan sponsors' request to re-open the plan to new members.⁸³

In reaching their decision, the Supreme Court majority emphasized the intimate connection between the trust as the funding vehicle and the pension plan which is a highly regulated arrangement between the sponsor, plan members and retirees. Application of the trust law rule was inappropriate because it was not designed for circumstances when the collapse of a trust fund can lead to the destruction of the plan which exists outside of the trust. The court held that the sponsor has a legitimate interest in the plan and its continued existence, and therefore, to allow the rule to apply would destroy that interest. This decision sets out the limits of trust law analysis in Canadian pension law and points out the important distinction between plan termination situations in which trust law principles applicable to classic trusts may be more applicable than situations concerning ongoing pension plans, where the employer's interest in a viable pension funding system is given some consideration.

d. U.S. – ERISA and federal pre-emption of state law

In 1974, the U.S. Congress passed the Employee Retirement Income Security Act (“ERISA”) and it was signed into law by President Ford. Alicia Munnell summarized its impact as follows:

... the legislation regulated five aspects of pensions: reporting and disclosure of plan administration; employee participation and vesting standards; funding schedules and fiduciary integrity; retirement plans for the self-employed; and delivery of vested benefits.⁸⁴

⁸² *Ibid.* at paras. 35-36, 44-57.

⁸³ *Pension Plan for the Employees of Premier Cable Systems Limited*, 2007 OSFI Document Repository http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/media/rgr_let_e.pdf (Superintendent of Financial Services 27/04, 2007).

⁸⁴ Alicia Munnell, *ERISA – The First Decade*, *supra* note 2 at 52.

Employer access to surplus is governed by two provisions, the exclusive benefit rule which denies employers a return of assets while the plan is ongoing and a plan termination rule, which permits employers to have access to surplus at termination, providing certain conditions are met. As noted above, the exclusive benefit rule has been part of the U.S. Income Tax Code since 1938.⁸⁵ The provisions of ERISA permit the distribution of “residual assets” to an employer when all liabilities have been satisfied, the distribution does not contravene any provision of law, and the plan provides for such a distribution on termination.⁸⁶ Plan members do, however, have a right to receive any residual assets attributable to their contributions on termination.⁸⁷ These provisions apply irrespective of the kind of funding vehicle chosen for the pension plan.

Prior to the enactment of ERISA, disputes over surplus in a pension plan would be determined according to state law, and in the case of a plan held in a trust, trust law.⁸⁸ Where a pension fund had paid all of the promised benefits, the courts would invoke the doctrine of a resulting trust which is applicable when there are trust assets remaining after all of the required distributions to beneficiaries have been completed. Under the doctrine the remaining assets are returned to the settlor, the employer. ERISA pre-empts all state law applicable to pension plans covered by it and requires all disputes regarding those plans to be brought in federal district courts. Amongst ERISA’s requirements is that plan assets in a defined benefit plan be held in trust or pursuant to an insurance contract.⁸⁹

ERISA imposed a number of trust-like obligations on plan administrators in respect of the assets of a pension plan, the foremost being the fiduciary duty to carry out duties solely in the interests of beneficiaries, the duty to hold the assets for the exclusive purpose of providing benefits to plan members, and the prohibition on any assets inuring to the benefit of the employer.⁹⁰ However, these trust attributes have been interpreted in

⁸⁵ Norman P. Stein, "Reversions from Pension Plans: History, Policies and Prospects" (1989) 44 *Tax Law Review* 259 [hereinafter Norman Stein, *Reversions*].

⁸⁶ 29 U.S.C.A. § 1344 (d)(1)(2006).

⁸⁷ 29 U.S.C. § 1344 (d)(3)(A) (2006).

⁸⁸ Jennifer L. Pratt, "Reversion of Surplus Pension Assets Upon Plan Termination: Is It Consistent with the Purpose of ERISA"? (1986) 62 *Indiana Law Journal* 805 [hereinafter Jennifer Pratt, *Reversion – Consistent?*] at 811.

⁸⁹ 29 U.S.C. § 1103(a) (2006).

⁹⁰ 29 U.S.C. § 1104 (2006); 29 U.S.C. § 1103(c)(1) (2006).

light of other ERISA provisions, in particular the provisions that contemplate reversion of surplus assets to the employer on plan termination.⁹¹ In addition, the U.S. courts have applied a more contractual reasoning to an employer's power to amend a plan to enable the surplus to be paid to it on termination by treating such amendments as exceptions to the trust-like duties in ERISA because they only affect the disposition of assets after the exhaustion of the purpose for which they are held – the provision of benefits under the terms of the plan. U.S. trust law also plays a role in the courts consideration of the amendment power in pension plan documents as a broad power of amendment in the trust instrument is considered to include the power to revoke the trust.⁹²

i. Use of Surplus in On-going Plans

Courts have dealt with surplus use by employers in the context of both on-going plans and termination of plans. The U.S. Supreme Court in *Hughes Aircraft Co. v. Jacobson* was faced with a number of claims by plan members and beneficiaries of a contributory defined benefit pension plan.⁹³ The plan had a surplus of over \$1 billion and the employer had ceased to make its contributions. The plan was then amended to provide early retirement benefits to certain active employees. It was subsequently amended to create a noncontributory plan with lower benefits for all new employees. Existing employees could continue to contribute or opt to be treated as members of the noncontributory plan.

The United States Court of Appeal for the 9th Circuit had held that the claims of the plan members could not be dismissed without a hearing. The plan members claimed that the employer had violated the ERISA prohibition against forfeit of accrued benefits in a pension plan because the use of surplus in the contributory plan to pay for benefits for new employees depleted the surplus to which the employees had a vested interest.⁹⁴ They also claimed that the use of the surplus by the employer breached the ERISA prohibition on any of the assets in an on-going plan inuring to the benefit of the employer.⁹⁵ The Court of Appeal also found that the amendments may have terminated the plan and

⁹¹ 29 U.S.C.A. § 1344(d)(1) (2006).

⁹² American Law Institute Restatement (Second) of Trusts, 331st (2007).

⁹³ *Hughes Aircraft Co. v. Jacobson* (1999) 525 U.S. 432 (U.S.S.C.).

⁹⁴ 29 U.S.C. § 1053(a) (1999).

⁹⁵ 29 U.S.C. § 1103(c)(1) (2006).

created two new plans. The plan members claimed that in doing so, the employer violated its ERISA fiduciary duties by: failing to act solely in the interests of the plan members by creating a plan outside the plan's purposes; taking part in a transaction which was a conflict of interest and breaching its duty to act solely in the plan members because the plan's assets were being used by employer to fund its contribution obligation.⁹⁶ Finally, the plan members claimed that the employer's depletion of the surplus was contrary to their ERISA right to receive the residual assets attributable to their contributions on a plan termination.⁹⁷

The unanimous decision of the U.S. Supreme Court found that the claims under the vested benefits and anti-inurement provisions of ERISA were based on the erroneous assumption that plan members have an interest in surplus. The court reasoned that the assets in an ongoing plan are not earmarked for individuals and that the structure of a defined benefit plan reflects the employer's risk of having to make up any funding shortfalls. Plan members only have a statutory claim to their defined benefits and that claim does not vary with the plan's investment experience. Accordingly, since a decline in the value of assets does not alter their accrued benefits, they have no claim to any surplus plan assets even if it is partially attributable to investment growth of the plan member's contributions.⁹⁸

The court rejected the characterization of the amendments as creating two plans, holding that as long as all benefit liabilities have a claim on a single pool of assets, a plan is a single plan for the purposes of ERISA. Therefore, the employer was not using plan assets for its benefit, but rather for their statutory purpose, to provide benefits to plan members. The fact that it may have received incidental benefits in the form of lower labour costs did not make the amendments a disguised attempt to transfer plan assets to an interested party because they are just the type of benefits that flow to an employer naturally as the result of offering a pension plan to employees.⁹⁹

⁹⁶ 29 U.S.C. § 1104(a)(1)(D) (2006); 29 U.S.C. § 1106(a)(1)(D) (2006).

⁹⁷ 29 U.S.C. § 1344(d)(3)(A) (2006).

⁹⁸ Hughes Aircraft v. Jacobson, *supra* note 93 at 440-41

⁹⁹ *Ibid.* at 442-446.

The court also rejected the use of trust law remedies in ERISA-governed pension plans. The plan members had argued that the plan should be terminated because its purposes had been exhausted, invoking the doctrine of a “wasting” (resulting) trust. The court characterized ERISA as a “comprehensive and reticulated” statute and held that trust law must give way if it is inconsistent with the statutory language, structure or purposes. In this case, trust law was inconsistent with the termination provisions of ERISA which provided “exclusive” grounds for termination of a pension plan and, in any event, the plan was continuing to provide benefits to current and new entrants, making the doctrine inapplicable.¹⁰⁰

Thus, with respect to ongoing plans, ERISA has been authoritatively interpreted to permit contribution holidays, creation of new benefit schemes for new employees funded by surplus generated by past contributions, and as being inconsistent with any legally recognizable interest in surplus for plan members. Merger of plan assets accompanying corporate reorganizations is permitted, as well as amendments that permit recovery of surplus by the plan sponsor as part of the merger process, providing the merger does not result in the reduction of the benefit they would receive if the plan was terminated on the date of the merger.¹⁰¹

ii. Surplus on termination

ERISA’s anti-inurement provisions prohibit any payment or return of surplus to an employer while a plan is on-going.¹⁰² However, ERISA does permit an employer to voluntarily terminate a pension plan at any time. After making provision for the accrued benefits of plan members, and distributing any residual assets attributable to member contributions to plan members, an employer is permitted to receive the balance of the residual assets if the plan provides for such a distribution.¹⁰³ Between 1980 and 1987, employers utilized these provisions to terminate more than 1,635 plans and obtain excess assets worth \$18 billion or 45 percent of these plans’ aggregate assets. These figures are

¹⁰⁰ *Ibid.* at 447-48.

