Systemic Failure of Disability Insurance in Health and Welfare Trusts

by Diane A. Urquhart, Independent Financial Analyst

A number of CALU members have assisted employers in putting in place long term disability programs for their employees, often using a group disability program offered through an insurance company. Some employers may express an interest in implementing a self-funded disability program, often through the structure of a Health and Welfare Trust (HWT). This option may be pursued as a result of the employer not being able to purchase insured disability benefits, at least at a reasonable cost; or because the employer wants a more flexible plan design than those offered by standard group disability plans, based on the number of employees and their demographics.

In the past the Canada Revenue Agency (CRA) has attempted to impose limits on the ability of employers to deduct contributions to fund such benefits under an HWT arrangement.[1] CALU and other groups have argued against these limitations, indicating that the lack of full deductibility may discourage employers from implementing disability programs, or properly funding such programs through an HWT structure. Such limitations have now been expressly incorporated into legislation governing Employee Life and Health Trusts (ELHTs),[2] which are very similar in their design and purpose to HWTs.

More recently it has become apparent that employees may be at risk where their group disability benefits are funded through an HWT, even where such funding is considered to be adequate based on actuarial determinations and the demographics of the employee group. The following article by Diane A. Urquhart highlights these risks, which she has experienced first-hand through working with a group of disabled Nortel employees.

Introduction

According to the Canadian Life and Health Insurance Association (CLHIA),[3] 61% of Canadian workers have disability insurance provided by third-party insurers; 7% have employer-sponsored disability insurance that is not insured through third-party insurers; and 32% have no disability insurance whatsoever. (See chart below.)

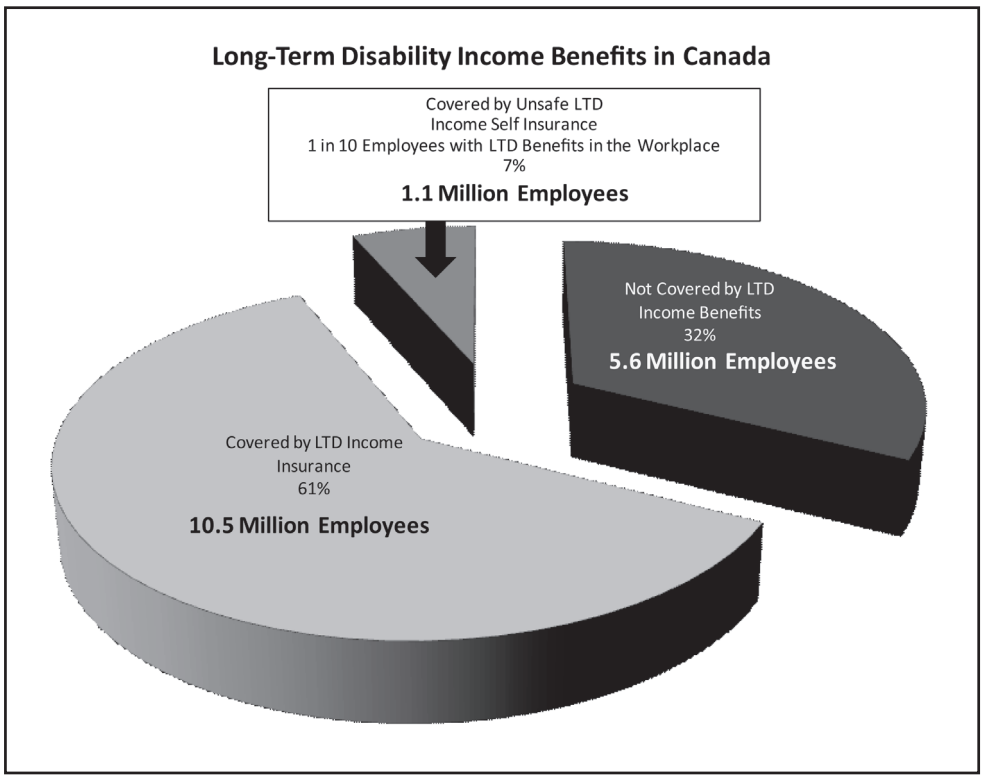
Employees covered by a non-insured program represent approximately 1.1 million Canadians. Due to recent Ontario court decisions, a number of these plans will likely fail to provide the promised plan benefits if their employer becomes insolvent. The fact that an employer's disability insurance program is "at risk" will not usually be discovered until the double jeopardy of disability and employer insolvency occurs. By then it is too late to obtain disability insurance from third-party insurers and the life of an already disabled person may spiral into financial crisis.

This lesson was unfortunately learned by the disabled employees of Nortel, who thought they were adequately covered under their employer's HWT, only to learn that on the bankruptcy of Nortel that their benefits were at risk. The purpose of this article is to discuss the Nortel situation and alert employee benefit advisors of the risks associated with establishing programs that are not fully insured through a third-party insurer.

