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Contents

CAN AN EMPLOYER TRIM ITS COSTS BY CHANGING ONE ELEMENT OF ITS EMPLOYEES' REMUNERATION ?

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To deal with the financial crisis that is mercilessly encroaching on Canada's economy, employers are sometimes tempted to cut certain elements of their employees' remuneration[1].

However, such a change may, in some cases, be tantamount to a constructive dismissal and give rise to legal proceedings.

The landmark Supreme Court of Canada case, *Farber v. Royal Trust Co.*[2], teaches us that constructive dismissal mostly occurs when an employer, without necessarily intending to eliminate an employee's services, unilaterally and substantially alters the essential terms and conditions of the employee's employment contract without reasonable notice or serious reason.

Following is a succinct look at three options available to an employer wanting to change its employees' working conditions without any counterproductive consequences.

Insofar as unionized employees are concerned, it should be noted from the outset that the employer cannot make any change to their working conditions without the union's consent in accordance with the terms and conditions of the applicable collective agreement. Therefore, the options discussed below do not apply to them.

OBTAIN CONSENT

Generally, obtaining the employee's consent, ideally in writing, before making the change, constitutes a solid ground of defence against a possible lawsuit based on constructive dismissal.

To be valid, the consent must be given "in a free and enlightened manner", that is to say, not invalidated by error, fear or injury.

GIVE REASONABLE NOTICE

To avoid being accused of having constructively dismissed its employees, an employer may give them a reasonable notice. Such notice informs the employees of the change that will be made to their working conditions.

However, in the mind of the employer wanting to urgently cut its costs to offset the effects of the current crisis, this option may seem well and fine in theory but it is pointless in practice. In fact, the notice in question is equivalent to the reasonable termination of employment notice. Such a notice of termination is determined on an individual basis and may reach up to twenty-four months for certain employees. This option does not always allow the employer to make the desired short-term change.

MAKE AN UNSUBSTANTIAL CHANGE

In the above-mentioned *Farber case*, the Supreme Court set out the following test to determine whether or not a change is "substantial": the court must ask itself whether a

reasonable person, finding himself or herself in the same situation as the employee, would have felt that the essential terms of the employment contract were being substantially changed. If the answer to this question is negative, the change to the employment contract is then justified by the employer's legitimate exercise of its right to manage.

Of course, the exercise of the employer's right to manage is not unlimited. It is the scope of this power to manage that must be analyzed with great care to determine the employer's margin of manoeuvrability.

A change representing a reduction of less than 5% of the elements of the employee's remuneration, where such a change is not accompanied by any other change to his working conditions, may not, depending on the circumstances, be considered as a constructive dismissal. However, each case is an individual one and no universal rule applies.

In short, the distinction between the employer's right to manage and constructive dismissal is often quite subtle but remember that it does exist and that the sum total of these slight individual changes may represent valuable savings for an employer in these difficult times.

ENTERING THE "ZONE OF INSOLVENCY" WHAT TO DO ?

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In today's economic climate, many companies have one foot, if not both feet, in the "zone of insolvency". In practice and as a general rule, a company steps into the insolvency arena when it faces liquidity problems that it cannot remedy, in particular, because of credit tightening. While directors try to find solutions, they often have no other choice but to resign themselves to the inevitable: the company is insolvent.

Legally-speaking, an insolvent corporation is generally defined as a corporation: (1) that is unable to meet its obligations as they become due; (2) that has ceased paying its current obligations in the ordinary course of business; or (3) the asset value of which is not sufficient to enable payment of its obligations due and accruing due.

From the moment a corporation is insolvent, it can declare bankruptcy under the *Bankruptcy and Insolvency Act* ("**BIA**"). However, in an attempt to avoid bankruptcy, it can also make a proposal under the BIA or, in certain cases, an arrangement under the *Companies' Creditors Arrangement Act* ("**CCAA**"). The main differences between these insolvency procedures must be understood.

BANKRUPTCY

Bankruptcy is the most drastic measure: a bankruptcy trustee takes possession of the debtor's property for the benefit of the body of creditors. The assets are liquidated and dividends are distributed to the creditors. This measure puts an end to the debtor's activities.

PROPOSAL

This measure takes place under the supervision of a trustee (although he or she does not normally take possession of the debtor's property) and enables a company to propose a compromise to its creditors with respect to their claims. Generally, the proposal only applies to unsecured creditors. During this process, the debtor benefits from a stay of all proceedings pending against it. The proposal may also be preceded by a notice of intention that enables the debtor to immediately benefit from such stay of proceedings, which is valid for an initial period of thirty days. This time period may be extended on certain conditions, but a proposal must be filed within six months of the filing of the notice of intention.

If half of the unsecured creditors, representing two-thirds in value of the claims, vote in favour of the proposal, it is accepted and, following approval by the court, it binds the debtor and its unsecured creditors.

If the proposal is not accepted, the debtor is deemed to be bankrupt.