¹⁰¹ 29 U.S.C.A. s 1058 (West 2006); *Malia v. General Electric Co.* (1994) 23 F.3d 828 (C.A. 3).

¹⁰² Norman Stein, *Raiders*, *supra* note 27 at 117-18

¹⁰³ 29 U.S.C. § 1344(d)(3)(A) (2006) distribution of residual assets attributable to employee contributions; and 29 U.S.C.A. § 1344(d)(1) conditions for distribution of residual assets to employer on termination.

just those plan terminations in which the reversions exceeded \$1 million per plan.¹⁰⁴ At that time, there were approximately 110,000 defined benefit pension plans with over 30 million plan members in the U.S..¹⁰⁵ Some of these terminations did not end the affected employees' accrual of pension benefits as some employers would immediately implement replacement plans, while others would split their plan into two plans, one plan with retirees only and another with current employees. By placing the bulk of the surplus assets into the retiree plan, which they would then terminate, the employers could continue to provide pension benefits for current employees while obtaining the surplus in the plan.¹⁰⁶

The crucial legal issue in light of the ERISA provisions concerning surplus to employers is whether a plan provides for payment of residual assets to an employer on termination and, if it did not do so when it was created, whether the employer can legally amend the plan to provide for receipt of residual assets. The prevailing trend in the US District Courts appears to be receptive to employer amendments, irrespective of whether or not a trust is the funding media. The main focus of the courts analysis is on the effect of language in the plan documents and on ERISA's provisions requiring assets be held for the exclusive benefit of the plan members. In *Borst v. Chevron Corp.*, the United States Court of Appeal for the 5th Circuit provides a detailed review of the results of litigation in the U.S. federal court system concerning employer amendments regarding surplus entitlement on termination.¹⁰⁷ Gulf Oil had merged with Chevron to avoid a hostile takeover and, as a result, the two corporations' pension plans were merged. While Gulf's pension plan contained no language expressly dealing with the distribution of surplus on termination, the Chevron plan expressly provided it would be distributed to the employer. Following the merger of the plans, the Chevron text applied to the Gulf employees as well. A significant number of employees were terminated as a result of the merger and, as

¹⁰⁴ *Amicus curiae* brief of the U.S. Pension Benefits Guarantee Corporation in the *Mead v. Tilley* 490 U.S. 714 (1989) case before the U.S. Supreme Court (Westlaw/e-carswell) 1988 WL 1025960(US).

¹⁰⁵ *Ibid.*

¹⁰⁶ Carl A. Butler, "Pension Plan Terminations and Asset Reversions: Accommodating the Interests of Employers and Employees" (1985) 19 *University of Michigan Journal of Law Reform* 257 at 260; Norman Stein, *Reversions*, *supra* note 85 at 277

¹⁰⁷ *Borst v. Chevron Corp.* (1994) 36 F.3d 1308 (C.A. 5) (21/10); affirming 764 F.Supp. 1149 (S.D. Tex. 1991), *cert. denied*, 514 U.S. 1066 (U.S.S.C. 1995) ('Chevron').

a result, the plan was considered to have been partially terminated, requiring immediate vesting of all benefits accrued by the terminated employees. Terminated employees sought a *pro rata* share of the surplus in the plan and objected to the application of the Chevron text provision expressly providing for reversion of surplus to the employer. With respect for the claim for a *pro rata* share of the surplus, the court held that ERISA did not require the distribution of surplus on a partial termination, and that surplus did not form any part of the “benefits” that a partial termination required the employer to vest in the terminated plan members. Although the plan text provided that the same scheme for the distribution of assets applied to both complete and partial terminations, that scheme did not make any provision for the distribution of surplus to the plan members.¹⁰⁸

The Fifth Circuit held that nothing in ERISA prohibited “reversion” of surplus on termination to the employer, and, in fact, such an eventuality was expressly contemplated. It rejected the plan members’ contention that a plan must contain express language permitting distribution of residual assets to the employer in order to comply with ERISA’s requirement that a plan must “provide” for such a distribution, holding the provision need not be “specific, explicit or express” and suggesting that “provide” could include the application of the doctrine of a resulting trust in favour of the employer.¹⁰⁹ In interpreting the plan text, the Court held that language providing that the plan assets were to be used solely for the exclusive benefit of plan members and prohibiting reversion to the plan sponsor were both subject to modification by the language that these restrictions would apply “prior to the satisfaction of all liabilities under the Plan” or until all liabilities had been satisfied in full. The Court held that the exclusive benefit and non-reversion provisions originated in tax legislation and that the legislation did not restrict distribution of surplus assets on termination, because, by definition all liabilities would

¹⁰⁸ *Ibid.* at 1316-18.

¹⁰⁹ *Ibid.* at 1314-15; in reaching this conclusion the Fifth Circuit did not accept the plan members’ argument, based on a pre-ERISA decision of that court in *Ball v. Victor Adding Machine Co.*, 236 F.2d 170 (5th Cir. 1956), that the pension plan trust should be considered one established by the employer for the consideration provided by the plan members services in which the resulting trust of surplus would be in favor of the plan members; rather the court was of the view that it was more akin to a gratuitous trust where the resulting trust was in favour of the employer as settlor.

have been satisfied and the tax legislation in question had contemplated reversion to employers on termination.¹¹⁰

Although the plan text had provided that the funds provided by the plan sponsor were “irrevocably contributed”, the Court held that the termination of the plan and distribution of residual assets to the plan sponsor after satisfying all liabilities involved a reversion, not a revocation of the trust and therefore, subjecting the plan to the Chevron text providing for reversion to the plan sponsor was not contrary to the plan text making the contributions irrevocable.¹¹¹ Finally, although the plan text prohibited amendments that would allow any part of the trust fund to be used for purposes other than the exclusive benefit of the plan members, the Court held that such language was not sufficient to preclude an amendment allowing reversion of excess assets to a plan sponsor, relying on several decisions in other Circuits.¹¹² It summarized the effect of these decisions as requiring that the plan text contain a strong, express prohibition on reversion in order to bar such an amendment. Such language has been found to exist when a plan prohibits reversion of any of the assets to the employer,¹¹³ where the plan prohibits any amendment that would vest title to the plan’s assets in the employer,¹¹⁴ or where an outline of the plan provided to the plan members provided that the company could not recover any of the contributions nor use any of the fund.¹¹⁵

Finally, the Fifth Circuit pointed out that the policy underlying ERISA supported its conclusions because it was important to not penalize employers who may over fund their pension plans out of an abundance of caution. The Court expressed concern that any award of surplus to plan members would encourage plan sponsors to fund a plan too

¹¹⁰ *Ibid.* at 1318-21 – absence of express surplus language, express distribution scheme that did not deal with surplus and prior to satisfaction language imply employer right to surplus on termination; *Outzen v. Fed. Deposit Ins. Corp. ex. rel. State Examiner of Banks* (1991) 948 F.2d 1184 1184 (C.A. 10) (8/11) (‘Outzen’).

¹¹¹ *Ibid.* at 1319-20.

¹¹² *Ibid.* at 1321, citing *Chait v. Bernstein* (1987) 835 F.2d 1017 (C.A. 3); affirming 645 F.Supp. 1092 (D.N.J. 1986); *Wilson v. Bluefield Supply Co.* (1987) 819 F.2d 457 (C.A. 4); *Outzen, supra* note 110; *In re C.D. Moyer Company Trust Fund* (1977) 441 F.Supp. 1128 (E.D.Pa.); aff’d mem. 582 F.2d 1273 (3d Cir. 1978); *Washington-Baltimore Newspaper Guild Local 35 v. Washington Star Company* (1983) 555 F.Supp. 257 (D.D.C.); aff’d mem. 729 F.2d 863 (D.C. Cir. 1984).

¹¹³ *Rosenbaum v. Davis Iron Works* (1989) 871 F.2d 1099 (C.A. 6); *Bryant v. Int’l Fruit Products Comp. Inc.* (1986) 793 F.2d 118 (C.A. 6); cert. denied 107 S.Ct. 576 (1986).

¹¹⁴ *Audio Fidelity Corp. v. Pension Benefits Guaranty Corp.* (1980) 624 F.2d 513 (C.A. 4).

¹¹⁵ *Albedyll v. Wisconsin Porcelain Co. Revised Retirement Plan* (1991) 947 F.2d (C.A. 7).

cautiously and thus harm the interests of present and future plan members in respect of security of their benefits.¹¹⁶

Overall, the U.S. courts appear to be open to plan sponsor receipt of excess assets following the termination of a pension plan, adopting a stance that such a distribution is not contrary to the purposes of ERISA or the use of a trust as a funding mechanism. Indeed, in order for a plan sponsor to be prevented from amending the plan text to obtain surplus reversion, that amendment must be precluded by a strong, express prohibition on reversion in the existing plan. Plan members have no claim to surplus while a plan is ongoing, and an employer may make any use it wishes of such a surplus with respect to its ongoing funding obligations.

e. U.K – European Union Pensions Directives; Pensions Act, 1995 and 2004.

