A Director's Guide to
EXECUTIVE COMPENSATION

THOMSON REUTERS

Volume 9, No. 1 Summer 2014

Constructive Dismissal: The Basics

Part 1 of 2

Constructive dismissal is a term used to describe the circumstances when an employee has not been expressly dismissed from employment, but has been effectively dismissed as a result of unilateral changes made by the employer that substantially alter the employee's essential terms and conditions of work. It may also arise when the employee is required to work in what amounts to a poisoned work environment.

Employees at all levels may find themselves having been constructively dismissed. Executives are not immune from constructive dismissals, even though they often have a high level decision making authority on terms and conditions of employment for the workforce.

If an executive is found to have been constructively dismissed from employment, the executive may be entitled to an award of damages equal to the notice and severance the employer ought to have provided the executive had the employer expressly terminated the executive's employment.

This newsletter is the first of two issues on constructive dismissal. This newsletter outlines the basic concepts pertaining to constructive dismissals. As will become apparent on reading these newsletters, determining when an executive has been constructively dismissed and the damages the executive may be entitled to as a consequence of the constructive dismissal requires an assessment of numerous aspects of the employment relationship over its history and how the impugned event or events unfolded at the time of the alleged constructive dismissal. Each employment situation is unique, especially when it comes to deciding whether an executive has been constructively dismissed. Similar factual scenarios may lead to different results, depending on the unique characteristics of any particular employment relationship. For example, an executive whose terms and conditions of work have been static historically may be treated differently in law than one whose terms and conditions of work have been fluid over the years, such that there is a pattern of material changes to the executive's essential terms and conditions of work.

The following explains some of the various principles that need to be considered in assessing whether an executive has been constructively dismissed from his or her employment and the damages to which he or she may be entitled as a result of the constructive dismissal.

From the Editor

The term "constructive dismissal" is often used and often misunderstood. This newsletter is the first of two issues that seeks to clarify what constitutes a constructive dismissal and the principles that need to be considered in assessing claims for constructive dismissals. The next issue will consider some of the cases where courts have considered constructive dismissal claims from executives.

CSuite Law, First Canadian Place, 100 King Street West, Suite 5700,
Toronto ON M5X 1C7 www.csuitelaw.com — *Nadine Côté LL.B.*

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

Nadine Côté is an employment and executive compensation lawyer at CSuite Law. She is also the author of Executive Compensation: A Director's Guide, the only comprehensive book in Canada on executive compensation.

General Editor & Author
ncote@csuitelaw.com

CONTENTS

Defining constructive dismissal

In *Farquhar v. Butler Brothers Supplies Ltd.*,[1] the British Columbia Court of Appeal described a constructive dismissal as follows:

> "A constructive dismissal occurs when the employer commits either a present or an anticipatory breach of a fundamental term of a contract of employment, thereby giving the employee the right, but not the obligation, to treat the employment contact as at an end… The employee's decision must be made within a reasonable time. But he is entitled to a few days, or even a couple of weeks, to think it over."

In *Farber v. Royal Trust*,[2] Supreme Court of Canada gave the following description of what constitutes a constructive dismissal:

> "Where an employer decides unilaterally to make substantial changes to the essential terms of an employee's contract of employment and the employee does not agree to the changes and leaves his or her job, the employee has not resigned, but has been dismissed. Since the employer has not formally dismissed the employee, this is referred to as "constructive dismissal". By unilaterally seeking to make substantial changes to the essential terms of the employment contract, the employer is ceasing to meet its obligations and is therefore terminating the contract. The employee can then treat the contract as resiliated for breach and can leave. In such circumstances, the employee is entitled to compensation in lieu of notice and, where appropriate, damages."

The test for whether an employee has been constructively dismissed is an objective one, as noted by the Ontario Court of Appeal in *Smith v. Viking Helicopters Ltd.*:[3]

> "In my opinion a damage action for constructive dismissal must be founded on conduct by the employer and not simply on the perception of that conduct by the employee. The employer must be responsible for some objective conduct which constitutes a fundamental change in employment or a unilateral change of a significant term of that employment."

