Emerging trends in pension investment litigation

By Michael Mazzuca

Increasingly, investment-related issues have become the focus of pension litigation. This is evidenced by class actions commenced by plan members regarding alleged imprudent investments and/or investment strategies, as well as a recent focus on investment issues by Canadian pension regulators.

The regulatory environment

Pension fund investments are subject to both legislative and regulatory enactments by the federal and provincial governments. All provincial pension statutes set out standards that must be followed for the investment of pension funds, including both a general standard of care and quantitative limits. Most provinces have now adopted the federal investment rules set out under the Federal *Pension and Benefits Standards Act*. Among other things, these rules establish restrictions on quantity and related-party transactions plus the requirement to have a Statement of Investment Policies and Procedures in place.

The standard of care provision set out in the Ontario *Pension Benefits Act* exemplifies the type of statutory standards expected of plan administrators. It provides that the administrator of a pension plan "shall exercise the care, diligence and skill in the ... investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person." In addition, the Ontario PBA sets out restrictions on conflicts of interest as well as a requirement to personally select and supervise any agents retained, including agents retained in regard to the investment of the pension fund.

Most plan administrators are generally familiar with these statutory and regulatory requirements. However, many may not be fully aware of all of the possible consequences of noncompliance. In addition to the prospect of an order from the regulator or a civil action, many pension statutes — including the Ontario PBA — also provide that legislative violations constitute a quasi-criminal offence with potential penalties on conviction of up to $100,000 for the first offence and up to $200,000 for each subsequent offence. Furthermore, directors, officers, officials or agents of a corporation may also be charged.

While pension regulators lay charges of this nature infrequently, pension administrators should remain cognizant of the possibility.

One of the first examples of charges laid relating to pension fund investments under the Ontario PBA arose from a situation involving a pension plan for employees of the Enfield Corporation Limited. Specifically, the members of the pension committee were charged with allegedly failing to supervise their internal investment manager adequately.

Convictions entered by the lower court were overturned on appeal, and verdicts of acquittal were entered, but there seems to be a clear indication that if the charges had been properly laid against the administrator rather than the members of a pension committee, the case would likely have concluded differently.

Defined benefit plans

In addition to possible regulatory charges, plan administrators may be sued civilly concerning fund investments. A civil action could be commenced where, the investment losses are allegedly a result of either an imprudent investment or an imprudent investment strategy; as well, a civil suit could arise as a result of claims that a plan administrator failed to properly select and/or monitor its investment agents.

There are already two certified class actions — one in Ontario and the other in Québec — dealing with pension fund investments, says Michael Mazzuca, a partner in the law firm of Koskie Minsky LLP.

Plan administrators also have an obligation to ensure that individual investments are appropriate for the pension fund, taking into account both risk and possible reward. In most cases, investment decisions will be delegated to investment professionals. Where such delegation is in place, then the plan administrator's responsibility is to ensure that the investment manager is properly selected and monitored.

There may also be situations where taken individually, an investment does not violate any of the statutory or regulatory requirements, but it is imprudent when viewed as part of an overall investment strategy. Because no single investment strategy or asset allocation is appropriate for all pension plans, the plan administrator must consider the specific plan's needs and the investment strategy, including asset allocation, must, amongst other things, take into account the plan's liabilities.

As indicated earlier, civil litigation dealing with pension plan investments is relatively new to Canada. However, there are already two certified class actions — one in Ontario and the other in Québec — dealing with pension fund investments.

The Ontario action is a proceeding regarding the Participating Co-operatives of Ontario Trusteed Pension Plan. It is alleged that that the board of trustees adopted an inappropriate and aggressive investment strategy for the fund which included the purchase of "protection contracts" based on "derivatives."

The Québec case involves the pension plan for employees of bankrupt Jeffrey Mines. At the date of bankruptcy, the pension fund was found to have a funded ratio of approximately 63%. The members of the pension committee (the plan administrator) all resigned, and the Québec regulator took over the administration of the plan. They are defendants in the lawsuit.