(i) Statutory Regime

In the United Kingdom the impetus to use trusts as the legal vehicle to hold the funds intended to fund defined benefit plans was provided by the requirement in the Finance Act 1921 which restricted relevant tax exemptions to pension schemes set up by trusts.¹¹⁷ The European Union Council and Parliament jointly issued a directive “on the activities and supervision of institutions for occupational retirement provision” (“the EU Pensions Directive”) on June 3, 2003 setting out the rules for pensions and their regulation in the EU.¹¹⁸ Member countries may make certain provisions applicable to insurance companies providing occupational retirement benefits, providing those companies must separate the assets and liabilities for those benefits and manage them separately from the insurer’s other business.¹¹⁹ All other pension plans covered by the Directive are required to have a legal separation between the sponsor and the assets of the pension plan to protect those

¹¹⁶ Chevron, *supra* note 107 at 1322

¹¹⁷ David Hayton, "Trust Law and Occupational Pension Schemes" *Conveyancer and Property Lawyer* 283 (Jul/Aug 1993) at 283; Andrew Thomas, et al, 'The Changing Role of the Occupational Pension Scheme Trustee Research Report No 124' (2000) in U.K. Department of Work and Pensions Research Report Series <<http://www.dwp.gov.uk/asd/asd5/rrep124.asp>> (accessed 10/10/07) at 5.

¹¹⁸ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the Activities and Supervision of the Institutions for Occupational Retirement Provision (European Union 2003).

¹¹⁹ *Ibid.* at Article 4.

assets in the case of the sponsor's insolvency.¹²⁰ The U.K. Pensions Act 2004 requires that all pension schemes with a centre of main administration in the U.K. must refuse to accept contributions if the scheme is not established as an irrevocable trust.¹²¹ For non-European pension plans administered outside the U.K. with U.K. resident members, contributions may only be made if the plan is established as an irrevocable trust and at least one trustee is a U.K. resident.¹²²

In the U.K., pension regulation is also divided amongst income tax regulation and pension regulation. Reflecting the income tax authorities concerns about the use of the tax preferred pension plan as a means of tax avoidance, U.K. regulation required pension administrators to take steps to reduce excessive surplus in on-going plans up until 2004. The tax regulation specified actuarial assumptions to be used in the calculation of the surplus amount and provided that one of the options for reduction could be payment of surplus to the employer, taxed at 35%.¹²³ The Pensions Act 1995 permitted the payment of surplus to an employer in an ongoing plan under certain conditions. Only trustees could exercise the power despite any plan rules providing that the employer had the power, they had to be satisfied it was in the interests of the members and the pensions provided by the plan had to be indexed at a statutorily prescribed rate.¹²⁴

When a pension plan was being wound-up the Pensions Act 1995 regulated the distribution of assets to an employer. If the plan was held in trust and conferred a power to distribute excess assets to the employer, that power could only be exercised after all liabilities had been discharged, any power to distribute assets to anyone other than the employer had been exercised or a decision made not to exercise it, pension benefits had been indexed in accordance with the statutory indexation requirements, and any prescribed notice had been given to plan members of the intention to distribute excess assets to the employer.¹²⁵ If the plan was held in trust and prohibited the distribution of

¹²⁰ *Ibid.* at Article 8

¹²¹ *Pensions Act 2004* (U.K. c. 35), s. 252.

¹²² *Ibid.* s. 253.

¹²³ *Pensions Act 2004 Explanatory Notes*, U.K. Department of Work and Pensions (2004) at para. 908 (copy on file with author) [hereinafter *Pensions Act Explanatory Notes*].

¹²⁴ *Pensions Act 1995*, (U.K. 1995 c. 26), s. 37.

¹²⁵ *Ibid.* s. 76

assets to the employer on wind-up, then assets could only be distributed to the employer after trustees had distributed the assets to increase benefits up to prescribed limits.¹²⁶

However, the tax law requirement to reduce excess surplus from an on-going pension plan was repealed by the U.K. Finance Act 2004, although the 35% tax on any surplus payment to an employer was retained. The Pensions Act 2004 amends the Pensions Act 1995 by permitting surplus payments to the employer, without requiring indexation of pension benefits, if scheme rules permit and if the trustees are satisfied it is in the interests of the members. A prescribed valuation must be carried out using prescribed valuation criteria and no more than the maximum amount in the valuation certificate may be paid out of the fund.¹²⁷

In addition, accompanying the new surplus payment provisions, trustees are also given the power to determine whether or not to permit the pension scheme's rules to allow payment of surplus to employers even if the rules as they existed before the restrictions in the Pensions Act 1995 gave a right to make payments to an employer without reference to the Income Tax Act requirement to reduce surplus. In making this decision, the trustees must be satisfied that their decision is in the interests of the members of the pension plan.¹²⁸

Thus, in the United Kingdom, irrevocable trusts are the means by which employers must hold the pension fund and payments of surplus to employers before the fund is wound up can only be made by trustees satisfied that such a payment is in the interests of the plan members. On wind-up, an employer may obtain payment of surplus if the rules of the pension plan provide or, if the rules prohibit recovery, if the surplus exceeds the amount required to provide indexed pensions up to the maximum permitted under income tax legislation.

(ii) Case Law

¹²⁶ *Ibid.* s. 77.

¹²⁷ Pensions Act Explanatory Notes, *supra* note 123 at paras. 911-14; *Pensions Act 1995*, (U.K. 1995 c. 26) s 37 as amended by *Pensions Act 2004* (U.K. 2004 c. 35, s. 250).

¹²⁸ *Pensions Act 2004* (U.K. c. 35) s 251.

With respect to surplus in plans being terminated, the regulatory scheme with respect to this issue has undergone a number of changes, with taxation regulation first permitting provisions prohibiting any surplus being provided to the employer. By 1970, as pension plans became over funded, the legislation was changed to require a pension scheme provide for the return of surplus to the employer on termination.¹²⁹ This has led to a form of bifurcated surplus entitlement on plan termination. If the pension scheme required surplus to be distributed amongst the plan members, it is required to be distributed to them up to the maximum pension benefit permitted under existing tax legislation. If any assets remain, they are to be returned to the plan sponsor under a resulting trust. Where subsequent amendments seek to alter provisions providing for surplus distribution to the plan members, it has been held that such amendments are void when they exceed the scheme's original restrictions on amendments that have the effect of allowing any part of the assets to revert to the employer.¹³⁰

(a) Discretionary disposition of surplus by trustees

One interesting facet of the case law in the United Kingdom is that the trustees of pension schemes are sometimes given wide-ranging powers to make amendments (often in consultation with the plan sponsor) and a discretion to increase benefits on wind-up using surplus before the sponsor can obtain any remaining surplus. In *Thrells v. Lomas*, the plan sponsor was in liquidation proceedings and the plan trustee had asked to court to exercise the trustee's discretion due to that trustee's conflict of interest.¹³¹ The court held that once a pension scheme had begun winding-up, the plan sponsor could no longer exercise its power of amendment to alter the winding-up provisions because they could not be altered once they came into operation without detracting from the rights of plan members. In exercising the discretion, the Court said a trustee should do what is just and equitable in light of the relevant circumstances, which included the scope and purpose of the power, the source of the surplus, its size, the financial condition of the employer and the financial needs of plan members. The purpose of the discretionary distribution

¹²⁹ Richard Nobles, "Who is Entitled to the Pension Fund Surplus"? (1987) 16 *Industrial Law Journal* 164 at 176-77, citing changes included in the U.K. *Finance Act, 1970*.

¹³⁰ *Harwood-Smart v. Caws*, [2000] O.P.L.R. 227 (Ch. D.).

¹³¹ *Thrells Ltd. (in liquidation) v. Lomas*, [1993] 2 All E.R. 546 (Ch. D.).

provision in this scheme was to alleviate the lower pensions that would be payable to those plan members whose service was terminated before they were eligible for a pension.

The Court held that trustees should not, however, refuse to exercise their discretion to increase benefits because it would deprive the plan sponsor of the surplus, since such a refusal would be contrary to the order of priority for the distribution of assets set out in the plan rules.¹³² The ruling in *Thrells, supra* built on an earlier Chancery Division decision that held that the discretionary power was a fiduciary power, even when the scheme gave the power to the employer.¹³³ The fact that the plan members gave consideration for the benefits set out in the pension plan, including the right to be considered for benefit increases out of surplus was one of the factors that the Court considered indicative of the power being fiduciary, rather than a non-obligatory mere power to appoint. As it was a fiduciary power, the holder was under an obligation to consider whether and how the surplus should be distributed as increased pensions, at least in part, to the plan members.¹³⁴ Thus, the degree to which pension fund trustees exercising discretion must advance the interests of various claimants to the surplus on wind-up is a unique aspect of the application of trust law to the distribution of surplus in the U.K..

(b) Resulting trusts and irrevocable trusts on termination

The role of the resulting trust on wind-up presents another unique aspect of the application of trust law in U.K. judgments. The Judicial Committee of the Privy Council was called upon to decide the fate of a surplus in a pension fund for employees of Air Jamaica.¹³⁵ The Air Jamaica plan was not subject to any pension legislation as Jamaica had not enacted such legislation and thus, the fund was held in a common law trust. When the airline was privatized, all of its employees were terminated, with many being re-employed by the new owners. After the employees were terminated, the plan was

¹³² *Ibid.*

¹³³ *Mettoy Pension Trustees v. Evans*, [1991] 2 All ER 513 (Ch. D.) ('Mettoy v. Evans').

