Real Estate in Your Daily Practice

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Companies whose primary business is real estate are not the only ones to invest in property. A large number of businesses must invest in real estate in support of their operations, whether it be in the hotel industry, transportation, communications, resources processing or retailing. In fact, nearly all industries need to invest, to varying degrees, in real estate assets. While in some cases the real estate is only required to meet a business's basic need to house its employees, for many others it is an investment strategy that is integral to their business plan, and which is intended to contribute to their profitability.

The McDonald's restaurant chain is a good example of a business that places real estate at the heart of its business strategy. More than 50 years ago, when the company was struggling to establish itself in the marketplace, its senior management decided that the company would invest in the sites of its future restaurants and rent them to its franchisees at a profit. This business model still exists today, leading numerous observers to say that McDonald's is just as much in the business of real estate as it is in fast food.

It is therefore not surprising to note that real estate law is an important area of practice for in-house corporate counsel, whatever the main business of their employer may be. As real estate transactions become increasingly complex, it is important for corporate counsel to see how the courts interpret or apply some of the contracts required to conclude such transactions.

In this text, while we are describing recent developments in Québec real estate case law, the lessons that can be learned from the judgments we have summarized are not unique to Québec and may be of interest to corporate counsel in other Canadian provinces.

RIGHT OF FIRST REFUSAL

A right of first refusal allows a tenant to maintain its presence in a quality location by becoming the owner of the leased property. This right therefore enables the tenant to minimize the risks associated with a sale of the property to a third party, the loss of the site on the expiry of the lease, or the acquisition of the site by a competitor. In a recent case[1] in which a large food chain was the tenant of a property and the beneficiary of a right of first refusal, the Court of Appeal found that the tenant's right of first refusal did not apply in all circumstances.

The relevant clause in the lease read in part as follows:

> "If, during the Term of the Lease, the Landlord wishes to sell, assign or otherwise alienate the Leased Premises, or if the Landlord receives a *bona fide* and acceptable offer to purchase, assign or otherwise alienate the Leased Premises or any part thereof, the Landlord shall then give the Tenant notice (…). The Tenant shall have a right of first refusal in priority to any such proposed purchaser (…)." [translation]

The landlord sold the property without first offering it to the tenant, and the tenant claimed damages from the landlord and the purchaser. The court did not question the drafting of the clause, but considered the circumstances of the sale of the property, which were, admittedly, unusual. The property was sold by the landlord to a corporation held by one of the landlord's two shareholders. This sale occurred in the context of a global division of the assets owned in equal shares by the landlord's two shareholders, which they had received as an inheritance from their deceased parents. The sale of the property by the landlord to a company held by one of the landlord's two shareholders was therefore part of a global transaction concluded after lengthy negotiations by the heirs to end the deadlock caused by their disagreement over the pursuit of the landlord's business.

For the court, an offer to purchase submitted by a genuine third party would have been the triggering factor required to give effect to the right of first refusal. The clause did not apply because no offer to purchase was made by a third party and the transfer of the property by the landlord was not the result of the landlord's wishes to sell or take advantage of a business opportunity, but rather, to resolve a deadlock created by the conflict between its two shareholders.

If a lesson is to be learned from this judgment, it is that despite the fact that concision in contract drafting is a good thing, it may be advisable, for greater clarity, to expand a clause

even if it seems like stating the obvious. Here, for example, the result may have been different if the clause had specified that the application of the right of first refusal was mandatory in the case of any sale, assignment or alienation to any person regardless of its relationship to the landlord and regardless of the circumstances.

CONTRACTUAL LIMITATION PERIODS

In real estate transactions, the parties to a contract will often set the maximum period within which a party may exercise a right under certain provisions of the contract. Some examples of this are: (i) the claim by a tenant seeking a revision or reimbursement of certain operating expenses paid under a commercial lease, (ii) the claim by the purchaser of a property where it believes that the vendor made false or misleading representations at the time of the sale, or (iii) the time period within which a building contractor may make a claim against the client for extras.

