

## **Court Of Appeal Decision In Kerry Not A Panacea**

By: Ian McSweeney & Louise Greig

On June 5, 2007, the Ontario Court of Appeal released its decision in Kerry (Canada) Inc. v. DCA Employees **Pension** Committee (Kerry). A key issue addressed by the Court of Appeal is what, if any, expenses can properly be charged to a registered **pension** plan. The Kerry decision, therefore, potentially impacts every employer, **plan administrator**, or trustee who, right now, is authorizing the payment of an invoice for a **pension** plan-related expense.

While the Court of Appeal decision was initially hailed as a big 'win' for **plan sponsors**, a sober second look discloses that a number of trouble spots remain. Contrary to some of the headlines, the Kerry decision does not give employers carte blanche to charge expenses to a **pension fund**. In addition, the case imposes a very high standard on **administrators** when communicating plan design changes to members.

### **What The Court Of Appeal Held**

The Court of Appeal's decision, in part, focused on the proper standard of legal review to be applied to the initial decision of the Ontario Financial Services Tribunal (FST) and the ability of the FST to award costs.

However, of particular interest to employers are the Court of Appeal's findings on the substantive issues of the case. When is it acceptable for pension plan expenses to be paid from the pension fund? Is it permissible to use surplus assets in the Defined Benefit part of the pension plan to pay current service costs of the Defined Contribution part of the plan? What constitutes proper notice of an amendment that will, or could, adversely impact plan members on a going forward basis?

On these issues, the Court of Appeal held that:

- The extent to which expenses can be charged to a pension fund will depend upon the wording of the historic plan documents. Based on such documents in Kerry, plan administration expenses generally could be paid from the plan fund, except for trustee expenses which the employer had originally committed to pay.
- The employer could take contribution holidays with respect to the DB component of the plan as there was nothing in the original plan text and trust which prohibited contribution holidays. For similar reasons, the surplus in the DB portion of the plan could be used to meet the employer's contribution obligations under the DC component of the plan, provided the plan was properly structured so as to make the members of the DC component beneficiaries of the plan's DB fund.
- The conversion of a pension plan from a DB plan to a DC plan creates uncertainty and risk for the plan members. As such, it is an "adverse amendment" within the meaning of Ontario's Pension Benefits Act and prior notice of the amendment must be given to affected members in accordance with Ontario's pension legislation before registration. The notice provided in this case was not sufficient as it was misleading and incorrect in that it did not properly describe the legal effect of the election to convert.

### **Background**

The Kerry pension plan has a similar history to many plans in Canada. It involved a DB pension plan that was established in the 1950s and funded through a trust. The plan was amended in the 1970s to permit plan expenses to be paid from the plan fund and was amended again in 2000 to introduce a DC component. In 1985, the employer began taking contribution holidays from plan surplus and charging expenses to the plan. After the DC component was implemented, the surplus in the DB component was also used to take employer contribution holidays under the DC component.

A group of former plan members (including executives who had made some of the decisions being challenged) complained to the Ontario Superintendent of Financial Services about the payment of plan expenses from the plan fund and the taking of DB and DC contribution holidays, alleging that these activities constituted a breach of trust. The superintendent investigated the matter and took action on only some of the member complaints. A series of appeals followed. The FST rendered a decision that was generally favourable to the employer. However, the Ontario Divisional Court largely overturned that decision in favour of the plan members. The matter was then appealed to the Ontario Court of Appeal.

## **Historical Plan Documents Still Determinative**

The Court of Appeal made it clear that the historic wording of plan and trust documents continues to be the key determinant when considering the ability of employers to pay plan administration expenses from the plan fund and to take contribution holidays. The requirement to undertake an analysis to determine whether contribution holidays are permissible is well-established in Canadian pension law. What was not clear before Kerry is what legal principles apply to such analysis in the determination of what plan expenses can validly be charged to a pension fund.

The Court of Appeal held that there is nothing in trust law which prevents a trustee from charging properly incurred expenses to a trust fund. In fact, that is the norm, subject to the provisions of the particular trust agreement. In Kerry, the original trust agreement required the employer to pay trustee expenses, but was silent on the subject of other types of expenses – investment, accounting plan administration, and actuarial fees. All of the parties accepted that the employer was on the hook for the trustee expenses. The only issue was whether a 1975 amendment authorizing the charging other types of expenses to the pension fund was invalid because of “exclusivity” language in the original trust agreement.

The Court of Appeal held that the 1975 amendment was valid. In reaching this conclusion, the Court of Appeal held that the restrictive “exclusive benefit” language in the original trust agreement was directed at what the Court of Appeal referred to as “true amendments,” that is, amendments which changed a party’s rights or obligations. The court stated that the amendment authorizing the payment of other types of expenses from the fund did not affect existing rights or obligations as the employer had not expressly or impliedly assumed the obligation to pay the expenses other than trustee expenses from the fund when the plan was established.

The Kerry case does not stand for the proposition that any plan-related expenses may be charged to the pension fund. The determination of whether expenses can be validly charged to the pension fund will turn on what the employer committed to paying when the plan was established (at least for plans funded through trusts).

## **Not All Expenses Can Be Charged To The Fund**

Even where plan language permits the payment of expenses from the plan fund, there still may be certain kinds of expenses that are not allowed. The Court of Appeal’s reasoning suggests that only those expenses incurred by the sponsor in its role as administrator (as opposed to its role as employer) can be charged to the plan fund. Thus, plan sponsors seeking to have expenses paid from the plan or assessing potential risks in relation to past expenses should be reviewing plan expenses to determine whether such expenses were incurred by the plan sponsor as employer or as administrator.

