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PROTECTING EMPLOYEE WAGES IN BANKRUPTCY

Margaret Smith
Law and Government Division

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PROTECTING EMPLOYEE WAGES IN BANKRUPTCY

INTRODUCTION

A business bankruptcy can affect a host of creditors from employees to suppliers of goods and services, secured creditors and lenders, and various levels of government. Like other creditors, employees who are owed wages share in the remaining assets of their bankrupt employer. In some cases, there will be sufficient assets to satisfy employee claims in full; in others, employees may be compensated for only a portion of their claims or receive nothing at all.

The issue of how to compensate employees for unpaid wages in an employer bankruptcy has been considered in the course of numerous proposals to amend Canada's bankruptcy laws over three decades. In the end, after debating wage protection funds, a super priority over other creditors and other possible approaches, little change has occurred – unpaid wages continue to rank as preferred claims in a bankruptcy behind secured creditors but ahead of ordinary creditors.

This paper examines a number of approaches for protecting unpaid employees under Canadian bankruptcy law. It also outlines various legal and administrative arrangements developed in countries such as Australia, the United Kingdom and the United States to protect unpaid employees.

At the outset, it is important to note that the question of wage entitlement in bankruptcy is a complex issue. In theory, it would be difficult to find anyone opposed to the notion of compensating employees for the wages and benefits to which they are entitled when their employer goes bankrupt. Employees are often the most exposed creditors and the least able to absorb a wage loss. Unlike some other creditors, they are not able to assess the risk of an employer bankruptcy or bargain with employers for greater protection.

But, on a practical level, the issue is less straightforward and involves difficult policy choices. Affording greater protection to unpaid wages comes at a cost either: to other creditors, if employees are given priority over such creditors; or to employees, employers or taxpayers if a fund is created (depending on how the fund is financed) to satisfy employee claims. Enhanced wage earner protection may also adversely affect the ability of businesses to obtain credit, especially if wage claims are given priority over secured creditors.

These concerns can be compounded by the difficulty in ascertaining the dimensions of the unpaid wage problem. Although statistics on the number of business bankruptcies are readily available, it can be difficult to determine the value of unpaid wages and the extent to which these claims have been satisfied. It is also worth noting that the significance of the problem can change at various stages of the business cycle. Business bankruptcies tend to increase when the economy weakens, and decrease when the business cycle is in an upswing.

A. Status of Unpaid Wages under the Current Canadian Bankruptcy Regime

Under the *Bankruptcy and Insolvency Act* (BIA),[(1)] creditors are classified as follows: secured creditors, preferred creditors, ordinary creditors and deferred creditors. These classifications determine where creditors rank in relation to their claims against the bankrupt debtor's assets.

Secured creditors rank first because a trustee in bankruptcy takes title to a debtor's property subject to the rights of secured creditors in that property. For example, a mortgagee would have first claim on real estate for the unpaid value of a mortgage before any other unpaid creditors could make a claim against that asset.

After secured creditors come the claims of preferred creditors, ordinary creditors and deferred creditors, in that order. Preferred creditor claims must be satisfied before those of ordinary creditors, and claims of ordinary creditors must be dealt with before deferred creditors are entitled to share in the bankrupt debtor's assets.

The BIA also ranks claims within the class of preferred creditors, with each sub-class of preferred creditor having priority over the subsequent sub-class. Section 136(1) of the BIA establishes the following order for preferred claims:

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(1) R.S.C. 1985, c. B-3, as amended.

- testamentary and funeral expenses of a deceased bankrupt;
- fees and expenses of the trustee in bankruptcy and legal costs;
- the Superintendent of Bankruptcy's levy;
- unpaid wages and salaries of employees earned within six months prior to the employer's bankruptcy up to a maximum of $2,000 and salespersons' expenses of up to $1,000 during that six-month period;
- alimony and maintenance payments accruing in the year prior to bankruptcy;
- municipal taxes;
- landlords' claims for up to three months' arrears in rent;
- certain fees and expenses incurred by execution creditors before a bankruptcy;
- claims resulting from employee injuries.

Thus, unpaid wages to a maximum of $2,000 and salespersons' expenses up to $1,000 currently rank fourth among preferred creditors behind funeral expenses, bankruptcy trustee fees and the levy charged by the Superintendent of Bankruptcy.

The *Bank Act*[(2)] also establishes a form of priority for unpaid wage claims. Under section 427(7) of the *Bank Act*, claims for wages earned within three months prior to a bankruptcy have priority over a security interest taken by a bank under that section. But this section is relatively ineffective in protecting wage claims against bank claims because banks also take security under provincial personal property security legislation, thereby avoiding the wage priority.