Employer's good faith or bad faith conduct

Employers may make changes to the employment relationship in good faith and with the intention of continuing the employment relationship in the restructured work environment. However, an employer's good faith intentions are not determinative of whether the employee has been constructively dismissed.

In *Cox v. Royal Trust Corp. of Canada*,[4] the Ontario Court of Appeal held that even though, the employer acted in good faith and with genuine concern for the company and the employee, the employer was still liable for constructive dismissal when it removed the employee's management functions and caused the employee to report to a former subordinate.

In *Farquhar v. Butler Brothers Supplies Ltd.*,[5] the employer faced business setbacks and sought additional working capital to keep the business operating. The employer also cut salaries by 5% for lower paid employees and up to 30% for higher paid employees. All of the employees accepted the reductions, except for Mr. Farquhar. Mr. Farquhar, the Credit Manager and Office Manager, faced a 30% salary cut and the elimination of his car allowance and director fees for a total loss of approximately 47% in compensation. Mr. Farquhar walked off the job and claimed he was constructively dismissed. As it turned out, the employer obtained its working capital, viability was restored and, over time, most of the former salaries were reinstated.

The British Columbia Court of Appeal accepted that the employer's actions may well have been justifiable to keep the business operating. However, the Court noted this did not affect the damages suffered by Mr. Farquhar. The Court confirmed the lower court ruling that Mr. Farquhar had been constructively dismissed and that he did not have to continue working there to mitigate his damages. The Court noted that it would have been humiliating for Mr. Farquhar to walk back into work, after he had walked out and that it would likely have affected his supervisory role over staff.

Conversely, employers may make changes to the employment relationship in bad faith, perhaps to 'push' the executive out of his or her job without having to provide what may be costly pay in lieu of notice of termination or severance pay. Still, the employer's bad faith misconduct may not be determinative of whether the executive has been constructively dismissed; but, it may impact the damages to which the executive is entitled.[6]

Single event or cumulative effect

Constructive dismissal may arise when the employer makes a single substantial change to an executive's essential terms of employment, such as a significant reduction in an executive's compensation as in *Farquhar*. Conversely, constructive dismissal may rise when there has been a gradual erosion of the executive's position within a relatively short period of time.

In *Greaves v. Ontario Municipal Employees Retirement Board*,[7] Mr. Greaves worked as a money manager for the Ontario Municipal Employees Retirement Board ("OMERS") from 1981 to 1993. Over the course of Mr. Greaves' employment, he held positions of increasing responsibility. Most recently, Mr. Greaves held the position of Vice-President Equities and Investment Strategy. In this position, Mr. Greaves managed approximately 50% of the $22 billion of assets under the management of OMERS. Mr. Greaves also had numerous other responsibilities, including assisting the Senior Vice-President, Investment Division in setting the investment strategy and deputizing for him in his absence and on his request; overseeing corporate governance policies; and, playing a major role in the development of a new incentive plan underway by the Senior Vice-President, Human Resources.

From May to October 1993, OMERS undertook a reorganization of its Investment Division for genuine business reasons. The organizational changes were carried out progressively over this period, as deemed appropriate. As part of the changes, Mr. Greaves would only be responsible for the Canadian equities with the new title Vice-President, Canadian Equities Internal. This change represented a 50% drop in his assets under management, from managing 50% to 25% of OMERS' assets

under management. The staff reporting to Mr. Greaves was reduced from 17 to 12 persons. Also, Mr. Greaves would no longer be the advisor to the Senior Vice-President on investment strategy, but would be a member of the advisory committee. Mr. Greaves would no longer be responsible for the corporate governance matters, but these would be assumed by a new corporate relations manager. In June 1993, at a meeting of vice-presidents and with no prior notice to Mr. Greaves, Mr. Greaves learned he would no longer be a lead in the development of the new incentive plan, but another employee would be promoted to the position of vice-president and would assume this responsibility. Mr. Greave would no longer deputize for his superior, but the responsibility would be rotated among the vice-presidents. Mr. Greaves salary was "red circled", so it would not be reduced despite the changes to his position.

