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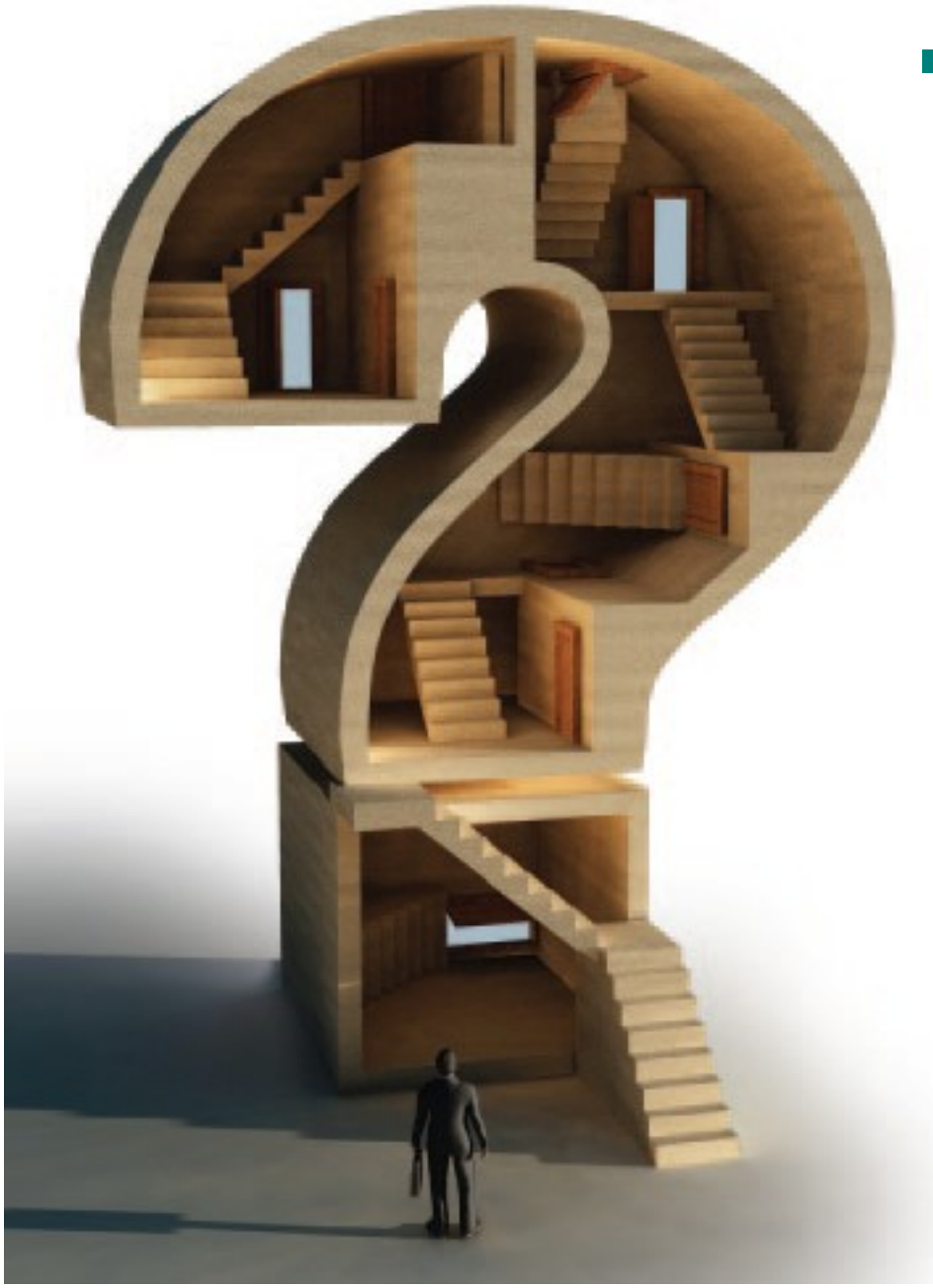
Cracks in the DIPs?



