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Indalex: Priority of Provincial Deemed Trusts in a CCAA Restructuring

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Case Considered:

Sun Indalex Finance, LLC et al. v United Steelworkers et al., 2013 SCC 6

Introduction

On February 1, 2013, Supreme Court of Canada ("SCC" or "Court") released its much awaited decision, *Sun Indalex Finance, LLC et al. v United Steelworkers et al*. The case involved a company, Indalex, that was pursuing restructuring proceedings under the *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 ("CCAA"). Prior to its restructuring, Indalex had been failing to meet its employer contribution obligations to the company's pension plan and when the pension plan was wound up, there was a deficiency in the funds.

During its restructuring, Indalex obtained debtor-in-possession ("DIP") financing to fund its operations and when it subsequently sold its business, the proceeds of the sale were not enough to pay its creditors. The members of the pension plan claimed that the shortfall in the pension plan entitled them to a super-priority, such that their claim would be paid before the DIP lenders.

There were two main findings by the Court. With regard to the deemed trust, the Court was split but it upheld the finding of the Ontario Court of Appeal that a deemed trust had arisen under the *Pension Benefits Act*, RSP 1990, c P-8 ("PBA") in favour of the pension holders for the wind-up deficiency payments. However, the SCC overturned the Ontario Court of Appeal in its finding of the priority of the deemed trust, unanimously maintaining that the deemed trust would not be granted super-priority over the DIP lenders.

The Court also unanimously agreed with the Ontario Court of Appeal in its findings on the existence of a fiduciary duty owed by Indalex as administrator of the pension plans, and on Indalex's breach of that duty. A majority of the Court, disagreed, however, with the Ontario Court of Appeal's remedy for that breach, finding that the imposition of a constructive trust was not appropriate.

Facts

Indalex Limited ("Indalex") is a wholly owned Canadian subsidiary of a U.S. company, Indalex Holding Corp. ("Indalex U.S."). In 2009, both companies ran into financial trouble and in March 2009, Indalex U.S. filed for Chapter 11 bankruptcy protection in Delaware and one month later, in April 2009, Indalex applied for a stay under the CCAA. The stay was granted in an initial

order by Morawetz J. and FTI Consulting Canada ULC was appointed as the monitor ("Monitor"). Pursuant to this order, Indalex obtained protection under the CCAA.

At this time, Indalex was the administrator for two registered pension plans, one for its salaried employees ("Salaried Plan") and one for its executives ("Executive Plan") (collectively referred to as the "Plan Members"). Both plans faced funding deficiencies, in the amount of $1.8 million for the Salaried Plan and $3.0 million for the Executive Plan.

On April 8, 2009, Indalex was authorized to borrow US$24.4 million from the debtor-in-possession lenders ("DIP charge") and grant them priority over all the other creditors in that amount. The DIP financing was necessary to support Indalex's business until the sale could be completed, as the sale of Indalex and Indalex U.S. as a going concern was how the reorganization would be achieved under the CCAA and Chapter 11. In June 2009, Indalex applied for authorization to increase the DIP loan amount to US$29.5 million, which the court granted.

To effect its sale, Indalex commenced a bidding procedure, through which SAPA Holdings AB ("SAPA") bid US$30 million. At the time, the Monitor estimated the liquidation value of Indalex's assets to be US$44.7 million. SAPA did not intend to assume responsibility for the pension plans' wind-up deficiency. When Indalex and Indalex U.S. brought motions before the courts for the sale to be approved under the terms of SAPA's bid, the Plan Members opposed it. Their grounds for opposition were as follows:

1. The Plan Members estimated a forced liquidation would produce greater proceeds than SAPA's bid;
2. They asserted that their claim had priority over the DIP lenders because the unfunded pension liabilities created a statutory deemed trust under the PBA; and
3. They maintained that Indalex had breached its fiduciary obligations by failing to meet its duties as a plan administrator.

