

## **Lenders beware – new employee super-priorities in Canada**

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*New legislation in Canada has given super-priority rights to employees for unpaid wages and pension contributions, which rank ahead of existing secured creditors.*

On July 7, 2008 new legislation called *Wage Earner Protection Program Act* (“**WEPPA**”) came into force in Canada. By this Act, the Federal government has created the Wage Earner Protection Plan to fund the payment of certain unpaid wages owing to employees at the time a business goes into bankruptcy or receivership.

Concurrent amendments have also been made to *Bankruptcy & Insolvency Act* (“**BIA**”) which have the effect of creating new priority charges in respect of unpaid wages and for pension contributions, which, for the first time, now rank ahead of the interests of secured creditors.

### **What does this mean for employees?**

Employees may apply to the Wage Earner Protection Plan for arrears of wages and compensation earned within the six months immediately preceding the bankruptcy or receivership. Their claim is the lesser of the unpaid amount and 4 weeks of insurable earnings under the *Employment Insurance Act* which currently equates to a maximum of \$3,000. Taxes will be deducted from payments at a prescribed rate. The definition of “wages” for the purposes of the WEPP includes salaries, commissions, compensation for services rendered, vacation pay and any other amounts prescribed by regulation, but does not include severance or termination pay.

It is intended that payments will be made to the eligible employees within the later of 56 days after the date of bankruptcy/receivership or their termination date. Thus, this should expedite payments to employees at a time when they may be out of work and experiencing financial hardship.

The following categories of employees are not eligible to claim against the WEPP: officers or directors of the insolvent employer; individuals who had a controlling interest in the business; individuals who occupied a managerial position with the insolvent employer; or employees who were not dealing at arms-length with the excluded individuals listed above. The WEPPA regulations have narrowed the definition of a “managerial position” to be someone that can make binding financial decisions affecting the Company or someone that can influence the payment or non-payment of wages.

To the extent that it makes payments to employees under the WEPP, the Federal Government is subrogated to the rights of those individual employees and will have a right to the benefit of the new priority charges referenced below.

#### **Additional administrative duties for trustees/receivers**

The WEPPA imposes numerous statutory duties on trustees in bankruptcy and receivers to administer and comply with the provisions of the WEPPA. In summary, the trustees and receivers are required to promptly quantify eligible claims for wages and compensation owed within six months prior to bankruptcy or receivership, advise employees of their rights and the amount of their claim under the WEPPA;; and provide information to the designated Minister about the wages and compensation each employee is owed under the WEPP.

There is provision for nominal compensation to receivers/trustees for work to be performed under the WEPPA, but with numerous exclusions. Essentially, this means that secured creditors will bear the burden of these additional costs. The WEPPA does not stipulate whether the receiver or the trustee should bear the duties and costs where both are appointed, and/or which secured creditor should bear the costs when there are multiple competing secured creditors.

#### **Statutory priorities for unpaid wages and pension contributions**

By a concurrent amendment of the *Bankruptcy and Insolvency Act* , new priority charges have been created in both bankruptcies and receiverships in respect of unpaid wages and pension contributions (BIA sec 81.3 through sec 81.6).

- Wage arrears, to a maximum of \$2,000 per employee (plus \$1,000 for disbursements owing to traveling salespeople), rank as a super-priority over the “current assets” of the corporation. “Current Assets” are defined to include: cash, cash equivalents, including negotiable instruments and demand deposits, inventory or accounts receivable, or the proceeds from dealing with those assets.

As stated above, the Federal Government’s subrogated claim arising from payment under WEPPA will have the benefit of this first ranking charge on the current assets of the employer, to the extent of \$2,000 per employee.

*Essentially, the wages claim will create a priority ahead of secured creditors, which can be estimated by multiplying \$2,000 by the number of employees.*

- An additional super-priority has been created for unpaid “normal costs” (as defined in s. 2(1) of the Pensions Benefits Standards Regulation, 1985 and the

Pensions Benefits Standards Act, 1985)) and unremitted employee pension deductions. The pension charge attaches to all of the Company's assets (as opposed to just the Current Assets) and these claims will have priority over all secured creditors in both bankruptcies and receiverships. It should be noted that deficiencies in pension plan assets are not 'normal costs' so are not covered by this charge. It should also be noted that the Current Service costs of a pension are considered "normal costs" even though these costs can be retro-actively amended up to two years after the fact based on actuarial reports; therefore the final amount may not be known for up to two years after the bankruptcy or receivership.

*There is no maximum amount for this priority charge, making it more difficult to estimate than wages claim. Further, the status of pension contributions are not something that would traditionally have been monitored by secured lenders so lenders may have to become more involved with the Company's actuarial advisors to better understand the potential exposures.*

#### **What does it mean for secured lenders?**

Super priority for wages and pension contributions will likely result in a reduction of available credit, as lenders take account of these priorities by reducing availability under operating lines of credit and/or taking increased reserves. With the current economic climate and shrinking credit markets, this is not likely to be helpful to businesses.

It will be interesting to see how lending practices evolve in response to this new legislation. The following practical steps might be considered by lenders in response:

- Insist on the company hiring an external payroll service that administers payroll and automatically remits the source deductions. In our experience, this helps to ensure that the payment of wages and source deductions are kept current and that accurate and reliable payroll records are maintained;
- Consider the need for reductions in the overall level of financing provided;
- Asset-based lenders may consider the need for enhanced reserves to account for the new super priorities;
- They may also require more frequent and detailed field exams to review their exposure;
- More detailed monthly reporting on the borrowing certificates should be requested as to the status of wages and pension contributions as well as copies of actuarial reports, when available;
- Inter-creditor agreements should be drafted to address how creditors will share the burden of these new super priorities.

### Where to from here?

The WEPPA succeeds in providing a level of comfort for employees, who have been identified as involuntary group of creditors that deserve protection. However, it will also add a new dynamic, level of complexity, and cost to bankruptcy or receivership proceedings. This will inevitably affect secured creditors and their lending practices. In the current environment of tightening credit, the resultant shrinkage in availability will not be helpful for businesses.

However, to give some perspective to the above we note that historically, in many insolvency situations, the lenders (particularly the Canadian chartered banks) have honored the outstanding payroll obligations to avoid negative publicity. Thus, it could be argued that the new wage arrears priority effectively codifies existing practice, and that reductions in credit facilities may be unduly conservative.

Exactly how the new provisions will play out is still to be determined and it will probably be some time before we determine the full implications of this for insolvency practitioners and the lending and business communities.

Allan Nackan is a partner with Toronto-based Farber Financial Group which provides a range of specialized financial services including corporate insolvency and restructuring, forensic accounting, fraud investigations, corporate finance, mergers and acquisitions, business valuations, distressed financial advisory services, turnarounds, CFO interim management, profit enhancement and opportunity assessments. A more complete description of these services may be found on its website at [www.farberfinancialgroup.com](http://www.farberfinancialgroup.com)

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