Legal Framework for Pension Investing in Ontario, Canada

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Trust law admonishes trustees, above all else, to preserve the assets of the trust (Fales v. Canada Permanent Trust Company, 316). With capital preservation in mind, trustees are required to use their powers of investment to yield the best possible returns in relation to the overall risk of the investments and to formulate their strategy accordingly (Cowan v. Scargill 1985). This approach and its foundations in the exercise of care, skill, diligence, and judgment have created a framework for assessing investment decisions, strategy, and accountability in the trust and pension contexts.

The prudence standard applied in the administration of pension funds is an application of this longstanding approach to trust-fund investing. The distinct nature of pension funds—as critical sources of income for members after they cease participation in the workforce—has reinforced the necessity for standards of prudence reflective of the level of risk involved in pension-fund investing and the unique implications for failure to exercise such prudence properly.

Statutory Law of Trusts

The statutory law of trusts provides that when investing trust property, a trustee must exercise the care, skill, diligence, and judgment that a prudent investor would exercise in making investments (Trustee Act, RSO 1990, C T23, s. 27). The trustee may choose to invest in any form of property as long as a prudent investor would make a similar investment decision. The decision in Fales v. Canada Permanent Trust Company (1977) illustrates that, even in respect of a simple non-pension trust, the common law holds trustees to a standard of reasonableness and ordinary prudence and imposes liability on trustees who fail to meet these standards.

In Fales, the Canada Permanent Trust Company (“Canada Permanent”) served as co-trustee of the estate of a deceased person. Canada Permanent was sued by the deceased’s wife and children after failing to sell shares of a company (Inspiration Limited) prior to its bankruptcy, leading to disastrous results for the residue of the estate. Key issues in this case included whether Canada Permanent had 1) failed to exercise reasonable diligence and skill, 2) failed to make proper inquiry regarding the sale of shares, and 3) whether there was a breach of duty because of the timing of the sale of shares. The specific instructions in the testator’s will were broad, but the court in Fales explained that even where a will creates additional latitude in the recognized powers of a trustee, he or she is not relieved of the duty to use ordinary skill or prudence, nor from applying common sense (Fales, p. 316). The Court of Appeal found that Canada Permanent had breached its duty to the estate as trustee and failed to apply the standard of ordinary prudence of a person managing his or her own affairs. Having seen the decline of Inspiration Limited prior to the bankruptcy, Canada Permanent’s actions were imprudent whether considered as the actions of a lay investor or as the actions of a large trust company established for the purposes of professionally managing estates.

Just as a trustee must acquire property on behalf of the trust as a reasonable and prudent investor would, he or she also must maintain these assets on the same basis. Specific elements of the ongoing obligation of prudence include seeking advice with respect to the value of the assets of the trust, and determining on an ongoing basis what property should or should not be held by the trust and when assets should be sold and converted to funds (Lottman v. Stanford 1980.)

Trustee Act

Under the Trustee Act s. 27(5), a trustee must consider the following in allocating the assets of a trust to different asset classes and investments:

- general economic conditions
- the possible effect of inflation or deflation
- the expected tax consequences of investment decisions or strategies
- the role that each investment or course of action plays within the overall trust portfolio
- the expected total return from income and the appreciation of capital
- needs for liquidity, regularity of income, and preservation or appreciation of capital
- an asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries

The Trustee Act s. 27(6) also requires trustees to diversify the assets of the trust to the extent that is appropriate based on the specific requirements of the trust and the demands of general economic and investment market conditions. Creating and maintaining such a plan in accordance with the requirements of the Trustee Act affords trustees important protections against liability in the event that an investment within a prudent portfolio of investments.
There are several other important Standard of Care for Trustees with an asset allocation plan that conforms to a prudent plan or strategy for the investment of the trust property as a whole. This protection from liability assumes that the plan created by the trustee included reasonable assessments of risk and return and was the type of plan that a prudent investor would adopt under comparable circumstances.

Under the Trustee Act s. 27.1(1) and (2), trustees may authorize an agent to exercise the trustee’s investment function, so long as the agent conforms to the prudent investor standard. An agent may exercise functions on the trustee’s behalf, but only if that agent complies with an asset allocation plan that conforms with the aforementioned terms.