The court approved the sale on July 20, 2009 and directed the Monitor to make a distribution to the DIP lenders. The sale proceeds resulted in $30.9 million. The Monitor distributed US$17.0 million to the DIP lenders, paid certain fees and withheld $6.75 million in reserve for the Plan Members, pending the outcome on their arguments on their rights to the proceeds of the sale. As Indalex had owed $27 million to the DIP lenders, the payment of $17 million left a shortfall of $10 million. Indalex US covered the shortfall, as it had guaranteed the DIP lending agreement. Since Indalex U.S. was subrogated to the DIP lenders' priority, it became the highest ranking creditor of Indalex, with a claim of $10 million.

The Plan Members brought motions in August 2009, for a declaration that a deemed trust in the amount of the unfunded portion of the pension liabilities existed, which would be enforceable against the proceeds of the sale. Such a deemed trust would give priority to the Plan Members over the secured creditors pursuant to section 57(4) of the PBA and section 30.7 of the *Personal Property Security Act*, RSO 1990, c P-10 ("PPSA").

History of Proceedings

At trial, Campbell J. dismissed the Plan Members' motion, finding that the deemed trust did not apply to the wind up deficiencies. The Plan Members appealed. The Ontario Court of Appeal allowed the appeal and found a deemed trust pursuant to the PBA, with respect to the wind-up

deficiencies. It also found that the Executive Plan's members had a claim arising from Indalex's breach of fiduciary obligation, which resulted in a constructive trust. The Ontario Court of Appeal maintained that imposing a constructive trust would not harm the DIP lenders but rather, would only affect Indalex US. With regard to priority, the Court of Appeal found that the constructive trust had priority over the DIP charge.

SCC Appeal

The Monitor and Sun Indalex, a secured creditor of Indalex US, appealed to the SCC and raised four issues:

1. Does the deemed trust under the PBA apply to the wind-up deficiencies?
2. If so, does the deemed trust supersede the DIP charge?
3. Does Indalex have fiduciary obligations to the Plan Members when making decisions in the context of insolvency proceedings?
4. Did the Court of Appeal properly exercise its discretion in imposing a constructive trust to remedy the breaches of fiduciary duties?

Scope of Deemed Trust

The Court had to consider whether the deemed trust arising under section 57(4) PBA extended to the wind-up deficiencies. Section 57(4) of the PBA states:

> 57. . . .
> (4) Where a pension plan is wound up in whole or in part, an employer who is required to pay contributions to the pension fund shall be deemed to hold in trust for the beneficiaries of the pension plan an amount of money equal to employer contributions accrued to the date of the wind up but not yet due under the plan or regulations.

Section 75 PBA imposes an obligation on the employer of a wound up plan to pay into the pension fund an amount equal to the total of all payments that are due or that have been accrued and have not been paid (s 75(1) (a)) and under section 75(1) (b), there is a formula for calculating the amount that must be paid to ensure the fund can cover its liabilities upon wind up.

The majority found that the wind-up deficiency contributions are subject to a deemed trust as of the date the pension plan is wound up. It does not cover the deficiency in the pension plan which is not being wound up.

Priority of Deemed Trust and DIP Charge

The Court unanimously found that the DIP charge had super priority, which prevailed over the PBA deemed trust.

Fiduciary Duty and Remedy

The majority of the Court generally agreed that Indalex had breached its fiduciary duty as plan administrator but that the constructive trust imposed by the Ontario Court of Appeal was not the appropriate remedy.

Analysis: Issues

I wish to address two issues with regard to this case. First there has been an uproar about the priority afforded to the DIP lender in relation to the pensioners, with the view being that the pensioners should have been afforded a higher priority as opposed to being superseded by large commercial lenders. Under this issue, I will discuss what makes pensioners (and employees) vulnerable creditors, the type of protection we have for these creditors and the reason for DIP priority.

Second, the Court found that a deemed trust did arise in favour of the pensioners. In this case, the deemed trust did not take priority over DIP lenders due to the doctrine of federal paramountcy. Two questions will be addressed here. First, will the amendments to the CCAA have an effect on similar cases in the future? Second, what is the type of priority afforded to deemed trusts in relation to secured creditors other than DIP lenders?