What if DIPs did not always work?
In a stunning decision rendered on April 7, 2011, regarding Indalex Limited, the Ontario Court of Appeal held that deemed trusts associated with underfunded pension plans survive a *CCAA* filing and may be held to trump previously authorized DIPs. Whether such deemed trusts will take precedence over DIPs is a matter of fact, which the Courts will be called upon to assess on a case-by-case basis.

DIPs are not the only focus of the Indalex decision and many aspects of the decision could be written about. However, regarding DIPs specifically, the decision raises many very serious practical issues as well as legal challenges for insolvency professionals. Besides the unpredictability that it instills in the market, the decision appears inconsistent with prior case law, incompatible with current practice and in clear contradiction with the terms (and philosophy) of the *CCAA*.

Leave to appeal to the Supreme Court of Canada has been sought, but if Indalex is allowed to stand, it will have profound implications for institutional lenders that lend against the inventory, accounts receivable or cash collateral, as well as for businesses that depend on such financing.

While the direct legal effect of the decision is limited to Ontario regulated pension plans, insolvency professionals, lenders and borrowers across Canada will also have to deal with the issues brought into focus by the decision.

Background

Indalex was the sponsor and administrator of two underfunded defined benefit pension plans. One of the plans (the plan for the benefit of former salaried employees) was in the process of being wound up when Indalex filed for protection from its creditors under the *CCAA*.

Shortly after the *CCAA* filing, Indalex obtained DIP financing secured by a super-priority court-ordered charge. The DIP order provided that the charge ranked senior in priority to all other liens, including statutory trusts. Indalex's U.S. parent guaranteed the obligations of Indalex under the DIP.

Subsequently, the *CCAA* Court approved a sale of Indalex's assets on a going-concern basis. At the sale approval hearing, representatives of the pension plan beneficiaries obtained an order requiring that $6.75 million, being the estimated amount of the underfunding of the pension plans, be held by the Monitor pending further order of the Court.

The proceeds of sale were insufficient to repay the DIP lenders in full and Indalex's U.S. parent paid the shortfall pursuant to its guarantee. The estate of the U.S. parent took the position that the U.S. parent was subrogated to the position of the DIP lenders under the super-priority DIP charge. The Court was asked to determine if the reserve funds should be used to cure the pension plan deficiencies or released to the U.S. estate.

Ontario Statutory Deemed Trust Includes Wind up Deficiency and Future Special Payments

The Ontario Court of Appeal held that upon the commencement of the winding up of an Ontario regulated defined benefit pension plan, there is a deemed trust prescribed by Section 57(4) of the *Pension Benefits Act* (Ontario) (PBA) that secures all amounts owed by the employer under Section 75 of the PBA, including future special payments and any wind up deficiency. That holding is inconsistent with comments made in by the same Court in Ivaco and the holding of the Superior Court of Justice in Usarco. In those earlier decisions the courts concluded that the deemed trust provision referred only to regular contributions and special payments that were to have, but had not been, made.

The Court of Appeal held that the phrase "accrued to the date of wind up but not yet due under the plan or regulations", which appears in section 57(4) of the *Pension Benefits Act (Ontario)* and establishes a deemed trust on the windup of a plan, includes all amounts owing to the pension plan on wind up even if those amounts are not yet due under the plan or regulations. The Court relied on the Supreme Court of Canada case law that held that money is "due" when there is a legal obligation to pay, while payments are "accrued" when the rights or obligations are constituted and the liability to pay exists, even if the payment does not need to be made until a later date. The Court of Appeal was of the view that the deemed trust includes all amounts owed by the employer on the wind up of its pension plan, including future special payments and any wind up deficiency payable over the period of time prescribed by the applicable regulations.