In another recent case,[2] the Court of Appeal considered the situation of a contractor who made a monetary claim against the client under a construction contract that provided for a strict claims procedure. Pursuant to this procedure, any claim by the contractor had to be received by the client no later than 120 days following the delivery of the work. The contractor admitted from the outset that it had not followed this claims procedure, but alleged that this contractual limitation was inoperative because a party to a contract cannot impose a limitation period other than that provided by law.[3]

After reviewing submissions by the parties, the Court of Appeal concluded that the contractual procedure, as drafted and interpreted together with the other provisions of the contract, merely established a condition precedent to the existence and validity of the right to make a claim. In other words, the contractor had no right to make a claim against the client unless it did so in a certain manner and within a certain time period provided for in the contract. If the contractor's claim had met these conditions, and the client had rejected the claim, the contractor could still have instituted legal proceedings following the refusal. In such a case, the contractor's action would have been subject to the time limit of three years provided by law to institute legal proceedings. Since the claim did not meet the conditions precedent of the contract, the contractor's right to a price adjustment was non-existent and the claim was rightfully rejected by the client.

This judgment clearly illustrates how the drafting of a claims procedure can be critical to its validity. Any contractual provision that states that no recourse may be brought before the courts within a shorter contractual time period than that provided by law must be avoided.

REAL GUARANTEE

In real estate financing transactions, the taking of collateral security is critically important. Lenders will often resort to a personal guarantee by which a person other than the principal debtor undertakes to repay the debt in the event of the debtor's default.

A real guarantee is similar to a personal guarantee except that, contrary to the personal guarantor, the real guarantor is not personally liable for the performance of the principal debtor's obligations. The real guarantor only mortgages its real property to secure the debtor's obligations to the lender. The mortgage granted by the real guarantor does not secure the performance of the real guarantor's obligations since the real guarantor is not personally responsible to repay the debt.

Given the similarities between these two types of security, for many years, there was doubt over the legal nature of the real guarantee: is it a guarantee governed by the rules of the Civil Code applying to suretyship, or is it in fact another form of legal transaction governed by the rules applying to mortgages? The Court of Appeal considered this issue[4] and resolved the debate, opting for the second theory, namely, that the real guarantee is governed by the rules that apply to mortgages, not those that apply to personal guarantees.

This ruling has three positive consequences for lenders: firstly, there is no doubt over the validity of a mortgage granted by a real guarantor, even if the guarantor does not personally undertake to repay the loan; secondly, since a personal guarantor benefits from certain rights and defences provided for by law, there may be an advantage for a lender who wishes to obtain a mortgage on the guarantor's property to ensure that the guarantor does not give an undertaking as a personal guarantor so that it will not benefit from those rights and defences; and thirdly, nothing prevents the lender from requiring both a personal guarantee and a real guarantee from the same person in order to maximize its rights and recourses in case of default by the debtor.

Of course, as always, the intent of the parties must be clearly expressed to prevent a real guarantee from being construed as a personal guarantee, in order to avoid giving the guarantor rights and defences that it would not otherwise have.

THE ENTIRE AGREEMENT/COMPLETE AGREEMENT CLAUSE

The "entire agreement clause" commonly found in commercial contracts is designed to prevent parties who have entered into a final contract from relying on previous discussions or agreements to give a different meaning to the terms of the contract they have signed. The reason for such a clause is simple: since the contract is supposed to reflect the parties' final agreement regarding their rights and obligations and therefore their true intention, it would be unwise to allow the parties to refer back to discussions or agreements from before the contract was signed.

The courts generally give effect to such clauses. However, when a literal reading of a contract leads to an absurd or unfair result, the courts will agree that the clause is ambiguous and requires interpretation. In such circumstances, the courts will disregard the clause and search for the parties' true intention. However, the Court of Appeal reminds us that: [translation] "Just because the parties have a different view as to how a clause should be interpreted does not mean it is ambiguous".