The culminating incident was the promotion of two of the vice-presidents that had been junior to Mr. Greaves in terms of the breadth of their responsibilities, salary and grade position before the reorganization to a position in-line with Mr. Greaves. Before the reorganization, five vice-presidents reported to the Senior Vice-President, Investment Division. After the reorganization, Mr. Greaves was to report to another vice-president who had just been promoted to his same level. After the reorganization, only two vice-presidents reported directly to the Senior Vice-President, Investment Division. The formal organizational change was made public on October 6, 1993, without any prior notice to Mr. Greaves. Mr. Greaves resigned the next day, notwithstanding the requests from two senior vice-presidents to stay. Mr. Greaves commenced an action for his constructive dismissal and his bonus under the new incentive plan, which was approved just a couple of weeks after his departure.

The Ontario Court of Justice, General Division, held that Mr. Greaves had, in effect, been demoted as a result of the cumulative impact of the organizational restructuring. The Court determined that the period of reasonable notice of termination owed to Mr. Greaves was 15 months, considering his 44 years of age, 12 years of service, the senior level of his position and how few similar positions were available in the marketplace.

Assessment period and condonation

Executives are entitled to a reasonable period of time to assess the changes to the work arrangement before they must decide if the changes amount to a constructive dismissal. Executives that continue working for the employers beyond this reasonable assessment period, may be found to have consented to, or condoned, the employer's changes by their conduct, such that they can no longer successfully assert a claim for constructive dismissal.

In *Greaves*, the Court rejected OMERS' argument that Mr. Greaves had condoned the changes as commented as follows on the employee's right to assess the changes for a reasonable period of time, at paragraphs 63 and 64 of the decision:

> "The employee must be aware of the full implications of the changes before it can be said that the employee has consented to them. Courts have generally found that the employee has not consented to the new arrangement unless and until a reasonable "trial period" has lapsed in which the employee can decide whether or not she/he wishes to work permanently under the change. The determination of a reasonable trial period depends on how long it ought reasonably to take a person in the employee's position to assess the suitability of the new working arrangement."

Damages

If an executive is found to have been constructively dismissed from employment, the executive may be entitled to an award of damages equal to the notice and severance pay the employer ought to have provided the executive had the employer expressly terminated the executive's employment.

The damages to which an executive may be entitled may be set out in a written contract. However, if there is no written contract specifying the executive's entitlements on a termination without cause, the executive may be entitled to damages for the employer's failure to provide "reasonable notice" of the termination of the executive's employment.

What constitutes "reasonable notice" typically depends on the executive's age, length of service, character of employment (managerial or non-managerial), the availability of similar employment and whether the executive was induced to leave his or her prior employment. Generally, the executive will be entitled damages based on the total compensation the executive would have earned had the executive worked during the reasonable notice period, subject to any contractual restrictions.

The duty to mitigate

Once it is determined that the employer has an obligation to provide notice of termination to the executive, then it must be determined if the executive has an obligation to mitigate his or her damages flowing from the employer's failure to provide the required notice. Generally, an executive has an obligation to mitigate his or her damages if it is required under his or her employment agreement, or if the executive has an implied obligation to mitigate his or her damages arising from the employer's implied obligation to provide reasonable notice of termination.

In *Farquhar,* the British Columbia Court of Appeal described the duty of an employee to mitigate his or her alleged damages as follows:

> "The employee is not obligated to mitigate by working in an atmosphere of hostility, embarrassment, or humiliation. But once the employer is clearly told, by words or equivalent action, that the termination is accepted by the employee, then, if the employer continues to offer a position to the to the employee, and the position is such that a reasonable person would accept it, if he were not counting on damages, then the duty to mitigate may require the employee to accept the position, on a temporary basis while he looks for other work, even if it is roughly his old position before the constructive dismissal."

For employers to be able to claim the executive had a duty to mitigate his or her damages by continuing to work for the employer during the period of reasonable notice of termination otherwise owed to the executive, the employer must clearly

state and reiterate its offer of continued employment to the executive, even after the executive takes the position he or she has been constructively dismissed.

