BEARING THE BURDEN OF UNPAID WAGES—
DIRECTORS' LIABILITY IN THE CONTEXT OF WAGE PROTECTION

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I. INTRODUCTION

In the event of bankruptcy or insolvency, where the assets of the bankrupt or insolvent enterprise are often not sufficient to meet its corresponding liabilities, the interests of one group must inevitably give way to another. This conflict of priorities is resolved by the scheme of distribution expounded in the federally enacted Bankruptcy and Insolvency Act \(^1\). While this scheme recognizes and indeed includes as an enumerated priority unpaid employee wages, more often than not, such claims are left unrealized.

Attempts to remedy the wage-protection problem have focused on a number of potential mechanisms. One of the most controversial is directors' liability for unpaid wages in bankruptcy. On February 22, 1996 a Senate Banking Committee, in considering various issues relating to corporate governance in general, heard the submission of Donald MacDonald, Canada's former Minister of Finance and a director on a number of corporate boards. In his submission, he voiced his concern over legislation which holds directors liable for unpaid employee wages. A better response to the problem, he argued, would be to amend the Bankruptcy and Insolvency Act "to give employees who are owed back wages a

† B.Comm. (British Columbia), LL.B. anticipated 1997 (Dalhousie).
higher claim against the remaining assets of a company." Other critics of directors' liability provisions in the area of unpaid wages have suggested that a pool of funds should be held and administered to accommodate the interests of employees in bankruptcy situations. This comment will attempt to assess the merits of each of these claims, and, following a review of the benefits and drawbacks, submit a proposal which more effectively addresses the objectives at the root of the problem.

II. WHY IS WAGE PROTECTION NEEDED?

Before addressing current wage protection techniques, it is useful to consider the reasons wage protection is needed in the first place— for these reasons represent the assumptions upon which the rest of this analysis rests. Do employees deserve special treatment and better protection than the law currently provides?

Employees do not stand on par with their employers with respect to negotiating terms of employment. The employer, as the provider of income, possesses a decidedly advantageous bargaining chip. As Dickson C.J.C. noted in Reference Re Public Service Employee Relations Act:

"Work is one of the most fundamental aspects in a person's life, providing the individual with a means of financial support and, as importantly, a contributory role in society. A person's employment is an essential component of his or her sense of identity, self-worth, and emotional wellbeing."

Employees can, in one sense, be seen as creditors of their employers. In most jurisdictions employees must give their employers credit for wages earned until they become payable, which is usually at least one pay period. This is not a matter of choice, but rather, one of custom. One might say, then, that employees are involuntary unsecured creditors with all their eggs in one basket. Unlike ordinary creditors, however, employees have

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2 Ontario, Senate Task Force on Corporate Governance, Transcript of Hearing No. 30577 (22 Feb. 1996) [unpublished] [hereinafter Senate Banking Committee Hearing].
limited access to the financial records of their employers, and are less likely to know their rights in the case of bankruptcy or insolvency.4

III. SCHEMES WHICH HOLD DIRECTORS LIABLE FOR UNPAID WAGES IN BANKRUPTCY

Over the past decade, directors have been held to owe a duty toward more than just the shareholders of a corporation. The corporation has taken on an enhanced public purpose well beyond its obvious private purpose of maximizing profit. In this light, both federal and provincial legislation has been introduced to hold directors liable for a number of business-related activities, including unpaid employee wages.5

In federal jurisdiction, several statutes impose varying degrees of liability upon directors for unpaid wages, and are often directed to specific industries. The relevant pieces of legislation include the Canadian and British Insurance Companies Act,6 Loan Companies Act,7 Trust Companies Act,8 Cooperative Credit Associations Act,9 and Canada Cooperative Associations Act.10 In a broader context, and perhaps more importantly, the Canada Business Corporations Act11 holds directors liable to employees for their salaries for a period not exceeding one year. Indeed it was section 119 of the CBCA that was the source of MacDonald’s concern in his comments before the Senate Banking Committee.12

The provinces have been even more aggressive in passing legislation to hold directors personally liable for employee claims. In fact, every province and territory, with the exception of Nova

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4 Committee on Wage Protection in Matters of Bankruptcy and Insolvency, Wage Protection in Matters of Bankruptcy and Insolvency (Ottawa: Queen’s Printer, 1981) (Commissioner: E. Landry) [hereinafter Landry Report].
6 R.S.C. 1985 c. I-12, s. 55.
7 R.S.C. 1985 c. L-12, s. 96.
8 R.S.C. 1985 c. T-20, s. 63.
9 R.S.C. 1985 c. C-41, s. 83.
10 R.S.C. 1970 c. 6, s. 74.
11 R.S.C. 1985 c. C-44, c. 27, s. 119 [hereinafter CBCA].
12 Supra note 2.
Scotia, Prince Edward Island, and Newfoundland, has directors' liability provisions as part of either their companies legislation or their employment standards legislation.¹³

In most jurisdictions, the applicable directors' liability provisions have similar characteristics. The directors will be held jointly and severally liable, and the liability tends to extend to only certain categories of employees. In addition, there is usually a stated maximum amount recoverable, and where an employee recovers, the director is subrogated to the employee's rights as against the company or other directors. In cases of bankruptcy, before a director will be held liable, the employee's claim of unpaid wages must be proved.

