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Pension Claims in Employee Termination Cases

A. Introduction

In Canada, when an employment relationship is terminated without cause, the employer must provide the terminated employee with reasonable notice or pay in lieu of notice. Employment standards legislation is in place to protect employees by way of minimum notice requirements. Legislation is supplemented by common law to further protect employees with the goal of putting the employee in the position that she would have been if she had worked through the notice period. Employment contracts are also used to provide certainty around the employment relationship, including with respect to obligations and entitlements at the time of termination of employment.

This paper will look at material employer obligations, specifically with respect to registered pension plans in the province of Ontario, that may arise when terminating an employee. Registered pension plans are highly regulated, complex and can be, from a dollar perspective, a significant part of an employee's compensation. In order to limit liability, an employer needs to fully understand the implications of terminating an employee who is a member of a registered pension plan.

B. Termination Notice Entitlements

1. Employment Standards Act (Statutory Notice)

The *Ontario Employment Standards Act*[1] ("ESA") provides minimum standards that employers must follow when terminating employees without cause in Ontario. Employees may have greater

[1] *Employment Standards Act*, 2000, SO 2000, c 41 [ESA]. The authors note that substantially similar legislation applies in other Canadian jurisdictions.

rights under common law or contract, but at a minimum, the ESA notice must be provided.

Section 57 of the ESA sets out the statutory notice period requirements which range from one to eight weeks, based on the terminated employee's years of service. Subject to certain listed exceptions, section 64 of the ESA requires additional "severance pay" of up to 26 weeks in cases of terminations of employees who have 5 or more years of service with the employer and where the employer has a payroll of $2,500,000 or more, or the employer has terminated 50 or more employees in a 6 month period because all or a part of the employer's business has closed.

Employee benefits must be continued during the statutory notice period. Section 60(1)(c) (working notice) and section 61(1)(b) (pay in lieu of notice) of the ESA require employers to continue benefit accruals and to make all benefit contributions that are necessary to maintain a terminated employee's benefits until the end of the statutory notice period provided for in section 57 of the ESA. If the pension or benefit plan in question requires employee contributions, the employee contributions must also be made in order to attract the required employer contributions.

Since the terms of many benefit plans require an employment relationship and often "active" employment status, section 62(1) of the ESA deems employees to be actively employed during the statutory notice period. This deeming of active employment status preserves the terminated employees' rights to participation in employee benefit plans and also allows an employee to comply with the *Income Tax Act* (Canada)[2] (the "ITA") requirements for continued employment with respect to registered pension plans, as discussed below.

2. Income Tax Act

All pension plans must be registered under the ITA in order to be considered tax-exempt. The ITA rules limit the amount of contributions that can be made and service that can be recognized under a registered pension plan which ultimately regulates the amount of benefits that can be tax sheltered and paid from a

[2] *Income Tax Act*, RSC 1985, c.1 (5th Supp).

registered pension plan. Where pension plans are registered under the ITA, the Canada Revenue Agency oversees the plan administrator's obligations to ensure that the plan complies with ITA requirements. One basic but very important ITA rule to remember is the requirement that an employee be employed and be receiving compensation in order to accrue pension benefits. That is, if an employee or former employee's income is considered "employment income" under the ITA and this income continues for the notice period (whether statutory or common law), then corresponding accruals and contributions may continue throughout the notice period. What is considered "employment" is a question of fact in each case, and employment does not have to be active employment. This ITA rule is important because, in the event of an actual termination of employment without proper notice, any claim or judgment for damages that relate to lost or reduced pension accruals or pension contributions cannot be paid out of the pension plan but must be paid from employer general revenues, which can be an unexpected and significant budget expense.

3. Common Law (Reasonable Notice)

(a) Damages for Pension Loss

Employers in Canada are also required to provide "common law" notice which is over and above what is required under legislation. Common law is judge made law and is based on precedent. Certain terms and conditions of employment are implied by common law. One such implied term is the requirement to provide reasonable notice of termination or pay in lieu of notice. There is no fixed formula used in calculating a reasonable notice period but a number of factors, such as age, salary, length of service, and job position, are taken into account. (Note that although Quebec is a civil law jurisdiction, many of the same principles apply in this specific area).

