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Commercial Law Backwards and Forwards: The Supreme Court Dials Back the Remedy of Rectification

Kierkegaard famously observed that life can only be understood backwards. Many a commercial lawyer finds this easy to understand. It is a reality of modern commercial life that increasingly complex and sophisticated transactions can have implications that are not understood or anticipated when they are executed, but only become clear later, and in hindsight. This may especially be the case where complex transactions need to be executed quickly and in real time.

On December 9, 2016, the Supreme Court of Canada released two companion decisions concerning when a court will step in to assist parties who have mistakenly structured transactions that trigger unanticipated and unwanted tax consequences.

In *Canada (Attorney General) v Fairmont Hotels Inc.*, the Court considered the scope of the common law and equitable principles of rectification. A companion decision, *Jean Coutu Group (PJC) Inc v Canada (Attorney General)*, considered the corresponding principles under Quebec law. In each case, the Court took a restrictive approach to rectification, severely restricting its availability to those circumstances where the parties actually intended to execute a specific transaction that differs from the one they in fact executed.

Fairmont Hotels concerned the termination of a financing arrangement between Fairmont and Legacy Hotels REIT that was intended to operate on a tax-neutral basis.

The financing arrangements exposed Fairmont to tax liability on account of foreign exchange fluctuations because the financing was in U.S. dollars. To hedge this risk, reciprocal offsetting loan transactions were entered into between two Fairmont subsidiaries and Legacy Hotels. The tax-neutrality of the financing was later put into jeopardy by a subsequent takeover of Fairmont. To preserve the tax neutrality of the financing for Fairmont, a plan was effected to hedge Fairmont's exposure to foreign exchange fluctuations. This plan, however, deferred protecting the subsidiaries' exposure to be dealt with later. Critically, there was no specific plan as to how this goal would be accomplished.

Later, and on an urgent basis, Legacy asked Fairmont to terminate the reciprocal loan arrangements involving the subsidiaries because Legacy wanted to sell the hotels to which the arrangements related. In terminating these arrangements, Fairmont redeemed its shares in its subsidiaries via resolutions passed by the subsidiaries' directors. This redemption triggered an unanticipated tax liability that was discovered in the course of a subsequent audit by the Canada Revenue Agency.

Had the termination of the reciprocal loan arrangements been effected differently by means of loans from the subsidiaries to Fairmont in the same amount as the share redemptions, the tax liability would not have been triggered. Fairmont commenced a court application seeking rectification of its directors' resolutions to convert the share redemptions into loans.

Both lower courts concurred in allowing the application for rectification. Following the decision of the Ontario Court of Appeal in *Juliar v Canada (Attorney General)*, both courts focused on the overall goal of Fairmont, which was to unwind the reciprocal loan arrangements on a tax-neutral basis. On this analysis, the vehicle of a share redemption reflected a mistake in selecting the means by which that overall goal was to be effected.

Brown J., writing for a majority of the Supreme Court in *Fairmont Hotels*, observed that the traditional basis for a remedy of rectification was that the parties to a transaction had a concluded agreement but made a mistake in expressing it. On this understanding, courts do not rectify agreements, but rather instruments. It is not the courts' function to correct belatedly recognized errors in judgment.

The majority found that *Juliar* could not be reconciled with this traditional understanding of rectification. It therefore overruled *Juliar* and re-emphasized that "the party seeking rectification must identify terms which were omitted or recorded incorrectly and which, correctly recorded, are sufficiently precise to constitute the terms of an enforceable agreement. The inclusion of imprecise terms in an instrument is, on its own, not enough to obtain rectification; absent evidence of what the parties had specifically agreed to do, rectification is not available. While imprecision may justify setting aside an instrument, it cannot invite courts to find an agreement where none is present."

Further, while it reaffirmed its prior finding in *FH v McDougall* that the proof on a balance of probabilities is the only civil standard of proof, the majority stressed that evidence sufficient to establish an antecedent agreement that had been written down incorrectly must be "evidence exhibiting a high degree of clarity, persuasiveness and cogency."

The majority specifically disagreed with the dissenting members of the court (Abella and Côté JJ.) who focused on one underlying rationale for the remedy of rectification—the avoidance of unjust enrichment. Brown J. disagreed with the dissenting judges' characterization of the governing intention as being the plan to achieve the unwinding of the reciprocal loans on a tax-neutral basis, observing that the party seeking rectification of an instrument is required "to show not merely an inchoate or otherwise undeveloped ‘intent’, but rather the term of an antecedent agreement which was not correctly recorded therein."

As the majority's italicization of word "intent" indicates, Fairmont Hotels lays bare a disquieting fact about the common law. While the concept of "intention" is ubiquitous, there is little consensus concerning what intention really is. In this, it is easy to confuse intention with motive. "Intention" concerns what a party sets its mind to actually doing. "Motive" concerns a party's reason for doing what it did. Very often the party's intention—its specific and deliberate decision to undertake an act—will yield results that do not conform with the overriding motive. Traditionally, in contract law, what is relevant is a party's intention, not its motive.

Fairmont Hotels and its companion civil-law decision *Jean Coutu* reaffirm that rectification is not available to permit parties to go back in time and re-engineer a concluded transaction that they intended to undertake, even though re-engineering the transaction may in hindsight be the only means of achieving the objective that may have motivated it.

Often, and sadly, commercial life can only be understood backwards, but as Kierkegaard went on to conclude, "it must be lived forwards."