IV. THE OBJECTIVES OF A WAGE PROTECTION SCHEME

Directors' liability is only one of several mechanisms used to address the problem of unpaid wages in bankruptcy. Prior to assessing alternative mechanisms, it would be useful to review the aims and objectives of wage protection. The following broadly defined goals of a workable wage protection scheme will be referred to throughout the rest of this comment.

First, a wage protection scheme must ensure that the payment claimed is likely to be recovered and that it can be recovered with minimal delay. In addition, the mechanism employed must be subjected to a cost-benefit analysis to ensure that the solution is not more costly than the problem itself. A workable wage protection scheme must also ensure that the burden of unpaid wages is allocated appropriately. There are four potential bearers of this burden: the employee, the employer, the creditors of the company, and the tax-paying public. Where should the burden fall? The method of wage protection chosen and the administrative mechanism employed to carry it out will have implications for the

allocation of this burden. A wage protection scheme must also recognize the potential for adverse incentives. There is always the danger that employers will be encouraged to ignore the issue of unpaid wages in conducting business, in the knowledge that employees will be compensated by such a scheme if bankruptcy ensues. In other cases, employers have a further incentive to ensure that major creditors are paid before any claims of employees are given priority, since owners or directors often sign personal guarantees with their creditors. A well-designed scheme will attempt to counter these incentives. Finally, an important consideration with any wage protection scheme is its constitutional soundness. Any government action, whether emanating from the provincial or federal level, must be within the jurisdiction of the level of government implementing it.

V. ALTERNATIVE WAGE PROTECTION MECHANISMS

The problem of unpaid wages in bankruptcy has not gone unnoticed in Canada. Numerous measures have been undertaken to address the issue at both federal and provincial levels, leaving open a broad range of choices for potential employees depending on the jurisdiction in which the matter arises. Directors' liability provisions were considered earlier. This section will examine other approaches, noting both the benefits and drawbacks of each.

The multitude of legislative and administrative remedies have been grouped into two broadly defined categories: 1) schemes which attempt to alter the priority of asset distribution upon bankruptcy and insolvency; and 2) schemes creating a separate source of funds.

1. Schemes which Attempt to Alter the Priority of Distribution

In the federal context, section 136(1)(d) of the Bankruptcy and Insolvency Act provides the basic scheme for the recognition of priorities in the event of bankruptcy. Under this Act, unpaid wages


\[15\] See supra note 13 and accompanying text.
are considered to be a "preferred" claim.\textsuperscript{16} This is a highly illusory term. Wages must give way to secured interests such as registered mortgages, liens, debentures, and bank securities. After secured claims, wages rank fourth, behind funeral expenses, administrative costs of bankruptcy, and government levies. Furthermore, the extent of any claim for unpaid wages is limited. Unpaid wage claims are restricted to wages with respect to services performed in the six months prior to bankruptcy, and only to a maximum of $2000.\textsuperscript{17} An additional limitation imposed by the \textit{Bankruptcy and Insolvency Act} is that it applies only in cases of bankruptcy, while it is well established that many unpaid wage claims arise in the context of insolvencies short of bankruptcy.

There are a number of pieces of federal legislation which deal with unpaid wage claims by attempting to alter the priority of distribution. The \textit{Bank Act}\textsuperscript{18} imposes an obligation upon banks to make prior payment to wage claimants before realizing on their own security where loans are made to certain classes of borrowers. The \textit{Winding-Up Act}\textsuperscript{19} contains a priority interest for the salaries or wages of clerks and other persons employed by a company being wound up. However, this priority is much like that described in the \textit{Bankruptcy and Insolvency Act} in that it ranks only after the costs, charges, and expenses due to the winding-up of the employer company.

In light of the serious limitations imposed by the \textit{Bankruptcy and Insolvency Act}, a series of attempts have been made to amend its scheme of priorities. Bill C-60,\textsuperscript{20} tabled in the House of Commons in 1975, proposed to grant an absolute priority to employees for unpaid wages over all other creditors, secured or unsecured, to a maximum of $2000 The Senate vigorously opposed the Bill, noting that it would seriously disrupt the commercial lending system.\textsuperscript{21} Another attempt to amend the priorities enumerated in the \textit{Bankruptcy and Insolvency Act}, Bill-S-11, met

\textsuperscript{17} Note that the time period has been extended from three to six months and the maximum claim from $500 to $2000 by a 1992 amendment to the \textit{Bankruptcy and Insolvency Act}, R.S.C. 1985, c. B-3, s. 136(1)(d), as am. by 1992 c. 27 s. 54(1).
\textsuperscript{18} R.S.C. 1985, c. B-1, s. 88.
\textsuperscript{19} R.S.C. 1985, c. W-11, ss. 93-95.
\textsuperscript{20} \textit{An Act Respecting Bankruptcy and Insolvency}, 1st. sess., 30th Parl., 1974.
\textsuperscript{21} Landry Report, \textit{supra} note 4.
with similar dissent in 1977. Despite these failed attempts, MacDonald, in his address to the Senate Banking Committee, insists that giving a high priority against the assets of the bankrupt employer's assets is a feasible solution to the problem of unpaid wages.

The lack of protection apparent from the priorities enumerated in the federal Bankruptcy and Insolvency Act has prompted various provinces to invoke their own remedies for wage protection in bankruptcy. The majority of these initiatives attempt to counterbalance the Bankruptcy and Insolvency Act by indirectly altering the priority of asset distribution as defined by that Act. Approaches include: the creation of statutory preferences, deemed trusts, and statutory security interests.