Role of Pension Plan Administrators and Trustees

As with trustees, the role of the pension plan administrators and trustees in the pension plan context is to make reasoned decisions for the purpose of preserving the assets of the pension fund and earning the best possible return commensurate with the appropriate level of risk. Section 22 of the Provincial Pension Benefits Act (PBA) (RSO 1990 CP8) codifies and enhances (as discussed below) the prudent person standard for administrators of pension funds and their agents. It provides that the administrator of a pension plan shall exercise the care, diligence, and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person.

The standard of care imposed in Fales, requiring a trustee to manage the affairs of the estate with the ordinary prudence of a person managing his or her own affairs, differs slightly from the standard codified in the PBA, which specifies that a plan administrator or trustee must use the care, diligence, and skill that a person of ordinary prudence would exercise in dealing with the property of another person. The most-frequently cited view as to the meaning of the reference to “another person” is that the standard of an individual dealing with the affairs of another person is higher than a person would apply when managing his or her own affairs. The reference to “another person” implies an obligation of a fiduciary character toward that other person that one does not owe to oneself. Accordingly, the PBA’s standard is likely a standard of care that requires lower risk and greater attention to the preservation of capital than the common-law standard generally applicable to trustees.

Pension plan administrators have considerable room to choose a range of investments, with a range of risk characteristics, so long as they are part of a prudent and proper diversification strategy.
The Canadian Association of Pension Supervisory Authorities (CAPSA) Guideline Number 6 provides a framework for pension plan administrators in regard to prudent investment practices. The guideline confirms that the plan administrator, rather than the plan sponsor, is responsible for the plan’s investment function. The guideline reiterates that the plan administrator’s strategy for managing and supervising investments is crucial to the plan’s overall success, and it requires that plan administrators adopt a “robust, process-oriented decision-making framework, within which investment management activities can be conducted.”

Plan administrators are responsible for keeping up with changes in their roles and responsibilities and, like trustees, must seek advice to reach informed investment decisions. They are required to establish and review their plan’s Statement of Investment Policies and Procedures (SIP&P), which reflects the administrator’s prudent asset allocation plan. This written statement of the pension plan’s objectives, along with other and often much more detailed documents, establishes the administrator’s prudent investment strategy.

In determining the suitability of a particular investment, an important consideration for plan administrators (and for lawyers who also may be evaluating the investment on their behalf) is the standard of care used by the managers or administrators of an investment itself. Because of the high degree of accountability involved in pension investments, plan administrators must probe potential investments with greater depth than a conventional investor. Pension plans are trusted entities and sources of income for a substantial number of members. Therefore just as a trustee’s or administrator’s standard of care varies based on experience or qualifications, a pension plan administrator’s conduct is likely to be more intensively scrutinized than the investment activity of other investor funds because of the nature of the pension fund itself.

Metropolitan Toronto Pension Plan v. Aetna Life Assurance Co. of Canada (1992, 98 D.L.R. (4th) 582 (O.C.G.D.)) confirms that professional agents of pension-fund administrators may be held to a high standard of care not only as a result of their trustees possessing specific skills or special experience, but also because they are compensated for their professional services:

In the case of an agent who is paid for his services, a higher standard is exacted than in the case of an agent acting without reward. The care, skill or diligence required is not merely that which the agent in fact possesses, but rather is such as is reasonably necessary for the due performance of his undertaking. If he is an agent following a particular trade or profession, and holding himself out to the world for employment as such, he represents himself as reasonably competent to carry out the business which he undertakes in the course of such trade or profession. He must then show such care and diligence as are exercised in the ordinary and proper course, and such skill as is usual and requisite, in the business for which he receives payment.

Pension Plan Administrators and Standard of Care for Investments

Applying the standard of care to investments of different asset classes entails its own complexity. When a pension administrator prepares to make an investment with a private equity fund, for example, the administrator may choose to invest in a fund, in which case the focus of the administrator’s due diligence is in selecting and monitoring the fund’s general partner. Alternatively, the administrator also may elect to participate in a co-invest strategy with the private equity fund and invest directly in a private company in conjunction with the private equity fund’s investment. Larger pension funds often employ both of these strategies—choosing both to invest in the private equity fund and to invest directly in certain private company investments.