Unpaid wages may also receive protection under provincial laws that establish a priority for wage claims over other creditors. And, in addition, provincial laws may give priority to unpaid wage claims through legal mechanisms such as statutory security interests and deemed trusts. These provincially established priorities, however, do not apply in a bankruptcy.[(3)]

The directors' liability provisions of federal and provincial corporations laws also provide a measure of protection for unpaid wage claims. Under the *Canada Business Corporations Act* (CBCA), for example, directors are liable to employees for up to six months' unpaid wages, subject to a due diligence defence. Section 119(1) of the CBCA provides that

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(2) Statutes of Canada, 1991, c. 46, as amended.

(3) Industry Canada, Corporate Law Policy Directorate, *Statutory Priorities in Business Insolvencies*, May 2001, pp. 35-36. http://strategis.ic.gc.ca/pics/cl/dp3e.pdf.

directors are jointly and severally liable to corporate employees for all debts to a maximum of six months' wages for services performed by employees for the corporation. A director, however, will not be liable for wages unless:

- the corporation has been sued for the debt within six months after it became due and the debt remains unsatisfied;
- the corporation has commenced liquidation and dissolution proceedings or has been dissolved and a claim for the debt has been proved within six months after the proceedings were commenced; or
- the corporation has instituted bankruptcy proceedings and the claim for wages has been proved within six months after the proceedings began.

In addition, liability for wages will only ensue if the director is sued while he or she holds office or within two years after ceasing to be a director.

Directors are entitled to rely on subsection 123(4) of the CBCA to exonerate themselves from liability for unpaid wages if they have acted with reasonable diligence, including reliance in good faith on the corporation's financial statements or the report of a professional such as an appraiser or lawyer.(4)

Employment standards laws may also impose liability on corporate directors for unpaid wages. The *Canada Labour Code* provides that directors are jointly and severally liable for wages as well as termination and severance pay, to a maximum amount not exceeding the value of six months' wages.(5) Provincial employment standards laws may create similar liabilities.

B. Overview of Attempts to Amend Canadian Bankruptcy Law to Protect Employees' Unpaid Wages(6)

Proposals to amend the *Bankruptcy Act* to introduce a greater measure of protection for unpaid wages in employer bankruptcies were first introduced in the 1970s.

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(4) R.S.C. 1985, c. C-44, as amended by Statutes of Canada 2001, Chapter 14, s. 50. http://www.parl.gc.ca/PDF/37/1/parlbus/chambus/house/bills/government/S-11_4.pdf.

(5) R.S.C. 1985, c. L-2, as amended, s. 251.18.

(6) The material in this section is drawn from Margaret Smith, *Bankruptcy Law Update*, 88-16E, Parliamentary Research Branch, Library of Parliament, 18 May 1999, unless otherwise indicated. http://www.parl.gc.ca/information/library/PRBpubs/8816-e.htm.

Bill C-60, introduced in 1975, had proposed super priority status for unpaid wage claims up to $2,000. This would have placed claims for unpaid wages ahead of all other creditors, including secured creditors. Secured creditors, of course, objected to the proposal as a potentially serious dilution of their protected status. After studying the bill, the Standing Senate Committee on Banking, Trade and Commerce concluded that super priority status for wages would be detrimental to a borrower's ability to obtain financing, especially in labour-intensive industries. Instead, the Committee recommended the creation of a government wage protection fund, made up of contributions from employers and employees, out of which outstanding wages to a maximum of $2,000 could be paid immediately after an employer bankruptcy. Bill C-60 was never enacted.

In 1980, the then Minister of Consumer and Corporate Affairs appointed a small task force of bankruptcy experts to investigate the problem of unpaid wages. The Landry Committee reported in 1981 that it was unable to determine the magnitude of the problem in view of the scarcity and incompleteness of reliable data on the number and value of unpaid wage earner claims; however, the evidence they were able to collect did verify the existence of a problem. The Committee's recommended course of action was a wage earner protection scheme. Believing that a permanent legislative solution could not be devised until the size of the problem had been determined and until federal and provincial policies had been coordinated, the Committee proposed an interim solution for a three-year period during which unpaid wages would be paid from the Consolidated Revenue Fund up to a maximum of $1,000.

The Landry Committee's recommendations were not accepted. In 1984, a bankruptcy bill (Bill C-17) maintained largely the same scheme – preferred creditor status – for protecting wage earners as had been included in a number of previous attempts to amend the then *Bankruptcy Act*. Amendments to Bill C-17 introduced at Committee stage, however, gave unpaid wage claims to a maximum of $4,000 super priority status over all other creditors. Bill C-17 suffered the same fate as its predecessor bankruptcy bills and was not enacted.[7]

In March 1985, an Advisory Committee on Bankruptcy and Insolvency (the Colter Committee) was appointed to examine the bankruptcy system, assess possible reforms, and recommend amendments. Reporting in 1986, the Colter Committee made a number of recommendations regarding wage earner protection.

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(7) *Statutory Priorities in Business Insolvencies* (2001), p. 10.

