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Lease discussions and negotiations:

When is the marriage consummated?

Overview

A recent decision rendered by the Superior Court reminds us that a lease may be formed verbally even if the parties were unable to agree on the signing of a formal lease document. Quebec law recognizes that an exchange of consents is sufficient to create a legal obligation and a lease, because the ratification of a written agreement is, in some cases, merely a formality. Furthermore, one party may not attempt to avoid its obligations by claiming that its representative was not authorized to bind the company, if the representative appeared to be an authorized agent and the third contracting party acted in good faith, as stipulated by the principles of the Indoor Management.

In matters of lease negotiations, the completion of a transaction may take many forms. In fact, the legal commitment that binds the contracting parties does not always reside in the formal signing of a contract (offer to lease or lease). In fact, it is necessary to ask whether, in the course of verbal discussions or written exchanges between the parties, our actions may carry concrete legal implications even before a formal agreement is signed. In other words, can simple discussions and verbal exchanges create a lease?

Another interesting question is "Who has the capacity to legally bind a company?" Only a vice-president? A leasing agent?

To answer these questions briefly, we can easily state the following: we can be bound by a contract more often than we think, and there are probably a lot more people who can bind a company than we think!

In all respects, one similarity between a leasing contract and a marriage contract is that we normally consult the contract when problems arise! The comparison, however, ends there. In fact, when one is married, one is well aware of it; while in matters of leasing, we may, as we will see, become either a landlord or a tenant without having signed any document, and without even knowing it!

The Van Houtte Case

A recent decision rendered by the Superior Court on June 17, 2008, reminds us of the fundamental principles regarding the formation of contracts in matters of leasing. In the case of Montréal Industrial and Commercial Developments Inc. v. A. L. Van Houtte Ltd. (June 17, 2008, Hélène Poulin, JCS, Superior Court, District of Montreal), the issues under consideration surrounded the formation of a lease in the absence of a signed written agreement. In this case, the parties were bound by a ten-year commercial lease that began in March 1988 and ended in March 1998. Well before the end of the lease, the parties agreed to commence discussions and negotiations regarding the renewal of the lease. The purpose of these discussions was to modify the rental rate before the expiration of the lease and to renew the lease for another ten-year period. The rental rate was to decrease from forty-two dollars ($42.00) to twenty-eight dollars ($28.00) per square foot, while the other provisions of the lease were to remain unchanged. Basically, the landlord's position was that an agreement had been reached regarding the renewal of the lease, which opinion was not shared by the tenant Van Houtte, who argued that negotiations had, for all useful purposes, been terminated. The tenant decided to vacate the space at the end of March 1998 (the expiration of the original lease) and to stop all rent payments. The landlord, who was of the opinion that the lease had been renewed, took legal proceedings against the tenant to recover rent, as well as to claim damages (the space having been left in a state of total desolation) and the reimbursement of legal fees, as this provision was provided for in the lease.

The interesting question for the Court to determine was whether, in the absence of a formal written document agreed upon and signed by both parties, the tenant and the landlord had, in fact, reached a new agreement regarding the renewal of the lease.

The court ruled in the affirmative after having examined and considered various conclusive facts. Over the course of the discussions between the tenant and the landlord, several months before the end of the initial term of the lease, the tenant had asked for an immediate reduction of the rental rate due to a general decrease in market rates. The landlord had agreed to such reduction and reduced the rent from forty-two dollars ($42.00) to twenty-eight dollars ($28.00) per square foot. Subsequently, the landlord prepared a written agreement confirming the new rate, but it was never signed by Van Houtte representatives. However, in a letter sent twelve months prior to the expiration of the initial term of the lease, the tenant referred to this "new agreement" (as specifically stipulated in said letter) and, furthermore, the tenant adjusted the rent to reflect this "new agreement," which gave immediate effect to the rent reduction discussed by the parties. The judge came to the conclusion that an agreement had been reached by the parties and that written confirmation was not required for it to be ratified. In her decision, the judge pointed out that:

[TRANSLATION]

"A lease is a consensual contract because a consent is sufficient to form a leasing contract," writes author Deslauriers. Then he goes on to say:

"(...) once (the offer to lease is accepted), the signature becomes a formality to be completed to facilitate the proof of the contract. (...) A preliminary commercial lease whose commitments have begun to be fulfilled constitutes an agreement that binds the parties, as they thus indicate that the signature is a simple formality."

[Judge's underlining]

In this case, the meeting of the minds regarding "the object being tendered, the rental amount, and the duration of the lease" was sufficient to ensure the formation of the contract."

An agreement was thus reached regarding the essential elements of a lease. Furthermore, it is important to point out that the lease did not stipulate any specific formality regarding its formation. According to Quebec civil law, unless a contract requires a particular form to be respected as a necessary condition of its formation, or unless the parties require the contract to take the form of a solemn agreement, Articles 1385 and 1388 of the Civil Code of Quebec clearly state that exchange of consents (i.e. the exchange of consents between the parties) is the sole condition required for the formation of contracts.

Furthermore, Article 1386 of the Civil Code of Quebec states that this exchange of consents between the contracting parties is reached by the express or tacit manifestation of their will.