This is not always an easy task, given the ‘two hats’ that plan sponsors wear in respect of pension plans. For example, in Kerry, it was found that the consulting fees incurred by the plan sponsor in considering whether to implement the plan conversion (the costs incurred by the employer in determining whether to change the plan design) were incurred as employer; thus, such costs could not be paid from the fund. On the other hand, the implementation of those conversion changes were incurred as administrator and could be paid from the fund.

## **Doubt Cast On Whether Internal Expenses Can Be Charged To The Fund**

The Court of Appeal decision also suggests that the payment of a plan sponsor’s internal expenses could amount to a “revocation of trust,” depending on the historical plan and trust language. The Court of Appeal noted that “revocation” means “the return of (some or all) the trust funds to the person who placed the funds in trust.” The court held that on the facts of the Kerry case there was no revocation of trust in respect of the expense charges because the employer was only asking that third-party expenses be paid from the fund, not internal expenses. However, the clear implication of the decision is that charging internal expenses to a pension fund could amount to a revocation of trust in certain circumstances.

This is a troubling aspect of the Court of Appeal’s decision because it appears to create an incentive for employers to minimize the internal resources devoted to plan administration and to outsource administrative tasks to third parties. It is hard to believe that the Court of Appeal intended this result.

The Court of Appeal’s holding also brings into question whether an employer can obtain reimbursement from the pension fund for third-party expenses even where such third-party expenses would properly be chargeable to the pension fund if they were paid by the fund directly, as such reimbursement arguably involves the return of trust funds to the employer. Perhaps, however, it is possible to argue that in such circumstances the employer is simply acting as paying agent for the fund, not in its capacity as employer. This would appear to be the right result from a policy perspective.

## **Cross-subsidization – Use Of DB Surplus To Fund DC Contribution Obligations Upheld**

One of the most controversial aspects of the lower court decision in Kerry was the holding that a partial plan conversion results in the creation of two separate plans and that the use of DB surplus to fund DC contribution obligations, therefore, amounts to illegal ‘cross-subsidization.’

The Court of Appeal has restored what many practitioners believe to be the correct legal analysis:

- first, a plan conversion does not generally result in the creation of two separate plans
- secondly, there is nothing wrong in principle for the sponsor of a converted or partially converted plan to use DB surplus to fund DC contribution obligations as long as it is documented and structured correctly. Indeed, (and as the Court of Appeal noted) the regulations under Ontario pension legislation expressly contemplated such use.

The Court of Appeal held that the flaw in Kerry was that the amendment implementing the partial plan conversion did not expressly make the members of the DC component beneficiaries of the DB fund. However, the Court of Appeal agreed with the FST that this deficiency could be remedied through a plan amendment and a restructuring of the funding arrangements for the plan.

Interestingly, the Court of Appeal indicated that if the DC members are made beneficiaries of the DB fund, they would have a claim to surplus on plan termination. This result seems logical, but it raises a question as to whether the converse would be true – that is, in an insolvency situation, would DC members have their benefits reduced if a plan is wound up with a DB deficiency? Given the nature of DC benefits, this would be a surprising result.

### **Communications With Plan Members**

The Court of Appeal was highly critical of the communications provided to plan members about the plan conversion. In the court's view, the communications did not properly describe the legal effects of the conversion. In particular, the Court of Appeal held that the statement that a member who elected to transfer to the DC component would "have no further rights and entitlements under the Defined Benefit plan" was misleading because it suggested that the conversion extinguished all rights, including the member's rights to surplus, which the court found to be incorrect in law.

The Court of Appeal has set a high standard for communications with plan members, placing an onus on plan sponsors to communicate clearly and accurately with plan beneficiaries. Communications that do not meet this standard could impair the effectiveness of changes to a pension plan or otherwise expose the plan sponsor to risks associated with miscommunicating the terms of a pension plan or benefits thereunder. Such risks could be even greater where members are being asked to consent to a change in, or make an election affecting, their benefits or rights under the plan.

### **Practical Implications Of The Kerry Decision**

A key 'take-away' from the Kerry decision is that an employer's ability to charge even routine expenses to a pension fund is dependent on the historical plan documentation. Employers and administrators cannot rely on favourable language in the current plan documents as authorization to pay expenses from a pension fund. Employers, therefore, need to ensure that proper advice is received when determining what expenses can be properly charged to the pension fund. As well, in our experience, the validity of charging expenses to the plan fund is frequently raised as a collateral issue in disputes between employers and members over surplus entitlement. Employers must, therefore, factor in potential claims concerning expenses when making strategic decisions regarding surplus.

A second lesson to be learned from Kerry is that when changes are made to a plan, how those changes are structured and documented will have a direct impact on whether the changes will achieve the intended result from a legal perspective. Not only does this apply to plan conversions, but it would also apply to other events such as plan mergers and asset transfers.

Third, employers need to ensure that communications to members are fully reviewed and vetted to ensure that they are consistent with pension legislation and the plan documents, and that they properly describe the legal effect of any changes or rights concerning the pension plan. This is true for all member communications, but particularly critical if the change is potentially disadvantageous to members.

So far, the member committee has not yet filed an application for leave to appeal the Court of Appeal's decision to the Supreme Court of Canada, but it has until September to do so.

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