The Colter Committee called for the creation of a wage earner protection fund financed by contributions from employers and employees to pay wage arrears on an employer's bankruptcy or receivership. Under the Committee's proposal, employees would be entitled to be paid:

- arrears of wages and commissions earned within six months prior to the insolvency;
- arrears of vacation pay earned within 12 months preceding the insolvency;
- arrears of all amounts withheld from employees such as pension benefits;
- union dues to a maximum of $2,000 per employee; and
- arrears of expenses incurred by an employee on behalf of an employer to a maximum of $1,000 per employee during the two-month period preceding an insolvency.

The Committee recommended that the Unemployment Insurance Section of the Department of Employment and Immigration administer the fund. Any amounts paid out by the fund would be subrogated as preferred status claims under the *Bankruptcy Act*, ranking immediately after the costs of administration.

Bankruptcy reform proposals announced by the then Department of Consumer and Corporate Affairs in June 1988 differed from the recommendations of the Colter Committee in two important respects. First, the wage protection program was to be financed entirely by the federal government rather than by employer and employee contributions. Second, the Superintendent of Bankruptcy – rather than the Unemployment Insurance Section of Employment and Immigration – would administer the fund. The Department, however, accepted the Colter Report's recommendation on monetary limits. The fund was to guarantee 90% of unpaid wages and vacation pay earned in the six months prior to bankruptcy to a maximum of $2,000, and up to $1,000 for arrears of expenses incurred on behalf of an employer.

The next bankruptcy bill, Bill C-22, as introduced at First Reading in June 1991, would have established a wage earner protection fund pursuant to a new statute, the Wage Claim Payment Act ("WCP Act"). But unlike the reform proposals announced in 1988, Bill C-22's proposed scheme was to be financed by contributions from employers. From this fund, employees could claim 90% of their unpaid wages and vacation pay earned within six months prior to their employer's bankruptcy, up to a maximum of $2,000 and 90% of salespersons' expenses unpaid during the same period, up to a maximum of $1,000. Pension contributions, severance pay and termination pay would not have been included. The Superintendent of

Bankruptcy would have administered the program, and benefits would have been paid out of the Consolidated Revenue Fund.

The fund was to be financed by a payroll tax on employers equal to 0.024% of an employee's weekly insurable earnings under the then *Unemployment Insurance Act*. The tax was to be imposed as of 1 January 1992 and collected jointly with the unemployment insurance program.

The concept of a wage protection fund was generally well received, but the method of financing the fund was not. Business along with institutions such as municipalities, hospitals and school boards, whose employees would likely never benefit from the fund, opposed a payroll tax. In its pre-study report on Bill C-22, the House of Commons Standing Committee on Consumer and Corporate Affairs and Government Operations rejected the concept of a wage protection fund and recommended that workers' claims for unpaid wages up to a maximum of $3,000 be given priority over the claims of all other creditors, in the event of an employer's bankruptcy, liquidation or receivership and that a fund be established to cover any shortfall.

During clause-by-clause consideration of the bill in late 1991, the Government proposed that the WCP Act be amended to defer the imposition of the tax for a period of one year and to allow the Governor in Council to adjust the percentage of the payroll tax to cover the payment of benefits under the program.

After procedural concerns in the Standing Committee, the Government reconsidered its position on the WCP Act and, in May 1992, the Minister of Consumer and Corporate Affairs announced that it would be withdrawn.

Amendments to the existing preferred creditor provisions were passed and came into force on 30 November 1992. Thus, the current provisions of the *Bankruptcy and Insolvency Act* maintain preferred creditor status for unpaid wage claims and salespersons' expenses where an employer is bankrupt to a maximum of $2,000 for wages and $1,000 for salespersons' expenses. Where an insolvent employer makes a proposal to reorganize his or her business, unpaid wages and salespersons' expenses to these maximum amounts are paid immediately after court approval of the proposal.

When Bill C-22 received Royal Assent on 23 June 1992, the Minister of Consumer and Corporate Affairs announced that the matter of wage claims would be reconsidered by a special Joint Committee of the House of Commons and the Senate, which would report by the summer of 1993. This Committee was never established.

Further amendments to the *Bankruptcy and Insolvency Act* in 1997 (Bill C-5) made no changes to the overall amount or status of wage claims. The bill, however, allowed a representative of a federal or provincial ministry of labour or a union to file a proof of claim on behalf of all employees.

Over the years, numerous private Members' bills aimed at enhancing the protection afforded to employee wage claims have been tabled in the House of Commons. The most recent of these is Bill C-423, tabled by Mr. Pat Martin (Winnipeg Centre) on 29 January 2002. Bill C-423 would replace preferred creditor status for wage claims with super priority status that would rank unpaid wages and other benefits up to $10,000 earned six months before an employer's bankruptcy and salespersons' expenses up to $4,000 for that same period ahead of all other creditors, including secured creditors.(8)

C. Options for Protecting Employees' Unpaid Wages and Entitlements

There are several approaches to protecting unpaid wages and employee entitlements in the case of an employer's bankruptcy. This paper examines four options:

- super priority;
- a wage guarantee scheme;
- the recognition of provincially created security interests and deemed trusts; and
- preferred creditor status.

