



## LITIGATION



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### **A Defining Mistake: The Importance of Accurate Drafting in All Commercial Documents**

**In this article, *Commercial Litigation Review* shifts our focus to a recent decision of the Quebec Superior Court. All counsel must remind**

**themselves constantly of the importance of precise drafting and that precision must extend both to the contract and to pre-contractual documents. Mr. Sandeep Joshi carefully analyses the legal interpretation of the Superior Court's decision (which is under appeal) and concludes with six precise guiding principles which are useful in everyday practice.**

In its recent decision in *IHAG-Holding AG v. Intrawest Corporation*,<sup>1</sup> the Quebec Superior Court reaffirmed the importance of proper and careful drafting in all commercial documents, including pre-contractual documents. While the case itself involved somewhat complicated and unusual facts, the underlying principles are of general application and serve as a useful reminder to counsel.

#### **Background**

In the case, IHAG claimed that it was entitled, in part, to approximately \$6.2 million from Intrawest pursuant to the terms of an earnout provision in the agreement executed between the parties as part of IHAG's sale of a mountain resort property to Intrawest.

At the time of the sale negotiations, the property had incurred significant losses, its EBITDA over the past several years was essentially zero, it required substantial capital expenditure and it had failed to generate any offers from third parties as part of an auction process. To allay IHAG's concern regarding the purchase price, Intrawest proposed an earnout provision, which was referred to as the Resort Operation Payment Amount ("ROPA"). IHAG responded to the ROPA proposal by requesting that it be amended to include an additional year, which Intrawest agreed to. As a result, Intrawest drafted and submitted a non-binding letter of intent, which included the agreed-upon ROPA provision. The parties subsequently executed the non-binding letter of intent.

Thereafter, Intrawest instructed its external legal counsel to prepare a draft agreement on the basis of the non-binding letter of intent. Intrawest's counsel circulated three drafts of the agreement for internal review before circulating it to IHAG's counsel. The first two drafts of the agreement contained a series of complex definitions, one of which correctly described how the ROPA payment was to be calculated. However, in an effort to "clean up" the agreement and make it "clearer", Intrawest's external counsel inadvertently revised the ROPA definition. While all of the elements of the provision remained in the revised definition, the order of the words themselves, and their effect, was altered. Instead of defining ROPA as "the amount, if any, equal to 4.8 times the amount by which (a) Net Resort EBITDA during the Resort Operation Payment Calculation Period exceeds (b) \$2,000,000" (as it was defined in the letter of intent), ROPA was defined in the agreement as "the amount, if any, equal to the amount by which (a) 4.8 times Net Resort EBITDA during the Resort Operation Payment Calculation Period exceeds (b) \$2,000,000."

The defining mistake made by Intrawest's external counsel was to insert the words "the amount by which" before instead of after the figure "4.8 times".<sup>2</sup> The change in the ROPA definition was not noticed by Intrawest or its counsel before the document was circulated to IHAG's counsel; nor was it noticed in any of the subsequent six drafts exchanged between the parties before the agreement, which contained an entire agreement clause, was executed.

In the first four years after the sale, Intrawest earned approximately \$1.7 million in total net revenues from

the property. Nonetheless, IHAG commenced an action claiming that it was entitled to \$6.2 million on the basis of the ROPA definition in the agreement. Intrawest argued that the ROPA definition in the agreement contained a drafting error (made by its own counsel) and, therefore, it did not reflect the agreement reached by the parties. Intrawest further argued that the ROPA definition in the executed, non-binding letter of intent should be the basis upon which the ROPA payment, if any, was to be calculated.