Below are three different cases in which the Court of Appeal set aside the "entire agreement clause" and relied on previous discussions, negotiations or documents to determine the parties' true intention.

THE NEGOTIATIONS AS EVIDENCE OF THE PARTIES' TRUE INTENTION

An ambiguous clause may be clarified by referring to the negotiations which preceded it, even if the contract has an entire agreement clause. This is what the Court of Appeal held with respect to an exclusivity clause in favour of Indigo.[5] Under

that clause found in a lease with Indigo, the lessor agreed not to rent space in the same commercial complex "to any tenant whose principal use is the sale of books".

As soon as it began negotiating with Indigo, the lessor informed Indigo that it was also negotiating with Archambault Group, whose business is primarily focused on music, but with an increasing number of book sales. The lessor ended up accepting Indigo's offer to lease. Three years later, the lessor developed a new phase of its commercial complex and planned to lease space to Archambault. Indigo viewed this as a breach of its exclusivity clause.

The dispute essentially revolved around the meaning to be given to the expression "principal use" found in the exclusivity clause. As the trial judge pointed out, the notion of "principal use" can be evaluated in different ways: should it be based on a percentage of sales, on a percentage of inventory or profits, or all of the above? What percentage should then be used?

Faced with an ambiguous clause, the court turned to two sources to help it determine the true scope of the exclusivity given to Indigo: (A) firstly, the negotiations between Indigo and the lessor clearly showed that Indigo had always maintained that it would not agree to sign a lease if Archambault also leased space in the commercial complex; despite the various incentives proposed by the lessor to induce Indigo to accept an Archambault store (rent reduction, distance between the two businesses, restriction on Archambault's sales), Indigo had categorically refused; (B) secondly, the offer to lease entered into three years later between the lessor and Archambault clearly showed that the lessor knew very well that Archambault was a competitor of Indigo. The offer provided that Archambault would limit its income from the sale of books and its inventory of books to 25 per cent. If the lessor felt it necessary to include such a restriction in the offer to lease with Archambault, it was because it considered Archambault to be a competitor of Indigo.

THE LETTER OF INTENT AS EVIDENCE OF THE PARTIES' TRUE INTENTION

In *IHAG-Holding AG v. Intrawest Corporation*,[6] the Court of Appeal set aside the entire agreement clause in a final agreement and referred to a prior letter of intent, which was not binding on the parties, to determine the method for calculating a purchase price.

The facts in that case can be summarized as follows. A letter of intent, which was not binding on the parties, set out an elaborate formula for calculating the purchase price of a sports complex. The final agreement signed by the parties reproduced the formula but with a typo that made the $6.2-million purchase price higher than it would have been if the formula in the letter of intent had been reproduced in full. The typo, which the parties had not noticed, was only discovered when the earn-out payment was made. The vendor therefore argued that the formula for determining the purchase price contained in the deed of sale ought to apply, since it was clearly more favourable to it, and relied on the entire agreement clause to exclude the formula contained in the letter of intent, which was less advantageous to it.

The Superior Court decided to disregard the formula for calculating the purchase price set out in the final contract signed by the parties and apply the formula contained in the prior letter of intent, which was not binding on the parties. The court came to the conclusion, which was affirmed by the Court of Appeal, that it was justified to disregard the entire agreement clause and, consequently, refer back to a previous agreement when it was clear that a party was attempting to take advantage of the entire agreement clause to profit from an error. The application of an entire agreement clause cannot have the effect of setting aside the good faith obligation by which the parties are bound.

With respect to the letter of intent, although it was not binding on the parties, the Court held that it could be applied because it represented what the parties had actually agreed upon with respect to the purchase price formula.