¹³⁴ *Ibid.*

¹³⁵ *Air Jamaica v. Charlton*, [1999] 4 LRC 444; [1999] 1 WLR 1399 (PC (Jamaica)).

amended to permit the employer to obtain the entire substantial surplus in the plan. The plan had provided that no contribution by the company would be repayable to the company and that any surplus on discontinuance of the plan would be used to increase plan members benefits. The Judicial Committee held that the surplus distribution provision and the amendment to that provision were both void for perpetuity because they vested trust funds more than 21 years after a life in being. In addition, the amendments were invalid because the company could not validly amend the plan to remove the restriction on repayment of contributions, nor provide for surplus distribution to the company.

Although the Attorney-General for Jamaica claimed the surplus in the fund as *bona vacantia* and should go to the Crown, the Judicial Committee held instead that it was held in a resulting trust for both employer and plan members in proportion to their contributions to the fund. It rejected the contention that the “non-repayment” intention was sufficient to rebut the presumption of a resulting trust because in every case there is an intention by the settlor to part with the beneficial interest. It held that a resulting trust arises by operation of law when that intention is defeated and its operation is outside the terms of the particular trust. In reaching this result, the Judicial Committee disapproved of the reasoning in an earlier case which held that since employees were receiving all of their benefits, any surplus attributable to their contributions was *bona vacantia* on the grounds that it was not obvious that the employees would not have a reasonable expectation that any over funding attributable to their contribution would be returned.¹³⁶

Thus, the application of resulting trust doctrine to a pension trust in which the plan does not completely dispose of any surplus remaining on wind-up has been approved by the Judicial Committee. Of course, the statutory scheme for distribution of surplus on wind-up in the *Pensions Act, 1995* will affect the application of this reasoning to many plans in the U.K.. However, it would require a reconsideration of the SCC’s discussion about the applicability of a resulting trust in *Schmidt v. Air Products, supra* for the reasoning in *Air Jamaica* to be applicable in Canada. In addition, the Judicial Committee reasoning was

¹³⁶ *Ibid.* referring to *Davis v. Richards and Wallington Industries Ltd*, [[1991]] 2 All ER 563 (Ch. D.).

premised on the surplus distribution language being void as a perpetuity, and not just vague or ambiguous in wording.

(c) Surplus use in on-going plans

The House of Lords has interpreted some of the statutory provisions concerning surplus in an ongoing plan in its 2001 decision in *National Grid Co Plc v Mayes*.¹³⁷ The House of Lords held that an employer, given the power to make arrangements to deal with any actuarially certified surplus in the fund that the actuary said were reasonable, could use part of the surplus to extinguish a debt owed to the pension fund for additional benefits granted to some employees made redundant. It held that such a use of the fund did not run afoul of the prohibition on any amendment “making any of the moneys of the Scheme payable to any of the Employers”. Such language had been included in pension plan documents to satisfy the requirements of income tax legislation which was concerned with preventing abuse of the tax exemptions by allowing the fund to be returned to an employer and not to provide rights or entitlement to plan members. The court held that extinction of an accrued debt did not have the same fiscal impact as the payment of some of the fund’s assets to the employer and was not subject to the prohibition.¹³⁸ In response to the argument that s. 37 of the Pensions Act 1995 delegated the power to pay surplus out of the plan to the trustees, subject to the conditions discussed above, not to the employer, the House of Lords held that the arrangement to extinguish the debt was not a payment out of the fund to which s. 37 could apply.¹³⁹ Although the House of Lords recognized that the provisions of the Pensions Act 1995 were enacted to protect plan members, not the fiscal interests of the Crown, it held that the degree of protection provided only extended to the removal of assets already in the funds, which it characterized as a balance between protection of members and flexibility of funding by the employer. Thus, contribution holidays with respect to accrued liabilities would not be prohibited by non-reversion language in the pension plan rules or affected by s. 37 of the Pensions Act 1995.

¹³⁷ *National Grid Co Plc v. Mayes*, [2001] 2 All E.R. 417 (HL); reversing [2000] I.C.R. 174 (CA (Civ Div)), reversing, [1997] O.P.L.R. 207 (Ch D) ('National Grid v Mayes').

¹³⁸ *Ibid.* at paras. 18 – 25.

¹³⁹ *Ibid.* at paras. 27-34.

In *Stevens v. British Airways Plc*, the Court of Appeal held that the pension plan provisions authorizing the trustees to create a “scheme” to dispose of excess assets gave them the power to create a reserve against future contingencies or increase member benefits, after granting a mandatory contribution holiday to the employer, but not to return contributions to the employer from the fund.¹⁴⁰ Finally, in a case in which an employer closed a defined benefit plan to new members and introduced a defined contribution plan for new employees and some defined benefit plan members who agreed to transfer, the Chancery Division held that the employer could use the surplus in the defined benefit plan to fund its contributions to the defined contribution plan without infringing on the prohibition in the pension fund rules on returning any portion of the fund to the employer.¹⁴¹ One of the arguments rejected by the Chancery Division was that the provisions of s. 67 of the Pensions Act 1995 prevented the amendment of the pension rules to provide a defined contribution because it would adversely affect a right or entitlement of members. The court held that the interest of plan members in “having surplus preserved for their benefit” is neither a right nor an entitlement under the provisions of the Pensions Act 1995.¹⁴² An earlier decision of the Chancery Division holding that an employer could not use surplus in this fashion was distinguished on the grounds that the documents creating the defined contribution plan contained an “unequivocal obligation” to actually pay its contributions into the fund.¹⁴³

It seems quite clear that the U.K. courts are able to allow employers to utilize surplus in an on-going plan despite their being funded through trusts in which tax regulation required that no part of the fund could be returned to the employer.

2. Comparison of Legal Rules and Media

At the outset the problems with inter-jurisdictional comparisons should be highlighted. The interpretation of statutes and common law decisions is highly contextual. The law

¹⁴⁰ *Stevens v. British Airways Plc*, [2002] EWCA Civ 672, [2002] O.P.L.R. 207 (CA (Civ Div)) ('Stevens v. British Airways').

¹⁴¹ *Barclays Bank Plc v. Barclays Pension Funds Trustees Limited*, [2001] O.P.L.R. 37 (Ch D) ('Barclays v Barclays Trustees').

¹⁴² *Ibid.* at paras. 119 – 130.

¹⁴³ *Ibid.* at paras. 94 - 96, distinguishing *Kemble v. Hicks*, [1999] O.P.L.R. 1, [1999] Pens. L.R. 287 (Ch. D.).

concerning pension plans in the jurisdictions reviewed above draws on concepts originating from income tax, employment, and trust law. Each country's pension system has a unique historical development which reflects its own legal and business culture as well as particular events which served as an impetus for legislative action. These differences can make comparisons of limited value.

a. Comparison of purposes and effects of segregation

The Commission has requested that this Report analyze how the various legal regimes deal with the purposes and effects of the segregation of plan assets. The purposes and effects of requiring external, rather than internal, pension funding were canvassed earlier in sections 1. c. & d.. They can be summarized as insulating the fund from the demands of a plan sponsor's creditors in the event of a bankruptcy and preserving the fund from being consumed to meet the financial demands of the plan sponsor's business. In addition, an external funding mechanism also separates the investment risk of the fund to be separated from the risks to the plan sponsor's particular business. The policy goals of the legal regimes can be divided into those arising from tax policy and those arising from regulation of minimum standards for pension plans in order to protect plan members' benefits.

Tax regulation was originally concerned with ensuring that pension funds were genuine benefits being provided to employees, and not a disguised accumulation of tax-free assets by a plan sponsor. These purposes were advanced by requiring a legal separation of the assets from those of the employer and withholding tax preference from contributions to funds where plan sponsors could recover those contributions and their investment returns at some later date by reserving the power to retroactively eliminate the benefit (by, for example, revoking a pension trust before employees benefits were vested) were two early forms of tax regulation.¹⁴⁴ Minimum standards pension regulation's purposes were to increase the protection offered to plan members and beneficiaries by legislation that bolstered the private pension system's funding of benefits by ensuring adequate funding and safeguarding them from speculative investments, while trying to provide some form

¹⁴⁴ Stephen Sass, *Promise of Private Pensions*, *supra* note 5 at 103–111; Donovan Waters, *Ontario Pension Surpluses*, *supra* note 37 at 147.

of portability of pension benefits.¹⁴⁵ This legislation adopted the requirement for separation of the assets from tax policy and also incorporated another mechanism, statutory minimum standards for vesting of benefits, which would protect the fund's assets from recapture through retroactive rescission of the promise by the plan sponsor, as well as increasing the number of plan members who would receive benefits after providing significant service to the plan sponsor.¹⁴⁶ By doing so, pension legislation gave actively employed plan members legally enforceable claims on the assets of the pension fund for the amounts needed to fund their vested pension benefits. Thus pension legislation made it clear that plan members were the beneficiaries of the fund's assets, at least to the extent they were required to pay for accrued benefits.

