Court File No.: 03-CL-5003

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

BETWEEN:

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C.1985, C. c-36, AS AMENDED
AND IN THE MATTER OF UNITED AIR LINES, INC. OF THE STATE O DELAWARE, IN THE UNITED STATES OF AMERICA AND THE OTHER ENTITIES LISTED ON SCHEDULE "A" APPLICATION UNDER SECTION 18.6 OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985 c. C-36, AS AMENDED

FACTUM OF THE ATTORNEY GENERAL OF CANADA

PART I – NATURE OF MOTION

Overview

1. The Office of the Superintendent of Financial Institutions ("OSFI"), as represented by the Attorney General of Canada, supports the motion of the International Association of Machinists and Aerospace Workers ("IAMAW") seeking amendments to the Initial Order made May 14, 2003 in this matter, as amended September 16, 2004. (the "Initial Order (Amended)". These proposed amendments would ensure that the requirements set out in the *Pension Benefits Standards Act, 1985* R.S., 1985, c. 32 (2nd Supp.) ("PBSA, 1985") are met and ensure that the purpose of those requirements, which is the protection of the interests of the members, former members, retirees and other persons entitled to a benefit under the pension plans established for the Canadian employees of United Air Lines, Inc. ("Pension Plans"), is respected.

2. It is the position of the Attorney General of Canada that the amounts accrued or owed to the Pension Plans by United Air Lines, Inc. (“United”) constitute a deemed trust pursuant to the PBSA, 1985 and do not constitute the assets of the Applicants. Consequently, the proceedings under the *Companies’ Creditors Arrangement Act* (“CCAA”) and Chapter 11 of the United States’ *Bankruptcy Code* should not affect these amounts.

3. Under the PBSA, 1985, a pension plan must be administered by the administrator of the pension plan in the same manner as a trustee. In addition, in respect of the Pension Plans which are defined benefit pension plans, these Pension Plans have been established as trusts. The proposed amendments to the Initial Order (Amended) would recognize that the CCAA proceedings should not affect the manner in which these Pension Plans are administered.

4. The proposed amendments to the Initial Order (Amended) would also recognize that the provisions of the PBSA, 1985 continue to apply to the Pension Plans during the CCAA proceedings and that OSFI continues to have the ability to take measures to ensure that the Applicants comply with the provisions of the PBSA, 1985.

PART II – FACTS

The Office of the Superintendent of Financial Institutions

5. OSFI was created in 1987 pursuant to the *Office of the Superintendent of Financial Institutions Act* (the "OSFI Act"). Part of OSFI's mandate is to administer the PBSA, 1985.

> Affidavit of Karen Badgerow-Croteau ("Affidavit"), para. 3.

6. In carrying out these objects, subsection 4(3)(b) of the OSFI Act provides that OSFI shall strive to protect the rights and interests of members of pension plans, former members and any other persons who are entitled to pension benefits or refunds under pension plans.

> Affidavit, para. 4
> *Office of the Superintendent of Financial Institutions Act* ("OSFI Act"), ss. 4(3)(b)

7. Subsection 4(5) of the OSFI Act provides that although the regulation and supervision of pension plans by OSFI may reduce the risk, the ultimate responsibility for the management of a pension plan rests with the administrator of a pension plan and there is always a risk that a pension plan may experience financial difficulties that can result in the reduction of benefits.

> OSFI Act, ss. 4(5)

8. It is submitted that CCAA proceedings should not unduly hinder OSFI in carrying out its mandate as set out by Parliament.

The Pension Benefits Standards Act, 1985

9. The PBSA, 1985 came into effect on January 1, 1987. The PBSA, 1985 requires that all private pension plans established in respect of “included employment” be registered under the Act and meet certain minimum requirements. These requirements include the manner in which a pension plan and its fund are administered and the funding of pension plans.

10. Subsection (4)(e) of the PBSA, 1985 defines “included employment” as “employment, other than excepted employment, on or in connection with the operation of any work, undertaking or business that is within the legislative authority of the Parliament of Canada, including, without restricting the generality of the foregoing, …(e) any aerodrome, aircraft or line of air transportation.”

