

## **Research Project #10: Protecting the Pension Fund**

### **Research Paper: Protecting the Pension Fund**

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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.