DOING BUSINESS IN QUÉBEC

Preparing Your Business for Economic Fluctuations

Business Strategies and Legal Considerations

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Economic Fluctuations: Are You Ready?

After more than two turbulent years of a pandemic, global geopolitical conflicts, a serious economic downturn followed by a series of record rebounds in public and private financial markets, the business community has had to adapt its risk management repeatedly through these exceptional situations. In this context, companies continue to face major challenges.

To help you easily adapt your business practices, better understand the legal consequences of the economic situation for your business and make informed decisions, Fasken has developed the guide "Preparing Your Business for Economic Fluctuations", which answers your main questions. This guide details the key elements to consider in your strategic planning or in the ordinary course of your business.

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Looking to the Future

To help you navigate more wisely in this context, we have identified seven main themes that are presented as questions:

01. How can you manage future interest rate fluctuations?
02. What are the impacts on public companies and their boards of directors?
03. Mergers, acquisitions and capital markets: what legal issues are at stake in a context of economic fluctuations?
04. How can you adapt your contractual arrangements to fit the economic situation?
05. How do you optimize your real estate leases?
06. Is it essential to protect your intellectual property during this period?
07. How do you build labour and employment relationships in a hiring freeze?

This guide does not constitute legal advice or opinions. It is intended to provide general guidelines that should be followed by specific advice tailored to your own situation.

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01. How can you manage future interest rate fluctuations?

As a further attempt to curb rising inflation, the Bank of Canada raised its key interest rate for the sixth consecutive time, to 3.75% as of October 26, 2022, representing a 14-year high.

Business managers may not realize it, but interest rates have a significant impact on their activities. It is important to keep a close eye on these trends.

Main Impacts

- Existing variable rate financing, including the amount of interest paid, will become more expensive.
- As a result of rising interest rates and a potential decrease in earnings due to the current economic environment, companies may find it more difficult or may no longer be in a position to comply with the financial ratios required under their loan agreements.

Advice From Fasken Legal Professionals

- Review the terms and conditions of your loan agreement. Specifically, you will want to determine whether, after giving effect to the interest rate increase and your financial projections, you will still be able to comply with the financial ratios required under your agreement.
- If a company does not expect to comply with the financial ratios required under its loan agreement, the company should contact its lender. The earlier the lender is notified, the easier the negotiations will be.
- Explore the possible options with your lender. The lender may, instead of recalling the loan and exercising its remedies and recourses, agree to tolerate the failure to comply with the financial ratios for a certain period of time. This tolerance period will provide the time needed to agree on revised terms and conditions for the credit agreement that are more flexible and suitable to the company going forward. These revised terms and conditions could include, among other things, the suspension of principal repayment for a certain period of time. In exchange for this tolerance, it is not uncommon for a lender to charge certain additional fees, including higher interest rates.
- Companies may also consider refinancing their current loan to implement an asset-based financing, if necessary. This type of financing typically imposes fewer financial ratios compared to a more traditional corporate financing.

- Companies with variable rate financings may also consider entering into an ISDA contract with financial institutions to fix all or a portion of their interest rate exposure on their borrowings.
- To the extent that an increase in interest rates threatens a company's ability to repay its loans, the company may consider setting up a protection plan under insolvency laws. This solution would obviously require prior consultation with professionals.

Any questions?

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02. What are the impacts on public companies and their boards of directors?

Rising interest rates and increasing geopolitical tensions are putting downward pressure on markets and the value of public companies, making them potentially more vulnerable to an unsolicited bid or proposal.

Advice From Fasken Legal Professionals

What should executives and the board of directors do?

- Plan your strategy now. In the event of an unsolicited offer or proposal, make sure you have the right tools to respond.
- As a board of directors, you are required by your fiduciary duties to assess any offer or purchase proposal received. When an unsolicited bid or proposal is made, your duties don't change: you must make your decisions in the best interests of the company and its stakeholders, including shareholders. In doing so, you must consider the long-term interests of the corporation. More precisely, the process involves comparing the benefits of the company's long-term business plan with those of the bid or proposal received.
- When considering an unsolicited bid or proposal, you must adopt the best corporate governance practices and implement a rigorous process to properly discharge your duties, which may include establishing a committee of independent directors and the hiring of legal and financial advisors. Having strong corporate governance before a bid or proposal is even made is a major asset for your company and your board of directors.
- If the unsolicited bid or proposal is made public, communications with your employees, suppliers and clients will need to be handled carefully and mindfully. This critical period, between the announcement of the offer and the shareholders' vote, if any, during which public relations, shareholder communications, regulatory approvals and other legal considerations come into play, requires effective and informed oversight by the board and management.

Did you know?

An unsolicited offer to purchase is not necessarily a “hostile” offer. An offer to purchase becomes “hostile” when it is made publicly, directly to shareholders, without first obtaining the approval of the target company’s board of directors – it is also known as a “take-over bid”.