Pension Benefits Standards Act, 1985 (“PBSA”), ss. 4(4)(e)

11. At this time there are approximately 1200 pension plans registered under the PBSA, 1985.

Affidavit, para. 3
PBSA, ss. 4(e)

12. Pursuant to the PBSA, 1985, the primary responsibility for the management of a pension plan and its fund is the administrator of the plan as defined by section 7 of the PBSA, 1985. The administrator is also responsible for ensuring that pension plan complies with the PBSA, 1985, its regulations and any direction issued by the Superintendent. In many cases, the administrator of a

pension plan is also the employer. In respect of pension plans under the PBSA, 1985, the employer is required to make contributions to their plans.

PBSA, ss. 7

13. Pursuant to subsection 8(3) of the PBSA, 1985, the administrator shall administer the pension plan and pension fund as a trustee for the employer, the members of the pension plan, former members, and any other persons entitled to pension benefits or refunds under the plan.

PBSA, ss. 8(3)

14. Subsection 8(4) of the PBSA, 1985 provides that in the administration of the pension plan and pension fund, the administrator shall exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person.

PBSA, ss. 8(4)

15. United is in the business of operating a line of air transportation. Consequently, employment in United constitutes “included employment” and pension plans established for its employees are subject to the PBSA, 1985.

Affidavit, para. 5

16. In respect of the Pension Plans, United acts as both the administrator and the employer.

Affidavit, paras. 5 and 6

17. In respect of a single employer pension plan, such as the Pension Plans, the employer's obligation to contribute to the pension fund is set out in the pension plan text, other supporting documents and the PBSA, 1985 and its regulations. It is submitted that the obligation of the employer to contribute in accordance with the pension plan text or other supporting documentation does not detract from the minimum funding requirements of the PBSA, 1985.

18. Pursuant to section 9 of the PBSA, 1985, a pension plan must meet the prescribed standards for solvency and funding. These prescribed standards are primarily set out in section 9 of the *Pension Benefits Standards Regulations, 1985* ("PBSR, 1985").

> *Pension Benefit Standards Regulations* ("PBSR"), s. 9

19. In respect of defined benefit pension plans, a key factor to determining an employer's obligation to contribute to a pension plan is the financial condition of the pension fund. Where the pension fund of a pension plan is not in surplus, the employer is required to remit contributions representing the <u>normal cost</u> of the pension plan and any special payments required to fund the pension plan's solvency deficiency and any initial unfunded liability. "Normal cost" is defined in subsection 2(2) of the PBSR, 1985 as meaning "the cost of benefits, excluding special payments, that are to accrue during a plan year, as determined on the basis of a going concern valuation."

> Affidavit, para. 15
> PBSR, ss. 2(1), 2(2) and 9(14)

20. Subsection 9(7) of the PBSR, 1985 provides that a plan shall be funded in each plan year by a contribution equal to the normal cost of the plan and any required special payments. Pursuant to subsection 9(7.1) of the PBSR, 1985, the normal cost may be reduced by the lesser of (a) the amount by which the going concern assets of the plan exceed the going concern liabilities of the plan, and (b) the amount by which the solvency assets of the plan, as referred to in the definition of "solvency deficiency" in subsection 9(1)(a) of the PBSR, 1985, exceed the solvency liabilities of the plan.

PBSR, ss. 9(7), 9(7.1), and 9(1)

21. The total or partial reduction of the employer’s obligation to fund the normal cost to a pension plan is commonly referred to as a contribution holiday.

22. The funding requirements set out in the PBSA, 1985 and the PBSR, 1985 are minimum funding requirements. A pension plan may contain terms that require funding that is greater than those set out in the legislation.

23. Subsection 8(1) of the PBSA, 1985 requires that an employer keep pension fund monies separate and apart from its own property and deems the employer to hold such amounts in trust for members of the pension plan, former members, and any other persons entitled to pension benefits or refunds under the plan.

PBSA, ss. 8(1)
Affidavit, para. 54

24. Subsection 8(2) of the PBSA, 1985, which applies in the event of any liquidation, assignment or bankruptcy of an employer, deems the amounts owed or accrued to the pension fund to be held in trust and deems money owed or accrued to the pension fund to have been kept separate and apart from and form no part of the estate in liquidation, assignment or bankruptcy, whether or not that amount has in fact been kept separate and apart from the employer's own money or from the assets of the estate.