What went wrong with Nortel's Disability Plan?

Nortel had established an HWT for its employees and the plan provided long-term disability benefits as well as group term insurance benefits to its employees. Nortel played the role of insurer with respect to disability income claims and it had the obligation for the orderly funding of disabled life reserves. In fact, Nortel acted as a responsible employer by fully funding its disability insurance in the HWT until 2005 when Nortel started to run into financial difficulties, which ultimately resulted in its bankruptcy.

In the bankruptcy proceedings there were competing claims to the assets held in the HWT, with several classes of members under the HWT laying claim to the remaining funds in the plan. Ultimately, the trustee in bankruptcy for Nortel, despite the objections of the disabled employees, negotiated an Interim Settlement that provided for only nine months, or



$12 million worth, of disability income, medical and life benefits. In exchange, the settlement extinguished the rights of disabled employees to pursue any remedies for the HWT funding shortfall, an amount unknown at the time. The disabled employees learned five months later that the HWT shortfall was at least in part caused by $45 million of assets being withdrawn from the HWT, and another $30 million of the remaining HWT assets being allocated to Nortel pensioners for a settlement of their life insurance coverage.

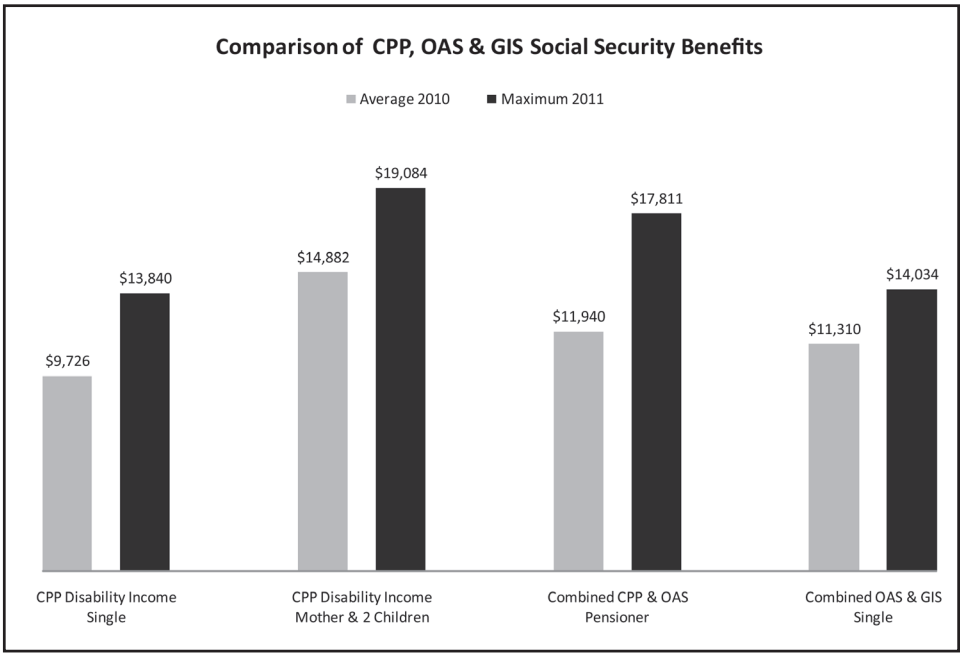
This result seems, to many, to be unfair given that a priority remedy for constructive trust and breach of fiduciary obligations in a trust has been validated in subsequent bankruptcy court cases. For example, in June 2010, the bankruptcy court gave a full priority settlement of $7 million for the deferred retirement income of nine Nortel executives using the reasons of constructive trust and unjust enrichment to the creditors.

In a similar situation, the Court of Appeal of Ontario granted a C*ompanies' Creditors Arrangement Act* (CCAA) appeal awarding full priority remedy for breach of fiduciary obligation in a trust by Indalex for not fully funding its Executive Pension Plan for 26 Indalex executives.

Canada's Social Safety Net for the Disabled is Inadequate

The financial issues faced by the disabled employees of Nortel have been further compounded by the lack of an adequate government social net. The maximum Canada Pension Plan (CPP) disability income benefit is $13,840 in 2011, and the average paid in 2010 was $9,726 per year for single disabled persons. As a result, disabled employees bear almost the full burden of the loss of wage loss replacement coverage upon the bankruptcy of their employer, potentially leaving them to lead a life in poverty.

Compare their situation with a retired low-income single person, who will receive a combined maximum CPP and Old Age Security income of $17,811, which is $3,971, or 29% higher, than a single person receiving the maximum CPP disability income. (See chart to the left.)



Other countries take much better care of disabled employees when their employers go bankrupt. For example, the U.K. Pension Protection Fund covers 100% of disability income to a limit averaging $36,068 per year. The U.S. Social Security for a disabled person with two dependent children pays $43,846 per year, whereas in Canada the maximum CPP disability is $19,084 per year for the same disabled mother with two

children. Canada can, and should, do more to move up to international standards for the disabled within its peer group of the United Kingdom and the United States.

