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THE LETTER OF INTENT: BEYOND THE WORDS, THE INTENT AND CONDUCT OF THE PARTIES

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A letter of intent often constitutes the first document that the parties sign in view of entering into a Business transaction. Its appeal lies in the fact that, in general, it does not constitute an official and final undertaking to enter into the contemplated transaction. However, the Ontario Court of Appeal recently ruled, in the case of *Wallace v. Allen* (2009 ONCA 36) that the wording of a letter of intent, as well as the intent and conduct of the parties may render a letter of intent binding on them.

THE FACTS

In August 2004, Mr. Allen (the "Seller") notified his neighbour, Mr. Wallace (the "Purchaser") that he intended to sell his Business (the "Business"). On September 24, 2004, after several weeks of negotiations, the parties signed a document entitled "letter of intent for the share purchase and the sale of the following companies […]". The parties acknowledged that the essential elements of the transaction were settled on the day the letter was signed and were contained in the agreement.

From September 27, 2004, the Purchaser visited the Business on a daily basis to familiarize himself with its operations, as well as to get to know its clients and the employees so as to ensure a seamless transition following the upcoming change of ownership.

On December 6, 2004, the Purchaser sent to the Seller a first draft share purchase/sale agreement, the negotiation of which was to be completed within 3 days. The parties agreed to formally enter into the transaction on December 29, 2004.

Up to that date, the Seller prepared the closing. He came to sign all the documents on the agreed upon date. However, the Purchaser ▸

neither attended nor signed any transaction document in advance. The Seller declared that the transaction was void and refused to close the transaction or to fix a new closing date.

THE DECISION

The Purchaser instituted proceedings against the Seller, seeking to have the Court declare him the owner of the Business. The trial judge dismissed his action, concluding that the letter of intent did not bind the parties to enter into the transaction.

The Ontario Court of Appeal, however, set aside the decision of the Superior Court and granted damages to the Purchaser. The Court of Appeal was of the view that the letter of intent that the parties had signed, read as a whole, clearly demonstrated their intent to be bound, as it contained words and expressions such as "this agreement", "it is agreed", "upon acceptance". In addition, the Court of Appeal considered that the conduct of the parties following the signature of the letter of intent showed the intent of the parties to be bound: the Seller had already announced the sale of the Business to his associates and had introduced the Purchaser as the new owner. However, the Court of Appeal was of the view that it could not force the sale since (i) the transaction did not in itself represent a unique opportunity for the Purchaser (the Purchaser was experienced in the purchase and sale of Businesses); and (ii) a 4-year period had passed since the last negotiations, which was too long to grant this order. The Court concluded that granting damages to the Purchaser was the appropriate remedy in the circumstances.

CONCLUSION

Despite the fact that this decision was rendered outside of Quebec and that it is not strictly applicable under Quebec law, it illustrates that the scope of the words and the conduct of the parties may result in significant legal consequences.

When drafting a letter of intent, it is important to specify whether the parties will be bound to enter into the contemplated transaction. The careless use of words and concepts related to such undertaking could also be interpreted as implicitly creating such binding effect.

In addition, even if the letter of intent provides that the parties do not intend to immediately undertake to enter into the transaction, the parties nonetheless have the obligation of negotiating in good faith. Furthermore, they could potentially be bound to enter into the transaction if it is possible to infer from their conduct a clear intent to do so.

In all cases, in order to avoid an unwanted result, do not hesitate to consult the legal counsel of the party you represent. ◄

MODIFYING A TRUST DEED: IT IS NOT SO SIMPLE!

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Drafting a trust deed is not to be taken lightly. A trust deed is a document that evidences the creation of a trust and establishes the rights, the powers and the obligations of the trustees who are responsible for managing the trust property, as well as those of the beneficiaries, who are entitled to the income and the capital of the trust. The provisions of the deed will guide the parties for the duration of the trust, which may represent a more or less lenghty period of time, as the case may be.

The Civil Code does not contain provisions that expressly authorize the persons involved with the trust to modify its terms. However, it contains an article which allows the courts to do so. Most authors are of the view that a trust deed is not a simple contract which may be modified at any time by consent of the parties.

