Research Project #13: Analysis of Pension Plans in Insolvencies

Research Paper: Analysis of Factors Leading to Insolvency and Restructuring and Their Effects on Pension Plan Wind-ups and Closures

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EXECUTIVE SUMMARY

Much of the impetus for Ontario's current regime of pension legislation had its origins in the need for minimum standards regarding adequate funding of private sector pension promises, which was highlighted by the termination of underfunded plans by insolvent plan sponsors and the loss of promised benefits by the affected plan members. Recently, some high profile insolvency proceedings involving Air Canada and Stelco highlighted another facet of the relationship between pension plans and plan sponsor insolvency when underfunded pension plans became a major factor in directors' decisions to restructure their liabilities. Thus, both plan members and the plan sponsor's investors have a shared interest in ensuring that pension plan liabilities are securely funded. This report reviews the sources of risks that pension plans will be underfunded, the potential effects of that underfunding on plan sponsor solvency, and the ramifications of sponsor insolvency for the pension plan members in an underfunded plan.

Legislative and Regulatory Mitigation of Insolvency Risk

The pension promise around which pension plans are built has some structural aspects that can lead to its being unfulfilled in the event of a plan sponsor's insolvency. In return for services rendered during the plan member's employment, the sponsor promises to pay benefits to the member for life, following the member's retirement from employment. Fulfillment of such a promise is premised on the sponsor's continued existence throughout the plan member's employment and, thereafter, for the balance of the member's life, as well as the financial capacity to pay the promised benefits at the time they are due. Plan sponsor insolvency can destroy those premises because the sponsor may not survive and its assets may be distributed among its creditors. Pension legislation has addressed these risks by requiring pre-funding of the promised benefits; providing plan members with an enforceable claim to their accrued benefits after a short period of service with the employer; and requiring, in concert with federal tax rules, that the assets required to be used for pre-funding the promised benefits be legally separated from those of the plan sponsor. The latter requirement insulates the pension plan's funds from the claims of the plan sponsor's creditors in the case of the sponsor's insolvency. These legislative and regulatory requirements have substantially mitigated the insolvency risk for plan members. However, there is still some risk of underfunding at the time of sponsor insolvency.

These remaining risks are two-fold. First, a sponsor in financial difficulty may delay remitting required contributions to the pension fund and, if the sponsor becomes insolvent, those unremitted contributions will have to be collected through the insolvency proceeding. Although pension legislation attempts to provide some protection by deeming these contributions to be held in trust, the statutory deemed trust has not proved effective in separating the amount of contributions owed from the other assets of the sponsor in insolvency proceedings. These unremitted contributions are therefore treated as unsecured claims in the distribution of the sponsor's assets among its creditors, with the result that the pension fund will recover only a small fraction of the contributions owing. This risk affects both defined benefit and defined contribution plans.

The second risk, unique to defined benefit pension plans, is that the fund set aside to pay for the promised benefits will not be sufficient to pay the full amount required to provide the accrued benefits if the plan is terminated as a result of the sponsor's insolvency. Pension legislation requires that the determination of the amounts required to be contributed by the sponsor to the pension fund be calculated by a member of the actuarial profession using accepted actuarial practice. Actuarial practice necessarily involves forecasting numerous future events in order to determine how much must be contributed today to fund benefits payable years, perhaps decades, in the future. Any deviation from that forecast may lead to the assets in the fund being less that the liabilities accrued at a particular point in time. If that point in time coincides with the sponsor's insolvency, then benefits will not be fully funded. Ontario pension legislation provides protection against this risk by requiring tri-annual assessments of the solvency of the pension fund and, if those assessments indicate that liabilities exceed assets, the sponsor is required to make special payments to the fund over the next five years in order to extinguish the shortfall. However, this payment schedule can expose the plan members to a shortfall risk in the event of the sponsor's insolvency for a period of up to eight years.

Relationship between Insolvency Risk and Sponsor Insolvency

Plan members share insolvency risk with the sponsor's investors. The requirement that the sponsor must make special payments over and above the normal cost of the pension benefits in order to pay off the solvency deficiency can impose significant demands on the sponsor's cash flow. If these demands coincide with a period of financial stress for the sponsor, they may be the trigger for the sponsor's insolvency. Economic shocks such as rapid drops in share price, steadily declining interest rates and unforeseen events that change expected earnings and/or the cost of benefits can increase risk to pension plans or can precipitate insolvency proceedings and impose losses on the plan members and beneficiaries in the form of reduced benefits. Plan members' claims for the balance of any remaining deficiency in the fund's assets and any unremitted contributions will be treated as unsecured claims in a liquidation and distribution of the sponsor's assets in an insolvency proceeding. Insolvency and bankruptcy law is aimed at providing an orderly distribution of assets where a plan sponsor is liquidated, while providing a mechanism that allows plan sponsors, in some circumstances, to attempt to devise a business plan such that the plan sponsor can restructure and carry on business. A restructuring plan may allow the sponsor to continue through the compromise of creditors' claims and

through pension risk allocation in the form of amended plans, extended amortization schedules, letters of credit and termination of plans.

While unremitted contributions during bankruptcy do not currently qualify for a preference, proposed federal legislation would enhance the position of such claims by securing pension contribution arrears with a charge over the assets of the plan sponsor in both bankruptcies and receiverships. The amendments would also enhance the position of such claims in an insolvency restructuring proceeding.

Ontario is a leader in reducing insolvency risk through its Pension Benefits Guarantee Fund (PBGF). From 1980 to September 2007, the PBGF has paid out claims from 107 plan sponsors with a total of 144 pension plans, which represents only a fraction of the 7,674 plans currently covered by the PBGF. The PBGF has paid claims totalling $883 million and has recovered $48.5 million from the estates of plan sponsors in the same period. The data on the intersection of pension law and insolvency law continues to be limited. Of the amounts paid out by the PBGF to March 2006, 70% of pension plans for which claims were paid had plan sponsors in bankruptcy proceedings. The dollar value of total claims paid in respect of plan sponsors under *BIA* and *CCAA* proceedings was $823 million, representing 93% of the value of all claims paid out by the PBGF.

Private receivership and voluntary assignment into bankruptcy appear to be the two routes most frequently utilized prior to plan termination and claims to the PBGF. There are also a number of cases in which the plan sponsor has filed bankruptcy after a restructuring effort under the *BIA* or the *CCAA* and claims have been paid out by the PBGF. In contrast, in most cases of successful *BIA* and *CCAA* restructuring plans, the pension plan does not require access to the funds of the PBGF, indicating that restructuring proceedings are likely an important risk reduction tool at the point of plan sponsor insolvency. The PBGF has, however, been used effectively in a few instances, to facilitate the survival of a plan sponsor. In terms of timelines, the claims made to the PBGF follow a markedly different pattern than bankruptcy cases, which have been steadily in decline for the past decade. However, if one separates out the bankruptcy cases that involved failed *CCAA* proceedings, it is evident that payments by value out of the PBGF track the number of *CCAA* filings. Given that both restructuring and liquidation proceedings in Ontario have been concentrated in the manufacturing and retail sectors, the PBGF figures for bankruptcy filings also track general bankruptcy sector trends.

Examination of jurisdictions such as the UK, the US, Germany, and Sweden indicates that there are multiple strategies to reduce insolvency risk, including well funded national pension guarantee programs; early warning programs; risk levies; and other strategies noted in the study.