In *Schumacher v. Toronto-Dominion Bank*,[8] the Ontario Court of Appeal held that the Bank had unilaterally and substantially changed the essential terms of Mr. Schumacher's employment, by among other things, significantly reducing his responsibilities. The Court rejected the Bank's assertion that Mr. Schumacher ought to have continued working under the new terms of employment to mitigate his damages during the notice period because the Bank itself had refused to allow Mr. Schumacher to do so. Mr. Schumacher's lawyer had written the Bank extending an offer for Mr. Schumacher to continue working pending their productive negotiation of the severance package. However, the Bank responded by stating that the option to remain at work while negotiating a severance package was not acceptable and tantamount to resignation. The Bank indicated that Mr. Schumacher would only be permitted to return to work if he accepted the new position unconditionally.

The impact on an executive's constructive dismissal damages award can be sever if the court finds an executive failed to meet his or her obligation to mitigate his or her damages. The court can reduce the amount otherwise awarded to the executive on his or her constructive dismissal claim by a percentage, reflecting the estimated amount the executive would have earned during the notice period had the executive mitigated his or her damages. The court can also eliminate the amount otherwise awarded to an executive who failed to mitigate his or her damages.

In *Greaves*, the Court noted Mr. Greaves' evidence of how he felt humiliated and embarrassed by the changes after the demotion of October 6, 1993. Nonetheless, the Court held that Mr. Greaves failed to mitigate his damages by continuing his employment with OMERS until he found a new job. The Court noted that there was a great deal of respect for Mr. Greaves as a professional and as a very capable, dedicated employee. The Court noted that Mr. Greaves was in a situation of mutual understanding and respect, and this was not a situation where the basic relationship of trust and good faith were gone from the employment relationship. Consequently, Mr. Greaves was not entitled to any damages for the 15-month notice period, otherwise awarded by the Court. The Court did however award Mr. Greaves the bonus under the new incentive plan for the period he worked up to October 6, 1993, but not beyond that date because of his failure to mitigate his damages. Mr. Grieves had been earning an annual base salary of approximately $145,000, and the bonus awarded for the period up to October 6, 1993 was approximately $40,000.

Burden of proof

The onus of proving that an executive has been constructively dismissed falls on the executive making the allegation. However, the onus of proving that the executive has failed to mitigate his or her damages falls on the employer making the allegation.

Contract terms: reserving the right to make changes

Employers sometimes include provisions in their executive employment contracts stipulating that the employer reserves the right to make changes to the executive's position, duties, reporting relationships, compensation and other changes over the course of time. These types of provisions can be of assistance to employers when they make relatively minor changes to the terms and conditions of the executive's employment as the executive will have been put on notice that such changes were possible.

It is less clear if employers can rely on these types of provisions to make material changes to an executive's terms and conditions of employment that might otherwise constitute constructive dismissal. Arguably, these types of provisions do not permit employers to make material changes to an executive's terms and conditions of employment without providing reasonable notice of the change to the executive. Indeed, it is difficult to envision a situation in which a court would allow an employer to, in effect, fundamentally breach an executive employment agreement without notice to the executive and deprive the executive of any recourse for the breach based on these types of provisions.

The foregoing outlined various legal principles that need to be considered when assessing if an executive has been constructively dismissed. Our next newsletter will continue on this topic with further examples of constructive dismissal cases.

* * * * *

Endnotes:

1 *Farquhar v. Butler Brothers Supplies Ltd.*, [1988] 3 W.W.R. 347 (B.C.C.A.) ("*Farquhar*") at p. 347.
2 *Farquhar, ibid.*
3 *Smith v. Viking Helicopters Ltd.* (1989), 24 C.C.E.L. 113 (Ont. C.A.) at p. 116-117.
4 *Cox v. Royal Trust Corp of Canada*, (1989) 26 C.C.E.L. 203.
5 *Farquhar, supra* note 1.
6 *Farber v. Royal Trust* 1997 CanLII 387 (SCC) at para. 27.
7 *Greaves v. Ontario Municipal Employees Retirement Board* 1995 CanLII 7288 (ON SC) ("*Greaves*").
8 *Schumacher v. Toronto-Dominion Bank*, [1999] O.J. No. 1772 (Ont. C.A.)

This newsletter reflects the views of the author(s) and is provided only for informational purposes. This newsletter does not constitute legal, tax, accounting, compensation consulting or other professional advice and cannot be relied upon as providing such advice. Your inquiries on these matters can be directed to Nadine Côté, CSuite Law at ncote@csuitelaw.com