A take-over bid is subject to specific requirements under securities legislation and requires the offeror to prepare a take-over bid circular. While the approval of the board of directors of the issuer is not required, the board has 15 days to respond to the offer by delivering a directors’ circular, which must contain a recommendation to the shareholders and, if no recommendation is made, the board must explain why.

There are several ways by which a company can prevent such offers from being made and defend itself when they occur or are about to occur, hence the importance of working closely with your legal advisor.

To anticipate any possibility and to ensure that you properly respond to any unsolicited bid or proposal, consult with professionals who have experience in this area (lawyers and financial advisors). Their expertise and advice will be invaluable throughout the process.

Are there opportunities?

Significant declines in global equity markets provide more buying opportunities. Unsolicited bids or proposals remain an attractive mergers and acquisitions strategy for well-capitalized companies that are positively positioned during this period of economic fluctuations, as these transactions have the potential to strengthen the strategic position of buyers in a more stable and growth-oriented environment.

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03.
Mergers, acquisitions and capital markets: What legal issues are at stake in a context of economic fluctuations?

Rising inflation, increasing key interest rates, the geopolitical crisis in Europe—what is the best way to navigate this context? According to PitchBook, in the second quarter of 2022, North American M&A continued its modest decline in terms of deal value and volume.

Advice From Fasken Legal Professionals

Turbulence also means opportunity

While the current environment is affecting the flow and volume of transactions overall, history shows that it will also create opportunities for strategic purchasers and investment funds with significant available capital. The turmoil in the stock market and the economy in general could therefore lead to the emergence of attractively priced acquisition targets in certain sectors.

- Be alert to potential opportunities. Companies and funds with access to a significant source of capital will take advantage of declining valuations to acquire rivals or assets and be strategically positioned for economic recovery.
- There are many mechanisms to consider when preparing your transaction, including the use of earnouts, which are gaining popularity in transactions. Fasken's lawyers can advise you on a strategy tailored to your business objectives.

Spotlight
Use of earnouts

Earnouts have been used in corporate divestitures for many years, but have gained popularity in recent months. This mechanism, which provides for the payment by the buyer to the seller of an amount in addition to the purchase price, is particularly useful in these times of economic fluctuations.

Continued on the next page.

The advantages are twofold:

- For the buyer, it reduces the transaction risk since a portion of the consideration becomes contingent on meeting future financial targets.
- For the seller, it reduces the valuation gap between the buyer and the seller. It may therefore be a good way to satisfy both the seller and the buyer during negotiations.

That being said, not all additional consideration clauses are created equal. The clause must be well thought out and, above all, well drafted. A poorly drafted clause carries a significant risk of dispute due to the amounts involved.

What are the tax implications?

Parties considering earnouts should be aware that their use requires a relatively complex tax analysis. This analysis allows to (A) determine, among other things, whether an alternative mechanism, such as a balance of sale, may be preferable, and (B) confirm that an earnout clause would not result in adverse tax considerations for either party.

The most important thing to remember from a tax perspective when using earnout clauses is that the resulting consideration is generally treated as business or property income (rather than as a capital gain – half of which is subject to tax). That being said, an earnout payment may qualify for capital gain treatment in the context of a stock sale, if certain conditions are met.

Work with your legal advisors to ensure that these conditions are met or to come up with a transaction structure that allows you to meet them.

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04.
How can you adapt your contractual arrangements to fit the economic situation?

A contraction in economic activity forces companies to change the way they deal with customers, partners, and suppliers.

Questions You Should Ask

How will budget adjustments (spending cuts) by your customers, partners and suppliers affect your contractual agreements with them?

How much leeway do you have to renegotiate or cancel agreements that will no longer serve you in the upcoming economic climate?

What potential litigation are you exposed to?

Advice From Fasken Legal Professionals

What you can do to anticipate and adapt

- Review the terms of your major contracts that involve termination, price setting/modifying, limitation of liability, force majeure and amendment. This will not only help you look ahead, but may also enable you to negotiate changes with your customers, suppliers or partners.
- Assess the risk of your commercial agreements and contracts based on criteria such as:
  - Excessive geographic concentration of your suppliers. Think of the supply problems from China during the pandemic, or more recently from Russia and Ukraine.
  - Fluctuations in your labour force.
  - As you think about a smaller labour force, plan for cutbacks in areas such as software licenses, cell phone agreements, office equipment, subscriptions to various online and offline services, and office space requirements.

- More specifically, make sure you understand the contractual framework in relation to the following situations:
  - Your rights in the event of a slowdown in your activities or those of your customers.
  - Your rights in the event of a late payment or if one of your customers or suppliers gets into financial difficulties.
  - The dispute resolution procedure.
  - The application of the force majeure clause.
  - A mechanism for revising prices or guaranteed volumes, as needed.
  - An early termination mechanism.