With respect to pension entitlements on termination, where actual notice is given, the employee remains employed and as a result pension accruals or contributions would continue as before. Where an employee is terminated without reasonable notice, damages in respect of the benefits the employee would have otherwise earned during the notice period would need to be determined.

For defined contribution pension plans, the calculation of damages which correspond to the notice period is relatively straight forward: the amount of the employer contributions that would have otherwise been made during the notice period, and possibly the investment return that would have otherwise been earned on those contributions.

For defined benefit pension plans, the calculation of notice damages is more difficult. Courts have historically addressed defined benefit pension loss in a variety of manners but the case law has now developed to the point where employers can be reasonably certain about their obligations.

In *King v Gulf Canada Ltd.*[3], the court was very clear in highlighting that for a defined benefit plan member, it is not the pension contributions during the notice period that must be assessed as damages but rather the loss in value of the pension benefit itself. In other words, damages in the case of a defined benefit plan are the difference between the value of the pension at the end of the reasonable notice period and the value of the pension at the commencement of the reasonable notice period.

Effective July 1, 2012, the PBA was amended to provide that all pension plan members are immediately entitled to pension benefits according to the plan provisions upon becoming a member in a registered pension plan. This means that employers will no longer have to determine whether a departing employee would have vested within his or her notice period if he or she had remained employed. The result is that all members of pension plans are entitled to pension benefits at the termination of their employment. This change will likely increase the costs to employers, especially if the employee turnover rate is high.

(b) Gross-up of Pension Related Notice Damages

For defined benefit pension plans, the tax payable with respect to a lump sum damages award for pension loss is generally greater than the amount of tax payable on periodic retirement payments. Consequently, the courts have considered whether awards should

[3] *King v Gulf Canada Limited*, (unreported), January 31, 1989, Doc. York 218856/84 (Ont. Dist. Ct.), affirmed by Court of Appeal at (1992), 60 O.A.C. 139 (Ont. C.A.).

be "grossed-up" for tax in order to put the terminated employee into the same position as he or she would have been if the pension benefit was payable over time.

In *Dowling v Ontario (Workplace Safety and Insurance Board),*[4] the Ontario Court of Appeal stated that a gross-up can correctly offset the additional tax liability that the dismissed employee would incur from the receipt of a lump sum payment as opposed to instalments over time. In ordering a gross-up, the court held as follows:

> To fail to take into account the adverse tax consequences occasioned by a change in the timing of their receipt would be to restrict a person from realizing the full benefit of the damages awarded in a wrongful dismissal case.[5]

As a result, damage awards for wrongful dismissal may be grossed-up so that the after-tax benefits do not reduce a terminated employee's net lawful entitlements.[6]

For defined contribution plans, the same tax issue does not generally exist, since the employer is simply providing contributions that typically can be tax sheltered in the terminated employee's personal registered retirement savings plan.

(c) Deductibility of Pension Benefits From Wrongful Dismissal Awards

The legal claims which terminated employees have on account of termination of employment are arguably distinct from their rights to pension benefits.

In its decision in *IBM Canada Limited v Waterman,*[7] the Supreme Court of Canada ruled that pension payments received by an employee were not deductible from wrongful dismissal damages. The Court's majority held that pension benefits are distinct from

[4] *Dowling v Ontario (Workplace Safety and Insurance Board)* (2004), 246 DLR (4th) 65 (ONCA).

[5] *Ibid* at para 77.

[6] Wrongful dismissal damages may also be grossed-up where the award is for a benefit that would otherwise be non-taxable. See *Alcatel Canada Inc. v Egan* (2006), 47 CCEL (3d) 87 (ONCA).

[7] *IBM Canada Limited v Waterman*, 2013, SCC 70.

employment contract claims and a pension does not represent indemnity benefit for loss of salary. Further, the decision notes the important policy consideration that employers should not have an incentive to dismiss pensionable employees.