1. Super Priority

a. Full Super Priority

The concept of granting a super priority for unpaid wages has a number of variations. A full super priority places unpaid wages and/or other employee entitlements ahead of all other claims, including the claims of secured creditors, in the distribution of a bankrupt employer's assets.

Proponents of full super priority have long maintained that there is no public policy reason why employees should rank behind secured creditors. They note that employees are often the most vulnerable creditors. Unable to protect themselves when their employer is in a

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(8) Bill C-423, An Act to amend the Bankruptcy and Insolvency Act, First Reading, 29 January 2002. http://www.parl.gc.ca/PDF/37/1/parlbus/chambus/house/bills/private/C-423_1.pdf.

precarious financial situation, employees do not have the ability or the opportunity to assess the financial risks of being involved with their employer or the same capacity as secured creditors to absorb a loss.

Critics of the full super priority approach point out that it does not necessarily guarantee that employees will recover the wages owed to them. The amount received depends on the value of the available assets. If the assets are insufficient to meet the outstanding wage claims, employees will have to settle for less than the full amount of their claim. Opponents further maintain that a super priority can have an adverse effect on the ability of businesses, particularly labour-intensive industries, to obtain credit. Bank lending policies would most likely become more restrictive and the cost of credit would rise if lenders were to lose their priority status. It has also been suggested that full super priority could make the administration of bankruptcies more costly because trustees would be required to do more work and incur additional expenses.

Critics also question why employees deserve special protection when unsecured trade creditors, most often small business owners, can be put in an equally tenuous position by a customer's bankruptcy.

b. Modified Super Priority

Unlike full super priority, a modified super priority grants priority over some but not all of a bankrupt employer's assets. One suggested approach is to give unpaid wages first priority over an employer's current assets such as cash, short-term investments, inventory and accounts receivable.(9) This form of modified super priority would provide less protection than full super priority but would not affect the priority status of lenders with security on fixed assets.

Industry Canada's Corporate Law Policy Directorate has assessed this modified form of super priority against fairness and efficiency criteria. The Directorate points out that although this approach would provide more protection than the current preferred creditor regime, it would also place a greater burden on working capital lenders that might lead to credit restrictions as well as reduced economic activity in certain business sectors. A study assessing the economic impacts of a super priority scheme for unpaid wage earners concluded the following:

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(9) *Statutory Priorities in Business Insolvencies* (2001), p. 14.

> The creation of the first-ranking charge described in the Proposal [a first-ranking claim for unpaid wage claims up to $2,000 and $1,000 in salespersons' expenses over the current assets of a bankrupt employer] will probably reduce the borrowing base of firms, as calculated by the banks, by an amount equal to the number of employees of the firm multiplied by the maximum claim per employee, in this case $2000. Absent a drastic change in banks' willingness to assume additional credit risk, this will in turn lead to a reduction in the amount of credit available to certain firms, particularly firms in knowledge-based industries, service providers of all sorts, restaurants and retailers of soft goods. A reduction in the supply of credit to these industries will cause any firms which do not have ready access to additional equity, typically the smaller firms in any given industry, to reduce the scale of their operations. This will in turn affect levels of employment in those sectors and overall economic growth.[10]

In addition to concerns about the impact on credit, delays in paying workers due to the time involved in realizing the employer's assets could make this form of super priority less attractive to workers than other options such as a wage guarantee program.[11]

In terms of efficiency, the Corporate Law Policy Directorate points out that

> Adopting a current assets super priority regime could generate efficiency gains where employees are taking on excessive risks of not getting paid and where creditors could adjust without greatly reducing credit availability to employer businesses. Such a system would not affect markets for fixed asset secured credit, which is significant as fixed asset secured creditors might be less able to adjust to any wage super priority applicable to their security. Working capital credit markets would be affected, although working capital lenders probably would be better able to adjust effectively. A super priority regime limited to current assets would generate added administration costs, but less so than a full super priority regime.[12]

Yet another form of modified super priority would give employee wage claims priority over all employer assets except those subject to purchase money security interests

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(10) Kevin Davis and Jacob Ziegel, *Assessing the Economic Impacts of a New Priority Scheme for Unpaid Wage Earners and Suppliers of Goods and Services*, Prepared for Industry Canada, Corporate Law Policy Directorate, 30 April 1998 (published 3 August 2001), p. 58. http://strategis.ic.gc.ca/pics/cl/unpaid_ws.pdf.

(11) *Statutory Priorities in Business Insolvencies* (2001), p. 14.

(12) *Ibid*., pp. 14-15.

