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dealing with participating funds – round 2 is final

The Supreme Court of Canada on May 24, 2012 dismissed with costs the application for leave to appeal the 2011 decision of the Ontario Court of Appeal which dealt with the complicated issue of dealings with the participating accounts of two large life insurance companies. The two class actions arose from an acquisition and the alleged breaches of provisions of the *Insurance Companies Act* ("**ICA**").

In 1997, The Great-West Life Assurance Company ("**Great-West Life**") acquired London Life Insurance Company ("**London Life**") for $2.9 billion. $220 million of the purchase price was paid by contributions from the participating accounts of both Great-West Life and London Life on the theory that the participating policyholders should help pay for the planned synergies which were expected to reduce operating costs for all concerned including these accounts.

Class actions were started and in late 2010, the trial judge found on a very technical argument, that the provisions of the *ICA* had been breached and ordered among other things that the $220 million plus a reasonable rate of return be returned to the participating accounts and that the companies be enjoined from changing the allocation for expenses between shareholders and participating policyholders.

The Court of Appeal, in a unanimous decision rendered at the end of 2011, agreed with the trial judge's assessment that there had been breaches of the *ICA* but disagreed with the trial judge's remedies in a decision that for the first time in Canada, sets out limits to the discretion that a trial judge has in dealing with the statutory compliance provisions of ICA 1031.

The Court of Appeal also made some interesting findings on the weight to be given in actions such as this to regulatory approvals received in connection with the transactions. The Court of Appeal also held that breaches of ICA 166(2) which requires directors, officers and employees to comply with the ICA could not be found when such directors, officers or employees were not named as parties in the suit.

There are a limited number of very technical provisions in the ICA that circumscribe the operations of participating accounts. The relevant provisions are found in ICA 331 and 456 to 464. These can be summarized as the requirement to apply generally accepted accounting principles in preparation of financial statements (ICA 331); defining what amounts may be transferred from participating funds (ICA 462); and determining the allocation of expenses to participating funds (ICA 458).

In essence, the companies in exchange for the $220 million withdrawn from the par accounts deposited pre-paid expense assets ("**PPEAs**") into the participating accounts representing the anticipated expense savings to be realized by those accounts over a twenty-five year period. The PPEAs were to be amortized each year for twenty-five years as the annual expense savings were realized. Further, an adjustment mechanism was put in place to check the estimates of expense savings after five years of actual experience which in 2002 indicated that the London Life PPEA should be increased by $68.2 million to reflect additional expense savings over that originally contemplated. While no further adjustments were provided for, London Life maintained that in 2008, an additional $27.1 million in expense savings was identified. Because of the PPEAs, the expense allocations that applied between shareholders and participating policyholders prior to the acquisition were not modified under ICA 458.

The trial judge found that the class representative, a former actuary of London Life, and the CEO of London Life at the relevant time both agreed that no person or group, including par policyholders, should get the benefit of reduced costs without making a contribution to those benefits. The Court of Appeal, time and time again, came back to this as a guiding principle for its decision and thus the ultimate disposition of the appeal hinged on this crucial fact.

On a very technical argument presented by experts on GAAP, the trial judge found that the GAAP requirements for treating something (the PPEAs in this case) as an asset had not been satisfied because the procedures required to change the allocation of expenses had not occurred and consequently the PPEAs provided no incremental benefit. The Court of Appeal agreed. Since the PPEAs were held not to be an asset, the Court of Appeal agreed with the trial judge that the provisions transferring monies from participating policy accounts in exchange for the PPEAs violated ICA 462. The Court of Appeal, however, made a significant finding that the enumerated exceptions to the prohibition against transferring assets under ICA 462 are not exhaustive as there are instances in normal insurance practice (for example, involving investments) that are permitted under ICA 462 even though not expressly enumerated in the exceptions to the prohibition.

As mentioned earlier since the directors, officers or employees of the companies were not sued (only the corporate entities were defendants), the Court of Appeal held there could not be a breach of ICA 166(2) which prohibits directors, officers and employees from breaching the Act.

Significantly, the Court held that for a number of reasons, OSFI's approval of the transaction was not determinative of the issues. Reasons given by the Court of Appeal for this conclusion were that this was not a judicial review; the record was not clear that OSFI in making its decision to approve had the significant expert evidence on the treatment of PPEAs under the meaning of GAAP that was put before the Court; the Court's ultimate jurisdiction to determine matters of statutory interpretation; and importantly because in this case, OSFI argued successfully that its deliberative secrecy should be respected, the representatives of OSFI who were witnesses at the trial, could only be asked certain limited questions and, therefore, the OSFI decision was opaque to the Court.

The most significant part of the decision rests on the Court's view as to the remedies that were available to the trial judge.

ICA 1031, being the operative section for the remedy in this case, permits a Court on a finding that an insurer has not complied with the ICA or the Regulations, in addition to ordering compliance or restraining breach, to "… make any further order it thinks fit." It was this provision that the trial judge applied in the remedies that she ordered.

Starting from the seminal 19th century English decision in Foss v. Harbottle, the Court traced the reluctance of courts to override the internal management of companies and the revisions that modern corporate statutes, like the *Canada Business Corporations Act* ("CBCA") introduced to deal with challenges to management decisions. The Court of Appeal examined the three categories: derivative actions, compliance provisions and oppression remedies contained in the modern corporate statutes.

While the ICA is modelled on the CBCA, the Court pointed out that it was significant that it only contained derivative actions and compliance provisions but not the oppression remedy found in the CBCA. The Court of Appeal held that it was inappropriate to apply the remedies available to a court in the cases of oppression as the ICA did not contain those provisions. The Court held that the remedies available under the three provisions are different and that the purpose of ICA 1031 is remedial rather than compensatory or punitive.

The Court held that while the action of the companies not to change the expense allocation methods between shareholders and participating accounts could form the basis for the determination that the PPEA was not an asset under GAAP, it could not realistically form the foundation for a finding that the reasonable expectation of the policyholders was that even without the PPEAs the expense allocations would have remained the same. The Court of Appeal kept coming back to the "no contributions/no benefit" expectation that the policyholder's representative, the company and the trial judge all accepted. The Court of Appeal looked at three alternatives for fashioning a remedy and settled on the remedy of cancelling the PPEAs in the par accounts as of a date to be determined and as of that date, cancelling the annual amortization charges in respect of the PPEAs and provided for a return of a portion of the $220 million adjusted upwards for certain matters including foregone investment income and **adjusted downwards for certain matters including expense savings received**.

The Ontario Court of Appeal decision is important as there are very few, if any, cases addressing the complexities, mechanics and treatment of participating policyholder accounts. Significantly,

- the Court held that the provision of ICA 462 regarding the transfer of assets from a participating account is not quite as narrow as the words might initially suggest;
- the Court held that the latitude of judges for fashioning remedies for breach of the compliance provisions of the ICA is considerably narrower than the remedies available in the case of oppression remedies; and
- the evidence and the trial judge's holding that the expectation was that the participating policyholder accounts would not receive the benefit of reduced expenses without somehow paying for them was the linchpin that the Court of Appeal used to fashion a remedy that responded to this expectation.

As the Supreme Court of Canada has refused leave to appeal, the Ontario Court of Appeal decision is the final authority on these matters.

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a cautionary note

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