

Dealing with Vendors: Beware of Liability Traps in Payroll Outsourcing Deals



Getting sued by your vendor is probably the last thing on your mind when you outsource payroll. Unfortunately, it's a real risk. In recent years, payroll service bureaus have begun suing client companies for wages paid to employees on the client's behalf and now can't get back from the client. And if the reason they can't get the money back is that the client is insolvent, the service bureaus will try to get their money out of the personal accounts of the company's directors. Here's what HR managers need to know to guard against this danger.

How Employees Get Paid Under Service Bureau Arrangements

Lawsuits by service bureaus against directors of clients happen because of how wages are paid to employees under typical payroll outsourcing arrangements. Consider this example of what happens during a week when payroll payments are to be made:

By End of Business, Tues.: The client company sends the service bureau the payroll information the bureau needs.

Overnight Tues.: The service bureau processes the payroll and debits the client's account dated for Wed.

Wed.: The service bureau sends its own bank account the information the bank needs for employees' direct deposits so these funds are available to employees before the start of business on Fri. Typically, 80% to 90% of payments are made via Electronic Fund Transfer (EFT) and the rest by cheque.

The problem arises when the service bureau makes payment to employees without verifying that the client *actually has* the funds to cover the debit. Once the debit is returned, it may be too late to recall the related employee credits and EFTs. Sometimes the client's bank will honour the debit. But if the client files for bankruptcy, the company or bankruptcy trustee may be able to order the bank to recover the money paid from the service bureau. Either way, the service bureau is left holding the bag.

WHAT THE LAW SAYS

Service bureaus are powerful entities that can afford the finest commercial lawyers in the land. But, they face an array of formidable legal obstacles in trying to get their money back.

The first obstacle is the bankruptcy law. When companies file for bankruptcy, the claims of their creditors are “stayed,” i.e., frozen, until the bankruptcy court (or receiver) sorts out the competing claims and decides how to distribute the company’s assets among the creditors. Creditors holding “secured” debts get paid before unsecured creditors. And because a service bureau’s claims are generally unsecured, the best it can probably hope for is pennies on the dollar.

Going After Directors

If the service bureau can’t get its money in the bankruptcy proceeding, it might try suing the client company’s individual officers, directors, shareholders or other officials (which, for simplicity’s sake, we’ll refer to collectively as “directors”). But directors aren’t generally liable for the debts of the corporations they serve. For a service bureau to hold a director personally liable, an exception must apply. There are at least 4 possibilities.

1. The Subrogation Theory

Basic debt collection law: If a debtor owes money to a creditor that it can’t pay off, a third person may agree to pay the debt. One way for the third person to get the money back from the debtor is by taking over the creditor’s legal claim. This process of stepping into a creditor’s legal shoes for purposes of asserting the creditor’s right against the debtor is called subrogation.

Example: Under the federal Wage Earner Protection Program (WEPP), the government pays the wage claims of a bankrupt company’s employees. It’s then subrogated to the employees’ wage claims against the company and can assert them in the bankruptcy proceeding against the company or in a separate lawsuit against the company’s directors.

The problem for service bureaus: Subrogation isn’t automatic. For the right to exist, there must be a specific contract provision or law giving the third party who pays the debt the right of subrogation to the creditor’s claims. But the service bureau doesn’t have a contract with a client’s employees—its contract is with the client company.

Thus, the only possible source of such a right would be a piece of legislation. One possibility is the part of employment standards laws, e.g., the *Canada Business Corporations Act* (CBCA), making directors “jointly and severally liable” to a corporation’s employees for up to 6 months of wages. The CBCA also gives the director(s) who pays the wages a right of subrogation against the other directors.

A decade ago, Ceridian brought a lawsuit attempting to piggyback on this subrogation right. But the court shot down the claim. ADP relied on similar language in Ontario law to make a subrogation claim against the director of an insolvent client. But ADP also lost.

2. The Unjust Enrichment Theory—Corporate Law Version

“Unjust enrichment” enables a court to force a person to repay a windfall benefit that he didn’t deserve in the interest of fairness. Service bureaus have tried to rely on the theory to get back the wages they paid from a client company’s directors. The directors were unjustly enriched by the bureau’s wage payment and should disgorge the benefit. But the argument failed in the Ceridian case. The directors derived no personal benefit from Ceridian’s payment, according to the court.

3. The Unjust Enrichment Theory—Employment Standards Laws Version

Service bureaus have tried another version of the unjust enrichment theory using the staple provision in employment standards law making directors personally liable to employees for a company's unpaid wages. The bureaus have argued that that wage payments benefitted directors by getting them off the liability hook under this provision. But so far at least, the argument hasn't worked.

4. The Piercing the Corporate Veil Theory

Service bureaus have also relied on a doctrine called "piercing the corporate veil" to try and get a client company to pay back wages. Explanation: Under the Canadian legal system, a corporation is an entity that has its own legal personality distinct from the individuals who serve it. Consequently, corporations are responsible for their own debts and liabilities. But if courts suspect that directors are abusing the protection of the corporate structure to commit fraud or conduct what are essentially personal transactions, it will "pierce the corporate veil" and hold the directors personally liable for the corporation's debt.

In the Ceridian case, Ceridian claimed the failure of the directors to notify it of impending bankruptcy was deceptive behaviour justifying piercing of the veil. But the court rejected the argument saying there was no reason to doubt that the directors had acted in good faith.

The War Isn't Over—& Neither Is the Risk

Be aware of the liability implications of payroll outsource arrangements you make or are thinking of making. Recognize that payroll service bureaus have the determination—not to mention legal budget—to go after your organization's directors to recover payroll payments. And while the results haven't been favourable so far, the challenges are likely to continue. Result: Liability risks remain a real possibility.