I. DIP Lenders v. Pensioners

a. Pensioners as Vulnerable Creditors

On the first issue, there has been much criticism about the lack of protection for pensioners, most recently in response to the *Indalex* decision. Most of the criticism is aimed at the preference for larger creditors over pensioners. For example, Terence Corcoran questions why creditors are entitled to priority status over pensioners and maintains that "the legal and financial professionals who work the lucrative insolvency field in Canada have a list of reasons to put banks and other lenders ahead of employees and pensioners, none of which deserve the reverence and support they've received from Ottawa" ("Pensioners victims of inaction in Ottawa", National Post, February 5, 2013, here). Similarly, Dave Coles maintains "Bankruptcy laws that prioritize wealthy creditors over pensioners are fundamentally unjust" ("Pensions need better bankruptcy protection, "Winnipeg Free Press, February 7, 2013, here).

Certainly, uproar over the seeming protection of larger creditors, typically banks, at the expense of the pensioners, seems justified. Pensioners, like employees, are vulnerable creditors. Vulnerable creditors are creditors who are not in a position to protect themselves against the bankruptcy of the company and they rarely have access to information that would allow them to assess the risk of their employer becoming bankrupt and to consequently structure their affairs in anticipation. Such self-protection can come in many forms, usually unavailable to vulnerable creditors. For example, creditors can diversify their lending portfolios, or they can ask for higher interest rates when lending. They can also demand access to information about the debtor's financial position.

In contrast, employees and pensioners cannot demand information about their employers' finances, and even if they could, they still have limited recourse to protect themselves. While pensioners may have invested their money in various places throughout their lives, in most cases, their biggest return will come from the company's pension plan into which they paid throughout the course of their employment. They pay into a pension according to the company's requirements; while they may have some options as to the structure of their plans, they do not typically have a choice about paying into the pension plan. They cannot diversify employment and therefore pension plans in the same way a lender can diversify a lending portfolio. They cannot demand an interest rate to protect themselves against the possibility of the failure of the plan.

b. Protection for these Vulnerable Creditors

Employees are also vulnerable creditors, and they face similar types of issues; Parliament has attempted to address those issues through legislation. Canada has recently introduced the *Wage Earner Protection Program Act* (SC 2005, c 47, s 1 as amended by SC 2007, c 36, "WEPPA") to make payments to eligible individuals for unpaid wages earned six months prior to their employers' bankruptcy or receivership (ss 4-5, WEPPA). Under the WEPPA, if an eligible individual receives a WEPP payment by the Crown for unpaid wages, the Crown is subrogated to the claims to which that employee is entitled under the *Bankruptcy and Insolvency Act* (RSC 1985, c B-3, ss 81.3-81.4, "BIA"). The BIA gives unpaid employees a limited super-priority against the current assets of the employer, for an amount up to $2000 (ss 81.3 & 81.4 BIA).

A similar type of protection was considered for pensioners but was rejected in the report of the Standing Senate Committee on Banking, Trade and Commerce, Debtors and Creditors Sharing the Burden: *A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act* (November 2003, here) ("Report"). The Report acknowledged the vulnerability of pensioners but maintained that retirement benefits can be accessed from other sources (Canada/Quebec Pension Plan, Old Age Security and Guaranteed Income Supplement programs, and possible private savings and RRSPs) and concluded by noting that while greater protection might be desired by some, that protection "must be balanced against the interests of others" (Report, page 98). In that same Report, the Senate Committee recommended that the legislation be amended to protect employees in the way that was subsequently codified in the WEPPA.

While the WEPPA does not directly address pension contributions, the BIA and CCAA were amended to provide protection for employees with regard to pension contributions. The BIA creates a charge to secure unpaid pension contributions with regard to prescribed pension plans in a bankruptcy and receivership (ss 81.5 and 81.6, BIA). The charge ranks above any other claim against the bankrupt's assets (which is not limited to current assets, unlike the WEPPA charge) except the right to recover thirty-day goods, the charge in favour of suppliers of agricultural goods, the WEPPA charge, and the source deductions related to income tax, Canada Pension Plan, Employment Insurance, or the provincial equivalents. There is no limitation on the pension contribution charge, neither in amount of the claim nor in the time period in which the claim may be made.

