

Flexible Boundaries: The Scope of “Surrounding Circumstances” in Contract Interpretation

February 20, 2020

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Modern contract interpretation requires a court to read the words used in a contract in a manner consistent with the “surrounding circumstances” known to the parties at the time of formation of the contract. This was the 2014 ruling of the Supreme Court of Canada in *Sattva Capital Corp. v. Creston Moly Corp.*, 2014 SCC 53 (paras. 46-47). In applying this rule, courts are faced with defining the boundaries of “surrounding circumstances”, also called the “factual matrix”. What is appropriately included? Are the parties’ negotiations leading up to the signed contract to be considered? What of prior drafts?

The two provincial appellate court decisions discussed below provide helpful guidance in answering these questions.

1079268 Ontario Inc. v. GoodLife Fitness Centres Inc., 2017 ONCA 12

In *GoodLife Fitness Centres*, the issue was whether Goodlife’s lease of the building that it was renting included the basement. The application judge held that it did not. The Ontario Court of Appeal found that the judge had erred and allowed the appeal.

At the outset, the Court of Appeal noted that the lease was unclear and contained “inconsistent and contradictory provisions” (para. 2). Because of the conflicting provisions, the application judge had found herself unable to give meaning to all of the terms in the lease. She resorted to considering “some of the features of the negotiations” to decide that the lease did not include the basement of the building.

The Ontario Court of Appeal reviewed the Supreme Court of Canada’s decision in *Sattva*, both on the issue of standard of review, as well as on the correct approach to contract interpretation. The holding of the Supreme Court in *Sattva* (para. 47) was that “a decision-maker must read the contract as a whole, giving the words used their ordinary and grammatical meaning, consistent with the surrounding circumstances known to the parties at the time of formation of the contract.” Because words take meaning from their context, the Supreme Court held that surrounding circumstances in the formation of a contract are relevant to its interpretation.

In *GoodLife Fitness Centres*, the lease’s inherent ambiguity was significant to the Ontario Court of Appeal’s reasoning. It held that “[t]he circumstances surrounding the formation of the lease take on particular importance in a case such as this, given the inconsistent and contradictory provisions that were included in the lease in its final form” (para. 28).

As the application judge had done, the Court of Appeal considered the draft leases exchanged between the parties in an attempt to determine the parties’ intention. However, the Court broadened the scope of review. It found that the application judge’s “consideration of the surrounding circumstances” was incomplete (para. 29).

The application judge had referred to some of the email correspondence, but the Court of Appeal held that she had failed to consider significant correspondence that took place early in the negotiations. In its view, this correspondence was key in making clear that the

parties' intention was to lease the entire premises, including the basement, on a lump sum basis rather on the basis of the actual square footage being rented (para. 29).

Subsequent drafts of the lease confirmed that the parties' intention was to lease the entire premises, and the parties' subsequent negotiations confirmed this understanding between them (paras. 33 and 37).

Thus, the Ontario Court of Appeal examined both the parties' contract negotiations as well as their various drafts to find that the understanding the parties reached early in their negotiations – that the lease was for the entire premises – continued until they signed the lease in its final form. The Court held that the application judge had “failed to consider all the material evidence before reaching her decision” that resulted in “an interpretation of the lease that was inconsistent with the intention of the parties” (para. 40). Characterizing this failure as an “error of law”, the Court of Appeal allowed the appeal.

The Ontario Court of Appeal's interpretation of the contract in *GoodLife Fitness Centres* turned on a careful examination of the parties' pre-contract negotiations and drafts. In contrast, the Alberta Court of Appeal recently ruled that such pre-contract evidence was inadmissible in the factual context of that case.

Alberta Union of Provincial Employees v Alberta Health Services, 2020 ABCA 4

In *Alberta Health Services*, the Alberta Court of Appeal concluded that an arbitrator in a labour dispute had erred in reviewing evidence of the parties' pre-contract negotiations and drafts because, in the Court's view, most of this evidence related to the parties' subjective intentions and was therefore irrelevant.