Even if one accepts that the parties could modify a trust deed without petitioning the court, certain limits must be taken into consideration. First, it must be ascertained whether the document constituting the trust contains provisions which would allow one or more parties to modify the trust and, if such is the case, what changes are allowed. Proper drafting of the trust deed is essential.

Under the current state of the law, in the absence of provisions in the constituting document that expressly allow the parties to modify it, it is doubtful that the changes subsequently made by the parties would be recognized as valid by the courts.

If the deed contains provisions allowing the trustees to unilaterally amend it, the trustees should be prudent in view of the contradictory opinions as to the validity of such provisions. The trustees should only make changes that are consistent with carrying out the objectives of the trust. Otherwise, they open the door to contestations by the beneficiaries. In order to reduce the risk, trustees should try to obtain the consent of the beneficiaries to the proposed changes. Obtaining this consent may however be difficult and even impossible when there are numerous beneficiaries or when certain beneficiaries who are not as yet of legal age or not as yet conceived are designated in the deed.

Section 1294 of the *Civil Code of Quebec* provides that "Where the trust continues to meet the intent of the settlor but new measures would allow a more faithful compliance with his intent or favour the fulfilment of the trust, the court may amend the provisions of the constituting act". The court seized with an application for making changes must therefore ensure that those elements are present before consenting to a change. If the settlor of the trust is alive and can testify on his intent when he created the trust, the court will probably consider it. However it is not certain that this will be the determining factor in all cases.

For instance, if a trust is constituted by Mrs. Scott for the benefit of her grandchildren Paul and Mary and, after the trust is constituted, a third grandchild, Alexander, is born, Mrs. Scott may want to petition the court to change the trust deed to include Alexander as a beneficiary of the trust. In light of actual case law, it is not certain that the court would grant the request. To the contrary, the court may seek to protect the interests of Paul and Mary and refuse to add a beneficiary. This situation could be avoided by properly drafting the trust deed and describing the trust beneficiaries as "all the grandchildren of Mrs. Scott".

Therefore, be vigilant when advising a client on the drafting of a trust deed... there is no room for mistakes! ◄

MAXIMIZING THE USE OF POST-MERGER LOSSES

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The reorganization of affiliates may be undertaken for various business or tax reasons or for reasons pertaining to the business in itself. However, the procedure used to reach the desired result may have divergent tax consequences although the final result may appear to be the same.

The *Income Tax Act* (Canada) ("ITA") provides for certain restrictions when using losses of merging corporations. Generally, it allows carrying forward losses incurred for taxations years ended prior to the merger to subsequent taxation years of the merged corporation.

Conversely, losses incurred by the merged corporation generally cannot be carried back to the taxation years of the merged corporations prior to the merger.

However, the ITA provides for an exception in this respect in the context of a vertical merger, that is, the merger of a parent corporation and one or several of its wholly-owned subsidiaries. At the time of a vertical merger, the losses incurred by the merged corporation may be carried back to the taxation years of the parent corporation ended prior to the merger.

In order to illustrate the issues that may result from differing fact patterns, let us look at the following example. Corporations A and B were wholly-owned by Mr. X and each their respective end of taxation years was December 31. Mr. X wished to merge corporation A and corporation B to simplify the corporate structure of his business. Corporation A and B thus merged on January 1, 2009. The merger resulted in a deemed taxation year end on December 31, 2008 for each of Corporations A and B and a new taxation year began on January 1, 2009 for the merged corporation (the "AB corporation").

The AB corporation incurred losses in 2009, which cannot be carried back against the income earned by Corporations A or B during the taxation year ended on December 31, 2008 since this merger was horizontal (two corporations held by the same shareholder).

In order to carry back the losses, Mr. X should have effected a tax-free transfer of all of his shares in A Corporation to B Corporation or vice-versa prior to carrying out the merger of these two corporations. Following the transfer, Corporations A and B would have merged on January 1, 2009 (vertical merger).

This procedure would have allowed carrying back the losses incurred by the AB corporation during its taxation year ended on December 31, 2009 against the income earned by the parent corporation for the taxation year ended prior to the merger, depending on the chosen scenario.

Always keep in mind that although all roads lead to Rome, one must know the best one to use. ◄

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