However, in the case of surplus plan assets in excess of the plan's current liabilities, the plan vesting provisions do not create a legal claim to those assets. None of the statutory pension regulation regimes in Canada, the U.S. and the U.K. directly assign the right to enjoy surplus assets in the plan. Instead, they all permit the plan sponsor to obtain the surplus assets from the pension fund, if the pension plan gives the plan sponsor a right to do so. In Canada, non-legislative rules created by the revenue department for registration of tax-qualified pension plans do require that the plan assign any surplus assets to the plan sponsor on termination, and permit a refund of excess assets to the plan sponsor from an on-going plan that the department considers to be excessively over funded. However, these rules are not determinative of surplus ownership.¹⁴⁷ Except for those plans where the plan sponsor's express right to surplus assets has been included in the terms of the plan funding arrangement from its inception, the bulk of the legal disputes concern the ability of the employer to amend the plan's terms to provide the plan sponsor the right to surplus assets in the pension fund.

i. Withdrawal of surplus from an on-going plan

A distinction can be made between withdrawals of surplus from on-going pension plans and terminated pension plans in respect of the analysis of the purpose and effects of

¹⁴⁵ Martin Friedland, Sydney Jackson and Clifford Pilkey, *Report of the Task Force on Inflation Protection for Employment Pension Plans* (Toronto: Queen's Printer for Ontario, 1998) at 14.

¹⁴⁶ Alicia Munnell, *ERISA – The First Decade*, *supra* note 2 at 52

¹⁴⁷ *Schmidt v. Air Products*, *supra* note 64 at 651

segregation of the pension assets. Withdrawal of assets from an on-going plan raises a number of conceptual and regulatory issues that are not present when the withdrawal is from a terminated plan. The first issue, mooted in cases in all jurisdictions, is that a surplus in an ongoing plan is not an “actual” surplus, but only the result of the best efforts by an actuary to calculate the future value of assets and liabilities in the plan. Recent events, which saw pension plans go from surplus to significant deficits over the course of a few years due to unexpected economic factors, provide evidence that permitting withdrawal of assets based on such surpluses may affect the security of the funding of plan members’ benefits. Nevertheless, revenue authorities do try to limit the over-funding of plans based on their concerns about the abuse of the tax-free accumulation of assets in pension funds. Thus, these two competing regulatory considerations affect policy concerning this issue.

The U.S. does not permit withdrawals of surplus assets by the plan sponsor from the plan while the plan is on-going.¹⁴⁸ In the U.K. such withdrawals are no longer required by the revenue authorities and are subject to the determination by the plan’s trustees that the withdrawal is in the best interests of the plan’s members.¹⁴⁹ In Canada, Ontario requires unanimous consent of plan members, retirees and beneficiaries to a payment of surplus to a plan sponsor from an on-going plan, in addition to the retention of a portion of the surplus as a cushion against adverse economic experience. All of these requirements reflect a concern about the effect on future security of benefits of allowing some of the assets to be withdrawn while a plan is on-going and recognize the interests of plan members in these effects by requiring the consent of the affected members or, in the U.K., trustees acting as fiduciaries. However, in all jurisdictions the use of surplus assets in lieu of additional employer contributions to fund pension benefits is permitted, unless the contribution obligation is to make a fixed contribution. Such a use of the surplus is not treated as a withdrawal since the assets remain in the fund.

ii. Surplus withdrawal from terminated plans

¹⁴⁸ Bernard Adell, *Path for Reform*, *supra* note 22 at 222

¹⁴⁹ See text accompanying notes 126 - 128 *supra*.

The concern about potential adverse effects on benefit security from a surplus withdrawal in an on-going plan is not present when the proposed surplus payment is from a terminated pension plan. In such a case, the surplus is not the result of an actuarial calculation based on a forecast about future events, but rather the actual value of the assets that exceed the cost of providing all of the accrued benefits up to the date of termination. The other policy concerns – ensuring that the plan genuinely benefits the sponsor's employees and it is not being abused to provide tax-preferred income for the sponsor are also not prominent concerns in this situation. Benefits are being provided and any abuse may be remedied. Two additional policy issues concerning defined benefit pension plan terminations may be relevant. The first issue concerns the incentives generated by the treatment of large pension surpluses on sponsors' decisions to terminate the plan. The second issue concerns the equities involved in competing claims to the ownership of the surplus.

The first issue is the concern that, if sponsors can gain access to a surplus by terminating the plan, there will be an increased incentive to terminate the plan in order to recapture the surplus. Such terminations will lead to diminished pension incomes on retirement, if not accompanied by the creation of another plan covering the same employees in which the employees receive credit for past service with the employer in calculating their benefits in the new plan.¹⁵⁰ Nevertheless, the private pension system in all three jurisdictions is premised on the plan sponsor's decision concerning the creation and maintenance of a pension plan as being entirely voluntary. To the extent a plan termination is motivated by the desire to obtain all of the surplus assets in the plan, some Canadian jurisdictions provide a mechanism for surplus sharing agreements as either an option or, in the case of Ontario, a prerequisite for surplus payments to the employer.¹⁵¹ However, an Ontario court has ruled that in order for a surplus sharing agreements to permit payment of surplus to a sponsor, provision must also be made in the plan for

¹⁵⁰ Richard A. Ippolito, "Issues Surrounding Pension Terminations for Reversion" (1986) 5 *American Journal of Tax Policy* 81 [hereinafter Richard Ippolito, *Pension Terminations*] at 83-86 provides calculations showing that the loss of future increases in the value of the pension benefits based on increases in wage rates that reflect future inflation until retirement is a substantial one when compared with the that portion of the employees' compensation which would have been contributed to the plan based on actuarial costing which takes future inflation into account.

¹⁵¹ See surplus sharing provisions outlined in section B. 1. b. *supra*.

payment of surplus to the sponsor on wind-up.¹⁵² This has constrained the use of surplus sharing agreements in Ontario to circumstances in which an employer is clearly entitled to the wind-up surplus or obtains a court order. Neither the federal, Quebec or British Columbia legislation imposes such constraints on agreements, provided the requisite level of consent has been obtained. While this decision may impose additional constraints on plan terminations in Ontario, if employers cannot obtain surplus on plan termination, the concern has been expressed that sponsors will fund at the bare minimum level and thus increase the potential for a deficit in the plan at some future date.¹⁵³

With respect to the equities concerning this issue a discussion of these will undoubtedly be included in the Commission's Report on Asymmetry and Deferred Wages. To some extent, some of them may be expressed in the decisions of the courts discussed below.

b. Comparison of results for different forms of media

In Canada, the outcomes of disputes over surplus entitlement have turned on two factors. The first factor is whether or not the funding is provided through a trust. The second factor is the types of constraints imposed on the power to amend the funding arrangements of the plan. Several comments on the relationship of the type of funding media and entitlement to surplus were reviewed for this report. What is clear is that there is nothing intrinsic in the use of a trust fund, per se, that determines the issue of surplus ownership. Rather, it is the choices made by Canadian courts concerning trust law principles together with the language of the trust chosen to meet the requirements of early taxation rules regarding pension plans that have created the current legal regime regarding surplus.

Canadian courts have made three choices concerning the application of trust law principles to pension funds held in trust that have inhibited plan sponsor access to surplus on termination of the plan. These choices are highlighted by Dona Campbell as follows: a refusal to restrict the scope of the trust to just those funds required to fund the benefits accrued on termination; equating an amendment to the trust providing for reversion of

¹⁵² *Kent v. Tecsyn International Inc.*, [2000] O.J. No. 1826 (O.S.C. (Div. Ct.)).

¹⁵³ ACPM, *Back from the Brink*, *supra* note 21 at 2.

surplus to the sponsor to a revocation of the trust; and, eliminating the possibility of a resulting trust by refusing to treat the payment of all pension liabilities on termination as the exhaustion of the objects of the trust.¹⁵⁴ The result of these choices is that a plan sponsor cannot validly amend the pension trust in order to insert new language to give the sponsor any surplus on termination. The trust extends to all assets, the power to revoke a trust must be expressly provided in the original trust order to make such an amendment valid and there can be no resulting trust as long as there are members of the plan who can benefit from the distribution of surplus.

Following the decision in *Schmidt v. Air Products*, *supra* Eileen Gillese called for the creation of a framework of intelligent and flexible principles to be used in the analysis of pension law issues.¹⁵⁵ She suggests that whether trust or contract reasoning should dominate might depend on whether the question was being asked about a continuing or a terminated plan. She pointed out the inconsistency with trust principles of allowing contribution holidays while a plan was on-going and suggested that it indicated that contract reasoning was more consistent with the on-going plan.¹⁵⁶ Approximately ten years later after Gillese's article was published, the Supreme Court of Canada outlined some limits to trust law's application to pension trusts in its decision in *Buschau v. Rogers Communications*, *supra*. In that decision, the court rejected the application of the trust law rule permitting all of the beneficiaries to collapse the trust holding that it was incompatible with the statutory scheme governing the pension plan.¹⁵⁷ Among the reasons why the trust law rule was inapplicable, offered in the judgment written by Deschamps J. for herself and two other members of the Court, was the fact that the sponsor had a legitimate interest in the plan and that the decision whether or not to terminate was ordinarily left to the employer. In addition, Deschamps J. pointed out that the important social purpose of providing financial security through periodic payments following retirement served by pension plans would be defeated by distributing the entire

¹⁵⁴ Dona L. Campbell, "Preparing for Successful Pension Litigation: An Analysis of the Implications of Trusts vs. Insurance Contracts for Entitlements to Pension Surplus" (1996) 15 *Estates and Trusts Journal* 331 at 338-340.

¹⁵⁵ Gillese, *Pension Plans supra* note 4 at 224.

¹⁵⁶ *Ibid.* at 235-36.