23 Supra note 2.
24 Employment Standards Act, R.S.O. 1990, c. E.14, s.14. While this type of provision provides some protection to the wage claimant, it has serious limitations. First, it clearly makes an exception for the priorities laid out in the Bankruptcy Act, and as such, does not apply in the bankruptcy context. Second, such a provision has been unable to withstand the claims of secured creditors. In Re Campeau Corporation v. Provincial Bank of Canada (1975), 7 O.R. (2nd) 73 (Ont. Div. Ct.), Houlden, J. held that the words "preferred creditors" did not include secured creditors. See also Labour Standards Act, R.S.N. 1990, c. L-2, s.37.
25 The typical provision provides for the creation of a deemed trust holding vacation pay or unpaid wages due to an employee, whether or not the amount has in fact been kept separate. The amount becomes a lien or charge upon the assets of the employer in the event of bankruptcy. See Employment Standards Act, R.S.O. 1990, c. E.14; Labour Standards Code, R.S.N.S. 1989, c. 246, s. 36(1); Labour Act R.S.P.E.I. 1988, c. L-1, s. 72 for the protection of vacation pay; and see Employment Standards Code, S.A. 1988, c. E-10.2, s. 113(1), Labour Standards Act, R.S.S. 1978, c. L-1, s.56 (1.1); Payment of Wages Act, R.S.M. 1987, c. P-31, s.3(4) for wage protection generally.
26 A statutory security interest is a lien or charge in respect of unpaid wages which is directly assigned, by statute, a high priority in the event of bankruptcy or insolvency. A number of jurisdictions provide statutory liens for wages earned by workers in certain designated industries. Potential claimants include woodspersons, see e.g. Alberta Woodsmen's Lien Act, R.S.A. 1980, c. W-14, s.5(2); warehouse workers, see e.g. British Columbia Warehouse Lien Act, R.S.B.C. 1979, c. 427, s.2(2)(b); miners, see e.g. Miners Lien Act, R.S.N.W.T. 1988, c. M-12, s. 2(1); and stable keepers, see e.g. Livestock Lien Act, R.S.B.C. 1979, s.244, s.2. Unfortunately, the relevant legislation tends to be limited to distinct industries. The statutory security interest differs from the trust approach in that it attempts to alter the
Critique of the Alteration of Priorities Approach

The first drawback to the alteration of priorities approach relates to provincially administered schemes. Their systems attempt to protect the employee by altering the scheme of asset distribution, albeit indirectly, and as such conflict with the Bankruptcy and Insolvency Act. Section 91(21) of the Constitution Act, 1867 grants the federal Parliament exclusive jurisdiction over "bankruptcy and insolvency," but section 92(13) assigns "property and civil rights" to the provinces. The courts have rejected double-aspect arguments and have found that the order of priorities provision (section 107) of the Bankruptcy and Insolvency Act for the distribution of assets upon bankruptcy, is in "pith and substance" related to bankruptcy and only incidentally related to property and civil rights in the provinces. As such, any provincial attempt to alter this scheme, whether directly or indirectly, may be considered constitutionally invalid by the courts. As noted by Wilson J. in Deloitte, Haskins, and Sells Limited v. Workers' Compensation Board: "[I]t would have the effect of permitting the provinces to determine priorities on a bankruptcy, a matter within exclusive federal jurisdiction."

If the scheme of priorities under the Bankruptcy and Insolvency Act were itself to be altered by the federal government according to the recommendations of MacDonald, skepticism would remain as to the effectiveness, or for that matter appropriateness, of such an amendment. Where an employee's claim for unpaid wages is given priority over the claims of other creditors, the risk and burden of bankruptcy is thrown upon the shoulders of creditors. Should creditors accept such a risk when extending credit? The payment of wages should not be characterized as a risk arising in the ordinary course of business. Rather, wages are a contractual obligation, either express or implied, between employers and their employees. When extending credit, creditors may foresee various risks: that supply may exceed demand; or that prices may drop for unexpected reasons arising from external consequences beyond the control of the business. These risk factors are taken into consideration when scheme of distribution set out in the Bankruptcy Act in a more direct manner. Inevitably, it results in serious constitutional uncertainty.

27 (U.K.), 30 & 31 Vict., c. 3.
determining the amount of credit, the interest rate, and whether credit is to be granted or not. What creditors impliedly expect in return for supplying credit is that the business itself will be conducted in a manner most conducive to ensuring a return on the investment. Wages, being one, if not the largest, component of operating expenses, are therefore a primary responsibility of the employer. When wages are left unpaid, it should be the employer, rather than the creditor, who should have to bear the burden: unpaid wages are not a foreseeable risk of business.

Allocating the burden of unpaid wages upon creditors has another negative consequence: such an approach would inevitably disrupt the commercial lending system. Creditors, aware of the additional risk borne by them in the event of bankruptcy, will be reluctant to extend credit. MacDonald himself accepts that this is likely to be the consequence of any attempt to alter the Bankruptcy and Insolvency Act. In his submission at the hearing, he notes rather unwittingly:

I predict to you [sic] that . . . bank officers will show up before this committee and threaten that if this measure is finally adopted, the banks will never lend a dollar again. When that happens, I say to you, as legislators, that you will earn your stipends. To earn the respect and affection of all decent citizens, rise to your feet as one person and laugh the bankers out of the room.