It is alleged the asset allocation was imprudent and based on an inadequate investment policy. In addition, it is suggested that there was an overweighting in equities (nearly 75%), which did not take into account the significant maturity of the plan.

While allegations in both the Ontario and Québec cases have not been proven in court, both cases bear watching and could be harbingers of things to come.

Defined contribution plans

Many defined benefit plans have been converted to defined contribution plans, and most new pension plans are DC arrangements. This trend is, in part, fostered by the belief of many plan sponsors that DC plans will reduce their risk exposure. In fact, when an organization moves from a DB to a DC plan, the type of risks may change, but risk is certainly not eliminated.

In DC plans, plan members may make their own investment decisions, but plan administrators still control the investment options and the information, or lack thereof, provided to plan members. And unlike the U.S., there is no safe harbour for Canadian DC plan sponsors. Further, DC plan administrators are still subject to the same fiduciary standards, either by statute or at common law, as administrators of DB plans.

The Capital Accumulation Plan Guidelines provide DC plan sponsors with some guidance and establish a minimum industry standard. Plan administrators who do not comply with the Guidelines are clearly at risk, but simply following the Guidelines will not provide any guarantee against liability.

Accordingly, administrators of DC plans should not be surprised if in the future they find themselves subject to a civil law suit if plan members suffer significant investment losses. These civil suits will likely allege that the investment options were not sufficient, the information provided was inadequate or nonexistent, that the administrator failed to facilitate the obtainment of appropriate investment advice, or that the investment advice provided was not prudent.

It is apparent that whether an organization sponsors a DB or a DC arrangement, plan administrators must ensure care is taken to avoid either imprudent or improper investment practices that can trigger legal consequences. — ***E.B.N.C.***

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Outlook for the income trust sector

By Michael Amm and Grace Pereira

On Halloween night, Jim Flaherty, the federal minister of finance, stunned investors by announcing proposals to significantly change the income tax treatment of most publicly traded trusts and limited partnerships. The proposals will be effective for the 2007 taxation year for trusts that are listed after Oct. 31, 2006, but will be delayed until the 2011 taxation year for pre-existing trusts. Draft legislation to effect the proposals was released at the end of December 2006. For investment managers to assess the future of the sector, they need to understand which types of entities are affected and the options available to those entities.

In general, the new proposals will tax certain types of income earned by income trusts and limited partnerships in a manner similar to income earned by a corporation. In addition, distributions of such income made by these entities to investors will be taxed in a similar manner to dividends from taxable Canadian corporations, including availability of the new enhanced dividend gross-up and tax credit in respect of eligible dividends.

The proposals came in response to the trust conversion announcements by telecommunications giants Telus Corp. and BCE Inc. Specifically, the government was concerned over the loss of significant tax revenues and the impact of the trust structure on productivity and efficiency in the economy.

The move resulted in an immediate loss of approximately 15% to 20% of the sector's value, representing a major shock to a promising sector that had grown to over 250 issuers with an aggregate market capitalization exceeding $215 billion. By halting the tide of income trust conversions and IPOs, the proposals have had their intended effect over the short term.

Designed to level the playing field between income trusts and corporations, the proposals expressly state that the new rules are targeted at nonresidents and tax-exempt entities (such as pension funds) that continue to obtain a sizable tax advantage if they invest in an income trust rather than a corporation. The proposals acknowledged that the previously announced enhanced dividend tax credit, which introduced tax neutrality between income trusts and corporations for Canadian taxable investors, had not had their intended effect, given the continuing advantages to tax-exempt and nonresident investors.

Using a simplified comparison of 2010 and 2011 investor tax rates, the chart below this article illustrates the effective tax rate differentials under the current system, based on a comparison of the combined entity and investor level tax. These figures clearly show the significant and targeted adverse impact of the proposals on pension funds and other tax-exempt and nonresident investors.