ABSURD AND UNFAIR RESULTS WILL PREVENT A LITERAL INTERPRETATION

An option to renew or terminate a lease generally provides for the mechanism that is necessary to exercise the option. Is the failure to comply with that mechanism fatal to the exercise of the right? If the clause does not specify that meeting the conditions is necessary to validly exercise the option, the option will be interpreted in favour of the person exercising the option, even if he has not scrupulously complied with the conditions for exercising it.

In *World Color Press Inc. v. Édifice 800 Industriel Inc.*,[7] the court had to determine whether the lessee had validly exercised a lease termination option, which provided that the lessee's right had to be exercised by no later than March 31, 2011, for termination on March 31, 2012, together with the payment of a $1-million penalty by no later than March 31, 2011, in [translation] "full and final payment of all the lessee's obligations under the Lease". The lessee sent the notice on March 30, 2011. It stated that a cheque in the amount of $1 million was attached to the notice, but no cheque was attached. Noticing its oversight, the lessee sent the cheque on April 8, 2011, but the lessor returned it, claiming that the option had not been validly exercised and that the lease would continue until March 31, 2017, the date the initial term expired.

In fact, the termination clause was reproduced upon each renewal. Only the dates and the amount of the penalty were changed. However, according to the lessor, at the time of the last renewal, the parties had wanted to ensure that the payment of the penalty coincided with the notice of exercise of the option. On the other hand, the lessee pleaded the entire agreement clause to exclude the discussions surrounding the changes made to the last version of the termination option.

Two issues were raised: was the failure to pay the penalty by the specified date fatal to the exercise of the termination option and, if not, did the penalty serve as the payment of the rent until the end of the term in 2012, since the penalty represented "full and final payment of all the lessee's obligations under the Lease".

The court held that the termination option was validly exercised by the lessee, but that it still had to pay the rent until the end of the term in 2012.

Here again, the court found that the entire agreement clause was inoperative in the circumstances and that it did not prevent the court from seeking to determine the parties' true intention since, on the one hand, the termination option clause was incomplete and, on the other hand, a literal application

of the clause would have led to an absurd result from a business perspective.

The termination option clause was incomplete because it did not specify whether or not time was of the essence. The court found that the parties never discussed this issue and, therefore, that time was not of the essence and the termination option had been validly exercised by the lessee. With respect to the penalty, the court held that it should not be considered as rent paid in advance, otherwise the notion of penalty would lose all its meaning. As a result, the lessee had to pay the rent until the end of the term in 2012 despite the words "full and final payment of all the lessee's obligations under the Lease", which could be given their full meaning under the previous versions of the termination option when the penalty was payable at the end of the term, but which led to an absurd result if the penalty was payable one year before the end of the term as in this case.

These decisions show the importance of negotiating and entering into clear agreements, particularly with respect to operative provisions relating to a specific procedure, such as the conditions for the exercise of a right, a calculation formula or a list of exclusions which are needed to determine the unambiguous intent of the parties. While the "entire agreement clause" may clearly indicate that "*this Agreement contains the entire understanding of the parties relating to the subject matter of this Agreement and supersedes all prior written or oral and all contemporaneous oral agreements and understandings relating to the subject matter of this Agreement,*" the court may find the entire agreement clause to be inoperative and use the pre-contract negotiations, discussions or ancillary documents to clarify the agreement and not to contradict it. ■

1. *Placements Suclo ltée v. Métro Richelieu inc*, 2012 QCCA 1929
2. *Construction Infrabec inc. v. Paul Savard, entrepreneur électricien*, 2012 QCCA 2304
3. Article 2884 of the *Civil Code of Québec*
4. *Roker v. Prêt Relais Capital Inc.*, 2012 QCCA 1295
5. *Immeubles Régime XV Inc. v. Indigo Books & Music Inc.*, 2012 QCCA 239
6. *IHAG-Holding AG v. Intrawest Corporation*, 2011 QCCA 1986
7. *World Color Press Inc. v. Edifice 800 Industriel Inc.*, 2012 QCCS 1774