(PMSIs). A PMSI gives a seller or a third-party lender who finances the purchase of a particular asset a security interest in sold property.(13)

Again, assessing this modified form of super priority against fairness and efficiency criteria, Industry Canada's Corporate Law Policy Directorate observes that a priority which excludes assets covered by purchase money security interests would provide better protection than a current assets priority system, particularly where employers have little in the way of current assets. But, like other forms of super priority, it could also lead to possible credit restrictions and loss of employment and would be less certain and prompt in terms of payment.(14)

As for efficiency, the Directorate suggests that

> Like the other super priority regimes, this regime would reduce labour market failures which may lead employees to bear an excessive risk under the current legislation. Although super priority regimes tend to restrict credit availability, in protecting PMSI lenders against added risk this regime would avoid credit restrictions by this important class of lenders. At the same time, lending by fixed asset, non-PMSI secured creditors for whom the adjustment to super priorities might be difficult, may be discouraged. Like the other super priority regimes, this regime would produce higher administration costs than the current regime.(15)

2. Wage Guarantee Schemes

a. Overview

Wage guarantee schemes ensure that employees will receive unpaid wages and, in some cases, other entitlements on an employer's bankruptcy. These schemes can take a number of forms, but the most common involve funding by government either from general tax revenues or by employers and/or employees through a payroll tax. Recognizing that employee wages and entitlements can often amount to significant sums of money, these schemes generally do not provide full payment of all entitlements but rather seek to guarantee a "reasonable" level of protection. Determining what is reasonable, however, can be problematic when competing interests must be balanced.

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(13) *Ibid*., p. 15.

(14) *Ibid*.

(15) *Ibid*.

To date, despite numerous reports recommending the creation of a wage guarantee scheme to protect unpaid employees, efforts to establish a wage guarantee program under federal bankruptcy legislation have failed. However, such programs have existed and continue to operate at the provincial level. Ontario[16] and Manitoba had established government-funded wage guarantee schemes, but these were terminated in the 1990s. New Brunswick's *Employment Standards Act*,[17] however, continues to provide employees with a mechanism to claim unpaid wages, vacation pay, public holiday pay and pay in lieu of notice from public funds. Employees apply to the Minister of Training, Employment and Development who, if satisfied that money is owed to employees after reasonable collection efforts have been undertaken, can pay employees from funds appropriated to satisfy the claims. Upon payment, the Minister is subrogated to the rights of the employees, can require the employer in question to reimburse the government, and may register a certificate for the amount owing as a court judgement against the employer.

b. Other Jurisdictions

Wage guarantee schemes operate in a number of countries. To illustrate the varying nature of such schemes, this section examines Australia's recently developed wage protection program as well as the United Kingdom's wage guarantee regime.

i. Australia

In 1999 and early 2000, two high-profile corporate insolvencies – Oakdale Collieries Pty Ltd. and National Textiles – left employees with millions of dollars in unpaid employee entitlements. The Oakdale Collieries situation was settled by the passage of specific legislation, after which the Commonwealth government issued a discussion paper in which it

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(16) In 1991, Ontario adopted the *Employment Standards Amendment Act (Employee Wage Protection Program), 1991* to assist workers in recovering unpaid wages when their employer was bankrupt, insolvent or when the employer did not pay because of other circumstances. Under the Program, unpaid workers could file a complaint with the Employment Standards Branch and, once the validity of the claim was determined, an order to pay – limited to a maximum of $5,000 – would be issued against the defaulting employer. If the employer failed to pay and did not appeal the order, the claimant was entitled to be reimbursed from the Employee Wage Protection Program. The Employment Standards Branch would then become subrogated to the rights of the employee to recover the unpaid wages and attempt to recover the money paid out from the employer.

(17) Consolidated Statutes of New Brunswick, Chapter E-7.2, s. 77. http://www.canlii.org/nb/sta/e-7.2/whole.html.

outlined two options for protecting employee wages and entitlements in the event of a corporate insolvency. The National Textiles employees received payment from the Employee Entitlements Support Scheme, a program based on one of the options described in the discussion paper entitled *The Protection of Employee Entitlements in the Event of Employer Insolvency*.(18) Issued in August 1999 by the Hon Peter Reith, Minister of Employment, Workplace Relations and Small Business, the paper set out two options for protecting employee entitlements:

- a basic payments scheme; and
- a compulsory insurance scheme.

The proposed limits on entitlements available under either the insurance or basic payments scheme would be equivalent to 29 weeks of pay, and would be composed of up to:

- 4 weeks' unpaid wages;
- 4 weeks' annual leave accrued in the previous 12 months;
- 5 weeks' pay in lieu of notice;
- 4 weeks' redundancy pay (where eligible); and
- 12 weeks' long-service leave (where eligible).