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05. How to optimize commercial leases

With office occupancy rates dropping significantly due to the pandemic, the transition to hybrid work has a major impact on your commercial leases. What are the right strategies for your business?

Impacts on Your Commercial Leases

New leases should be negotiated with mindfullness about our new reality. Terms should include contraction rights and early termination rights.

With respect to existing leases, consider:

- Auditing variable lease costs, such as operating expenses and insurance premium.
- Reviewing the assignment and sublet provisions and be properly prepared for this exit strategy.
- Discussing your renewal terms in advance with landlords and assessing openness for introducing new terms and conditions and rent rates.

Advice From Fasken Legal Professionals

What should you do?

- Landlords and tenants must be creative in structuring commercial leases that are suitable for both parties.
- As a landlord, keep in mind that you must obtain sufficient security from tenants to guarantee any financial hardships they may encounter in a difficult economic climate.
- The tenant, on the other hand, should maintain enough flexibility to allow it to refinance its operations.

Commercial leases generally represent the second largest expenditure after payroll. It is therefore essential to work with professionals who will take the time to review your lease contracts and optimize them.

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Is it essential to protect your intellectual property during this period?

Businesses have to juggle countless expenses and cutting those related to intellectual property (IP) assets may seem like a simple solution. But is this a good idea?

Your IP assets deserve to be protected. Whether they are inventions, products, software, logos, slogans, designs or processes, they all add value to your business. In times of economic fluctuations, IP is vital to your company's economic well-being.

Advice From Fasken Legal Professionals

What should you do?

- Conduct an audit of your IP asset portfolio to identify assets that add significant value to your business and those that are no longer relevant.
- Assess which assets should be protected in light of applicable rules.
- Determine which assets can generate additional income (licensing) or be used as financial collateral. An up-to-date IP portfolio also makes it easier to finance your business and any transactions that could add value to it.
- Reassess your IP holding structure to ensure that these assets are protected.
- Assess the company's dependence on third-party IP and take steps to ensure continued use, even if the third party faces significant financial issues.

Your intellectual property could be critical to achieving your goals in times of crisis. Throughout economic fluctuations, IP assets tend to retain and create value because, by innovating, you can capture new market shares. Talk to your legal professionals.

Any questions?

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07.

How do you build labour and employment relations during a hiring freeze?

Teleworking, hybrid work, labour shortages, remote onboarding, the “great resignation,” “ghosting” and a new work pace—organizations are facing many challenges as they move toward the “new normal” in a post-pandemic world. Businesses are racing against the clock to adapt to this new work reality while trying to stand out and attract the few candidates available in a competitive job market.

Impacts on Your Human Resources Strategy

- Despite the severe labour shortage that employers are currently facing, a number of layoffs are to be expected as many businesses have already announced hiring freezes to prepare for an unstable economic environment over the next 12 months.
- For most companies, the coming months will see a focus on minimizing costs, especially salaries, to ensure the financial well-being of the business.

Advice From Fasken Legal Professionals

What strategies should you adopt?

Set your short- and long-term goals. An HR strategy drawn up during a time of economic fluctuations must preserve the balance between maintaining quality services and keeping the company competitive amid staff reductions or hiring freezes.

Layoffs

- Assess the possibility of temporary or permanent layoffs. Depending on the number of people affected, there may be additional requirements in the context of a mass layoff. In any event, it would be wise to foresee the necessary documents.
- Assess your contractual obligations in the event of a layoff to minimize the litigation that could arise. Updating employment contracts could be a good tool to prevent potential disputes.

Temporary or Fixed-Term Labour

- Consider hiring employees on a temporary or fixed-term contract basis. In such cases, a document reflecting the term of the employment would be an asset.

Subcontracting

- Assess the possibility of outsourcing certain tasks. This will allow you to limit your fixed costs and better manage the changes in demand. A formal service agreement will help define the obligations of each party. Note that if your workers are union members, the collective agreement may limit your ability to subcontract.

Reopening a Collective Agreement

- If your workplace is unionized and you need to reduce salaries or other monetary benefits, verify whether your union would be willing to reopen the collective agreement and allow you to maintain the pace of business so as to weather this period of economic fluctuations.

Mobilizing Resources

- Retain your high-performing employees with incentives (monetary or non-monetary) to prevent losing your most valuable assets.
- Assess the possibility of increasing teleworking to reduce rental space, if applicable. Be sure to carefully draft remote work agreements, as they must be discretionary and temporary, should you want to bring employees back to the office in the future.

New Talent

- Take advantage of the weakened position of certain companies to solicit new talent. But be careful what you promise to new recruits!

These strategies will help you make informed decisions in financially difficult times. Your legal advisers can help you develop your strategy and prepare the necessary documents.

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