The proposals provide an exception for certain real estate investment trusts that invest primarily in real properties situated in Canada. However, the proposals will catch REITs that derive their income principally from other sources, including foreign properties and active management of real property (such as hotels or nursing homes). In addition, issuers of income deposits and similar securities that are not structured as income trusts or limited partnerships appear not to be caught by the proposals.

Whatever path is chosen by an individual trust, it is clear that there will be significant activity and a major reduction in participants in the income trust sector in the next several years, says Michael Amm, a partner in the corporate/securities group of Torys LLP.

In general, affected income trusts that cannot significantly increase their distributable cash during the four-year transition period will likely be forced to cut their distributions thereafter, and many trusts will no longer be able to raise additional equity in the market. The proposals also limit "undue expansion" by income trusts during the transition period.

In mid-December it was announced that trusts will be permitted to issue new units worth as much as 100% of their Oct. 31, 2006 market value between now and 2011.

In addition, the new rules will allow trusts to merge with other trusts and convert to corporate status without adverse tax consequences to unit holders.

Trustees and management of affected trusts are currently assessing the changes and deciding whether the trust structure continues to make sense for them. A poll of trust executives and advisers conducted in December 2006 by Deloitte & Touche showed that the vast majority of respondents believe that by 2011 only 50 to 100 of the existing 250 trusts will continue to exist.

So what is likely to happen to these trusts? A range of possibilities is open.

Some of the affected trusts that have strong earnings growth potential (such as Yellow Pages, which recently increased its distribution level) have stated that they see no need to alter their organizational structure. Other trusts that need to raise capital and make acquisitions to support their growth plan are looking at the alternatives available to them.

One possibility is to go private, with the assistance of private equity financing, or to be acquired by a strategic industry player. Many U.S. and Canadian private equity firms have expressed their interest in participating in these transactions. Another possibility is to merge with another trust in the same industry in order to bulk up and realize synergies. As a result, M&A activity is likely to be vigorous in the sector, which in the case of otherwise healthy trusts holds out the potential of significant transaction premiums for investors.

Another option is to convert to a conventional corporate structure during or just after the four-year transition period. Yet another possibility that has been raised is to convert an existing trust to a new structure whereby investors would directly hold both an equity and a debt security in the underlying business rather than holding trust units. This structure could largely replicate the economic benefits of an income trust. However, it is unclear whether the government would seek to apply the anti-avoidance rules announced as part of the proposals to eliminate the effectiveness of these structures.

Whatever path is chosen by an individual trust, it is clear that there will be significant activity and a major reduction in participants in the income trust sector in the next several years. As the sector declines, Canadian investors, including pension fund managers, will have to look elsewhere in their search for yield. This may result in increased demand for high-dividend-paying common and preferred shares and lead to the development of new high-yield-based investment products, perhaps including a new high-yield debt market in Canada. — **E.B.N.C.**

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Taxation of income trusts vs. corporations

Investor Type	Current tax rate on income trust distributions (applicable also through 2010)	Tax rate on corporate dividends (applicable to most trusts after 2011)
Taxable Canadian	46%	46%
Canadian tax-exempt	0%	32%
U.S. investor	15%	42%

SOURCE: DEPARTMENT OF FINANCE (CANADA)

The battle continues ...

The fight to change or repeal the new trust tax continues both on Bay Street and on Main Street. Lobby groups including the new Canadian Association of Income Trust Investors, the Canadian Association of Income Funds and the Coalition of Canadian Energy Trusts persuaded the House of Commons Finance Committee to hold hearings on the matter in late January. Because it is extremely unlikely that Finance Minister Jim Flaherty will back down, the best hope for investors may be if an election occurs before the trust legislation is passed in Parliament. But even then, the new government (whether Liberal or Conservative) could reintroduce the trust tax. — *S.S.*