PBSA, ss. 8(2)
Affidavit, para. 54

25. Subsections 8(1) and (2) of the PBSA, 1985 impose a deemed trust upon amounts owed or accrued to the fund including, the aggregate of the prescribed payments that have accrued to date (ss. 8(1)(b)) and other amounts due to the pension fund from the employer (ss. 8(1)(c)(ii)).

PBSA, ss. 8(1), 8(2)
Affidavit, para. 54

26. Subsection 9(14) of the PBSR, 1985 provides, as a minimum, the required timing of remittances of contributions to a pension fund. It provides that the normal cost of the plan and any special payment to be made during the plan year shall be paid in equal instalments or as an equal percentage of the anticipated remuneration to be paid to the members during the plan year and shall be paid not less frequently than quarterly and not later than 30 days after the end of the period in respect of which the instalment is paid.

PBSR, ss. 9(14)

27. In respect of contributions or payments prescribed by the regulations to be made to a pension fund, the deemed trust imposed by section 8 of the PBSA, 1985 applies to the amounts that have accrued.

PBSA, s. 8
Affidavit, paras. 44 and 54

28. Section 12 of the PBSA, 1985 sets out the requirements that an administrator must meet in reporting to OSFI. Subsection 12(3) of the PBSA, 1985 provides, amongst other things, that the administrator must file with OSFI actuarial reports at such intervals or times as the OSFI directs. Subsection 12(4) of the PBSA, 1985 provides that every document required to be filed pursuant to section 12 shall be filed within six months after the plan year end of the plan year to which it relates unless otherwise directed OSFI. OSFI requires that plans with a solvency ratio that is less than one must file an actuarial report on an annual basis.

PBSR, s. 12
Affidavit, para. 20

29. The purpose of performing valuations of pension funds is to determine whether a pension fund is adequately funded in accordance with the prescribed tests and standards for funding and solvency. In respect of defined benefit pension plans, the amount of benefits payable to the members of the plan is predetermined and it is the responsibility of the employer and administrator to ensure that the pension plan or fund is sufficient to meet that obligation. Where a pension plan reports a solvency deficiency or an initial unfunded liability, unless

contributions by the employer have been set, the employer must make special payments to the plan to fund the deficiency over a five year period and an initial unfunded liability over a fifteen year period. This requirement to make special payments and the level of special payments that are required to be made are prescribed by the PBSR, 1985. If the employer's contribution levels have been set by the terms of the pension plan or collective agreement, the liabilities in the plan must be reduced in order to bring the plan into compliance with the prescribed solvency and funding standards.

Affidavit, para. 20

30. A plan may have a large deficit (i.e., the liabilities of the plan exceeds the plan's assets) but the latest actuarial report may disclose a small or no solvency deficiency for that reporting year. The reported solvency ratio of a plan (i.e., the ratio of the plan's assets to its liabilities) is a more accurate indicator of the financial health of a plan. If this ratio is less than one, a plan beneficiary can expect that on the wind up of the plan they will receive a percentage of their benefits based upon this ratio.

Affidavit, paras. 23, 25, 29 and 31

31. Amendments were made to the PBSA, 1985 in 1998. Many of these amendments were directed towards giving OSFI more regulatory powers. These amendments included the addition of a new section 11 of the PBSA, 1985 allowing OSFI to issue a direction to a plan administrator, employer or any person to cease or refrain from committing a certain act or pursuing a certain course of conduct and perform such acts as in the opinion of OSFI are necessary

to remedy the situation. In the event that a person does not comply with a direction, an order of the Federal Court may be obtained pursuant to section 33.1 of the PBSA, 1985 and that person may be charged with an offence under section 38 of the Act.

PBSA, s. 11 and s. 33.1

32. The exercise of these regulatory authorities or powers is consistent with OSFI's mandate as set out in section 4 of the OSFI Act.

OSFI Act, s. 4

The Pension Plans In Issue

33. The two Pension Plans have been established in respect of employment with United. Both of these plans have defined benefit provisions.

Affidavit, para. 5

34. Actuarial or valuation reports in respect of the Pension Plans were filed with OSFI pursuant to section 12 of the PBSA, 1985 in 2004. According to those reports, in addition to normal costs, United was required to make special payments in respect of both Pension Plans to address solvency deficiencies or unfunded liabilities.