The maximum rate of payment for each week of entitlements would be based on a weekly pay rate corresponding to an annual salary of $40,000; the total amount an employee could receive would be capped at $20,000.(19)

Under the basic payments scheme, the government would guarantee employees a portion of their lost wages and entitlements in the event of an employer's insolvency. The Commonwealth and State/Territory governments would each contribute 50% of the funding for the scheme with the State/Territory portion coming from a payroll tax from which small business would be excluded. State/Territory participation in the scheme would be optional, however. If a State or Territory did not join, the Commonwealth government's portion of the scheme would

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(18) Australia, Minister of Employment, Workplace Relations and Small Business, Ministerial Discussion Paper, *The Protection of Employee Entitlements in the Event of Employer Insolvency*, August 1999 ("Ministerial Discussion Paper"). http://www.dewrsb.gov.au/ministers/reith/disc_info/disc/emp_insolvency.asp.

(19) *Ibid*., p. 7.

still operate in that jurisdiction but the maximum level of compensation available to employees would be 50% of the benefits otherwise available.[20]

The annual cost of the scheme to all levels of government was estimated at $100 million.[21]

The second option – a compulsory insurance scheme – would involve the introduction of a national program covering all private-sector employees. Businesses with more than 20 employees would be required to take out compulsory insurance to protect their employees' entitlements. The Commonwealth and State/Territory governments would jointly fund direct payments to protect the entitlements of employees of small businesses (those with fewer than 20 employees).[22]

The compulsory insurance scheme was the most highly criticized of the two options. Critics argued that the insurance premiums would represent a significant additional cost for business, and some questioned whether the Commonwealth government had the constitutional authority to enact legislation in this area.[23]

In 2000, the Commonwealth government adopted the national basic payments option and established the Employee Entitlements Support Scheme (EESS) under an administrative arrangement within the Department of Employment, Workplace Relations and Small Business.[24] At the outset, no State or Territory supported the EESS, but two eventually agreed to participate.[25]

In the wake of the collapse of Ansett Airlines in September 2001, the Commonwealth government conducted another review of employee entitlements in bankruptcy and announced a four-pronged strategy that would involve measures to address the Ansett situation specifically as well as employee entitlements generally.

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(20) *Ibid*., p. 9.

(21) *Ibid*.

(22) *Ibid.,* p. 9.

(23) Ben Dunstan, *Protecting Employee Entitlements in an Insolvency*, February 2000. http://www.aar.com.au/publications/insolfeb00.htm.

(24) The operational arrangements for the Employee Entitlements Support Scheme are set out on the website of the Department of Employment, Workplace Relations and Small Business. http://www.dewrsb.gov.au/workplaceRelations/employeeEntitlements/operationalArrangements.htm.

(25) Parliament of Australia, Parliamentary Library, Current Issues, *Corporate Insolvencies and Workers' Entitlements*, updated October 2001, p. 6. http://www.aph.gov.au/library/intguide/econ/insolvencies.htm.

The strategy includes:

1. Creating a new government-funded employee entitlements scheme, to meet the anticipated costs of Ansett staff terminations;
2. Imposing an airline ticket surcharge of $10.00 to cover the costs of the Ansett terminations;
3. Giving wage earners priority over the secured creditors of a bankrupt business;
4. Replacing the EESS with a General Employee Entitlements Redundancy Scheme.[26]

The General Employee Entitlements Redundancy Scheme (GEERS) replaced the EESS in relation to insolvencies occurring on or after 12 September 2001. The GEERS pays:

- all unpaid wages;
- all unpaid annual leave;
- all accrued long-service leave;
- all unpaid pay in lieu of notice; and
- up to 8 weeks of redundancy entitlements.[27]

The practice of reducing entitlements under EESS by 50% (due to non-participation of States/Territories) has been terminated under GEERS. The previous payout cap of $20,000 has been removed and the $40,000 annual salary threshold for determining weekly payments has been replaced by a threshold of $75,200.

ii. United Kingdom[28]

The United Kingdom has two parallel tracks for protecting employee entitlements in the event of an employer insolvency. First, employees are preferred creditors in relation to certain entitlements under the *Insolvency Act 1986.* As preferred creditors, employee claims for wages and annual leave have a priority over debts secured by a floating charge, but rank below debts secured by a fixed charge and certain other debts such as expenses arising from liquidation

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(26) *Ibid*., p. 8.

(27) Australia, Department of Employment and Workplace Relations, General Employee Entitlements and Redundancy Scheme Operational Arrangements. http://www.dewrsb.gov.au/workplaceRelations/employeeEntitlements/geersOperationalArrangements.asp#6.%20Payments%20for%20which%20employees%20are%20eligible.

(28) The material in this section is taken largely from Attachment B to the Australian Ministerial Discussion Paper (1999), pp. 15-17.

or receivership. Preferred creditor status applies to employees' remuneration during the four months prior to the employer's bankruptcy to a maximum amount (£800) and accrued annual leave due on termination of employment.