As bold and creative an argument as this may be, he is mistaken to suggest that the impact of such a measure upon the banking community can be disregarded so easily. Not only will the consequences be borne by creditors, but by all participants in the banking system. Where credit is extended, interest rates will reflect the additional risk, making it more expensive for both consumers and entrepreneurs to borrow money.

The alteration of priorities approach also fails to address the imbalance of incentives faced by management. In realizing that claims for unpaid wages will be treated similarly to claims of other creditors, management is actually encouraged to ignore the

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31 Supra note 2 at 0990-5.
consequences of wage claims in conducting the day to day affairs of the business.

Despite its negative impact on creditors, the alteration of priorities approach does provide limited protection for the unpaid employee. However, because the employer’s assets may not be sufficient to meet its liabilities in bankruptcy, this approach may not prove to adequately compensate the employee on a regular basis, and thus fails the certainty of payment objective. This is largely due to the fact that it depends upon the availability of the insolvent employer’s assets. In most cases of bankruptcy and insolvency, available assets are rarely sufficient to cover the claims of any of the unsecured creditors. In all likelihood, the employees will be among the last of these unsecured creditors to collect.

Finally, the “alteration of priorities” approach fails to meet the “speed of payment” objective. Bankruptcy proceedings are lengthy and the employee is often left waiting for an uncertain payment at the end of them. A 1977 European Economic Community Commission Report noted:

[The employee] having to wait for the perhaps partial satisfaction of his claims from the employment relationship represents at least a temporary threat to the livelihood of himself and his family.32

In addition, the employee is left alone to take the initiative of staking out his or her claim. Too often employees do not recognize that a right exists or, where there is recognition, abandonment of the claim because the cost of seeking a remedy is prohibitive.33

2. Schemes Creating a Separate Source of Funds: The Wage-Fund

The alternative to creating a separate wage-fund, from which unpaid employees can collect in the case of bankruptcy, provides a more complete form of security for the employee. Manitoba,34

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33 Brown Report, supra note 30.
34 Payment of Wages Act, R.S.M. 1987, c. P-31 s. 19.
Ontario,\textsuperscript{35} and New Brunswick\textsuperscript{36} have each created wage funds, though the attributes of each vary. There is, however, no federally regulated wage fund in Canada.

The provincial funds, despite their differences, share four significant features.\textsuperscript{37} First, to be eligible, an employee must establish his or her claim for unpaid wages.\textsuperscript{38} Second, the employee (or in some jurisdictions, a public agency acting on the employee's behalf) must show that all reasonable attempts to recover the amount owing from the employer have met with failure.\textsuperscript{39} Third, the amount of any claim is subject to a statutory limit.\textsuperscript{40} Fourth, the administrative agency regulating the fund is entitled to be subrogated to the employee with regard to the claim.\textsuperscript{41}

\textsuperscript{35} Employment Standards Act, R.S.O. 1990, c. E-14 at ss. 58.1-58.18

\textsuperscript{36} Employment Standards Act, S.N.B. 1982, c. E-7.2, s. 77.

\textsuperscript{37} Employment Law in Canada, supra note 14 at 837.

\textsuperscript{38} All three jurisdictions require an employee to establish his or her claim by obtaining an order under the appropriate legislation and that the order not be under appeal or review; see Manitoba, Man. Reg. 106/87 R, s.2; New Brunswick, Employment Standards Act, S.N.B. 1982, c. E-7.2, s. 77(1)(c); Ontario, Employment Standards Act, R.S.O. 1990, c. E-14, s. 58.4(1).


\textsuperscript{40} In Manitoba, these limits are expressed in terms of a maximum dollar amount of $1,200 per year as well as by excluding termination wage entitlements from coverage, see Man. Reg. 106/87 R, s.3.

In Ontario, entitlements correspond to what is available under the Act, supplemented by "such additional payments as may be prescribed by regulation," see Employment Standards Act, R.S.O. 1990, c. E-14, s. 50.1(2).

In New Brunswick, the entitlement to compensation from the fund covers wages, vacation pay, and termination pay, but does not cover "any other benefit owing to an employee" and "compensation for economic loss," see Employment Standards Act, S.N.B. 1982, c. E-7.2, ss. 77(1)(a-c) [am. S.N.B. 1988, c.59, s. 21], s. 65 (1)(c)(i-v) [as am. by S.N.B. 1988, c. 59, s.20].

\textsuperscript{41} See Manitoba, Man. Reg 106/87 R s.4; New Brunswick, Employment Standards Act, S.N.B. 1982, c. E-7.2s. 77(2); Ontario, Employment Standards Act, R.S.O. 1990, c. E-14, s.40(o). See also Re James, Director of Employment Standards Division et al. v. Trustee, [1985] 4 W.W.R. 526 (Man. Q.B.) in which subrogation entitled the director to claim status pursuant to then s.107(1)(f) of the Bankruptcy Act.
ii. Critique of the Wage-Fund Approach

The wage-fund approach, unlike the alteration of priorities approach, avoids reliance on an employer's assets upon bankruptcy. For that reason, the expected payout from a wage fund is generally more certain than the expected payout from the priority of distribution approach. However, if not financed properly, it is quite possible that a wage fund, as the sole source of compensation for unpaid wage claims, may be insufficient to meet every claim. The wage-fund approach is not dependent upon bankruptcy proceedings and therefore provides a more timely payout to employees. The experience of the United Kingdom, which established a "redundancy fund" to protect employee wages, suggests that a well-administered fund may ensure payment in a matter of days.\(^{42}\) After payout, the administrative agency regulating the fund is subrogated to the rights of the employee for the value of the claim and may seek payment once bankruptcy proceedings have commenced.