Affidavit, paras. 21-26 and 27-32

35. On December 11, 2002, Mr. Justice Wedoff made an order pursuant to Chapter 11 of the United States *Bankruptcy Code* (the "Chapter 11 Proceedings") authorizing United to continue operating their businesses while

they formulated a restructuring plan and implementing an automatic stay of proceedings against the United and their property.

Affidavit, para. 34

36. On May 14, 2003, United filed an application for an order under the CCAA:

- declaring that the Applicants are entities to which section 18.6 of the CCAA applies;
- recognizing the proceeding commenced by the Applicants in the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division under Chapter 11 of the United States Bankruptcy Code ("Chapter 11 Proceeding") be determinative of all such claims;
- staying and enjoining any claims, rights, liens or proceedings against or in respect of the Applicants;
- staying all proceedings against the Applicants, the directors and officers of the Applicants and the Applicants' property;
- restraining the right of any person or entity to assert, enforce or exercise any right, option or remedy arising as a result of the making or filing of this proceeding, the Chapter 11 Proceeding or any allegation made in this proceeding or in the Chapter 11 Proceeding;
- recognizing the U.S. claims bar order;
- authorizing the Applicants, by written consent of their counsel of record, to waive protections contained in the order;
- authorizing the Applicants to apply, if necessary, for further and other relief; and
- authorizing any interested person to apply for variation or recission of the order on proper notice to the Applicants and other interested parties.

Affidavit, para. 35

37. During the 2003 plan year United remitted or paid to the pension funds all of its required contributions, including normal cost and special payments. These remittances or payments included those that were required to be paid into the pension fund after May 14, 2003.

Affidavit, para. 36

38. Until July 31, 2004, United remitted all the required payments or contributions due in the 2004 plan year. United did not remit the second instalment of the quarterly payments or contributions that were required to be made by July 30, 2004. The custodian of the pension funds for both Pension Plans, RBC Global Services, informed OSFI that as at July 31, 2004, the contributions required to be made by United had not been remitted to the funds and that in total the amount owed to both Pension Plans was $192,273.00.

Affidavit, paras. 37 and 38

39. United was informed by OSFI that by failing to make the required remittances or payments to the Pension Plans, United was not in compliance with PBSA, 1985 and that the amounts owed or due the Pension Plans were subject to a statutory deemed trust in favour of the beneficiaries of the Pension Plans. United was informed that the payments owed to the Pension Plans should immediately be remitted to their respective pension funds.

Affidavit, paras. 39 and 41

40. United has not committed to making any outstanding contributions or payments to the funds of the Pension Plans. In fact, United has also not remitted the third instalment of the quarterly payments that were due to be remitted by October 30, 2004 which amount to $247, 629.00.

Affidavit, paras. 38, 40, 43, 46 and 48

41. United was informed that since, in the opinion of OSFI any transfers out of the pension funds would impair the solvency of the Pension Plans, that transfers out of the pension funds pursuant to subsection 26(4) of the PBSA, 1985 (i.e. portability entitlements) could not occur unless consented to by OSFI.

Affidavit, para. 42

42. The amount of special payments, contributions and other payments that are owed, due or accrue to a pension plan or fund are subject to a deemed trust imposed by subsections 8(1) and (2) of the PBSA, 1985.

Affidavit, paras. 44 and 54
PBSA, s.8

43. Prior to July 30, 2004 and the granting of the amendment to the Initial Order (Amended) under CCAA on September 16, 2004, United remitted to the pension funds all of the required quarterly instalments of the required employer contributions due to be paid into the pension funds prior to July 30, 2004.

Affidavit, paras. 36 and 37

PART III – ARGUMENT AND LAW

Deemed Trust

44. The deemed trust imposed by subsections 8(1) and (2) of the PBSA, 1985 is a deemed trust in favour of members of the pension plan, former members, and any other persons entitled to pension benefits or refunds under the plan. The deemed trust imposed by the PBSA, 1985 is not a deemed trust in favour of Her Majesty in Right of Canada. Consequently, it is submitted that section 18.3 of the CCAA does not apply.

45. United has failed to establish and, in fact, has never even suggested that the remittance of the outstanding payment as at July 30, 2004 of $192,273.00 or its further funding obligations would jeopardize its restructuring.