Second, a redundancy(29) payments regime provides for the payment of outstanding employee entitlements from the National Insurance Fund as provided under the *Employment Rights Act 1996*.(30) These insolvency provisions, which ensure that employees can recover amounts owed to them within a reasonable time, implement the UK's obligations under European Community Directive 80/987/EEC.(31)

If an employer becomes insolvent, employees can apply to the Fund for the payment of outstanding entitlements upon termination. Entitlements claimed through the redundancy payments regime include up to eight weeks' unpaid wages, statutory payments for time off work including leave on medical or maternity grounds, any protective award,(32) up to six weeks' unused annual leave, up to 12 weeks' pay in lieu of notice, compensation awards for unfair dismissal, and redundancy payments up to 30 weeks. For 2002, the maximum weekly payment is set at £250 per employee.(33)

The government assumes all the rights and remedies of the employee with respect to payments made from the Fund and stands in the employee's place as a preferred creditor in relation to a debt that has preferred status under the *Insolvency Act 1986*.

The National Insurance Fund is mainly funded by employers and employees through National Insurance Contributions. Treasury Grants from general taxation are made when needed.

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(29) A redundancy generally means the termination of an employee's employment because the job is no longer available.

(30) *Employment Rights Act 1996*, Statutes 1996, Chapter 18, ss. 182-190.

(31) Under the 1980 European Directive, Member States must provide protection for employees where their employer goes bankrupt by guaranteeing wages and other amounts that employees would have been entitled to if their employer had not become bankrupt.

(32) A protective award is an award made by an industrial tribunal where an employer has failed to inform or consult an employee representative about a collective redundancy.

(33) United Kingdom, Department of Trade and Industry, Limits on Payments (PL827 Rev 7). http://www.dti.gov.uk/er/pay/limits-pl827b.htm.

c. Advantages and Concerns Associated with Wage Guarantee Schemes

Perhaps the most significant advantage of wage guarantee schemes is the high degree of protection they provide to employees on an employer bankruptcy; payment is certain, and generally more timely than payments under the bankruptcy distribution process.

The most notable concerns, however, relate to:

- the spectre of "moral hazard" – knowing that a government-funded scheme is available to compensate employees, some employers might deliberately avoid their legal obligations to employees;
- the costs to taxpayers (if the scheme is funded from general tax revenue); and
- the additional costs to employers and/or employees if the scheme is funded through employer and/or employee contributions.

Weighing these advantages against these concerns involves a complex balancing of interests that can be difficult to achieve.

3. Recognizing Provincial Statutory Security Interests and Deemed Trusts

A common approach under provincial legislation to protecting employees when employers fail to pay wages and other employee entitlements is to create a statutory security interest in the debtor employer's assets for the amounts owed. These security interests take priority over most other types of security, rights or interests in the employer's property.

The Saskatchewan *Labour Standards Act*, for example, provides as follows:

> Wages accruing due or due to an employee are deemed to be secured by a security interest upon the property and assets of the employer or his estate, whether or not such property or assets are subject to other security interests, and the security interest for wages is payable in priority to any other claim or right in the property or assets, including any claim or right of the Crown in right of Saskatchewan, and, without limiting the generality of the foregoing, that priority extends over every security interest, lien, charge, encumbrance, mortgage, assignment, including an assignment of book debts, debenture or other security, whether perfected within the meaning of The Personal Property Security Act, 1993 or not, made or given, accepted or issued before or after the wages accrued due, without registration or other perfection of the deemed security interest for wages.[34]

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(34) *The Revised Statutes of Saskatchewan, 1978,* Chapter L-1, s. 56(1.2), as amended. http://www.qp.gov.sk.ca/documents/English/Statutes/Statutes/L1.pdf.

In addition to granting deemed security interests for employee wages and other entitlements, provincial laws often deem such wages and entitlements to be held in trust by the employer for the employee.

In Manitoba, for example, *The Employment Standards Code* makes the following provision:

> Despite any other Act, an employer is deemed to hold the wages that are due or accruing due to an employee in trust for the employee, and the employee has a lien and charge on the property and assets of the employer for the amount of the wages, whether or not the amount is kept separate and apart by the employer or the business of the employer is in receivership.(35)

Deemed security interests and deemed trusts established under provincial law apply when an employer is not bankrupt, but do not operate in a bankruptcy. When an employer is bankrupt, the provisions of the *Bankruptcy and Insolvency Act* take precedence and employees' wage claims are relegated to preferred creditor status. Professor Ronald Cuming described the relationship between provincial and federal law in this area in a paper prepared for Industry Canada's Corporate Law Policy Directorate:

> Thus, while individual provinces can define and rank categories such as "secured creditor" or "trust" as they each have their own purposes, those provincial laws which enter into conflict with the provisions of the *Bankruptcy Act* are simply without application in bankruptcy... Parliament has enacted a complete code in the *Bankruptcy Act*, one which necessarily calls upon provincial law for its operation. But Parliament's invitation stipulates an important limitation at the threshold of its domain, namely, that provincial law simply cannot apply when to do so would entail subverting the federal order of priorities in the *Bankruptcy Act*.(36)

One option for providing increased protection to employees' wage claims would be to amend the BIA to recognize provincial statutory security interests and deemed trusts.