The wage-fund may, however, be fraught with flaws if not structured or financed properly. Its greatest potential downfall is with regard to the choice of financing. Who should contribute to the fund? This question depends largely upon whether the problem of unpaid employee wages is characterized as a social issue of public concern or a private matter between the employee and employer.

As noted earlier, unpaid wages should not be characterized as a risk in the ordinary course of business from the point of view of a creditor lending money. It follows that creditors should not be required, whether directly or indirectly, to contribute to such a fund. Regardless, a provincial wage-fund relying to any extent on the assets of the employer upon bankruptcy would have the effect of bumping creditors in the priority of distribution. Unless it is initiated by the federal government along with an amendment to the *Bankruptcy and Insolvency Act*, such a wage-fund would have constitutional obstacles to overcome.

Should the risk be borne by the taxpayer? An employee wage-fund financed by the Consolidated Revenue Fund imposes the burden of unpaid wages, and bankruptcy, upon the public. Such an approach would be tantamount to socializing the costs of private

economic failure. The Landry Report expressed similar disdain in allocating the burden on taxpayers:

[W]age protection is not on the same level of social objectives as those measures that are already covered by the general tax paying system . . . [T]here does not appear to be any social justification to impose the total burden of protecting wage claims directly on the taxpayer. A source of financing closer to the causes of the problem of unpaid wages must be identified.43

Does the Committee imply that both the employee and employer should contribute to the wage-fund? One might look to the example of employment insurance and argue that the problem of unpaid wages, much like unemployment, should be rectified by imposing periodic levies on both employees and employers to finance the wage-fund. This approach characterizes the issue of unpaid wages as it should be: a problem existing in the private sphere of business, but at the same time, deserving of public regulatory attention.

Yet the contribution of employees to the fund also raises some concern. Requiring employees to contribute would be to insist on a sort of private insurance to protect against the breach of an express or implied term of an employment contract (that is, the obligation to pay). Given the already inferior position of employees vis-à-vis their employers, such a requirement is rather onerous. As the Landry Report notes:

[T]here is a distinction between a program to insure income maintenance during a period of unemployment, in respect of which employees are required to contribute, and a program intended to provide payment of amounts legally owed to employees for work performed. Therefore, the Committee does not endorse the allocation of any cost of wage protection on employees.44

A similar view is taken by European countries. Austria, Belgium, Denmark, France, Germany, and a host of other European countries, finance their respective wage-funds exclusively by

43 Supra note 4 at 41.
44 Supra note 4 at 45.
employer contributions. The EEC Report addressed the financing issue by stating:

These [wage] guarantees should not lead to any additional financial burdens on the employees. The funds for this purpose should therefore be raised only from the employers' contributions. In this connection the contributions are to be calculated in such a way that the institutions will always have adequate cover in reserve.46

We are left, then, with employers as the sole contributors to the wage-fund. This approach would address the important issue of the imbalance of incentives in a more favourable way. Management's incentive to see that creditors, to whom personal guarantees may be owed, are paid in priority is countered by the fact that the wage-fund provides a separate and distinct source of funds to which creditors have no access.

The wage-fund concept is potentially open to abuse. Germany's experience with its Bankruptcy Indemnification Fund provides a telling tale of the moral hazards which may ensue. Employers often increased wages prior to the date of insolvency. Related or fictitious persons would be added as employees on the eve of a bankruptcy. Businesses would sustain hopeless operations by encouraging employees to forego wages on the basis that they were protected by a fund. Individuals would set up businesses for the sole purpose of creating their own wage claims and then force the business into bankruptcy.47

In addition, the wage-fund is not always a cost-efficient alternative. The total value of claims for unpaid wages would be much smaller than claims for unemployment benefits, for example. The cost of administering such a fund would be a larger percentage of the value of the fund itself. This raises the obvious question: is it financially feasible? This is particularly the case for a provincially administered fund.48

46 Ibid. at 26.
47 Brown Report, supra note 30. at 17.
48 The Brown Report, ibid., estimates the administrative costs of a provincial wage fund by considering the expenses of other administrative agencies. It notes that the Criminal Injuries Compensation Board administered approximately $3,000,000 in awards in 1983 and its administration costs were approximately...
VI. DO DIRECTORS’ LIABILITY PROVISIONS
MORE EFFECTIVELY MEET THE OBJECTIVES OF
WAGE PROTECTION?

It is apparent that both priority-alteration schemes and wage-funds are to some extent effective in meeting the objectives set out earlier, although each has its drawbacks. Directors’ liability provisions similarly fall into this “middle-ground” level of effectiveness. To some extent, the ability of directors’ liability provisions to meet the objectives of wage protection depends on one’s assumptions about the role of directors.