46. The purpose of the deemed trust is to protect the beneficiaries of a pension plan from a scenario where the employer has financial difficulty and may have to resort to CCAA or bankruptcy. The deemed trust under the PBSA, 1985 is intended to establish priorities and protect the beneficiaries when they are most vulnerable. The financial distress of an employer should not allow that employer to avoid its obligations to the beneficiaries of a pension plan or diminish the protection afforded those beneficiaries when most needed. An employer's failure to comply with a statutory duty should not extinguish or put at risk an employee's right, and former employee's right, to something as significant as pension benefits.

Neal v. Toronto Dominion Bank, [1997] O.J. No. 39, paras. 26-28

47. Pursuant to subsections 8(1) and (2) of the PBSA, 1985, the amounts owed or accrued to the Pension Plans by United are subject to a deemed trust and do not constitute the property of United. Consequently, it is submitted that these amounts are not subject to the proceedings under CCAA

48. The cessation or suspension of contributions and other payments to a pension plan increases the risk of loss for the plan's beneficiaries, including those not represented by a collective bargaining agent such as retirees and the members of the Salaried Plan. To date there is no indication that all beneficiary groups have separate and independent representation in this matter.

Affidavit, para. 49

Duties as Administrator

49. In respect of the Pension Plans, United acts as both the administrator and the employer.

50. The administrator of a pension plan must ensure that amounts owed to a pension plan are remitted to the pension fund on a timely basis. Therefore, in addition to its duties as employer, United as administrator must ensure that required remittances have been made to the pension plans that they administer. In the event that they do not do so, in its role as administrator and trustee of the pension funds, United will be liable for the payment of those amounts.

51. The failure of an administrator to ensure that contributions are remitted on a timely basis constitutes not only a breach of the administrator's duties under the terms of the pension plan and supporting documents (such as a trust agreement) but also a breach of the statutory duty that requires an administrator to act as a trustee.

52. It is also submitted that the failure of the administrator to ensure the timely remittance of contributions would, in respect of a pension plan, constitute a course of conduct that is contrary to safe and sound financial or business practices.

Duties as Employer

53. As employer or plan sponsor, the obligation to contribute is a contractual, statutory and trust obligation. Even if the employer or plan sponsor has a discretion whether or not to contribute the normal cost or other required payments to a pension fund, such discretion must be exercised in good faith.

54. It is submitted that making a decision not to make the required contributions or payments while a pension plan has a significant deficit would not constitute the exercise of such a discretion in good faith and, in respect of a pension plan, would constitute a course of conduct that is contrary to safe and sound financial or business practices.

55. United has not been consistent in its reasons for ceasing to make contributions to the Pension Plans. At first, the rationale was that they did not receive funding from the Air Transportation Stabilization Board ("ATBS")and that, therefore, they needed to consider various options given the financial blow caused by the decision by the ATBS. Later, the rationale for not making the contributions was that critical motions were to be heard in mid-January, 2005. Although negotiations and motions in the United States resulted in cost cutting for the operations of the airline, United did not contact OSFI to inform them of the next steps. Rather, the court report to the United States Bankruptcy Court shows that United wants its pension plans changed from defined benefit to defined contribution pension plans. However, such a change would not negate the liability or funding obligation in respect of the Pension Plans.

PART IV – ORDER REQUESTED

56. In light of the provisions of the PBSA, 1985 and the PBSR, 1985 and the actions of United to date in refusing to address the concerns raised by OSFI, the Attorney General of Canada supports the motion of the IAMAW and asks that the Court amend the Initial Order in accordance with the draft terms attached to the Notice of Motion.

Date: February 1, 2005

Ian R. Dick of Counsel for the
Attorney General of Canada

SCHEDULE "A" - CASE LAW

1. Neal v. Toronto Dominion Bank, [1997] O.J. No. 39

SCHEDULE "B" – STATUTES AND LEGISLATION

1. *Office of the Superintendent of Financial Institutions Act*, R.S., 1985, c. 18 (3^{rd} Supp), as amended

2. *Pension Benefits Standards Act,* R.S., *1985*, c.32 (2^{nd} Supp.)*,* as amended

3. *Pension Benefit Standards Regulations*, *1985*, SOR/87-19