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The Law of Unintended Consequences: Supreme Court Rules on Rectification

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At common law, Courts have always had the power to correct mistakes in a contract or written legal instrument where that instrument incorrectly records the parties' agreement. Known as rectification, this equitable remedy has been used for centuries to amend a written document that inaccurately reflects the parties' intentions.

Canadian Courts have spilled much judicial ink on the scope of rectification. It has always been the case that rectification is available to correct an instrument that does not reflect an agreement between the parties, where that agreement's terms are definite, clear and ascertainable.

But what about the case where an instrument fails to reflect a party's general intentions, i.e. where those intentions are not "definite, clear and ascertainable", and where leaving the instrument in its current flawed form will produce unintended consequences?

In such cases, should the Court be allowed to amend the instrument and, in effect, correct the agreement between the parties to reflect their intentions and to avoid the unfavorable result?

A recent decision of the Supreme Court of Canada, *Attorney General of Canada v. Fairmont Hotels Inc.*, 2016 SCC 56, weighs in on the debate.

In *Fairmont*, the majority of the Court reinforced the limits of rectification. The majority held that while rectification can be used to change an instrument which inaccurately reflects a party's agreement as to what was to be done, it cannot be used to change the agreement to salvage what the parties hoped to achieve. This distinction is fine, but important.

The dissent in *Fairmont* would have applied rectification more broadly, allowing the remedy to be used to amend an instrument to reflect the continuing, ascertainable intentions of the parties, even if those intentions were not "definite".

Fairmont involved complicated financing arrangements in which Fairmont Hotels had always intended to unwind these arrangements on a tax-neutral basis. The arrangements involved Fairmont's and its subsidiaries' participation in the

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financing of Legacy Hotels' purchase of two hotels in U.S. currency. Legacy Hotels was a real estate investment trust in which Fairmont held a minority interest. Fairmont's participation in the arrangement exposed it to a potential foreign exchange tax liability, because the financing was arranged in U.S. dollars.

Fairmont was ultimately acquired by other companies. As a result of this acquisition, Fairmont's desired intent of tax neutrality was frustrated. The acquisition would trigger a foreign exchange loss on the part of Fairmont and its subsidiaries. To avoid any tax exposure, the parties involved in Fairmont's acquisition agreed on a plan in which Fairmont would hedge itself against any tax exposure. However, the plan did not protect Fairmont's subsidiaries.

Legacy Hotels later requested that its financing arrangement with Fairmont be terminated to allow for the sale of the two hotels. Accordingly, Fairmont redeemed its shares in its subsidiaries by way of a directors' resolution. The directors' resolution resulted in an unintended tax liability. Fairmont then applied to Court and sought rectification of the directors' resolution to avoid the liability.

The Ontario Superior Court and Court of Appeal both allowed rectification of the directors' resolution to preserve the parties' intended tax neutrality.

On appeal to the Supreme Court of Canada, the majority of the Court allowed the appeal and held that rectification was not available in the circumstances.

Rectification Unavailable to Correct Unintended Consequences

Writing for the majority of the Court, Justice Brown upheld the more traditional and conservative approach to rectification. The theory is that rectification is a narrow doctrine, limited to correcting errors in a written instrument where that instrument fails to correctly reflect the parties' agreement. However, the Court made it clear that rectification cannot be employed to undo the unintended consequences of that agreement:

> Rectification is not equity's version of a mulligan. Courts rectify instruments which do not correctly record agreements. Courts do not "rectify" agreements where their faithful recording in an instrument has led to an undesirable or otherwise unexpected outcome.

The Court's reasoning was based on the fact that rectification is a powerful tool that has the potential to be misused. In particular, rectification allows the Courts to rewrite "what the parties had originally intended to be the final expression of their agreement".

A broad and relaxed approach to rectification would undermine the necessary due diligence the parties should exercise when executing the document. Moreover, a broad approach would undermine the commercial world's confidence in the certainty of written contracts. The traditional approach to rectification keeps the Courts out of the agreement reached between the parties.

Rectification Requires "Definite and Ascertainable" Terms

The majority of the Court further identified the two types of mistakes that could give rise to the rectification of a written instrument.

Where there is a common mistake, in which both parties agree to a document that inaccurately records their prior agreement, rectification is only available if the following prerequisites are met: (i) the parties reached a prior agreement whose terms are "definite and ascertainable"; (ii) the agreement was still effective when the instrument was executed; (iii) the instrument fails to record accurately the prior agreement; and (iv) the instrument would carry out the agreement if it were rectified.

The second type of mistake to attract rectification is a unilateral one, i.e. where the document "formalizes a unilateral act (such as the creation of a trust)" or where the document was meant to record an agreement between the parties, but the parties each dispute whether the document accurately does so. In the case of a unilateral mistake, an additional precondition to rectification is added. The party resisting rectification must know or ought to have known about the mistake. Allowing the party to take advantage of it would amount to "fraud or the equivalent of fraud".

The analysis above has significant implications. According to the majority of the Court, where rectification is sought in the case of a common mistake, the preconditions set out above must be met, including the

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requirement that there was a "prior agreement whose terms are definite and ascertainable".

Applying these principles to the facts in *Fairmont*, the majority held that rectification was not available for two reasons.

First, the majority concluded that Fairmont was seeking not to correct an inaccurate directors' resolution, but to alter the resolution to *avoid* the unintended tax liability. Rectification is not available to assist the parties to avoid the unintended consequences of their agreement.

Second, Fairmont's intention was a general one, i.e. to avoid the tax liability. As a common mistake, this plan lacked the "definite and ascertainable" terms of a prior agreement, which are a necessary precondition to rectification. The "plan was not only imprecise: it really was not a plan at all, being at best an inchoate wish to protect, by unspecified means, [Fairmont's subsidiaries] from foreign exchange tax liability".

Is Rectification Too Narrow a Doctrine?

The Court's reasoning in *Fairmont* upholds the traditional approach to rectification. Although the majority properly recognized the potential for Courts to misuse rectification by rewriting the written document between the parties, the Court may have been overly cautious.

The majority arguably fails to give effect to the parties' intentions, where those intentions are reasonably ascertainable. As Justice Abella observed for the dissent, "[w]hat matters instead is that the substance of the intention 'can be ascertained with a reasonable level of comfort'". Definite and ascertainable terms of a prior agreement may not always be required in order to give effect to the parties' intentions and to apply rectification.

The debate regarding the scope of rectification is clearly not over, though it has been muted somewhat by *Fairmont*. For now, rectification remains a corrective doctrine only, with strict prerequisites before it can be applied. It remains to be seen if new cases will once again push the boundaries of this doctrine in order to honour the parties' general intentions.

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