Current Legal Framework is Deficient

The bankruptcy court's decision in *Nortel* appears to demonstrate that we have a regulatory framework in this country that puts at risk the full protection of disabled employees' benefits on the bankruptcy of their employer. Something should be done to fix this problem, providing the courts with effective and timely remedies for failed employer sponsored disability programs. In the view of the author, disability insurance coverage offered through insolvent employers should have the same regulatory protections as disability insurance underwritten by insolvent insurers.

For example, disability insurance provided by insurers has three elements of protection under Canadian law:

(1) a requirement for disability income reserves;

(2) policyholders are given statutory preference over the creditors of insolvent insurers under the *Federal Winding-up and Restructuring Act*; and,

(3) the insurance industry protection program, Assuris, provides further protection of disability insurance once the insurer has failed.

If employers are permitted to play the role of disability income insurer, at least the first two protections noted above need to be put in place:

(1) there needs to be mandatory disability insurance reserves held in a trust account, which likely requires legislative or regulatory amendments at both the federal and provincial levels, and

(2) there needs to be clear priority of disability insurance claims over creditors under both the federal *Companies' Creditors Arrangement Act* and the *Bankruptcy and Insolvency Act*.

The federal and provincial governments should not permit under-funded employer-sponsored disability insurance programs. Under current rules, employees do not become aware of the plan solvency issues until the employer files for bankruptcy protection, at which time it is too late to replace such coverage.

The Income Tax Act Needs to Allow Employer Deductions

As already noted in the introduction to this article, the CRA's administrative position for HWTs, as well as the new rules governing ELHTs, defer or deny the deduction of employer contributions that are designed to create a reserve fund for incurred disability claims. These tax rules discourage employers from fully funding disability benefits and put employees at risk in the event of their employer's bankruptcy. Both the CRA and the Department of Finance need to reconsider this situation and put in place rules that ensure employees have adequate coverage in situations where the employer has decided to not use an insurance company to cover disability benefits.

There is also a strong argument that the CRA's administrative position on the deductibility of contributions for incurred disability claims could be successfully challenged by an employer.[4]

Corporate and Employee Call to Action

Employers need to either convert to disability insur-

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ance with third-party insurers, or set up an HWT or ELHT solely to provide disability benefits if they wish to ensure that disability benefits survive the financial difficulty of the employer.

With a separate HWT or ELHT for employer-sponsored disability insurance, there can be no doubt about other employee groups having any legal rights to make claims against the trust assets for settlement of their medical, dental and life benefits that were paid annually through the trust.

Advisors working with employers and employees also need to be aware of the risks associated with unfunded or poorly funded disability programs. They should be recommending other options to the employers and/or ensuring their clients also obtain individual coverage as a fall-back position to the failure of the employer's plan.

Canadians now have a greater responsibility to find out if their disability insurance is self-insured and consider opting out of employer-sponsored disability insurance within multi-purpose trusts, in order to purchase personal disability insurance from insurance companies. The higher cost is worth it, as the bankruptcy court and governments have systemically failed to protect Canadians who have employer-sponsored disability insurance, when they become disabled and their employers go bankrupt.

About the Author

Diane A. Urquhart is an independent financial analyst with over 30 years of experience in research, specializing in investments and insurance. Her work is used by federal and provincial legislators, the media, police forces, Canadian and U.S. securities and accounting regulators, citizen associations, and victims of systemic financial negligence or fraud. You can reach her at (905) 822-7618 or (647) 980-7618, or by e-mail at urquhart@rogers.com.

Endnotes

[1] The CRA has taken the position that only contributions required to fund benefits payable in the year are deductible by the employer. As a result, an employer seeking to establish a reserve for incurred claims may not be able to deduct its full contribution to the HWT.

[2] Subsection 144.1(4) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended, herein referred to as "the Act." For more discussion of these rules please refer to "CALU Submission to Finance re ELHTs" dated April 20, 2010, located in the section "Special Articles and Bulletins" on the member-only side of the CALU website at www.calu.com.

[3] CLHIA Policy Paper entitled "Protecting Canadian's Long Term Disability Benefits" dated September 2010.

[4] In the case of *Canadian Pacific Limited v. The Minister of National Revenue (Ontario),* 99 DTC 5286 (ON CA), the court supported the position that a lump sum contribution to an HWT for current and future obligations was a legitimate business expense and not prohibited by paragraph 18(1)(e) of the Act as a "contingent" amount. While the CRA has accepted the decision in *Canadian Pacific*, it has gone on to state that it would apply subparagraph 18(9)(a)(iii) to deny the expenses as a "prepaid" insurance expense (see Question 7 in CRA Technical News No. 25 dated Oct. 30, 2002). This position has not been challenged in court and arguably employer contributions to an HWT for incurred disability claims do not represent "consideration for insurance in respect of a period after the end of the year."