¹⁵⁷ *Buschau No. 2, supra* note 81.

capital in lump sum payments.¹⁵⁸ The decision written by Bastarache J. on behalf of himself and two other members of the Court agreed with the result and pointed out that the plan stated it was intended to be continued indefinitely and that allowing termination and distribution of the fund was inconsistent with the social policy of retirement security for plan members.¹⁵⁹ Both decisions expressed concerns about the effects on the private pension system of giving plan members a unilateral right to terminate a plan which an employer voluntarily created.

Canadian jurisprudence can be contrasted with U.S. cases dealing with surplus on termination which reach opposite conclusions about the choices concerning the application of trust law. In these cases, a broad power to amend is held to be sufficient to validly amend the plan to provide for surplus assets to be distributed to the plan sponsor on termination, unless the plan expressly prohibits any reversion of assets to the sponsor in strong language.¹⁶⁰ Even the characterization of the sponsor's contributions as irrevocable has not been sufficient to prevent an amendment permitting the sponsor to obtain the surplus on termination.¹⁶¹

In addition, U.S. federal courts have found that pension plan trusts containing language mandated by the pre-ERISA Internal Revenue Code non-diversion requirements implicitly incorporated the qualification in the Code that non-diversion requirement only applied until after the satisfaction of all liabilities.¹⁶² Therefore, since ERISA's passage had not affected this provision, an amendment could be made permitting the sponsor to obtain the surplus on termination and that this result was also consistent with the trust doctrine of a resulting trust.¹⁶³ Where a pension trust was created prior to ERISA and prohibited any amendments that diverted any part of the trust fund to the sponsor, the federal court held that the sponsor could amend the trust to receive the surplus on

¹⁵⁸ *Ibid.* at 997-98.

¹⁵⁹ *Ibid.* at 1021.

¹⁶⁰ See text accompanying notes 108 to 116 *supra*.

¹⁶¹ *Borst v. Chevron Corp.* (1994) 36 F.3d 1308 (C.A. 5) (21/10); affirming 764 F.Supp. 1149 (S.D. Tex. 1991), *cert. denied*, 514 U.S. 1066 (U.S.S.C. 1995) ('Chevron'), *supra* note 107

¹⁶² *Pollock v. Castrovinci* (1983) 476 F.Supp. 606 (S.D.N.Y.).

¹⁶³ *Ibid.* at 616.

termination because the trust referenced in the amendment provision was only for those assets needed to fund the accrued benefits and not for any surplus assets.¹⁶⁴

Daniel Fischel and John Langbein have highlighted what they consider to be the inaccurate portrait of the reality of a modern pension plan in ERISA's importation of the duty of loyalty from trust law in the form of the exclusive benefit rules.¹⁶⁵ In their view, the inaccurate portrait can only be corrected when courts and decision-makers "recognize the multiplicity of interests that inhere in the modern pension ... trust" and suggest that the trust law concept of the duty of impartiality should be the basis for taking these multiple interests into account.¹⁶⁶ They argue that both employers and employees should be considered both settlors and beneficiaries of a pension trust. They are settlors because the funding of the trust is part of the employees' compensation and the employer must be willing to create the plan. They are beneficiaries because they both enjoy the tax advantages of a registered pension plan and because they share the benefits of reduced labour costs resulting from decreased turnover, recruitment and training costs. Thus, pension plans operate for the mutual advantage of both parties, not the exclusive benefit of one of them. ERISA's exclusive benefit rules fail to articulate this economic reality.¹⁶⁷ However, they point out that, in the case of asset reversions on plan termination, ERISA has been treated by the courts as abridging the exclusive benefit rule because the exclusive benefit provisions are expressly made subject to ERISA's termination provisions which permit asset reversions to sponsors.¹⁶⁸

Fischel and Langbein suggest that the fact that the pension scheme is a complex multiparty arrangement indicates that plan administrators may owe duties to the plan members, the sponsor, its shareholders, the federal PBGC and the revenue authorities. With respect to the sponsor they argue that recognition of the sponsor's interests in the plan is already present in the power to create, amend, terminate, appoint plan administrators and recapture surplus assets. While recognizing the potential for conflicts

¹⁶⁴ ¹⁶⁴ C.D. Moyer, *supra* note 112.

¹⁶⁵ Daniel Fischel and John Langbein, "ERISA's Fundamental Contradiction: The Exclusive Benefit Rule" (1988) 56 *University of Chicago Law Review* 1105.

¹⁶⁶ *Ibid.* at 1105

¹⁶⁷ *Ibid.* at 1118-19.

¹⁶⁸ *Ibid.* at 1152-53.

of interests and opportunistic behaviour by sponsors after the plan is in place, they suggest that actions by the sponsor be evaluated in light of what reasonable parties would have decided at the time of the plan's creation based on their mutual beneficial interests in a pension plan.¹⁶⁹

Thus, in the U.S. pension trusts are interpreted in light of the intent of the statutory provisions incorporated into these trusts to qualify them for tax deferral. In addition, under U.S. trust law, a broad power to amend is considered to include the right to revoke the trust. The Restatement of the Law of Trusts 2nd contains the following commentary on the power to modify a trust:

§331 h. Whether power to modify includes power to revoke. If the settlor reserves a power to modify the trust, it is a question of interpretation to be determined in view of the language used and all the circumstances whether and to what extent the power is subject to restrictions. If the power to modify is subject to no restrictions, it includes a power to revoke the trust.¹⁷⁰

There do not appear to be any differences in the results based on the pension funding mechanism, although none of the cases reviewed involved an insured benefit or a fund administered by an insurance company. The absence of such cases may reflect the smaller number of plan members of U.S. defined benefit pension plans funded solely through insurance companies. Between 1993 and 2004 the U.S. Department of Labour reported that the single employer defined benefit plan members whose pension funds were invested in a trust increased from 61.97% to 69.38% of the total membership of single employer defined benefit pension plans. In the same time period, the percentage of members in plans where the funds were invested in an insurance company went from 1.53% to 1.97% of total membership in such plans.¹⁷¹

¹⁶⁹ *Ibid.* at 1157-59.

¹⁷⁰ § 331, 2007.

¹⁷¹ Percentages calculated from the U.S. Department of Labor, '1993 Private Pension Plan Bulletin', Abstract of 1993 Form 5500 Annual Reports (1996) in Publications Table B9 - Number of Participants by type of plan and method of funding <http://www.dol.gov/ebsa/publications/bulletin/tbl_b9.htm> (accessed 05/11/07) and the U.S. Department of Labor, '2004 Private Pension Plan Bulletin', Abstract of 2004 Form 5500 Annual Reports (2007) Table B9 Number of Participants by type of plan and method of funding <<http://www.dol.gov/ebsa/PDF/2004pensionplanbulletin.PDF>> (accessed 5/11/07).

In the U.K. the use of pension surplus on plan termination has been highly regulated for a number of years. Priority claims on surplus were given to the provision of indexation in accordance with the statutory minimum requirement. As well, trustees given the discretion to distribute surplus to plan members are under a fiduciary obligation to consider whether and how much to distribute before any distribution to the employer may occur. Finally, the plan must provide for distribution of assets to the employer. Where the scheme's amendment powers prohibit amendments that would allow any of the trust assets to be returned to the plan sponsor, or where the scheme requires surplus to be distributed to the plan members, any amendment to distribute surplus to the employer will be invalid. None of the cases concerning surplus distribution on termination seem to turn on the funding medium being a trust rather than a contract, but none of the few cases concerning surplus on termination involved an insurance company funding arrangement. In part this may reflect the fact that insurance arrangements are more prevalent among the smaller plans in the U.K. In a 2003 survey of employers in the UK, 23% of salary-related (defined benefit) schemes were insured.¹⁷² However, the insured plans were more prevalent in plans with the fewest members, with only 4% of schemes with more than 5000 members insured, growing slowly to 5% of schemes with 1000 – 4999 members and 10% of schemes with 500 – 999 members. For plans with less than 499 members, approximately 25% were insured plans.¹⁷³

In his article “Pensions as Property”, Richard Nobles examines the claims of both plan members and sponsors in a U.K. defined benefit pension scheme to determine if they can be characterized as property or contract claims.¹⁷⁴ He points out that lawyers would not find any of the legal rights (alienation, management and enjoyment) normally incident to property ownership to be residing in either members or sponsors while a plan is on-going. Instead members enjoy the right to pension benefits, while sponsors may enjoy residual assets on wind-up, although that enjoyment may be conditional on the discretionary

¹⁷² Andreas Cebulla and Sandra Reyes De-Beaman, 'Employers' Pension Provision Survey 2003 Research Report No 207' (2004) in U.K. Department for Work and Pensions Research Reports <<http://www.dwp.gov.uk/asd/asd5/rports2003-2004/rrep207.asp>> (accessed 29/10/07), Table 7.1.

¹⁷³ *Ibid.* at Table 7.3.