In an ideal case, directors’ liability for unpaid wage claims allows the burden of bankruptcy to be directed back to its root cause. This perspective assumes that directors are the directing minds of a company, aware of all business decisions, including any decision to withhold the payment of wages or file for bankruptcy. However, this assumption is not always accurate; it may be true in a closely-held corporation, but it is not always the case in widely-held corporate entities. As a recent Toronto Stock Exchange Committee on Corporate Governance in Canada (the Dey Report) 49 suggests the key role of a director is to supervise and oversee the management of the corporation. A director cannot, and should not, be expected to be aware of the intricacies of daily managerial tasks. As Michael Geist notes, “It is beyond the board’s responsibility... to engage in the day-to-day management of a corporation, a responsibility that must be delegated to senior management personnel.” 50

This view of a director’s obligation is well accepted in common law as well. In Re City Equitable Fire Insurance Co., Romer J. held twenty percent of that figure. Based on 1985 statistics, the Unemployment Insurance Commission [now the Employment Insurance Commission] where eight percent of the amounts administered and the Workers’ Compensation Board’s costs of administration were approximately fourteen percent of their total revenues. The report estimated that the establishment of a provincial fund would likely require thirty new personnel and an overall net cost of ten percent of the monies administered by it (note that these figures represent estimates for a provincial as opposed to a federal fund and are based on statistics available in 1985).


50 M. Geist, “The Dey Report: The Wave of the Future” (Faculty of Law, Dalhousie University, 1995) [unpublished] at 6.
that a director was not expected to give "continuous attention" to the daily affairs of a company. The same case held that in the absence of grounds for suspicion, a director is justified in delegating management related duties to officials, and trusting such officials to perform these tasks efficiently and honestly. The payment of wages is a largely administrative task that would fall into this category.

There may, however, be some merit in the claim that, while it is not a director's duty to pay wages per se, directors have the responsibility of monitoring a company's internal controls, including its payroll. The Dey Report recommended that boards appoint an audit committee to monitor a company's finances. Given the supervisory function of directors over finances and internal controls, and their access to financial information, such as the company's accounts and payroll, it would seem appropriate that where a company faces imminent bankruptcy, a director would owe a duty to all parties, including employees, who would be adversely affected by the company's insolvency.

While directors may not be well informed of payroll mechanisms, especially in larger companies, a liability for unpaid wages may nonetheless generate important incentive effects.

[The] underlying purpose for imposing personal liability on a director is to encourage directors to ensure that salaries are determined in advance by the company and paid regularly to the employees.

The most valid reason for imposing liability on directors for unpaid wage claims is that it clearly addresses the balance of incentives problem. A director's potential personal liability to

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51 [1925] Ch 407 at 429.
52 Ibid. at 429.
53 The Dey Report, supra note 49, suggests that the board of a company assumes five specific duties, of which one is the maintenance of the integrity of the corporation's internal controls and management information systems.
54 Supra note 49.
55 It has been suggested, however, that in cases of bankruptcy and insolvency a director's duty is primarily toward the creditors of the company. Such an approach may in fact work counter to the interests of employee, see Employment Law in Canada, supra note 14 at 852, see also M. Geist, Lecture, (Dalhousie University, January 1996).
employees counters the personal guarantee provided to creditors, making the liabilities to each more equal in the eyes of directors. Although, the incentive effect is far more predominant in closely-held corporations.

Clearly the strongest argument against directors’ liability is that it adds one more catch to the director’s job description. There is the serious possibility that competent directors will be discouraged from accepting board positions. This chilling effect of section 119 of the CBCA was the focus of MacDonald’s arguments before the Senate Banking Committee:

The effect of provisions like section 119 is that, in circumstances where a corporation is in difficulties, and at the very moment in time when it is in greatest need of wise counsel and direction from a board of directors, for personal reasons members of the board cannot afford the risk of continuing in office.

The impact of such a provision is particularly detrimental in labour intensive industries, where both the potential for claims as well as the value of claims, are likely to be higher than average. It may be said that holding directors liable for unpaid wages is too harsh an imposition, especially in cases where directors may not have been responsible for the non-payment decision or, for that matter, the bankruptcy itself.

It is also unlikely that full payment of wages can be effectively realized under a director’s liability provision standing alone, even if the provision demands joint and several liability. In many cases of bankruptcy, the directors themselves end up bankrupt or are responsible for personal guarantees granted to commercial creditors, which reduces their ability to pay employees. However, directors’ insurance is common among most corporations. In

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57 Employment Law in Canada, supra note 14 at 851. Geist, supra note 50 at 8, notes: “increased personal liability of directors compounds the difficulty of recruiting qualified individuals to serve as directors.”

58 Senate Banking Committee Hearing, supra note 2, at 0990-3.

59 In response to MacDonald’s comments before the Senate Banking Committee, supra note 2, Senator Meighen notes that the Committee had just the day prior heard evidence from someone in a labour intensive industry who indicated that wages over six months would amount to approximately $400 million without benefits and holiday pay.
addition, the CBCA and some provincial corporations statutes, allow a company to indemnify a director for any charges laid against him or her. Of course, where the company itself is bankrupt, the impact of such a provision is diminished.

Imposing director liability may not be the most cost-effective approach to the unpaid wages problem. It entails civil action and carries with it the usual pitfalls of the litigious forum. Given relatively small claims and minimal chances of recovery, the costs of pursuing a director’s liability claim for unpaid wages are too often prohibitive for an employee. Furthermore, the fact that the employee’s claim for unpaid wages must be proved before a director will be held liable usually means waiting until lengthy bankruptcy proceedings are complete before any claim will be payable.

VII. AN ALTERNATIVE APPROACH

Two points are clear from the analysis. First, the mechanisms currently employed to protect wages are diverse and scattered among legislative enactments set out by both levels of government. Second, each mechanism, standing alone, appears to fall short of fully meeting the objectives of a valid and effective wage protection program.

