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Pension Update

June 2006

Trust Issues Continue To Cause Concern To Employers and Plan Administrators

The Ontario Divisional Court has recently added to the growing line of judicial decisions restricting the payment of expenses from pension plans, and cast doubt on some comments funding arrangements in hybrid defined benefits / defined contribution plans, in its decision in Nolan v. Superintendent of Financial Services. The good news is that the decision affirms the legitimacy of contribution holidays.

The Kerry Decision - Causing More Waves In The Pension Industry

Every now and then the courts throw another zinger at defined benefit plans. This is notwithstanding the efforts of the Financial Services Tribunal (the "Tribunal") which often arrive at reasonable decisions that reflect an understanding of the purpose of such plans.

The most recent zinger is the decision of the Ontario Divisional Court in Nolan v. Superintendent of Financial Services of March 15, 2006, an appeal from two 2004 decisions by the Financial Services Tribunal , and is usually referred to as the "Kerry" decision because the sponsor of the pension plan in dispute was Kerry (Canada) Inc.

The Kerry decision has cast fresh doubt in a number of areas. This update deals with two of the most important::

- The legitimacy of payment of expenses from the pension plan; and
- The use of defined benefit surplus to fund a later-created defined contribution component of what is called a "hybrid" plan.

Payment of Expenses From the Pension Plan

March 4, 2004 decision of the Tribunal focused more on the issue of which expenses could properly be paid from the plan and which expenses could not. There has been little disagreement with the Tribunal's view on this issue. However the Divisional Court disagreed on the issue of whether any expenses could be paid from the plan.

The Court reviewed the historic plan documents, determined there was a trust, with "exclusive benefit" and "irrevocable contribution" language, and an original plan text that was silent as to the payment of expenses. The power to revoke the trust was not reserved. The Court held that later amendments to permit the payment of expenses from the plan constituted an improper revocation of the trust.

We would have thought that the payment of the necessary expenses of the plan were at least an indirect benefit to the beneficiaries; we would also have thought that ordinary trust law principles contemplate the payment of trust expenses from the trust fund. However, the Divisional Court thought otherwise.

What are the implications of this aspect of the Kerry decision? Where expenses are being paid from the plan, there must now be a legal review of the historic plan and funding documents to ensure that expenses can be so paid at all and a clear policy as to which, if any, expenses can properly be paid from the plan.

Use of Defined Benefit Surplus To Fund The Defined Contribution Component

The plan in question was a defined benefit pension plan to which was added a defined contribution component. Notice of an election to convert to a "new plan", eliminating any pension entitlement "under the "current defined benefit plan", was given to members of the original defined benefit plan. The plan text was amended adding a defined contribution component. Those who converted and new hires were members of the defined contribution component. Those who did not convert continued to accrue benefits under the defined benefit component. The defined benefit component continued to be funded under a trust agreement. The defined contribution component was however funded by an insurance contract, which was not made an asset of the defined benefit trust. There appear to have been no overlap between the members of the defined benefit and defined contribution components.

The Divisional Court held that the surplus in the defined benefit component of the plan could not be used to fund the defined contribution component. The Court found that there were in effect two plans, notwithstanding the plan text that indicated there was a single plan with two components. Monies from the trust could not be transferred out of the trust which was for the exclusive benefit of the defined benefit component members to the funds held by the insurance company for another plan with different beneficiaries.

The implications of the Kerry decision to hybrid plans are serious. It is usual on plan conversions to provide that surplus in the defined benefit component will be used to fund the employer's contributions to the defined contribution component. It has also been common for the defined contribution component to be funded by an insurance contract that is not an asset of the trust governing the defined benefit component, because of the foreign property restrictions under the Income Tax Act that were in effect until recently. It is probably even more common for there to be some common membership in the defined benefit and defined contribution components of the plan. Plan conversions often require participation in a defined contribution component for future service, with an optional conversion of accrued defined benefits.

The Kerry decision is under appeal. Unfortunately its decision will be many months away. Plan sponsors, administrators and custodians have to deal with the decision we have. There may be steps that an employer with a hybrid plan can take in the meantime. Certainly they should seek legal advice about any present hybrid plan. Plan sponsors contemplating a conversion should also obtain legal advice as to the structure of the converted plan, and as to whether there are any impediments to the use of surplus in both components in the historic plan and trust documentation.

Was there anything positive for employers in the Kerry decision? Yes, the Divisional Court bowed to the Supreme Court of Canada in the Schmidt v. Air Products decision in permitting contribution holidays – just not in this hybrid plan situation. But once again, the courts have moved to constrict the ability of employers to deal with the monies in their pension plans. Creative legal approaches – and perhaps new legislation are called for.

Pallett Valo LLP Pension Law Group

The Pallett Valo Pension Group has the senior counsel experience and capability to deal with all aspects of the establishment, operation and dissolution of pension plans. These can include plan mergers, asset transfers, surplus management and withdrawal, partial wind-up issues, as well as employer-sponsored retirement or savings arrangements (savings plans, Group RRSPs, defined contribution plans, defined benefit plans and executive supplementary arrangements). Recent regulatory guidelines governing capital accumulation plans have added a layer of complexity to these arrangements. We also advise and help develop compliance and good governance procedures in accordance with best practices to minimize liability of employers, administrators and custodians.

The members of the Pension Group work closely with the Pallett Valo Insolvency and Corporate Restructuring Group for the restructuring of pensions and other retirement or savings arrangements, and with respect to employee medical and insurance benefits.

Contact Members of the Pension Law Group at Pallett Valo LLP

Priscilla Healy phealy@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 255

John Varley jvarley@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 291

Michael Nowina mnowina@pallettvalo.com
Direct Dial: 905.273.3022 Ext. 285

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If you would like additional copies of the bulletin, or know of anyone who would be interested in joining our mailing list, please contact **Jenny Chiu** at **jchiu@pallettvalo.com**.