The Court of Appeal also distinguished the recent decision of the Supreme Court of Canada in Century Services and held that the filing by an employer under the *CCAA* does not trigger bankruptcy priorities. Accordingly, the Court of Appeal held that provincial non-bankruptcy rules continue to apply to the extent that they are not inconsistent with the *CCAA*. The Court of Appeal did not discuss the September 2009 pension related amendments to the *CCAA*, which were made after the commencement of the Indalex case and therefore the Court of Appeal did not address whether or not Ontario statutory priorities are now inconsistent with the amended *CCAA*.

***CCAA* Applicants Wear Two Hats**

In Indalex, the Court of Appeal invoked what has been referred to in

other cases as the "two hats" analogy. That analogy holds that an employer wears its corporate hat when managing its business and wears a fiduciary hat and must act in the best interests of the plan's members and beneficiaries when acting as plan administrator. The Court of Appeal held that, when an employer is the administrator of a pension plan (which is normal in all provinces except for Quebec), the employer owes a fiduciary duty to the pension plan beneficiaries both at common law and by virtue of Section 22 of the *Pension Benefits Act (Ontario)*. The Court of Appeal held that the duty did not prevent Indalex (wearing its employer hat) from filing under the *CCAA*. However, it was improper in the Court's view for Indalex (wearing its plan administrator hat) to do nothing to protect the rights of the pension plan beneficiaries and to fail to put someone else in the position to protect those rights.

The Court also stated that it was improper for Indalex to seek leave to file for bankruptcy (without any request from arm's length creditors) and to delay the commencement of the wind up of one of the pension plans in order to reverse the priority of the pension claims.

The Court concluded that it was appropriate to protect the beneficiaries of the plan that was not being wound up at the time of the sale by imposing a constructive trust as a remedy for the breach. In so doing, the Court emphasized that it was the estate of the U.S. parent of the employer that would have benefitted if the constructive trust was not imposed to protect the pension plan beneficiaries.

Super-Priority DIP Financing?

The Court of Appeal confirmed that *CCAA* courts have jurisdiction to grant priority to a DIP lender over pension claims, but held that in order to do so there must be adequate notice and disclosure and explicit recognition of such priority in the court record based on the paramountcy of federal insolvency law over provincial law relating to property and civil rights. The Court also accepted the proposition that upon payment under its guarantee the U.S. parent was entitled to recover the balance of the DIP loan on a subrogated basis. However, the Court held that the subrogated claim did not have priority over the statutory or constructive pension trusts for various reasons including that the disclosure and notice given at the time the DIP loan was originally approved by the Court was inadequate.

Navigating the New Landscape

Some of the implications of the decision (unless overturned on appeal) are as follows:

1. Lenders relying on the security of accounts receivable and inventory are at risk of being subordinate to wind up deficiencies of Ontario regulated defined benefit pension plans. Lenders, swap counter-parties, and others relying on cash collateral (in the form of bank deposits) as security may also be subject to that risk. Banks may conclude that taking *Bank Act* security as well as security under provincial legislation helps to mitigate the risk.
2. The practice used when applying for or recommending court approval of DIP and receiver's charges will likely evolve to require additional disclosure and broader notice. One option is U.S. style, two-stage interim and final approval motions. A different approach to the *CCAA* comeback clause may also be necessary.
3. The appointment of independent plan administrators may become more common in restructurings and receiverships. Receivers and Monitors with enhanced powers may be concerned about personal liability in the absence of such appointments.
4. Doubt has been cast about the use of bankruptcy proceedings to defeat the priority of provincial statutory liens and trusts for pension and other claims. Accordingly, receivers may not get court authority to assign debtors into bankruptcy. Any application for authorization to make an assignment will have to be brought on notice to the plan members or their representatives.
5. It is possible that constructive trust claims will come to be asserted more frequently in Canadian insolvency proceedings.

Clearly, the decision does not mark the end of DIP lending in Canada. However it does add a layer of cost, complexity and uncertainty to the practice of asset based lending, especially to distressed businesses. This, in turn, could very well have the effect of tightening the credit available to Canadian distressed businesses. RS

Éric Vallières has been retained by CAIRP to intervene in this case.