HUNTER-LIBERATORE-LAW

Case Law Update: "Changed Substratum" Doctrine

Effective employment contracts include termination clauses that set out an employee's entitlements upon termination of employment. These clauses are vulnerable to attack under the "changed substratum" doctrine which applies when an employee has received significant promotions and increased job responsibility during their employment.

If the original employment contract has not been amended to reflect these changes to the employment relationship, a court may determine that the original contract was not intended to apply to the new employment conditions. This is because the "substratum" or foundation of the employment contract has disappeared or substantially eroded such that the enforcement of the contract terms (particularly the termination clause limiting notice entitlements) would be unfair to the employee.

In *Celestini v. Shoplogix Inc.*, the Ontario Court of Appeal found that an otherwise valid termination clause was unenforceable under the doctrine.

Background

Celestini was hired as the Chief Technology Officer ("CTO") pursuant to an employment contract signed in 2005. At the time of hire, the position did not involve sales, travel, infrastructure responsibilities, or financing. That contract provided that upon a without cause termination, Shopologix would pay Celestini his base salary for 12 months. Shopologix would also make a pro-rated payment of his annual bonus accrued up to termination.

In 2008, the parties entered into an Incentive Compensation Agreement ("ICA"), a bonus plan which significantly changed Celestini's compensation. At that time Shopologix engaged a new CEO who drastically reduced the number of senior management employees, resulting in a substantial increase to Celestini's workload and responsibilities, which now included managing important aspects of sales and marketing; directing managers and senior staff reassigned to report to him; travelling to pursue international sales; handling all the company's infrastructure responsibilities; and soliciting investment funds.

In 2017, the Celestini's employment was terminated without cause, and he received the notice entitlements as set out in his 2005 contract. He filed a claim for wrongful dismissal arguing that the termination provisions in the original contract had disappeared due to material changes in his employment duties since 2005; he claimed entitlement to common law reasonable notice damages.

On a motion for summary judgment, the motion judge found that Celestini's responsibilities had "substantially and fundamentally" increased over the course of his employment and that the parties had failed to ratify the 2005 contract when they entered into the ICA; the termination clause in the original contract was no longer enforceable. The motion judge awarded Celestini 18 months reasonable notice damages and the bonus entitlements he would have received over the 18-month notice period (less the accrued bonus paid to him at termination).

On appeal, Shopologix argued that the motion judge had incorrectly expanded the "substratum doctrine" and erred in finding that any minor and incremental changes to Celestini's employment duties were significant enough to oust the termination provisions of the 2005 contract – Celestini was hired as a senior executive and continued to hold that position throughout his employment. Celestini also appealed the motion judge's decision to deduct the bonus payment he'd received at termination from the damages award.

Decision

The Court of Appeal upheld the motion judge's finding that the changed substratum doctrine applied. The Court observed that,

> The written employment contract may oust the application of the changed substratum doctrine, if it expressly provides that its provisions, including its termination provisions, continue to apply even if the employee's position, responsibilities, salary or benefits change…. The written employment contract may also have continuing force even if there have been substantial changes in the employee's duties if the

> parties ratified its continued applicability when those changes occurred (at para 35).

The Court affirmed that the substratum doctrine applies when there have been fundamental expansions of the employee's duties after the employment contract was made and does not require a promotion or change in title:

> It may be relevant that the employee was given a new title, but it is simply one contextual factor. More important is whether there were actual increases, of a fundamental nature, in the duties and degree of responsibility of the employee. If there were, the employee was for all intents and purposes "promoted", given their escalated status, even if the assigned title did not change. Put another way, where the duties and responsibilities are fundamentally increased the meaning of the job title is redefined as if a new job title were given (at para 42).

The Court also found that Celestini was entitled to his bonus payment throughout the reasonable notice period. In previous articles, we have discussed the dueling approaches in how the courts approach calculating damages for lost incentive compensation during a reasonable notice period. The "Purist" approach requires the Court to look at the terms of the incentive plan to determine what, if anything, the employee was entitled to during the reasonable notice period while the "Pro-rata" approach states that an employee must be compensated on a pro rata basis for the lost opportunity to earn incentive compensation, even if the terms of the incentive plan itself disentitle the employee from receiving this compensation during or after the reasonable notice period.

In *Celestini*, the ICA provided that if Shoplogix terminated Celestini's employment for a reason other than cause, then Shoplogix would pay the bonus earned up to the date of termination. The Court found that the terms of the ICA did not clearly oust Celestini's common law entitlement to damages for the loss of his ICA bonus in the circumstances that arose – a without cause termination without reasonable notice:

> …termination without cause must be taken to mean a lawful termination following the reasonable notice period. I agree with the motion judge that the ICA did not oust the right to common law damages representing the loss of bonus over the reasonable notice period (at para 55).

The Court concluded that the motion judge made no reversible error when he calculated the bonus entitlement Celestini would have earned during the notice period by averaging the annual bonuses Celestini had earned in the three calendar years preceding his dismissal. The Court therefore affirmed the motion judge's "Pro-rata" approach.

Lastly, the Court of Appeal considered Celestini's argument that the judge should not have deducted the entire bonus payment made to Celestini at the time of termination pursuant to the 2005 contract. Even though the employment contract was not enforceable, the ICA was still in force and obligated Shoplogix to pay Celestini his bonus earned prior to the date of dismissal. The Court did find however that Shoplogix overpaid Celestini's bonus entitlement at the time of dismissal as this amount was calculated based on the formula in the 2005 contract and not the three-year averaging formula adopted by the motion judge.

Takeaway for Employers

- Employers should include a clause in employment contracts affirming that the terms and conditions of the contract continue to apply regardless of the length of employment and any subsequent change to the position, duties and responsibilities, or the compensation.
- When promoting employees and/or expanding employee duties and responsibilities, offer letters setting out these new duties should ratify the terms and conditions of the original contract and confirm that they continue to apply. Alternatively, employers should draft a new written agreement encompassing the increased responsibilities and/or increased compensation.
- Employers should ensure that the terms and conditions of the original contract, particularly the termination clauses, are not superseded by

the terms of any subsequent compensation agreements or bonus plans.

2 Pardee Avenue, Suite 300, Toronto, Ontario, Canada M6K 3H5
Tel: 416-534-7770 Fax: 416-534-7771 hunterliberatore.ca