c. Reasons for DIP Priority

While it may seem unfair that commercial creditors are entitled to priority over pensioners, this situation is necessary if financially troubled companies are going to attempt to restructure rather than declaring bankruptcy. And DIP lenders are vital to restructuring. The reason DIP lenders get a super priority is because they take on an enormous risk by lending to an insolvent company that has already given a security interest in all its present and after acquired assets. But companies that are attempting to restructure are, by definition, financially troubled. There is no guarantee that the restructuring will work but the restructuring attempt can only succeed if the company can borrow money. This means that no one will take on that risk without a guarantee that the loan will be repaid and in the absence of anyone taking on that risk, companies cannot restructure. Such a guarantee is not possible without a super priority, as insolvency is, by definition, the state of being unable to pay one's debts as they become due. Accordingly, unless a lender has a higher priority, it is unlikely the lender will be repaid anywhere near the full amount of the loan, if anything at all. As the Senate Committee noted, "insolvency – at its essence – is

characterized by insufficient assets to satisfy everyone, and choices must be made" (Report, page 99).

As unfair as it may seem, and it is unfair to those who are expecting payments from their companies after retirement, unless the regime is structured in this way, there will never the potential for companies to emerge from dire financial situations. If claims are allowed to supersede a DIP charge, potential DIP lenders have no incentive to lend to a sinking company, which all but guarantees the company's failure. These choices are difficult and on their face, seem to be feeding into the public outcry against big corporations who profit at the expense of individuals. The Court itself noted, "the harsh reality is that lending is governed by the commercial imperatives of the lenders, not by the interests of the plan members or the policy considerations that lead provincial governments to legislate in favour of pension fund beneficiaries" (*Indalex*, para 59). And when faced with the alternative, which is a potential undermining of our restructuring regime as a whole, a different path is difficult to justify.

II. Deemed Trusts

The main issue in this case was the priority of the deemed trusts in relation to the DIP charge. On this, the SCC held that the DIP charge given under the CCAA had priority over the provincial deemed trust based on the doctrine of paramountcy (*Indalex*, para 60). The PPSA requires pensioners to be paid before the secured creditors, but the Amended Initial Order in this case provided that the DIP charge ranked in priority to "all other security interests, trusts, liens, charges and encumbrances, statutory or otherwise" (*Indalex*, para 60). Being that priority was court-ordered under the CCAA, it has the same effect as statutory priority. And the inconsistency in the federal and provincial statutes gives rise to a different order of priority. Once the doctrine of federal paramountcy is applied, the claims by the DIP lenders supersede the pensioners' claims.

This decision was made pursuant to the CCAA as it was prior to the 2008 amendments. One of the questions that remain is whether the amendments would have any effect on the decision. Also, this decision discusses deemed trusts and their priority in relation to DIP lenders. Will secured creditors, other than DIP lenders, also have that priority over provincial deemed trusts in situations outside formal bankruptcy proceedings?

First, it is helpful to lay out the priorities under the different legislation, depending on the proceeding being utilized, as there are different priorities afforded to creditors, depending on the applicable legislation.

a. In Provincial Legislation

In this case, the PBA creates a provincial deemed trust (s 57(4)). The Ontario PPSA subordinates a security interest in an account or inventory or its proceeds to the interest of a person who is the beneficiary of a deemed trust arising under the PBA (s 30(7)). So the priorities are clearly set out under provincial legislation: in a situation involving the PBA and PPSA, the provincial deemed trusts take priority over secured creditors.

b. Provincial and Federal Legislation: the BIA

Once federal legislation becomes applicable, however, things change. Under the federal BIA, the treatment of trusts depends on their nature. The BIA exempts trust property in the hands of the

bankrupt from being distributed to creditors, meaning trust property is not available to be distributed to secured creditors (s 67(1)(a) BIA). However, deemed trusts in favour of the Crown get different treatment. The BIA holds that property of the bankrupt shall not be regarded to be held in trust, notwithstanding any provision in federal or provincial legislation that has the effect of deeming property to be held in trust for the Crown, if the trust would not be so regarded in the absence of that statutory provision (s 67(2) BIA). There is an exception to this, with regard to statutory deemed trusts for source deductions, such as Canada Pension Plan, Employment Insurance premiums and unremitted income tax (s 67(3) BIA).