### **The Decision**

In determining whether a ROPA payment was due, Justice Mayer first considered whether the entire agreement clause in the agreement precluded the admissibility of certain evidence, such as the history of the negotiations and the letter of intent. Although he recognized that Quebec law traditionally recognizes the validity of entire agreement clauses, Mayer J. concluded that, in the circumstances, the Court would not apply the entire agreement clause for two reasons:

1. Article 1425 of the Quebec Civil Code imposes an obligation upon the Court to seek out the common intention of the parties when interpreting a contract and provides that "all evidence of any fact relevant to a dispute is admissible and may be presented by any means."<sup>3</sup> As a result, Mayer J. concluded that he was required to look at the documentation entered into before the execution of the agreement in order to determine whether there was an error in the drafting of the agreement that defeated or contradicted what the parties intended.<sup>4</sup>
2. In the circumstances, IHAG was not acting in good faith when it sought to enforce the ROPA definition in the agreement for its benefit and to the detriment of Intrawest.

After concluding that the entire agreement clause should be set aside and not applied, Mayer J. considered whether there was a drafting error in the ROPA definition in the agreement. He concluded that there was a material drafting error in the ROPA definition in the agreement for two reasons:

1. The ROPA definition in the agreement was never discussed, commented on or negotiated during the drafting process and, therefore, it had been overlooked by all parties.<sup>5</sup>

2. Enforcing the ROPA definition in the agreement would result in an unreasonable commercial transaction because it would result in a selling price for the property that was not reasonably conceivable in the circumstances.<sup>6</sup>

After concluding that there was a drafting error in the ROPA definition, Mayer J. then considered whether the error was excusable. Although the agreement was drafted by experienced legal counsel and reviewed by other experienced professionals, Mayer J. concluded that the error was excusable because it was “a difficult error to detect in a long and complex series of definitions” and it was “not that easy to discern” the error other than by translating the words into the appropriate mathematical formulas.<sup>7</sup>

In determining the appropriate remedy, Mayer J. concluded that the most equitable solution in the circumstances was to enforce the common intention of the parties with respect to the ROPA payment and to declare the correct ROPA definition in the agreement to be the ROPA definition set out in the executed non-binding letter of intent.<sup>8</sup> Justice Mayer noted that although the letter of intent was a non-binding agreement in the sense that it did not create legal obligations, it evidenced “a meeting of the minds which [reflected] the business terms agreed to by the parties.”<sup>9</sup>

## **Analysis**

The decision reached by Mayer J. is, on the facts, an equitable result. Although the case was decided under Quebec’s Civil Code, the same decision would likely be reached by a judge applying the common law in a case of mistake, albeit by different means. The decision is therefore a useful reminder of the importance of accurate and careful drafting at each stage of a commercial transaction, including in pre-contractual documents.

### **The Parol Evidence Rule and Entire Agreement Clauses**

In *IHAG*, Mayer J. relied, in part, on article 1425 of the Quebec Civil Code to sidestep the entire agreement clause and review the history of the negotiations and letter of intent in order to determine whether there was a drafting error that defeated or contradicted the common intention of the parties.

At common law, both the parol evidence rule and entire agreement clauses are often relied upon to prevent the admission into evidence of agreements, negotiations and understandings for the purpose of varying or contradicting the express terms of a written agreement. However, neither the parol evidence rule nor an entire agreement clause will operate to prevent the admission of extrinsic evidence if there is a claim for rectification because (i) the essence of a rectification claim is that the agreement as drafted contains a mistake and, therefore, does not properly reflect the entire agreement between the parties; and (ii) extrinsic evidence is necessary to determine whether the agreement as drafted accurately records the parties’ common intention and agreement.

It is likely that at common law a judge in a similar case would be able to sidestep the parol evidence rule and entire agreement clause and consider the same evidence considered by Mayer J. in *IHAG*.

### **The Rectification Remedy**

In *IHAG*, Mayer J. concluded that the drafting error was an excusable error and, therefore, he was permitted to order the equitable remedy sought by Intrawest.