In addressing the concerns of employees, the author recommends the use of a combined approach, one which fully brings to light the potential benefits of the various mechanisms but which makes adjustments to weed out their inherent flaws. The

60 The CBCA, R.S.C. 1985 c. C-44, c. 27, s.124(1) allows for indemnification of all charges, costs, and expenses reasonably incurred by a director in respect of any civil, criminal or administrative action or proceeding to which she or he is made a party by reason of being or having been a director of the corporation.

61 Under the common law, a plaintiff must not only show that a director breached his or her duty, but also that it was the directors’ negligence that caused the loss in question; see Barnes v. Andrews, 298 F. 614 (S.D.N.Y., 1924) [hereinafter Barnes]. However, section 119 of the CBCA has been held to impose absolute liability upon the director whereby unpaid wages are payable despite evidence of no wrong doing on behalf of the director, see Senate Banking Committee Hearing, supra note 2. Despite this absolute liability, proof of the claim itself would likely be required, and this would entail awaiting the close of bankruptcy proceedings.
A detailed description of the internal workings of this proposal is not intended here. At the risk of overlooking technicalities, the scope of this comment permits only a broader exploration of the principal policy issues involved. To facilitate the analysis, characteristics of the proposed approach are highlighted first. A closer look at its benefits, particularly its ability to meet the stated objectives, follows.

1. Characteristics of the Proposed Approach

The proposed approach should be initiated by the Canadian federal government. It would combine a wage protection fund with a directors’ liability provision. The fund itself would be financed solely by employers by way of a contribution based on payroll. The fund would be regulated by the federal government, and would operate under the administrative infrastructure of the employment insurance program.

The fund would make timely payments to employees, up to a maximum or threshold amount, and such payments would be made as soon as possible after the appointment of a receiver or liquidator in bankruptcy. For any proved value above the threshold amount payable by the fund, officials would be subrogated to the rights of the employee to collect the outstanding value from the directors of the company. Various safeguards would be included in the scheme to protect directors from the moral hazard of overzealous claims.

A threshold or maximum value must be defined as the point at which the fund will no longer make the payout and instead, the subrogated rights of officials will kick in to hold the directors liable. This cap can be either monetary or a limit in terms of a period of employment. A monetary limit may be inappropriate in

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62 See Part IV.

63 At the Senate Banking Committee Hearing, supra note 2 at 0990-9, Senator Meighen questioned MacDonald: "Would you not think it necessary to consider a cap on the liability of directors to remove what has been termed as liability chill and the discouragement of good people from serving on boards?" MacDonald responded: "I have not really thought about a cap, but I appreciate the suggestion. I will think about it when I leave."
the face of inflation and also because it may not take account of differences in earning levels between employees. As such, a cap by way of time period is more suitable. The time period chosen must somehow coincide with the time period during which an employee can be expected to become aware that his or her wages are not being paid. When the cap, as defined, does not adequately cover the total of the unpaid wage claim in question, officials should give effect to the directors’ liability provision for the remaining value of the claim. If an amount is recovered from the directors, it should be handed over to the employee.

2. Benefits of the Proposed Approach

i. Federally Enacted

Ideally, any initiatives regarding wage protection should be taken by the federal government, which has been given the express authority to legislate with regard to bankruptcy and insolvency. But the benefits of federal enactment are rooted deeper than a mere recognition of responsibility.

First and foremost, federal action would remove any doubts as to the constitutional validity of a wage protection measure. Conflicting provincial schemes would be replaced with the federal mechanism, resulting in a more readily accessible, nationally consistent, and certain remedy.

Second, if enacted by the federal government, the existing administrative infrastructure of the Employment Insurance Commission could be used to administer the wage protection program. While this would require the concurrence of the provinces, the potential cost savings of this approach clearly makes it a favourable alternative.

ii. Certainty of Payment

An approach which combines a wage-fund with a directors’ liability provision ensures a more likely payout to the employee. There is no dependence on the company’s assets. Further, any amount claimed above the fund’s cap would be subject to recovery from the directors.
iii. Speed of Payment

The wage-fund’s payout procedure would be designed to make timely payments by ensuring that any proven claim for unpaid wages is disbursed to the employee from the fund, up to the value as defined by the cap, immediately upon the appointment of a receiver or liquidator to the bankruptcy. This is the approach taken by the administrators of the United Kingdom’s Redundancy Fund, and has resulted in expedient disbursements.\(^{64}\) In Sweden, the agency administering the Wage Guarantee Fund is mandated to act as quickly as possible, even when there is the possibility of improper payment. This is seen as an “acceptable cost of expediting payments of small sums if the employee’s claim seems likely.”\(^{65}\) The proposed approach eliminates the need for an employee to prove that a director’s negligence caused the lost wages to accrue, at least up to the cap of the wage-fund. After the cap amount has been reached, the onus would shift to the director to prove due diligence or lack of responsibility for the non-payment decision.\(^{66}\)

iv. Addressing the Balance of Incentives

The proposed scheme puts employees on par with commercial creditors in the eyes of the board of directors: there is the potential to be held directly liable for any unpaid wages in the event of bankruptcy. The potential abuses of a wage-fund, standing alone, are also reduced. Since director’s will be held liable for wages above the fund’s cap, the incentive to abuse the fund is lessened. This would eliminate director abuse such as: attempting to remain afloat by foregoing wages on the basis that such wages will be covered by a fund; inflating wages; or adding fictitious employees to the payroll on the eve of bankruptcy. Furthermore, an incentive is created for directors to take a more active role in monitoring finances and internal procedures, including the payroll of a corporation.