Exchange of consents, as a fundamental condition to the formation of contracts, is presented persuasively in the case of Jet Films Inc. v. Sky High Entertainment R.S.C.S. Productions Inc.[1] Indeed, Honourable Justice Hélène Langlois of the Superior Court of Québec (Montreal District) states in paragraph 49 of her decision that:

[TRANSLATION]

[49] The fact that there exists no written contract does not preclude the creation of a contractual bond, provided the parties have not made it a necessary condition to the formation of the contract. This is the case when the written contract is not the result of an agreement that creates obligations for the parties, but merely represents the manifestation of an exchange of consents that has already occurred. (1)

[Our underlining]

It is also important to emphasize that the party claiming that a contract has been formed must prove its existence. Obviously, the best proof of the existence of a contractual agreement is always a formal signed contract. However, as previously seen, this is not a mandatory requirement when there is consent on the essential elements, which, in commercial leasing, landlord-tenant matters are rent, leased premises, and term.

The conduct of the parties is another important aspect to consider when attempting to establish the parties' obligations. Indeed, in the Van Houtte case, Justice Poulin noted that the conduct of the tenant demonstrated that at one point it clearly felt bound by the discussions that had taken place between the parties. These facts may be pertinent when attempting to establish the formation of contractual obligations. Furthermore, the court pointed out that the tenant was a company with a long experience in commercial matters and that it had not pleaded error. In such circumstances, there was a meeting of the minds and, consequently, there was a binding agreement between the parties.

Indoor Management

As a subsidiary argument, tenant Van Houtte, claimed that its representative was not authorized to bind the corporation. This issue is very pertinent and frequently raises questions, such as: who is really authorized to bind a corporation? Many landlords do mandate agents to act, negotiate, and make representations on their behalf and in some cases, however, these agents may bind the corporation without realizing they have done so.

The Court rejected this line of reasoning by applying the principles of Indoor Management, because the landlord acted in good faith with a person it believed was authorized to represent the corporation. Furthermore, the landlord fully believed that the agent had the authority to legally bind the corporation it represented. As a result, Van Houtte was bound by the transaction regardless of whether the internal by-laws of the company authorized this person to act in such a manner. (This principle is well

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explained by Maurice and Paul Martel in La Compagnie au Québec, Volume 1, Les Aspects Juridiques, Wilson Lafleur, January 2008, no 26-25 and 26-26.).

The Indoor Management rule provides that executives and representatives of any company have the power given to them by its directors, subject to the by-laws of the company. However, third parties entering into contracts with the company need not to be concerned about these internal rules. This is quite reasonable, especially when one considers that third parties are unable to verify if the internal formalities of a company are indeed respected. A fundamental decision rendered by the Privy Council in the case of Montreal and St-Lawrence Light and Power Company v. Robert [1906] A.C. 196:

[TRANSLATION]

If companies were allowed to take advantage of irregularities committed by their directors and officers, no one would be safe in dealing with them.

However, as we have mentioned, this principle is subject to a fundamental condition. As stipulated in Quebec law in Articles 123.30 and 123.31 of the Companies Act (as well as its counterpart, Section 18 (d) of the Canada Business Corporations Act), the third party contracting with the company must be acting in good faith[2]. In other words, if the third party (the landlord in the Van Houtte case) knew that the person it was dealing with was not authorized to bind the tenant (or had a doubt in this regard), the landlord would not have been acting in good faith and would not have been able to invoke the principles of Indoor Management. Furthermore, the legislation explicitly stipulates that in order to benefit from the principles of Indoor Management, people who were aware or who should have been aware of the actual affairs of the company because of their relationship with it (and, consequently, of the irregularity of a situation), may not benefit from this protection. Therefore, if you believe, know, or should know that the person with whom you are dealing with is not authorized to bind the company he/she is representing, you may be considered not to have acted in good faith and may be denied the possibility of invoking the principles of Indoor Management.

This Superior Court decision brings to light one obvious fact: the importance of being cautious.

When parties are negotiating a contract and verbal discussions reveal that they are approaching an agreement, and when letters are being exchanged, it is strongly recommended to specify that these negotiations do not form any legal obligation between the parties until a formal agreement is agreed upon and signed by all parties. (Some parties even go so far as to specify in writing that their agent is not authorized to bind the corporation.) In other words, it is preferable to advise the other party, one way or another, that the formation of a contract is and remains at all times conditional upon the signing of a written agreement. It is common practice in the industry that the parties are not legally or contractually bound until an agreement is duly signed by them. However, in certain circumstances, when the actions of the parties demonstrate that an agreement has clearly been reached regarding the essential elements of the transaction, the written document may become superfluous and a mere formality. In this regard, bear in mind that the party claiming that there has been an exchange of consents (and, consequently, the formation of a contract) has the burden of proof. But, as seen in the Van Houtte case, this process, sometimes difficult, may, for the party that invokes it, be worth the effort! •

REFERENCES

[1] Jet Films Inc. v. Sky High Entertainment R.S.C.S. Productions Inc., REJB 2003-40641 (S.C.).

[2] In Quebec law, Articles 123.30 and 123.31 of the Companies Act establish the presumption in favour of third parties acting in good faith. Section 18 d) of the Canada Business Corporations Act offers similar protection.