The Pension Benefits Standards Act (PBSA) sets out quantitative limits for investments such as those mentioned above. A plan administrator is not permitted to lend or invest money of the plan, directly or indirectly, equal to more than 10 percent of the total book value of the plan’s assets to any one person, two or more associated persons, or two or more affiliated corporations (PBSA, 1985, schedule III, s. 9). This limitation does not apply to assets of a plan held by a bank, trust company, or other financial institution to the extent the institution is insured by the Canada Deposit Insurance Corporation or the Canadian Life and Health Insurance Compensation Corporation or in certain other prescribed circumstances. The PBSA quantitative limits also prohibit a plan from holding securities of a corporation to which are attached more than 30 percent of the votes that may be cast to elect directors of a corporation. The 30-percent limit does not limit shareholdings in a real estate corporation or a resource corporation if certain enumerated conditions are met (PBSA, schedule III, s. 11–13). The PBSA regulations also limit related-party transactions.

In evaluating potential fund investments, a pension plan administrator should make inquiries into the standard of care that the private equity fund’s directors apply in making their investment decisions. Though there may be variation in policies and practices from fund to fund, a typical private equity fund seeks to apply a prudent person standard based on business-law principles. However, unlike pension administrators, the directors of a private equity fund, in a non-pension context, may attract a significant degree of deference.
under the business judgment rule. This common-law rule stands for the principle that the courts will not interfere in business judgments of directors except in cases of fraud, illegality, or conflict of interest (see Silensky v. Wrigley 1968). Furthermore, courts may respect the business judgment of corporate management when decisions fall within the range of reasonable decisions in a given set of circumstances, even if those decisions do not necessarily yield favorable results (see BCE Inc. v. 1976 Debentureholders 2008). The business judgment rule is based on the view that business executives should not be limited by the fear of narrow legal limitations to the point that such concerns impede their ability to take the risks required to be successful. However, the flexibility of this rule does not preclude directors from performing due diligence and taking steps to ensure that their decisions are justifiable if called into question in the future.

Whether the directors of a private equity firm will be considered to have breached the standard of care is dependent on the nature of the investment. When courts find that the business judgment rule has been breached, the burden of proof shifts to the directors to show the intrinsic fairness of the transaction. The courts rely upon a two-part intrinsic fairness test to determine whether a breach has occurred. They examine both fair dealing and fair price. The fair dealing aspect of the test examines the actual conduct of the directors in effecting the transaction, questioning how the transaction was initiated, structured, and negotiated. The fair price element examines the economic and financial terms of the transaction. The courts will conduct a review of the value of the transaction and a comparison to the value that an otherwise arm’s-length transaction would have provided under similar circumstances.

When investing pension assets, however, private equity funds and their directors may not be able to rely on the business judgment rule, depending on the nature of their relationship to the pension plan administrator. In MacKinnon v. Ontario Municipal Employees Retirement Board (2007 ONCA 874 at para 54–55), a fiduciary relationship was found to exist between the managers of a fund and the pension plan administrator because the fund manager was considered to owe a fiduciary duty to the pension plan that was created by the management agreement signed by the parties and the fees collected by the fund manager. MacKinnon creates grounds upon which to consider the decisions made by directors of a private equity fund with respect to assets of a pension plan as decisions made by agents of the pension plan, and therefore as decisions with a higher degree of fiduciary duty attached than the duty owed to an individual or non-pension plan investor in the private equity fund. In light of the decision in this case it may be prudent for both pension plan administrators and private equity fund managers to acquaint themselves with this standard and govern their investment relationship accordingly.

Pension plan administrators face additional challenges when investing in offshore funds with exemptions from local regulatory compliance and in hedge funds or other funds with opaque strategies. Many offshore funds, for example, are created for the purpose of distribution to nontaxable institutional investors such as pension funds. Currently, when a pension fund invests in an offshore fund it must take into consideration that often the fund’s directors and investment manager or investment advisor are located outside of Canada, and this may result in an inability to effect service of process in Canada upon such persons in the event of a legal issue. This also results in difficulty in satisfying judgments against the offshore fund or enforcing any legal proceeding against them. In the event of a problem with an offshore investment, any legal proceeding will take place outside of Canada and will be difficult and costly as a result. A prudent plan administrator may consider that these factors render such an investment imprudent for pension assets.

Conclusion

Though based in the principles of trust investing, the standard of prudence for pension fund administrators and trustees requires a unique level of care, diligence, and skill. Cognizant of the risk involved in pension investments and the reliance of those whose pensions are their principal source of income, pension fund administrators and trustees must examine investment options carefully and consider the many facets of an investment, its potential risks, and its role within the fund’s overall diversification strategy and objectives.

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Endnotes

1 See University of Winnipeg Trusteed Pension Plan Trust at http://www.uwinnipeg.ca/index/cms-filesystem-action?file=hr-docs/hr-benefits/duties%20of%20trustees.pdf.