Litigation Risks Of De-Risking

September 26, 2016

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At first blush, the idea that "de-risking" could carry risk seems oxymoronic. Pension de-risking, when done correctly, can be very effective. Nevertheless, sometimes the steps employers take to de-risk pension plans can create litigation risk. To understand why, we need to recognize that "de-risking" is something of a misnomer.

When we talk about "de-risking" a pension plan, we are really talking about reducing the risk *to the employer*.[1] More specifically, the term is most often used to refer to steps that employers take to insulate themselves from the consequences of poor investment performance in defined benefit plans ("DB Plans"). While carefully-designed de-risking measures can substantially reduce the risks employers face, such steps do not eliminate risk. Instead, they simply transfer risk to another party. In some cases, that party will be an insurance company. More often than not, however, de-risking measures transfer risk to employees and beneficiaries. Employers, of course, have the right to take steps to shift risk in this way. They need to be aware, however, of the consequences of doing so.

Employees and beneficiaries who suffer losses as a result of risks that their employers have shifted to them often turn to litigation in an attempt to "return the favour", by imposing the consequences of the risk back upon their employers. When a number of beneficiaries are affected in the same way by a de-risking measure, such litigation may take the form of a class action. Ontario Courts have characterized pension claims as uniquely-suited to proceed as class actions. For employers, this means that even decisions that have a relatively small effect on each individual beneficiary may result in litigation.

The litigation risks discussed below are not reasons to forego de-risking. De-risking strategies are a good idea for most employers. Employers simply need to be aware that proper de-risking will reduce the risks they currently face, but will not entirely eliminate risk. An awareness of the remaining risks will assist employers to work with their professional advisors to reduce them further.

Communication breakdown...

The most popular de-risking techniques have one thing in common: they all involve changes to existing pension arrangements that the employer must explain to the plan beneficiaries.

Claims for negligent misrepresentation have become increasingly common in the pension sector. Such claims are not unique to de-risking measures. Whenever an employer gives an employee or pensioner a choice, the employer must be careful to provide fair and accurate information about the consequences of that choice, and to do so in a way that the employee or pensioner can understand. Otherwise, that person may have a claim, if she can prove that she relied to her detriment upon an inaccurate or misleading statement that the employer made negligently, and that she suffered a loss as a result.

Examples of "decision points" that are specific to the pension de-risking context include the following:

- **Plan Conversions** : When an employer decides to replace an existing DB Plan with a defined contribution plan (a "DC Plan") or component, the employer sometimes encourages existing employees to transfer from the DB Plan to the DC Plan or component. It is essential that the employer explain to employees the consequences of a transfer, and preserve evidence of the information that the employee received (ideally with an acknowledgment of that information, signed by the employee). Otherwise, if the DC Plan performs poorly, the employee will allege that they switched to it as a result of the employer's representations.
- **Investment Options within DC Plans** : Employers who implement DC Plans sometimes think that they have washed their hands of pension risk. This is not necessarily true. If employees receive inaccurate or incomplete information about the risk associated with various options within their DC Plans, they may be able to sue their employer for misrepresentation. This particular risk applies to all DC Plans, regardless of whether they have been implemented as part of a de-risking strategy.
- **Buy Outs**: In some cases, employers who want to reduce the risk they face as a result of existing DB Plans will try to “buy out” their employees by paying them a lump sum in return for ceasing to participate in the pension plan. Again, there is a risk of liability if employees receive inaccurate or incomplete information.

Employers contemplating the types of changes discussed above should consult with legal and financial experts to craft an appropriate communications strategy.

Failing to plan, planning to fail...

Given the risks associated with providing options to employees, it might be tempting for employers to elect to act unilaterally. Unfortunately, this approach offers no safe harbour from litigation either.

Unless employers carefully plan and design their de-risking measures, with the benefit of legal and actuarial advice, they risk litigation. The nature of the risk depends upon the measure that the employer implements:

- **Plan Amendments** : Employers can try to reduce the risks (or at least the costs) associated with DB Plans by amending their plans. Examples of such amendments include: the elimination of indexing and early retirement pensions (which can lead to unpredictable liabilities); plan "freezes" (i.e. closing the plan to new members and/or terminating the accrual of additional benefits by existing plan members); and changes in benefit or contribution formulae. The employer's ability to enact such amendments will be limited by applicable pension legislation, the plan documents, and the employer's fiduciary duties. Some amendments may also engage the so-called "50% rule" applicable in some jurisdictions, which restricts what portion of the value of a pension benefit may be funded by employee contributions. Even if the employer meets all statutory and contractual requirements, it may be vulnerable to a constructive dismissal lawsuit if an amendment substantially reduces the total compensation offered to an employee. In unionized workplaces, employees may also be able to advance labour grievances, if pension benefits are protected under a collective agreement. These risks can arise even with respect to purely prospective amendments.
- **DC Plan Design Risk** : An employer that offers a DC Plan (whether as a result of de-risking or otherwise) may owe a duty of care to its employees to ensure that the plan offers appropriate options to employees and, in particular that the default option (i.e. the manner in which the employee's contributions will be invested if he fails to select an option), are appropriate. Once again, appropriate professional advice is essential.
- **Plan Merger Risk** : In some cases, large companies or companies that are part of a larger corporate group may operate more than one DB Plan. Merging the plans can spread the investment risk. Plan mergers involve complicated issues of statutory and trust law and must be approached with caution (and expert legal advice!).

The buck stops at you...

De-risking is not only important for employers. Over the last decade or so, a number of companies that sponsored DB Plans have become insolvent, at a time when their pension plans had deficits.

When there is a plan deficit and no sponsor to fund it, employees whose benefits are reduced as a result will look to others to blame. In such cases, there have been claims against company directors and service providers (investment managers, institutional custodians, actuaries, etc.). These individuals and organizations should be aware that they, too, have a stake in de-risking initiatives.

The right bowl of porridge ...

When it comes to the investments of a DB Plan, de-risking usually involves moving assets to more secure, lower-return investments. Assuming the investments are well-selected, this will generally reduce risk, while increasing the pension plan's cost to the employer. As a result, there is a tension between investment strategies that are "too cold" (i.e. those that are low risk but are unappetizing because they render the plan too expensive) and those that are "too hot" (i.e. those that decrease the employer's costs but create too great a risk of getting burned).

Employers must remember that what constitutes an appropriate or “low risk” investment strategy can vary significantly from one plan to the next. In the past, employees have sued pension plan investment managers for recommending inappropriate investment strategies to an employer that later became insolvent. This has occurred where: (i) the plan's membership consisted of an older population with relatively few active members; (ii) the employer was in a failing industry; and (iii) the investment strategy did not reflect the fact that the plan was unlikely to continue over a long period of time.

It is also worth noting that a conservative investment strategy is no guarantee that deficits will not arise. Even if a plan were fully-funded and invested in cash, it could develop a substantial deficit in a short period of time if long-term interest rates drop significantly. This is because actuaries are required to prepare solvency valuations for DB Plans by assuming that the plan would have to purchase annuities for all beneficiaries at the time of the valuation. Since the cost of annuities is inversely proportionate to long-term interest rates, the plan's liabilities can increase and create a deficit, even if the value of the assets has not changed.

Just when you thought you were out...

Most employers assume that once members have ceased to participate in their pension plans and have been annuitized, the employer is no longer at risk from lawsuits. This is not necessarily true.

Plan administrators may have a duty to obtain independent advice to select an appropriate annuity provider to pay pension benefits to its former employees. In at least one case, where an insurance company failed, employees successfully sued their employer with respect to benefits that had been annuitized.

Cover me, I'm de-risking...

This discussion above was not intended to provide a comprehensive description of all of the litigation risks associated with pension de-risking. It certainly should not be read as discouraging de-risking measures. Instead, it was intended to be illustrative of fact that, sometimes, de-risking involves trading one devil for another. While well-designed de-risking measures will ensure that the "new" devil is much smaller and less threatening than the current one, employers should still watch and guard against that smaller devil.

The key points that employers should remember are:

- Don't assume that "de-risking" will eliminate risk.
- To understand the risks that you will still face, obtain expert legal and financial advice.
- Consider what additional measures you can take to address litigation risk. Those measures should include seeking professional advice, and may include purchasing insurance, or making changes in corporate governance and record-keeping.

[1] In most single-employer defined benefit pension plans, the employer is both the sponsor and the administrator of the plan. As the sponsor, the employer is responsible for funding the plan and has the ability to amend it (subject to certain limits). As

administrator, the employer has a fiduciary duty to administer the plan in the interests of the employees and beneficiaries. Some of the potential risks discussed in this article affect employers in their capacity as sponsors. Others affect only those employers who are the administrators of their pension plans.

See our previous issues **Pension Risk Management: Financial Risks** **Pension Risk Management: Investment Risks** and **Pension Risk Management: Administration Risks**

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