ARRANGEMENT

The arrangement under the CCAA is similar to a proposal, but it is only available to corporations having a total indebtedness of five or more million dollars.

It is a restructuring process carried out under the supervision of the court and a monitor (who essentially plays the same role as a trustee in the case of a proposal).

Compared to the BIA, the CCAA provides much more flexibility with respect to the proposed restructuring and allows the debtor or the creditors to submit special applications to the court during the process. *Inter alia*, the courts regularly authorize interim debtor-in-possession financing which enables the company to secure immediate financing where it needs cash assets during its restructuring. This type of financing is actually possible since the courts then allow the creation of securities guaranteeing this financing that rank prior to existing securities.

However, it should be noted that this flexibility comes with a price. As proceedings to propose an arrangement are often quite costly, they do not, therefore, lend themselves to any circumstance.

As it is sometimes difficult to establish which of the insolvency procedures is the most germane in a given case, we must conclude with a simple and important piece of advice: do not wait to consult your financial and legal advisers until it is too late! While there is still time, they can implement an array of measures enabling you to weather a situation that seems unresolvable.

ECONOMIC SLOWDOWN - SOME CONCRETE FINANCING INDICATIONS AND HOW TO REACT

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Despite the global crisis rattling the financial markets, there are still financing opportunities in Quebec. In addition to funds available from traditional lenders, the Government of Canada recently announced a $350 million investment in the Business Development Bank of Canada, increasing lenders' supplies of cash across the country. In Quebec, the government announced a program to aid Quebec businesses having difficulty finding financing. This program, christened "Renfort", is intended to help so-called "performing" businesses overcome the hardships caused by the economic slowdown. Administered under the direction of Investissement Québec, Renfort will extend up to $250 million in direct financing in the form of term loans to eligible businesses.

However, as we all know, there is currently a "tightening" of credit terms due to increased prudence on the part of financial institutions. The crisis has, among other things, changed the power relationship between lenders and borrowers. Borrowers had an advantage in this relationship during recent years when credit was readily available. However, we are now witnessing a swing of the pendulum making the negotiation of credit terms more difficult for borrowers. The real impact of this new dynamic on a business will largely depend on the soundness of its economic resources.

For businesses in sound financial health that do not have an urgent need for additional financing, the entrepreneur may be tempted to postpone projects likely to increase the need for credit. In fact, some will find that pricing increases, as well as the tightening of credit terms, are not conducive to starting up new projects. However, admittedly, certain interest rates, due to the lowering of the Bank of Canada's guide rate, are now quite advantageous, despite the increase in the spread charged by financial institutions. For instance, a financial institution's base rate is generally made up of the Bank of Canada's guide rate plus 175 basis points. The guide rate is presently 0.50%. Thus, the base rate should be approximately 2.25% even though most banks are posting a 2.50% base rate. Moreover, an additional spread to the base rate, generally calculated according to the business's financial health (frequently based on a financial ratio) must be taken into account. This spread also increased recently.

In addition, if the business is facing temporary hardships, it may not be a strategic move to provide its lender with an opportunity to re-examine its financing. This does not mean playing a cat and mouse game. On the contrary, the preferred approach remains one of transparency. In fact, a business that foresees absorbing major expenses or a significant decline in income affecting its capacity to meet its financial ratios or other obligations will instead have an interest in disclosing its position to its financial institution as soon as possible. Proactive disclosure will facilitate the negotiation of waivers with the lender in the event of a default and may help securing further credit from the lender for the purpose of enabling the borrower to weather this difficult period. However, as mentioned above and even more so for businesses facing hardships, one should expect that any agreement with the lender will include more onerous terms than previously. A business planning to negotiate waivers or secure further credit will also have to provide its financial institution with concrete budgets stating its anticipated cash inflows and submit a realistic recovery plan that includes solutions to overcome its financial difficulties. More than ever, a borrower must establish and maintain a spirit of continuous cooperation and demonstrate transparency toward its financial institution. In fact, in today's climate, a worried or nervous banker will not be as patient with the business.

What about businesses facing serious financial hardships ? Experience dictates that their banker may withdraw and they might find themselves with limited financing options. If traditional lenders no longer show an interest in a business, it stands to reason that other lenders have also tightened their eligibility criteria, if not completely stopped lending. As alternate sources of financing are thinning, these

businesses may have to turn toward completely different forms of financing, such as factoring and asset-based financing or, inasmuch as they qualify, government programs aimed at supporting businesses in difficulty, such as Investissement Québec's Renfort program.

All in all, while credit terms have certainly tightened in recent months and will continue to tighten for some time, credit does remain accessible. However, borrowers should be aware of the impact that the economic slowdown may have with respect to their financing and to the terms and conditions inherent therein in order for them to be better prepared and thus still make the most of the situation despite the adverse economic climate.

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[1] For instance, by cutting the employees' salaries or the employer's contributions to their pension plans, bonus plans or profit sharing plans.

[2] [1997] 1 S.C.R. 846 (S.C.C.) (hereinafter "**Farber**").

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