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(35) *Continuing Consolidation of the Statutes of Manitoba,* Chapter E110, s. 100. http://www.gov.mb.ca/chc/statpub/free/pdf/e110.pdf.

(36) Ronald C.C. Cuming, *Enhanced Enforcement of Wage Claims under Canadian Bankruptcy and Receivership Law*, Prepared for Industry Canada, Corporate Law Policy Directorate, April 1998 (published 3 August 2000). http://strategis.ic.gc.ca/SSG/cl00316e.html#2b6.

In assessing this option, Industry Canada's Corporate Law Policy Directorate notes that recognizing deemed trusts under the BIA would provide protection comparable to partial super priority models, but this protection would vary among the provinces because provincial legislation is not uniform.(37)

The Directorate observes that this option could have the effect of restricting credit and raising borrowing costs, but it would also remove the incentive for secured creditors to force a bankruptcy in order to defeat provincially created priorities.(38)

4. Preferred Creditor Status

As mentioned earlier, the current provisions of the *Bankruptcy and Insolvency Act* confer preferred creditor status on unpaid wage claims and salespersons' expenses to a maximum of $2,000 for wages and $1,000 for salespersons' expenses in an employer bankruptcy.

Indeed, the bankruptcy laws of a number of countries provide preferred creditor status for unpaid employee claims, although the amount and type of employee entitlements to which preferred creditor status applies vary from country to country. In New Zealand, for example, employees can claim preferred creditor status for four months' outstanding wages and holiday pay to a limit of $NZ1,500 or otherwise established by regulation. Arrears above this limit rank as ordinary claims.(39)

In the United States, employees' claims for unpaid wages, salaries or commissions including vacation, severance and sick leave pay earned within 90 days before an employer's bankruptcy up to a maximum of $4,300 are given preferred status and rank third on the list of preferred creditors. The same ranking applies to sales commissions not exceeding $4,300 earned 12 months prior to bankruptcy.(40) As well, U.S. bankruptcy law recognizes state-created statutory security interests relating to unpaid wages.(41)

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(37) *Statutory Priorities in Business Insolvencies* (2001), p. 16.

(38) *Ibid*.

(39) Australia, Ministerial Discussion Paper (1999), p. 25.

(40) *Ibid*., p. 26 and 11 USC 507.

(41) *Statutory Priorities in Business Insolvencies* (2001), p. 12.

Overall, preferred creditor status for unpaid wage claims would appear to offer limited protection to employees. This narrow protection has long been acknowledged by Canadian policy-makers and legislators in numerous, albeit unsuccessful, efforts to enhance employee wage protection.

CONCLUSION

There are a number of approaches to protecting employee wages and entitlements when employers go bankrupt. Many of these approaches have been explored over the past three decades in the course of various attempts to amend federal bankruptcy law in Canada.

Wage guarantee schemes offer employees the greatest certainty in terms of the amount paid and timeliness of payment. At the same time, however, it is important to recognize that such schemes typically cap the amount an employee can recover in order to manage program costs. In the end, such schemes must strike a balance among the following elements: ensuring payment, paying a "fair and reasonable" amount, and controlling costs.

Perhaps the greatest obstacles to implementing a wage guarantee scheme are the costs involved and the determination of who will pay those costs. Someone has to fund the program, whether it is taxpayers, employers, employees or some combination of these, and a wage guarantee program can be expensive, particularly in an economic downturn. In an era of considerable public distaste for funding new programs through existing tax dollars or levying additional taxes, and when business and workers alike frown upon incurring additional costs, there may be little public appetite for legislating a wage protection scheme.

Another concern is the potential for abuse by employers who might avoid paying employees because they know a wage guarantee scheme is in place.

The current preferred creditor ranking for unpaid wages under the *Bankruptcy and Insolvency Act* offers limited protection for unpaid wages but does not burden taxpayers with program costs. Except for changes in the dollar value of unpaid wages eligible for preferred status, this ranking has been the norm for decades. As evidenced by the many proposals for change that have been put forward over the past 30 years, the level of protection afforded by preferred creditor status has long been considered worthy of improvement.

Proposals to alter the BIA's statutory distribution scheme to place unpaid wage claims ahead of the claims of other creditors have been part of past bankruptcy law reform

proposals. From the employees' perspective, full super priority (or some modified form of super priority over certain assets) would appear to offer the best level of protection after a wage guarantee scheme. However, granting a super priority to unpaid wages and other employee entitlements would affect the priority position of secured creditors and likely increase the cost and/or reduce the availability of credit. Indeed, past attempts to introduce a super priority were strongly opposed by credit grantors and businesses alike for these very reasons and, as was recently suggested, there would appear to be no evidence that this opposition has weakened.[42]

(42) Cuming, *Enhanced Enforcement of Wage Claims under Canadian Bankruptcy and Receivership Law* (1998). http://strategis.ic.gc.ca/SSG/cl00313e.html.