The common law incorporates the remedy of rectification, which is a narrow equitable remedy designed to remedy cases of mistake and to ensure that one party is not unjustly enriched at the expense of another.<sup>10</sup> The essence of the remedy is to correct an inaccurately drafted written agreement so that it conforms to the agreement that the parties intended to make.<sup>11</sup> It is a limited remedy and is not available to vary the intentions of the parties or to correct poor business decisions. Although there is some variation based upon the type of mistake alleged, a party seeking rectification is required to (i) establish that the contractual document contains a mistake and, therefore, does not reflect the true agreement between the parties; and (ii) lead strong, clear and convincing evidence of the actual common intention of the parties. Since rectification is an equitable remedy, it is subject to a number of equitable defences, including delay, estoppel and acquiescence.

It is likely that at common law a judge presented with a similar set of facts would engage the equitable remedy of rectification and reach the same result as Mayer J.

### Avoiding a Defining Mistake

Although Mayer J.'s decision in *IHAG* achieved a proper and equitable result in the circumstances, the decision should not be interpreted to mean that counsel should carelessly draft commercial documents on the basis that the rectification remedy will provide full protection if a problem subsequently arises. On the contrary, the decision is a useful reminder that the equitable result was achieved only because of the steps that had been taken, the most significant of which was the preparation of a properly and carefully drafted letter of intent that reflected the common intention of the parties and their agreement on a key term in the transaction. If the letter of intent did not exist at all or was not as carefully drafted as it was, it is likely that the decision could have been significantly different and, perhaps, inequitable.

The best way to avoid the ramifications of a defining mistake is to ensure that the problem does not arise in the first place. This can be achieved by ensuring that all commercial documents, including pre-contractual documents, are properly and carefully drafted. Although rectification is available to correct mistakes that do arise, it is a remedy that should be used only sparingly and then only in the clearest of cases. It therefore does not provide a full measure of protection against drafting errors. The only way to fully protect against unintended circumstances is to avoid or correct drafting errors before it is too late.

There are a number of ways in which counsel can attempt to ensure that their clients (i) avoid drafting mistakes, and (ii) successfully maintain a claim for rectification if a drafting mistake occurs:

- I. Keep it simple. Avoid long and complex definitions and provisions. If appropriate, use mathematical formulas instead of words.
2. Pay attention to the basics. Avoid treating definitions and boilerplate clauses like block quotes — draft and review them carefully.
3. Learn as much as you can about the proposed transaction and make sure that the agreement as drafted is consistent with your understanding. Ask your client to do the same.
4. Get involved in the transaction early and stay involved throughout the process.
5. Ensure that all pre-contractual documents are drafted as carefully as the actual contract. The pre-contractual documents may turn out to be more important than the final contract.
6. If a mistake is discovered, alert the other side and correct the error promptly.

Following these tips is one way to ensure that you avoid making a defining mistake and having your client deal with unnecessary litigation.

<sup>1</sup> *IHAG-Holding AG v. Intrust Corporation*, 2009 QCCS 2669. The decision is currently under appeal.

<sup>2</sup> In formulaic terms, the difference is as follows:

<u>Executed Non-Binding Letter of Intent</u>	<u>Agreement</u>
ROPA = 4.8 x (cumulative EBITDA - \$2 million)	ROPA = (4.8 x cumulative EBITDA) - \$2 million

<sup>3</sup> *Supra* note 1 at para. 133.

<sup>4</sup> *Ibid.* at para. 138.

<sup>5</sup> *Ibid.* at para. 154.

<sup>6</sup> *Ibid.* at para. 165.

<sup>7</sup> *Ibid.* at paras. 189, 190 and 192.

<sup>8</sup> *Ibid.* at para. 201.

<sup>9</sup> *Ibid.* at paras. 205, 206.

<sup>10</sup> *Royal Bank of Canada v. El-Bris Limited*, [2008] O.J. No. 3386, 92 O.R. (3d) 779 at para. 13 (C.A.).

<sup>11</sup> *Ibid.*