

Conversion Of DB To DC Plans

By: Evan Howard

Most employers with Defined Benefit plans are looking to contain their pension costs. Accordingly, many are switching to Defined Contribution plans in an effort to achieve more predictable funding costs. However, making such a switch can be complex and does not immediately eliminate the funding obligations associated with the DB pensions already accrued or in pay. As part of switching to a DC formula for future service, employers will need to manage, among other things, how the prior DB pensions will be treated, how the new DC arrangements will be structured, and how and when such changes will be communicated to employees.

Furthermore, while DC arrangements may yield more predictable funding costs, they nonetheless bring potential risks to plan sponsors. Unlike the U.S. under its ERISA legislation, most Canadian jurisdictions have no 'safe harbour' rules and plan sponsors are subject to fiduciary duties in relation to the administration of the plan, including the selection of investment options.

Converting Or Freezing

When switching to a DC arrangement, the accrued DB pensions for existing members do not automatically 'convert' to account balances under the DC plan. Such conversion can only occur if the plan sponsor gives plan members a conversion option and individual members so elect to convert. Note too that a union cannot usually give such consent on behalf of its members.

Determining conversion values must be made in accordance with applicable regulatory policy and commuted value rules under applicable legislation. Further, any funding deficiency or shortfall in respect of converted benefits would need to be covered by the employer as part of the conversion.

For those who do not elect the conversion option, the accrued DB benefits may remain 'frozen.' That is, members would still retain the right to receive a DB pension on retirement, but with no further accruals after the conversion date. Though frozen, employers would remain liable for any of the ongoing funding and administration associated with such benefits. Provided there are sufficient plan assets, employers often settle such remaining DB obligations by purchasing annuities.

Another issue is how the defined benefits will be frozen. Will it be a 'hard freeze' where no further service or salary is recognized for defined benefit accrual purposes or a 'soft freeze' where future salary increases are recognized (thus possibly increasing the value of the frozen benefit)?

However, a hard freeze is not possible in all cases. For instance, Quebec's pension legislation mandates a soft freeze and a recent case in Alberta found that its pension legislation may require a soft freeze depending on the plan's DB formula.

Structuring The Change

Any change from DB to DC would need to be effected through amendments to the existing pension plan documents. Such amendments need to be carefully considered and drafted to ensure the changes properly reflect how past benefits are to be treated and that the changes are consistent with terms of the existing plan documents and regulatory policies.

Employers whose pension plans are subject to collective bargaining may find that under the terms of the collective agreement or the pension plan they are prevented from changing plan design absent union consent.

New plan rules will need to be drafted to reflect not only the new DC benefit formula, but also the various rights and obligations of the employer and plan members in respect of the DC arrangements. Furthermore, consideration needs to be given when structuring the DC arrangement and its related funding agreements should an employer wish to use any DB plan surplus to offset employer contribution obligations for the DC arrangement.

The switch to a DC arrangement will likely also require engaging a new or an additional custodian to administer member account balances. The documents associated with this should be reviewed to ensure compliance with the voluntary Guidelines for Capital Accumulation Plans published by the Joint Forum of Financial Market Regulators.

Communicating The Change

Pension legislation and regulatory policy generally requires that advance notice of a change in plan design be provided to members within specified timeframes.

However, that is not the extent of the notice obligations. Any change in the benefit formula to the detriment of employees could, depending on the circumstances, be construed as a fundamental breach in the terms of employment and thus give rise to constructive dismissal issues. In other words, an employee who is significantly affected by the change could treat his or her employment as terminated and sue for damages under common law if reasonable notice of the change was not provided. Accordingly, employers should review the impact of the new benefit formula on plan members, then assess if sufficient advance notice is being provided to mitigate the risk of successful constructive dismissal claims.

It is important that all communications clearly and accurately describe the legal effects of the conversion or change. Ontario courts, for instance, have been very critical of employers who have not met this standard and have indicated that any failure could impair the effectiveness of the changes to the plan. Employers may also be sued for breaches of representation in respect of statements made in such communications.

Ongoing Risks

While DC arrangements may yield more predictable funding costs, such arrangements nonetheless bring potential risks to plan sponsors. DC plans in most cases are not subject to U.S.-style safe harbour rules in respect of the plan investment options that may be provided to employees. Further, under DC arrangements plan sponsors remain subject to broad fiduciary duties in relation to the administration of such plans. While a plan sponsor may engage outside service providers to provide advice and much of the day-to-day administration, the plan sponsor ultimately remains responsible for administering the plan and supervising those who support its administration.

While the investment risk is generally borne by the plan member in a DC arrangement, it is up to the plan sponsor to ensure that an appropriate range of investment fund options is provided to plan members. Furthermore, these funds should be reviewed from time to time to ensure that they are performing according to expectation and members have the resources to assist them in making the appropriate fund selections. Many of these services may be contracted out, but it is ultimately up to the employer to ensure that such obligations are being fulfilled.

Careful Management (Now And In The Future)

Plan sponsors must tread carefully when switching from DB to DC, not only when formulating future benefits, but also in terms of:

- how such change is implemented to ensure compliance with applicable laws
- whether the newly structured arrangement meets all employer funding and other objectives
- whether communications with employees have been thoroughly reviewed to ensure accuracy and consistency with pension legislation, regulatory guidelines, and plan documentation

Finally, plan sponsors need to be cognizant of their continuing fiduciary duties and obligations in respect of the plan. This means managing those providing services to the plan and periodically reviewing the plan and its investment options. ■

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