¹⁷⁴ Richard Nobles, “Pensions as Property”, (1994) 14 *Legal Studies* 345-63 [hereafter Richard Nobles, *Pensions*].

decision to increase benefits using surplus assets on wind-up.¹⁷⁵ He suggests that pension disputes can be characterized as a contest between two divergent perspectives on what the rights of the parties to the pension scheme ought to be based in the understanding of the degree to which the incidents of ownership are transferred through the creation of a trust. These perspectives serve as a context from which the court interprets the meaning of the words in the pension documents.¹⁷⁶ Nobles contrasts the two possible extremes of interpretation of a pension trust as: first, a transfer of beneficial ownership from the settlor to the beneficiaries, who may then collapse the trust if they all consent; and, second, a discretionary trust in which the settlor retains important ownership powers, including the powers to dismiss and appoint trustees, amend the trust and change classes of beneficiaries, while the beneficiaries have no claim that the trustees' discretionary power to distribute assets to trust beneficiaries must be exercised in their favour.¹⁷⁷ As Nobles points out, neither members nor sponsors had been entirely successful in convincing the courts in the U.K. to adopt their perspective on the issues. On the one hand courts have held that employees were not entitled to have a portion of the surplus in a fund transferred to another pension fund because the surplus in an ongoing plan could be used to fund the employer's contribution.¹⁷⁸ On the other hand, courts have required a discretion to use surplus assets on wind-up to increase member benefits to be exercised as a fiduciary power¹⁷⁹ and required an sponsor's veto on using surplus to increase benefits in an ongoing plan to be exercised reasonably and in a way that reflected the relationship of trust and confidence between the sponsor and members.¹⁸⁰ Nobles concludes then that property concepts do not assist in understanding the pension scheme's rights and duties because of their inability to resolve issues arising from the complex mixture of common law, equity, statutory requirements and discretionary power in the pension scheme.

Instead, Nobles suggests that courts' decisions in these cases were influenced by the origins of the pension scheme in the (explicit and implicit) contractual terms of the

¹⁷⁵ *Ibid.* at 346-47.

¹⁷⁶ *Ibid.* at 350-51.

¹⁷⁷ *Ibid.* at 353.

¹⁷⁸ Citing *Imperial Foods Ltd's Pension Scheme, Re*, [1986] 2 All ER 802 (Ch. D.).

¹⁷⁹ Citing *Mettoy Pension Trustees v. Evans*, [1991] 2 All ER 513 (Ch. D.) ('Mettoy v. Evans'), *supra* note 133

¹⁸⁰ Citing *Imperial Group Pension Trust Ltd v. Imperial Tobacco Limited*, [1991] 2 All ER 597 (Ch. D.).

employment relationship, so that a power to consent was subject to the implicit good faith obligation. Similarly members' reasonable expectations arising from the fact the contributions by the employer are earned required that discretion over use of surplus to increase benefits be exercised as a fiduciary discretion. He suggests that courts will end up creating rules for pension disputes by looking at how the parties would have expected discretionary power to be exercised based on what is appropriate within an employment relationship.¹⁸¹ In Nobles' view, while the employment relationship can serve as a source of protection against an abuse of power or actions which undermine employees' limited property rights in the pension scheme, it will not increase those proprietary claims.¹⁸² In his 2001 case comment, Nobles expressed concern that the House of Lords in *National Grid Co. plc v. Mayes*¹⁸³ may have acted contrary to the expectations of the members by refusing to differentiate between employer surplus refunds, forgiving debts due to the pension plan and contribution holidays from increasing benefits to the plan members. He points out that although they may have the same effect on security of their benefits, the refunds to the employer reduce the value of the employer's past contributions (and therefore employees' past compensation) retroactively.¹⁸⁴

The views of Gillese, Fischel and Langbein and Nobles about the role of trust law in the determination of rights and obligations in defined benefit pension plans share the common theme that trust concepts do not capture all of the factors that must be evaluated to make that determination. Two factors that do not appear to be completely captured are the role of the pension contribution as part of the plan members' compensation and the benefits delivered to the plan sponsor from a functioning pension plan. In addition, the provision for a constantly shifting plan membership from new hires, employees of businesses acquired by purchase or merger and from layoffs and voluntary terminations add to the conceptual difficulty of defining a proprietary relationship between the plan members and the trust fund's surplus assets using trust concepts.

¹⁸¹ Richard Nobles, *Pensions*, *supra* note 181 at 357-60.

¹⁸² *Ibid.* at 363.

¹⁸³ *National Grid Co Plc v. Mayes*, [2001] 2 All E.R. 417 (HL); reversing [2000] I.C.R. 174 (CA (Civ Div)), *reversing*, [1997] O.P.L.R. 207 (Ch D) ('National Grid v Mayes'), *supra* note 137

¹⁸⁴ Richard Nobles, "Pension Scheme Surpluses: National Grid in the House of Lords" (2001) 30 *Industrial Law Journal* 318. at 319.

3. Litigation Experience

The Commission requested an assessment of levels of litigation, if possible. There are certain evidentiary difficulties with such a request. Litigation is a multi-faceted activity, much of which does not end in a final decision by the courts. Proceedings are commenced and then settled or abandoned as parties re-assess their legal positions in light of information gained during the litigation process. In addition, litigation is cyclical. Once a particular point of law has been authoritatively established, litigation concerning that issue may subside and another issue may become the focus of litigation.

It is difficult to determine what information needs to be included in an assessment of levels of litigation. Beyond saying that there has been litigation concerning surplus distribution on plan termination and concerning the use of surplus in on-going plans, there is little in the way of assessment one can conduct in terms of a level of litigation. A review of the LexisNexis Quicklaw database of reported decisions of Canadian courts and tribunals concerning pension surplus disputes was conducted. An attempt was made to categorize the results by:

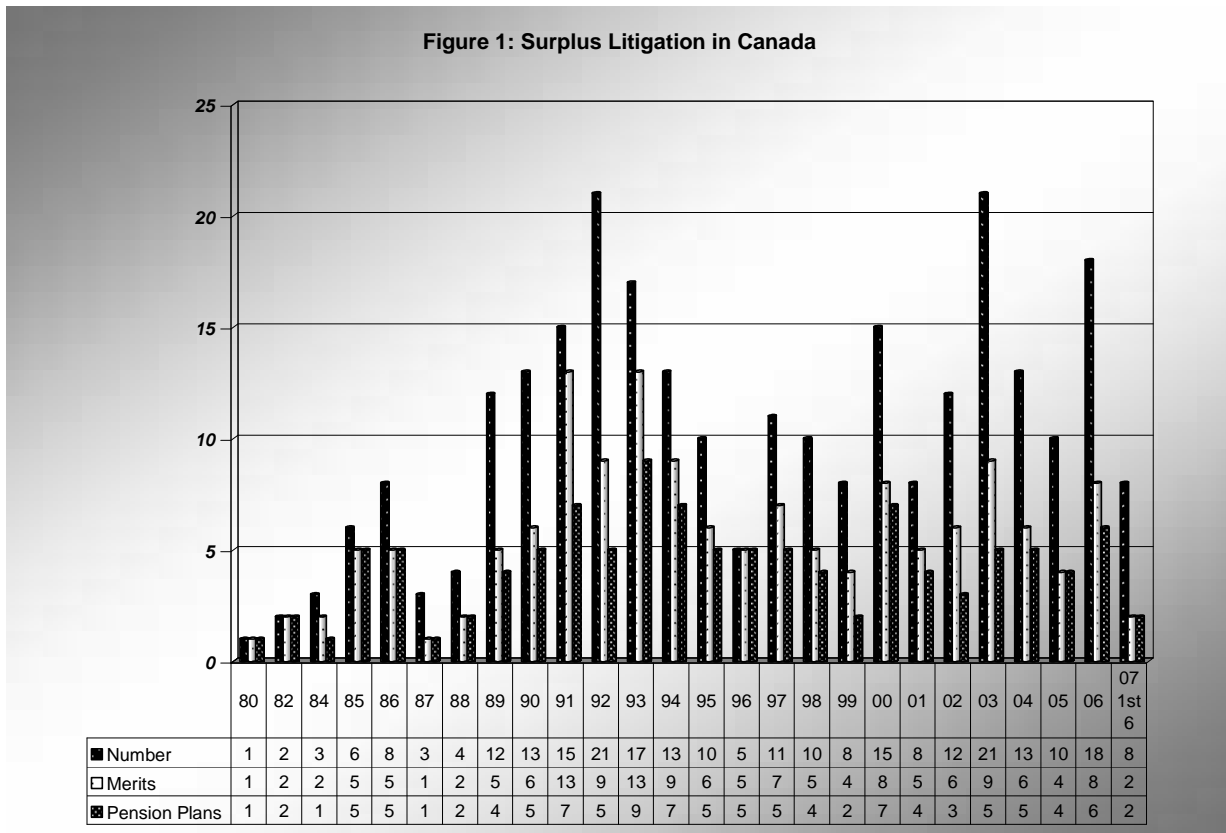
1. The total number of reports dealing with disputes over the ownership or use of surplus assets in a defined benefit pension plan, excluding disputes about breach of fiduciary duties unconnected to surplus ownership or use – “Number”
2. The number of reports dealing with the merits of these disputes, excluding class certification decisions and post-merits decisions about costs or damages, but including court orders sanctioning settlements of the disputes – “Merits”
3. The number of reports dealing with particular pension plan, excluding earlier decisions by lower courts or tribunals where the appeals were reported – “Pension Plans”
4. The number of reports in which the plan funding mechanism was an insurance contract – “Insurance Contract”, a trust fund – “Trust” or some other form or not described in the report – “Other or Unknown”.

The data suffers from a number of shortcomings. Using key words to conduct an electronic search for legal cases can cause one to miss those cases where the words are used in a way that is outside the parameters of the search submitted to the data base. Determining whether the issue is one concerning surplus ownership or the use of surplus

assets is a matter of judgment and errors in judgment are possible. Classification of the pension plan funding mechanism can be difficult because it may not be mentioned in the case report or because the plan has been funded by different mechanisms during its life. In some of the latter cases, both types of funding mechanism have been counted where it is not clear that the court relied on one or the other in making its decision. As well, some reports concern two different plans with different funding mechanisms. Thus, while the data may give a fair understanding of the relative numbers of disputes and the role of various funding mechanisms, it does not purport to provide absolute numbers in these categories.