4. Employment Contract

In general, obligations concerning a termination of employment can be governed by a private employment contract, so long as the minimum statutory requirements described above are met. The existence of a contract, if drafted correctly, can provide clarity around matters such as notice entitlements and limit the employer's liability. However, in complex areas, such as employee benefit accruals and participation, poorly drafted employment contracts, and collateral documents such as benefit plans and benefit communications, can create significant confusion and the potential for unexpected cost. A leading example of the latter situation is found in *Taggart v Canada Life Insurance Co*.,[8] where the Ontario Court of Appeal ruled that the pension plan at issue was, at best, ambiguous, and certainly insufficient to disentitle an employee from a damages claim for the loss of pension benefits during the common law reasonable notice period.

Taggart was employed for 30 years at Canada Life before he was terminated as a result of a corporate restructuring. Taggart was offered 24 months notice, comprised of two months working notice and 22 months pay in lieu of notice. Pension accruals were only offered for the two months of working notice because the Canada Life pension plan restricted accruals to periods of active employment. This action denied Taggart the opportunity of retiring early with an unreduced pension, which he would have qualified for if he had been provided with accruals for the full notice period. Canada Life relied on language in the pension plan text that prohibited pension benefits from being used to increase dismissal damages or from being used to enlarge employee rights.

The Court of Appeal decided in favour of Taggart, holding that payment in lieu of notice and any damages award must fully compensate an employee for any benefits they would have earned during the notice period. The Court of Appeal further indicated

[8] *Taggart v Canada Life Insurance Co*., [2006] OJ No 310 (CA).

that in order to counter an employee's claim, the pension plan must explicitly state that the employee is disentitled to damages for loss of pension accruals during the notice period. In this particular case, the Court of Appeal found that the Canada Life pension plan restrictions did not meet that standard.

C. Pension Grow-in Rights on Termination of Employment

Grow-in rights under section 74 of the PBA allow defined benefit plan members who meet the eligibility requirements to "grow-in" to enhanced retirement benefits (if a plan provided for enhanced benefits) even though they do not qualify for the enhanced benefits at the time employment was terminated. An example of an enhanced benefit pension is a right to an early unreduced pension. Plans that provide enhanced benefits typically require members to meet certain age and service criteria to qualify for the benefit. The PBA grow-in rules require a member of a defined benefit pension plan to have 55 points (age plus years of service) at the time of termination of employment in order to grow-in to an unreduced pension provided by a pension plan. Prior to July 1, 2012, grow-in rights existed only when a pension plan was fully or partially wound-up.

Under the amended PBA, all employees terminated after June 30,2012 without cause will be eligible for grow-in rights, regardless of whether the pension plan is wound-up or not. Consequently, if an employee is terminated prior to achieving the requirements for enhanced pension benefits, but otherwise has 55 points at the time of termination of employment, the employee can grow-in to the enhanced benefits.

There are three notable situations where the expanded grow-in rule does not apply.

First, employees who resign will not qualify for grow-in benefits. Grow-in rights require that an employer terminate the member’s employment.

Second, section 74(1.1) of the PBA provides that grow-in rights do not arise if the termination is a result of wilful misconduct, disobedience or wilful neglect of duty by the pension plan member that is not trivial and has not been condoned by the employer.

Accordingly, if a member is terminated for "wilful misconduct," then the employee is not entitled to grow into enhanced benefits. Termination for "wilful misconduct" is not equivalent to termination for "just cause." The former is an employment standards statutory concept, while the latter is defined by common law. In *Oosterbosch v FAG Aerospace*[9], the employee was terminated pursuant to a progressive discipline policy following unsatisfactory work performance and falsification of records. The Court agreed with the employer in finding just cause for termination. However, the Court did not agree with the employer that the employee's behavior amounted to "willful misconduct, disobedience or willful neglect". Although the employee's behaviour appeared to constitute persistent misconduct, it was not found by the Court to be intentional, which would be a necessary finding when concluding behaviour is willful. Based on this approach to "wilful misconduct", it appears that this exception will be a difficult one to rely on.

Third, section 74(2.1) of the PBA provides authority to jointly sponsored and multi-employer pension plans to opt out of providing grow-in benefits to their members.

The statutory changes regarding grow-in benefits will make more employees eligible for enhanced benefits and, as a result, will increase the cost to employers with defined benefit plans. Employers will need to think about these enhanced benefits when structuring termination packages.

