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WHAT HAPPENS WHEN A CONTRACT DOES NOT REFLECT WHAT WAS AGREED UPON BETWEEN THE PARTIES?

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ON OCTOBER 28, 2011, THE QUEBEC COURT OF APPEAL UPHELD A JUDGMENT OF THE SUPERIOR COURT[1] ALLOWING FOR CLAUSES OF A LOAN AGREEMENT TO BE MODIFIED BY THE COURT SO AS TO REFLECT THE COMMON INTENTION OF THE PARTIES AFTER IT WAS PROVED THAT THERE WAS A DISCREPANCY BETWEEN THE REAL INTENTION OF THE PARTIES, AS STATED IN A LETTER OF INTENT, AND THE WORDING OF THE DOCUMENT DRAWN UP TO IMPLEMENT THE LETTER OF INTENT, NAMELY A LOAN AGREEMENT.[2] THE COURT THEREFORE REFUSED TO GIVE EFFECT TO A CLAUSE IN THE LOAN AGREEMENT THAT CONTAINED A SIGNIFICANT ERROR THAT WOULD HAVE RESULTED IN MATERIAL FINANCIAL CONSEQUENCES FOR THE BORROWER.

THE FACTS

The appellant, IHAG-HOLDING AG ("IHAG"), is a holding company that operated, through its wholly-owned subsidiary, Mont Sainte-Marie (1994) Inc. ("MSM"), a resort in the Gatineau region, including a ski centre, a golf course and a hotel known as Mont Ste-Marie. In 1995, with MSM having been in the red for several years despite major investments, IHAG began looking for a possible purchaser.

After several attempts, a letter of intent was finally signed on October 21, 1996, between IHAG and Intrawest Corporation ("Intrawest"). This letter provided for the sale of all of the shares that IHAG held in MSM.

As the financial situation of the resort was precarious at the time, it was difficult for the parties to come to an agreement on the real value of MSM. The transaction was thus structured in such manner as to provide for a cash payment as well as the assumption by the purchaser of a portion of MSM's liabilities. Included in such liabilities were significant amounts advanced by its sole shareholder, IHAG, in the form of a demand loan. Concurrently with the sale of the shares, the parties agreed to amend the terms of the loan, which was converted into a term loan repayable in installments. The amount of these installments was determined by a formula which considered mainly the operating results for MSM's first four years.

Under this formula, any earnings before interest, tax, depreciation and amortization ("EBITDA") generated by MSM in excess of $500,000 annually over a period of four years were payable to IHAG, the whole multiplied by a factor of 4.8. In other words, if MSM generated a cumulative EBITDA in excess of $2,000,000 over a period of four years, Intrawest would have to pay such excess increased by a multiplier of 4.8. Mathematically, this could be represented as: 4.8 x (cumulative EBITDA - $2,000,000).

[1] *Ihag-Holding, a.g.* v. *Intrawest Corporation*, 2009 QCCS 2699 (S.C.).

[2] *Ihag-Holding, a.g.* v. *Corporation Intrawest*, 2011 QCCA 1986 (C.A.).

Pursuant to the letter of intent executed by the parties, Intrawest asked its lawyer to draft an agreement called the "Term Loan Agreement" (the "**Loan Agreement**"). Several versions of the draft Loan Agreement were circulated between Intrawest and its lawyer over a short period of time. While the first versions that were circulated included the formula agreed upon in the letter of intent,[3] the version ultimately sent to IHAG had been unilaterally and unintentionally amended by Intrawest's lawyer with the aim, according to her own testimony, of simplifying the verbiage of certain definitions.[4] This amendment to the Loan Agreement had the result of modifying the formula in such a way that the amount payable was no longer 4.8 times the amount of the EBITDA in excess of $2,000,000, but rather 4.8 times the EBITDA, less $2,000,000. Mathematically, this could be represented as: (4.8 x cumulative EBITDA) - $2,000,000.

In all, six versions were exchanged before the signature of the final version on January 29, 1997, with the error going unnoticed.

The confusion concerning the definitions had unfortunate consequences for Intrawest. Indeed, in April 2003, at the end of the four-year period, a literal application of the clause as drafted in the Loan Agreement called on Intrawest to pay IHAG an amount of $6,203,632, while the clause as drafted in the letter of intent did not call for any additional payment by Intrawest. However, IHAG, basing itself on the Loan Agreement, claimed the amount of $6,203,632 from Intrawest under the pretext that it was not an error but rather the real intention of the parties.[5]

[3] The first version read as follows:
" "**Net Resort EBITDA**" means, in respect of the Resort Operation Payment Calculation Period, the amount, if any, by which EBITDA during the Resort Operation Payment Period exceeds the aggregate of:
(a) $2,000,000; [...]
"**Resort Operation Payment Amount**" means the amount, if any, equal to 4.8 EBITDA during the Resort Operation Payment Calculation Period; "

[4] The erroneously modified version read as follows:
" "**Net Resort EBITDA**" means in respect of the Resort Operation Payment Calculation Period, the amount, if any, by which EBITDA in respect of the Resort Operation Payment Calculation exceeds the aggregate of:
(a) ~~$2,000,000;~~ [...]
"**Resort Operation Payment Amount**" means the amount, if any, equal to ~~4.8~~ the amount by which (a) 4.8 times Net Resort EBITDA during the Resort Operation Payment Calculation Period exceeds (b) $2,000,000; " [our underlining]

[5] It should be noted that the professional liability of the drafting lawyer does not seem to have been raised in any way in this case. See in particular: 2009 QCCS 2699 (S.C.), paras 93 and 101.