\(^{64}\) EEC Report, \textit{supra} note 32 at 22.
\(^{65}\) \textit{Ibid.} at 22.
\(^{66}\) See \textit{infra} note 68 and accompanying text.
v. Safeguards to Limit Directors’ Liability

The fact that yet another dimension to directors’ liability is being mandated by this proposal should not be ignored. From the directors’ standpoint, a position on the board is not as attractive as it used to be, and this may deter competent persons from accepting such positions. For this reason, the proposed scheme would contain various safeguards to limit the potentially burdensome impact on directors. Some of these safeguards are inherent in the proposal without being explicitly stated. For example, directors would only be liable for claims above the wage-fund cap. The cap itself is designed to be adequate in covering expected wage losses, leaving only occasional circumstances and limited amounts for which directors will potentially be liable. In addition, as previously mentioned, directors are usually covered by insurance to compensate them for personal liability.

More explicitly, various limitations would be contained in the proposed scheme to restrict the reach of the directors’ liability provision. For example, the provision would only be accessible to agency officials and not to employees bringing any action independently. It would be accessed within a strictly regulated administrative framework. As such, discretion may be utilized to decline imposing liability where a director can bring forth evidence suggesting that he or she had opposed, unsuccessfully, the employer’s decision to withhold pay or file bankruptcy. This is in line with proposals found in the Dey Report, which suggests a due diligence defence is appropriate in liability cases involving unpaid wages.67 Such an approach also places the onus on the director to prove a lack of negligence, as opposed to the onus on the employee to prove causation under the common law.68 Further discretion may be utilized to limit the claims upon a director where the amount is too high, as might exist in labour intensive industries or where the potential for contribution from other directors is slim.69

67 Supra note 44. See also: Senate Banking Committee Hearing, supra note 2. MacDonald also advocates a due diligence defence in his submission before the Senate Banking Committee. However, he prefers the approach of abolishing the directors’ liability provision in section 119 of the cECA altogether.

68 Barnes, supra note 61.

69 Employment Law in Canada, supra note 14 at 852.
vi. Burden Appropriately Allocated

The combined approach places the burden of unpaid wages in bankruptcy where it should fall in two respects. First, the wage-fund is financed solely by employer contributions via payroll deductions. Second, by imposing a potential liability on directors, the burden of unpaid wages and of bankruptcy is re-routed to its primary cause. Of course, the latter assumption remains more accurate in the case of closely-held corporations. In any case, the creditors and the tax paying public remain unaffected.

vii. Cost-Effectiveness

It was suggested earlier that one of the drawbacks of a wage-fund was that the cost of its administrative structure would be too large in relation to the total value of the fund to make it cost-effective. A directors’ liability provision, standing alone, was also seen as cost-prohibitive from an individual employee’s point of view. Because the proposed approach would be implemented by the federal government, it could be administered within the existing machinery of the Employment Insurance Commission, thereby preventing duplication of resource expenditures that would occur with a separately administered wage-fund. In addition, a national scheme, as opposed to a provincial one, would be able to take advantage of economies of scale. Because the value of a federal fund would be larger, administrative expenses would encompass a lower percentage of the total value administered by the fund. Also, the cost of obtaining a remedy would be reduced for the employee since the administrative mechanism, as opposed to litigation, would be utilized to seek compensation.

3. Potential Criticisms of the Proposed Approach

One may argue the suggested proposal merely imposes an additional tax upon the employer, and that, in the larger scheme of things, the employees, the public, and even the creditors will share in that burden. Employers, faced with an additional operating cost, will pass this cost on in the form of lower employee wages, higher consumer prices, and higher risk premium to creditors. Unfortunately, this trickle down effect might be an unavoidable and indirect result of any proposed scheme. It cannot, however, be used to justify directly placing the burden of unpaid wages and bankruptcy upon those who are not directly responsible for it.
Another argument recognizes a potentially adverse effect of the proposal; smaller businesses could be subsidizing larger businesses in contributing to the employer-financed wage-fund. With careful planning, this need not be the case. Employer contributions to the wage-fund, which would form a percentage of the total payroll, could be adjusted in a manner more representative of the potential liability of the company over time. Indeed, various adjustments to the scheme would necessarily emanate from regular reviews of the functioning of the program.

VIII. CONCLUSION

Earlier in this comment, a critical question was posed: do employees deserve special treatment and better protection? The underlying emphasis of this paper, and indeed a common thread running throughout it is that the answer is in the affirmative. An equally important question, however, is how can this special treatment and better protection be provided? Admittedly, directors' liability is a controversial issue. When imposed without safeguards, it has the potential to cause serious detriment not only to directors serving on boards, but also to the supply of future directors. In exploring the various mechanisms employed by both levels of government to protect employee wage claims in bankruptcy, it is clear that there is no clear winner. The key aim of this comment is to illustrate this very fact. However, when joined, these approaches may serve to provide a remedy in which the combined whole is better than the sum of the individual parts. In the author's opinion, directors' liability provisions, when combined with a wage-fund scheme offers one such beneficial compromise. Admittedly, only a skeletal framework is provided here; much more will need to be decided upon before such a proposal could be accepted. However, the author submits that a first step desperately needs to be taken. In the past twenty years, the federal government has repeatedly acknowledged the need for such action, but it has done nothing. The pressing need for some form of wage protection is only accelerating, and the inadequate, not to mention conflicting, nature of existing legislation begs for a national response.