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## Contractual Interpretation on Appeal: A Clarification

A recent decision of the Ontario Court of Appeal has now clarified the standard of review where an appellate Court considers the lower Court's interpretation of a contract. In *Deslaurier Custom Cabinets Inc. v. 1728106 Ontario Inc.*, 2017 ONCA 293 ("*Deslaurier*"), the Court resolved some of the confusion that may have arisen regarding the applicable standard of review, following the Supreme Court of Canada's decisions in *Sattva Capital Corp. v. Creston Moly Corp.*, 2014 SCC 53 ("*Sattva*") and *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 ("*Ledcor*"). In essence, *Deslaurier* establishes that the standard of appellate review of a contractual interpretation case is flexible. It depends on the nature of the contract at issue and the legal tests that apply when interpreting it.

*Deslaurier* involved an appeal from a motion for summary judgment. The motion judge granted damages against the landlord in a commercial lease case where the leased premises were damaged in a fire. The fire caused damage to the tenant's property and its business operations. On appeal to the Court of Appeal (the "First Appeal"), the Court allowed the

appeal and dismissed the tenant's action against the landlord.

Amongst other rulings, the Court of Appeal held in the First Appeal that the motion judge made legal errors involving extricable questions of law, such that the applicable standard of review on appeal was the less deferential standard of correctness. These errors included: (i) a misinterpretation of the lease by failing to hold that the tenant had contractually assumed the risk of damage to its property; (ii) the admission of extrinsic evidence of the leases the landlord entered into with other tenants on the premises as part of the factual matrix; and (iii) the ruling that the tenant's breach of its duty to add the landlord as an additional insured to its insurance policy did not bar the tenant's subrogated claim against the landlord for the losses incurred during the fire.

The tenant then sought leave to appeal the First Appeal to the Supreme Court of Canada. After the tenant sought leave, the Supreme Court of Canada rendered its decision on the applicable standard of review in the interpretation of standard form contracts in *Ledcor*. As a result of its



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ruling, the Supreme Court of Canada remanded the tenant's case back to the Ontario Court of Appeal, for reconsideration of the decision in view of *Ledcor* (the "Second Appeal").

In the Second Appeal, the Court of Appeal affirmed its decision in the First Appeal. One of the more important rulings made in the Second Appeal was that the standard of review of the motion judge's interpretation of the lease remained correctness. This was because the motion judge committed legal errors that constituted "extricable questions of law".

The Court held that the following errors amounted to extricable questions of law attracting the less deferential standard of correctness: (i) the motion judge failed to apply precedential decisions governing the interpretation of the lease, including principles governing the contractual allocation of risk; (ii) the motion judge failed to "assign meaning to all the contested terms of the lease"; and (iii) the motion judge adopted a "construction of the [l]ease that fails to accord with governing principles of contractual interpretation".

In reaching this conclusion, the Court of Appeal clarified the following principles regarding the standard of review.

### **1. Contractual interpretation usually involves a question of mixed fact and law.**

The first principle established in *Deslaurier* is that the exercise of contractual interpretation generally engages a question of mixed fact and

law, such that the more deferential standard of review, "palpable and overriding error", applies on appeal.

Citing *Sattva*, the Court of Appeal noted that because contractual interpretation typically involves the application of legal principles to the words of a written contract, considered in light of the "factual matrix", the interpretation of an agreement usually involves a question of mixed fact and law. In the words of *Sattva*, the "interpretation of a negotiated contract is generally subject to a deferential standard of review".

### **2. If the lower Court's interpretation of the contract involves an "extricable question of law", the less deferential standard of correctness applies.**

The Court of Appeal observed, however, that *Sattva* carved out an exception to the deferential standard of review where the contractual interpretation involved an "extricable question of law". In these cases, the less deferential standard of review of correctness applies to the interpretation of the contract. The legal errors that would attract a correctness standard, as identified by the Court, include: the application of an incorrect principle of law; the failure to consider a required element of a legal test; the failure to consider a relevant factor; the substantive requirements for the formation of a valid contract; and the content of a given legal principle of contractual interpretation.

The Court noted that the Supreme Court of Canada in *Sattva* or *Ledcor* did

not establish that the list of legal errors above was exhaustive. Accordingly, other legal errors committed during the process of contractual interpretation could attract the correctness standard.

### **3. The correctness standard may apply in cases of standard-form contracts.**

The Supreme Court of Canada's decision in *Ledcor* involved the interpretation of a standard-form property insurance policy, i.e. a contract of adhesion. *Ledcor* held that the standard of review of correctness applies if three factors are met: the appeal involves the interpretation of a standard form contract; the interpretation of the contract is of precedential value; and there is no meaningful factual matrix that is specific to the parties to assist in the interpretation process.

If these three criteria are not met, however, *Ledcor* establishes that the interpretation of a standard form contract may amount to a question of mixed fact and law, such that a deferential stand of review applies:

...For instance, deference will be warranted if the factual matrix of a standard form contract that is specific to the particular parties assists in the interpretation. Deference will also be warranted if the parties negotiated and modified what was initially a standard form contract, because the interpretation will likely be of little or no precedential value. There may be other cases where deferential review remains appropriate.

In general, the factual matrix is less relevant in the interpretation of contracts of adhesion. Therefore, if the three criteria above are met, the correctness standard applies.

Critically, the Court of Appeal in *Deslaurier* observed that “nothing in *Ledcor* deviates from the holding in *Sattva* that the correctness standard of review applies to extricable questions of law arising within what is initially characterized as a question of mixed fact and law”.

#### **4. The factual matrix / surrounding circumstances of the contract are critical.**

The Court in *Deslaurier* also affirmed the principle from *Sattva* that the relevant surrounding circumstances at the time of contract formation remain an important factor in the exercise of contractual interpretation. That is, “objective evidence of the background facts at the time of contract formation” is a necessary tool to discern the

contracting parties’ intentions. Absent a contractual ambiguity (see *Shewchuk v. Blackmount Capital Inc.*, 2016 ONCA 912), the surrounding circumstances **at the time of contract formation** are critical to determining the contract’s meaning.

#### **Conclusion**

The Court’s decision in *Deslaurier* goes a long way to establishing the core principles governing the standard of review of appeals from contractual interpretation decisions. At the core of the Court’s analysis is an emphasis on context and flexibility when applying the standard of review.

The lesson from *Deslaurier* is that *Sattva* and *Ledcor* do not establish rigid standards of review that must be applied in all contract interpretation appeals. Rather, the standard of review will adapt to the type of agreement at issue and the legal principles which apply to it.