THE COURT OF APPEAL'S JUDGMENT

The first issue raised before the Court was whether the "Complete Agreement" clause contained in the Loan Agreement could be an obstacle to the determination of the common intention of the parties. In this instance, this clause was drawn up as follows:

> "Complete Agreement. There are no representations, warranties, covenants or agreements between the parties in connection with the subject matter hereof other than those expressed herein."

The Court of Appeal did not intervene with respect to the trial judge's conclusions. In this regard, it wrote:

> [Translation]
>
> "The judge concluded that, in the search for the common intention of the parties, the Complete Agreement clause could be put aside. In his opinion, although a clear contract is assumed to reflect the intention of the parties, if it is possible to legally put into evidence elements that give one reason to believe that it does not respect the intention of the parties, article 1425 C.C.Q. applies.
>
> The trial judge also felt that the rules of good faith constituted an additional reason for not applying the Complete Agreement clause.
>
> According to the judge, a contract should not become a tool for oppressing one of the parties. He felt that no Complete Agreement clause could allow one to set aside the rules of good faith because it is an implicit and imperative obligation in every contract."

As for whether the Loan Agreement contained a significant error, the Court of Appeal also upheld the decision of the trial judge who stated that he was of the opinion that there was a significant error:

> [Translation]
>
> "First, the appellant never re-examined the calculation of the ROPA in the LOI, or even discussed or commented on the first two versions of the contract concerning this subject. The only remarks concerned the number of years considered for calculation purposes and the inclusion of additional costs in the calculation of the EBITDA. In short, the evidence shows that the change was not noticed by any party.

> The judge also concluded that this would lead to an unreasonable transaction; by adding the 6.2 million dollars claimed to the 3.2 million dollars already paid in the context of the transaction, the multiple of the EBITDA would be in the order of 11, which constitutes an abnormal result for this kind of transaction."

The Court of Appeal said that it was even more convinced of the error when it considered the context of the sale, that is a quick sale due to the unprofitability of MSM, and confirmed that the error was excusable:

> "In the opinion of the judge, he could determine whether that constituted an excusable error. In this respect, he stated that the error was difficult to find. Even the grammatical change did not make the error obvious unless one did the mathematical calculation that it described. Therefore, one cannot say that there was gross or inexcusable negligence.
>
> According to the judge, even if the LOI is not a binding document, there is cause to draw inspiration from it to correct the error because the evidence shows that it was essentially that document that led to the contract."

In light of the cases *Québec (Sous-ministre du Revenu)* v. *Services environnementaux AES inc.*,[6] *Riopel* v. *Agence de revenu du Canada*[7] and *Sobeys Québec inc.* v. *Coopérative des consommateurs de Ste-Foy*,[8] the Court of Appeal concluded as follows:

> [Translation]
>
> "In light of the principles set out in the Sobey's, Services environnementaux AES and Riopel cases, the trial judge was right to search for the common intention of the parties, considering the discrepancies between the LOI and the Loan Agreement.
>
> It must be emphasized that the file contained a commencement of proof in writing making it possible to present testimonial evidence.
>
> Furthermore, the Complete Agreement clause could not interfere with the determination of the common intention of the parties.
>
> Therefore, what is decisive is the judge's conclusion according to which the evidence clearly established that there was a discrepancy between the negotium, the LOI, and the *instrumentum*, the Loan Agreement."

COMMENTS

This case serves as a reminder to lawyers and their clients that it is of capital importance to draft financial clauses contained in a loan agreement in the clearest fashion possible, and with an understanding of the practical consequences of their application.

This decision of the Court of Appeal teaches us that when a contract must be interpreted, the courts will be more inclined to search for the common intention of the parties than to focus on the literal meaning of the words used. Thus, the courts will correct excusable errors in certain circumstances.

However, it also serves as a reminder of the importance of the documents that precede the contract in the context of commercial negotiations because anyone who wishes, in the end, to contradict the terms of an agreement recorded in writing must establish that a commencement of proof supports its allegations; otherwise, the very stability of contracts (as a societal tool) would be affected. In this instance, the documents that preceded the contract (i.e. the previous versions of the Loan Agreement) were very useful in establishing that a commencement of proof had occurred. Even if it is possible to do so by means of testimony,[9] establishing a commencement of proof without these documents would have been substantially more difficult

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[6] J.E. 2011-470 (C.A.); leave to appeal to the Supreme Court filed by the Deputy Minister of Revenue of Quebec, May 5, 2011, no. 34235.

[7] J.E. 2011-957 (C.A.); leave to appeal to the Supreme Court filed by the Deputy Minister of Revenue of Quebec, August 18, 2011, no. 34393.

[8] 2005 QCCA 1172 (C.A.).

[9] *Civil Code of Québec*, art. 2865. See in particular: *Banque Nationale du Canada* v. *Buffone*, J.E. 95-83 (S.C.).

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