D. Communication Obligations

Employers and benefit plan administrators have statutory and common law duties to communicate relevant information to employees. This positive duty is especially important when employees are vulnerable and dependent on the employer for information, as is usually the case with employees who have been terminated. Liability can arise if communication is incomplete or inaccurate and an employee relies on this information to his or her detriment.

[9] *Oosterbosch v FAG Aerospace*, 2011 ONSC 1538.

1. Statutory Requirements

The administrator of a registered pension plan is required by the *Pension Benefits Act*[10] (Ontario) ("PBA") to provide a terminating member with a written statement outlining the benefits, rights and obligations of the member, no later than 30 days after termination.[11] The termination statement for a member who is entitled to a deferred benefit must contain, among other things, the plan name, member's name and date of birth, years of credited employment, benefits payable, transfer value, transfer options, and the time period for exercising transfer options. It should be noted that an "administrator," as defined by the PBA, may or may not be the employer[12] since this role is sometimes delegated to professional third parties with specialized skills and knowledge.

2. Capital Accumulation Plans Guidelines

In 2004, the Joint Forum of Financial Market Regulators released the Guidelines for Capital Accumulation Plans ("CAP Guidelines"). These guidelines, which apply to all capital accumulation plans, including defined contribution registered pension plans, do not have the weight of law but they are widely followed as industry best practices.[13] Section 7.2.1 of the CAP Guidelines addresses the communication requirements to departing members. Upon a member's termination of employment, retirement or death, the sponsor should inform the member (or the member's beneficiary or personal representative) of his or her options, the actions the member must take and the corresponding deadlines, the default options if no action is taken, and the impact of termination on each of the member's investment options.[14]

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[10] *Pension Benefits Act*, RSO 1990 [PBA].

[11] RSO 1990, c P8, s 28.; *Pension Benefits Act*, RSO 1990. Regulation 909, ss 41-44.

[12] RSO 1990, c P8, s 8(1).

[13] Canadian Association of Pension Supervisory Authorities, *Guideline No. 3: Guidelines for Capital Accumulation Plans*, May 28, 2004.

[14] Ibid, s. 7.2.1.

3. Common Law

Pension plan administrators also face common law disclosure duties to communicate relevant and accurate information to employees in a timely manner. The importance of this duty is demonstrated in *Allison v Noranda Inc* .[15] The plaintiff, Allison, was terminated without cause and given two "separation pay" options. The first option was to take a lump sum payment with the employment ending on the date when the notice of termination was issued. The second option was to become an inactive employee and take salary continuation payments for the full notice period. The employer did not advise Allison of the pension consequences of electing a lump sum or salary continuation, and in particular that the value of the two options was quite different. If Allison took the salary continuation option, his retirement benefit would be significantly larger ($887 per month vs. $302 per month) by virtue of his ability to accrue eligible service during the notice period. Proceeding without this information, Allison selected the lump sum alternative. On discovering his reduced pension entitlement, Allison sued his former employer. The New Brunswick Court of Appeal stated the following:

> Surely, an employer is under an obligation to make sufficient disclosure to enable an employee to make an informed decision in cases where the employer asks an employee to make an election with respect to separation pay options that impact significantly on pension benefits. I say this because pension information is of a specialized nature and in the present case, within the control of Noranda as administrator of the pension scheme.[16]

E. Conclusion

In order for employees to protect their pension entitlements and for employers to avoid liability, it is important that both sides understand their rights and obligations upon a termination of employment.

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[15] *Allison v Noranda*, 2001 NBCA 67, 619 APR 211.

[16] Ibid, at p. 289-90.

Employers should continue benefits through a statutory notice period. Employers should also be aware that employees are generally entitled to damages for lost pension accruals during the reasonable common law period, and that damages awarded by courts may be grossed-up. In addition, employers need to be mindful that pensionable employees are not entitled to less by way of reasonable notice solely by virtue of being eligible for or actually receiving pension benefits. Where drafting or reviewing an employment contract to limit liability or provide clarity, the language used should be clear and unambiguous.

Employers and other pension plan administrators must ensure that they disclose all material information to departing employees. This communication must be accurate, complete and timely in order to limit exposure to claims.

Administration of pension and retirement arrangements is complex and this complexity is very apparent when terminating an employee. Overlooking pension obligations when terminating an employee can have unexpected and costly implications.

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