The arbitrator had been required to determine the meaning of the words “Operational Restructuring” in the parties' collective agreement. The meaning of the term was important because it determined the scope of the protection for union members against job losses resulting from changes to Alberta Health Services' operations.

The Alberta Court of Appeal explained that surrounding circumstances are objective “background facts”, known to both parties at the time of contracting. Such facts are relevant to the interpretive exercise because they are capable of affecting how a reasonable person would understand the language of the contract (para. 25). Examples of surrounding circumstances might include the genesis of the transaction, its commercial purpose, the background, the context, and the market in which the parties are operating (para. 24). Evidence of such facts must be admitted in all cases, whether or not the contract contains an ambiguity, and the failure to admit such evidence is a mistake of law (para. 40).

For the Alberta Court of Appeal, however, evidence of pre-contract negotiations generally falls in a category separate from evidence of surrounding circumstances (see, e.g., para. 49). The Court stated that “[e]vidence of pre-contract negotiations, including prior drafts, is generally *inadmissible as part of the surrounding circumstances*” (para. 27, italics in original).

Nevertheless, the Court left the door open. It allowed that, in some instances, surrounding circumstances and evidence of the parties' pre-contract negotiations “may overlap” (para. 27). In addition, the Court stated that a decision-maker may appropriately admit evidence of the parties' pre-contract negotiations where there is an ambiguity in the contract language (see paras. 32 and 49). In *Alberta Health Services*, the arbitrator had found the phrase “Operational Restructuring” to be patently ambiguous (para. 46).

But the presence of an ambiguity was not the end of the matter. The Court was categorical in stating that in all cases “evidence of the parties' subjective intentions *always* remains inadmissible” (para. 27, italics in original). The Court noted that the reason subjective intention evidence is inadmissible is because “it is irrelevant” (para. 30).

The Court went on to find that the arbitrator had used evidence from the pre-contract negotiations that fell “on the wrong side of the

line between evidence of surrounding circumstances ... and evidence of the parties' subjective intentions about the meaning of the phrase 'Operational Restructuring'" (para. 51). The Court also found that the arbitrator had reasoned backwards from the parties' subjective intentions in reaching his conclusion, and that he had used the subjective intention evidence in an unbalanced way. Contrary to the direction in *Sattva*, the arbitrator had allowed the extrinsic evidence to "overwhelm the text of the agreement" (paras. 55-57).

The Alberta Court of Appeal concluded that it was "unreasonable" for the arbitrator to consider the subjective intentions of the parties as reflected in the pre-contract evidence in interpreting the contractual words in dispute (para. 58). It allowed the appeal, quashed the arbitration award, and remitted the matter to the parties for further action.

Takeaways

The Ontario Court of Appeal's decision in *GoodLife Fitness Centres* and the Alberta Court of Appeal's decision in *Alberta Health Services* illustrate that the boundaries of "surrounding circumstances" in a contract interpretation case may shift depending on the factual context and the purpose for which such evidence is tendered.

The following points arise from the two decisions:

1. In all cases of contractual interpretation, regardless of whether there is any ambiguity, a decision-maker is required to read the words used in a contract in a manner consistent with the surrounding circumstances known to the parties at the time of formation of the contract.
2. Although evidence of pre-contract negotiations and drafts is not readily admitted in interpreting a contract, in some cases such evidence will overlap with surrounding circumstances, and pre-contract evidence will be particularly relevant and admissible in interpreting a contract where there is an ambiguity or inconsistency in the contract language.
3. The goal of contract interpretation is to make findings based on objective evidence of the parties' mutual intentions, not their subjective intentions, with the result that any evidence that relates to one party's subjective intentions is irrelevant and inadmissible.

As we have seen, these principles will play an important role in a court's decision to admit or exclude evidence of pre-contract negotiations and drafts as part of the surrounding circumstances in the process of interpreting a contract.

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

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