While the BIA provision clearly lays out the treatment of deemed trusts in favour of the Crown, issues can arise with deemed trusts that arise in favour of parties other than the Crown, such as those arising under pension legislation. However, the case law indicates that those trusts get the same treatment. A case commonly cited on this issue is *British Columbia v Henfrey Samson Belair Ltd*. (1989), 59 DLR (4th) 726 (SCC) ("*Samson*"), where the Court determined that if the property deemed to be in trust by the province under the *Social Service Tax Act* (RSBC 1979, c 388) formed a true trust at common law, then the property would be exempt from distribution, thereby affirming the provision in the BIA. The *Samson* case has given rise to two interpretations, a narrow one which benefits ordinary unsecured creditors for whom a deemed trust is created (since they are not the Crown), and a broader one which maintains that any deemed trust created by provincial legislation, in favour of the Crown or not, must meet the common law requirements of trust law in order to obtain priority over secured creditors pursuant to the BIA. The broad view has been adopted by the Ontario Court of Appeal in *Re Ivaco Inc.* (2006), 275 DLR (4th) 132 (Ont. CA).

c. Provincial and Federal Legislation: the CCAA

The issue here is that while the priorities of deemed trusts in relation to secured creditors under the BIA might be clearly set out, it is not the case under the CCAA, another federal statute. If this were a case where the debtor initially proceeded under the CCAA, only to fail and end up under the BIA, then the BIA priorities would govern. But in this case, Indalex proceeded to sell its assets under the CCAA, not the BIA, leaving open the question of how the priorities would be interpreted. This can be moderated if courts permit claimants to obtain bankruptcy orders after liquidating pursuant to the CCAA, as doing so would trigger the rule in the BIA and annul the deemed trust (see Rod Wood, *Bankruptcy and Insolvency Law*, p.415; *Re Ivaco Inc*., *supra*).

In *Indalex*, the Court noted that courts do favour the interpretation of the CCAA "in a way that affords creditors analogous entitlements" (*Indalex*, para 51) but determined that that "does not mean that courts may read bankruptcy priorities into the CCAA at will" (*Indalex*, para 51). Finding that, the Court went on to conclude that the provincial deemed trust under the PBA applies in CCAA proceedings, subject to the doctrine of federal paramountcy, because of the Amended Initial Order, and noting that that means that when there is a CCAA liquidation proceeding, the PPSA may determine the priorities rather than the federal scheme under the BIA (*Indalex*, para 52), since analogous priorities are not set out in the CCAA.

d. Potential Issues under CCAA

As noted earlier, priorities with regard to deemed trusts under the BIA are not the same as under a CCAA restructuring, which could be problematic.

The *Indalex* decision was made pursuant to the CCAA as it existed prior to 2009, when many amendments were proclaimed, including the addition of provisions about interim financing (DIP financing). Interim financing is now provided for in the CCAA, and the provisions state that a court may make an order ranking the security or charge in priority of any secured creditor (s 11.2(2), CCAA). It is unclear whether a deemed trust will fall under the claim of a secured creditor. The definition of "secured creditor" under the CCAA does not appear to encompass beneficiaries of deemed trusts. If it doesn't capture them, there would be no inconsistency between the two statutes on the priority of deemed trusts, making the doctrine of federal paramountcy inapplicable and potentially leaving the door open to having deemed trusts take priority to DIP financing.

The Court itself noted that when there is a CCAA liquidation proceeding, the PPSA may determine the priorities, rather than the federal scheme under the BIA (*Indalex*, para 52). Aside from the inapplicability of federal paramountcy, an additional problem is that the provincial PPSAs and pension benefits legislation are not identical in their treatment of deemed trusts in relation to security interests arising under the PPSAs. In situations outside a formal bankruptcy proceeding, this could result in different treatment of pension benefits in different provinces depending on the wording of the provincial legislation, so long as it is not inconsistent with the interim financing provisions in the CCAA. While federal bankruptcy legislation does allow for different treatment of certain issues between the provinces, such as, for example, provincial exemptions, ideally the imposition of the federal scheme would allow for as few disparities as possible.