The total number of decisions collected involving disputes regarding surplus entitlement and use in defined benefit pension plans for the period 1980 – 2007 (first six months) was 267. However, if only the reports dealing with the merits of the disputes are counted that number is reduced from 267 to 148. If one only counts the disputes concerning particular pension plans once, then the number of disputes is only 111.

Figure 1 below shows the comparison between these three categories by year.



The decisions concerning those plan included in the Pension Plans category, above, have been subdivided by the type of funding mechanism reported in those decisions. In some cases more than one type of funding mechanism was used or otherwise relevant. Figure 2 below shows the comparison among those categories by year.

Figure 2: Funding Mechanisms in Surplus Disputes

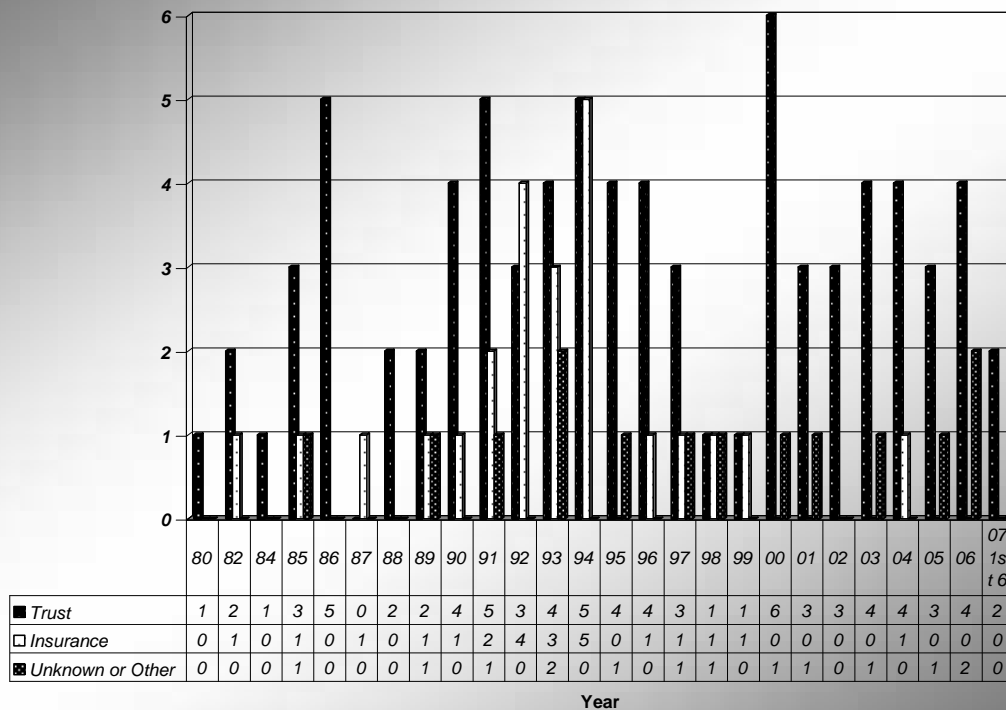
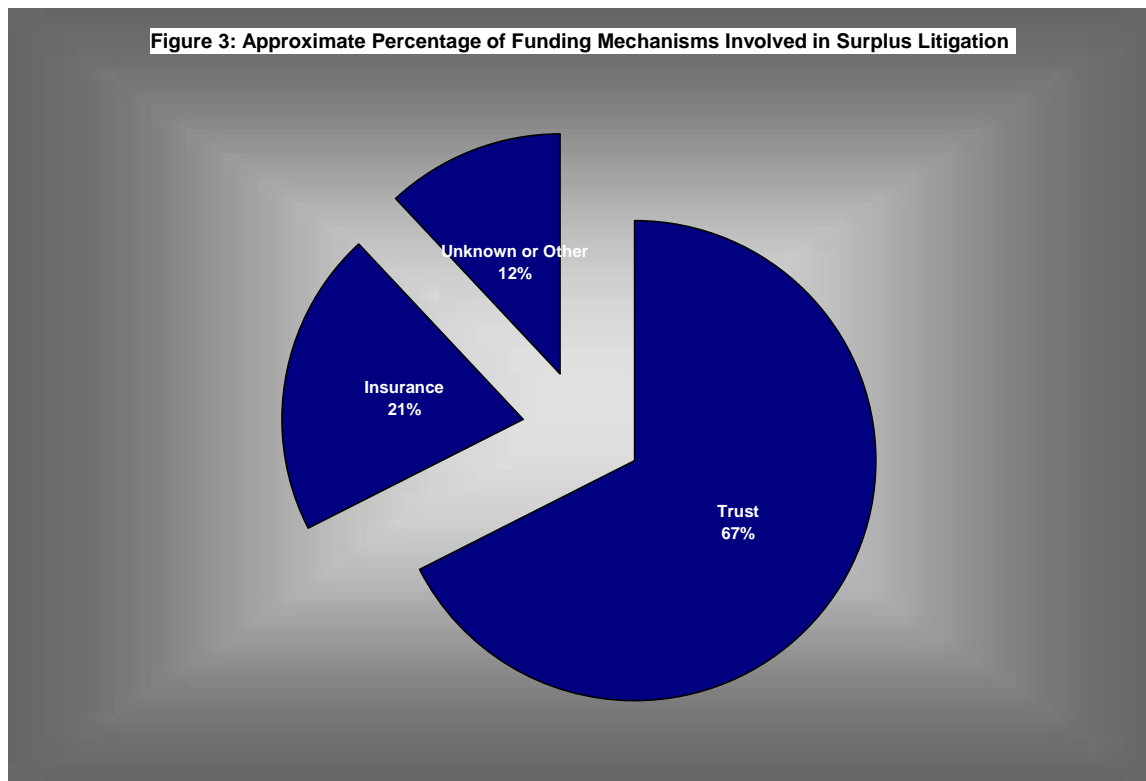


Figure 3 below compares relative totals of the various funding mechanisms in surplus disputes.



Another factor in assessing levels of litigation is the dominance of the trust as a funding medium for large plans in Canada. In fact, the percentage of plans and plan members in defined benefit pension plans funded by insurance contracts has declined since 1974. In 1974 61.9% of defined benefit plans with 11.4% of defined benefit plan members were funded by insurance contracts, while in 2006 those percentages were 28.8% and 7.2% respectively. The percentage of all defined benefit pension plans funded by a trust agreement has grown in the same period from 35% in 1974, when those plans' membership was 62.7% of the total membership of defined benefit plans to 68.8% in 2006 with their membership increasing to 76.8%.¹⁸⁵

¹⁸⁵ Statistics Canada. no date., Table 280-0014 - Registered pension plans (RPPs) and members, by funding instrument, sector, type of plan and contributory status, annual, CANSIM (database), . http://cansim2.statcan.ca/cgiin/cnsmcgi.exe?Lang=E&CANSIMFile=CII\CII_1_E.htm&RootDir=CII/ (accessed: November 21, 2007)

The potential for legislative intervention to deal with the policy issues concerning surplus in pension plans has been discussed by the Supreme Court of Canada¹⁸⁶ as well as in research reports to government task forces.¹⁸⁷ Without definitive legislation, our legal tradition determines and clarifies the rights and obligations of the parties concerning surplus distribution and use through common law adjudication.

Some Canadian jurisdictions have attempted to provide an alternative to costly litigation through a surplus sharing agreement mechanism, however, the use of such a mechanism requires a willingness to bargain on both sides of the agreement. In addition, the requirement under Ontario legislation that the employer establish an entitlement to surplus in the plan as a precondition of an effective surplus sharing agreement may have imposed some additional constraints on such agreements in that jurisdiction.¹⁸⁸ Some jurisdictions have also mandated arbitration of surplus disputes, however, this does not avoid costly litigation since the entire cost (including the cost of the arbitrator's fees) will be borne by the parties to the dispute.

A comparison of levels litigation between Canada and other countries is not possible within the parameters of the mandate, nor would it be useful because of the vastly different legislative and regulatory regimes in each country. As well, litigation decisions are driven by more than the formal entitlements created by the existing law. A number of other factors specific to a particular country may affect the decision to litigate a pension dispute. These may include regimes for the allocation of legal costs, the availability of class action procedures and the availability of specialized legal advice on pension matters, for example.

In Canada, most reported decisions involve a trust funding mechanism or a insurance contract held in trust. This should not be surprising since the trust is a predominant funding mechanism in larger Canadian pension plans where there is the potential for

¹⁸⁶ In *Schmidt v. Air Products*, *supra* note 64 at 680, Cory J. suggests a legislative scheme for the equitable distribution of surplus would avoid the unfairness of different results based on the funding medium chosen for the plan.

¹⁸⁷ Bernard Adell, *Path for Reform*, *supra* note 22 at 219, noting the absence of legislation that determines how surplus must be distributed.

¹⁸⁸ *Kent v. Tecsyn International Inc.*, [2000] O.J. No. 1826 (O.S.C. (Div. Ct.)), *supra* note 152

larger surpluses that would justify the expense of court proceedings concerning entitlement. In fact the proportion of cases involving trusts – 61%, is comparable to the proportion of plans in which a trust is the funding mechanism – 68.8%.