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Why a Contract Clause's Purpose Matters



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Since the Supreme Court of Canada released its leading decision on contract interpretation in 2014, *Sattva Capital Corp. v. Creston Moly Corp.*, 2014 SCC 53 ("*Sattva*"), Canadian Courts have placed weight on the purpose of the contractual provision as a key factor in deciding how to interpret it.

A recent decision of the Ontario Court of Appeal emphasizes the importance of a contractual section's purpose in determining how a Court will give meaning to the words used in the clause.

In *Starrcoll v. 2281927 Ontario Ltd.*, 2016 ONCA 275, per Doherty J.A. ("*Starrcoll*"), the Court looked to the reason why the parties included an escrow clause in their agreement of purchase and sale to determine the clause's meaning.

The Facts

Starrcoll involved the sale of three apartment buildings from one company, Starrcoll Inc. ("*Starrcoll*") to another company, 2281927 Ontario Inc. ("*228*"). Starrcoll sold the buildings to 228 for \$11,860,000.00.

The Agreement between the parties included an escrow clause which provided that \$300,000 of the purchase price would be held in escrow by Starrcoll's lawyer for three years (the "Escrow Clause"). After the three year period expired, some or none of the \$300,000 would be paid to Starrcoll, depending on the amount of rents the apartment buildings generated.

Specifically, the Escrow Clause provided, in part, that:

payment by the Purchaser of the sum of \$300,000.00 payable to the Vendor's solicitors and to be held in an interest bearing escrow account... to secure the performance of the Property for the three year term commencing at closing (the "Performance Period"). At the end of the Performance Period, to the extent the rent roll of the Buildings...reveals gross rental of no less than \$960,000.00 (the "Gross Rental Threshold")...the Vendor's Solicitors in trust shall pay the Escrow Amount to the Vendor...

To the extent that at the end of the Performance Period, the Gross Rental Threshold has not been achieved...the Vendor's Solicitors...shall pay from the Escrow Amount the Purchaser the sum of \$5.00 for every dollar that the Rent Roll of the Buildings is less than the Gross Rental Threshold (the "Capitalization Payment") and pay to the Vendor any balance remaining after making the Capitalization Payment...

In other words, the Escrow Clause provided that where the gross rents amounted to \$960,000, Starcoll would be paid the entirety of the escrow amount, i.e. \$300,000. However, if the rents for the apartment buildings did not meet the \$960,000 threshold, 228 would be allowed to keep a portion or all of the \$300,000 held in escrow.

The amount of \$960,000 as the Gross Rental Threshold was reached at by the parties as being approximately \$125,000 above the annualized rent from the buildings based on February, 2011 rent rolls for the building given to the principal of 228 before the transaction closed.

At the end of the three year period, the parties disagreed as to whether the Gross Rental Threshold of \$960,000 in the Escrow Clause had been met.

Starcoll argued, amongst other things, that the \$960,000 threshold was met and it was entitled to keep the entirety of the \$300,000. Starcoll claimed that the monthly

rent at the end of the three year performance period on May 1, 2014, being the last month in the three-year performance period, was at least \$960,000 when annualized. Accordingly, Starcoll claimed that the \$960,000 threshold was met.

228 disagreed. It claimed that the \$960,000 threshold would only be met in the Escrow Clause if the rents for any twelve-month period during the three years reached \$960,000 or more. 228 held that since this did not happen, it was entitled to paid back a portion of the \$300,000.

The application judge held that the \$960,000 threshold was met if rents for any month in the three-year period reached \$960,000 when annualized. Thus, Starcoll was allowed to keep the entirety of the \$300,000 as the rents for April 1, 2014 exceeded \$960,000, when annualized.

On appeal to the Court of Appeal, the Court dismissed the appeal and held that Starcoll was entitled to keep the \$300,000. However, the Court held that the application judge erred in his interpretation of the contract.

The Purpose of the Contractual Clause is Key

In interpreting the Escrow Clause, the application judge held that where there is no ambiguity in a contract, the contract's words should be given their ordinary meaning. However, if there is an ambiguity in a contract, the Court can then look at objective evidence of the factual

matrix underlying the negotiation of the contract to resolve any ambiguity.

The Court of Appeal held that the application judge erred in his approach to contractual interpretation. In particular, the Court held that the words of a contract "and the context in which those words are used, cannot be separated and approached at different stages in the interpretive process. Words in an agreement have no meaning without context".

Citing *Sattva*, the Court of Appeal noted that the Court had to read the contract as a whole. This meant giving the words used in the contract their ordinary and grammatical meaning, "consistent with the surrounding circumstances known to the parties at the time" the contract was formed.

Most important, the Court held that the new approach to contractual interpretation that the Supreme Court of Canada set out in *Sattva* involved considering the "objective intention of the parties". The objective intention could be determined by looking at:

- i. the language of the relevant provision considered in the context of the entirety of the contract;
- ii. the purpose of the provision;
- iii. the nature of the relationship created by the contract; and
- iv. any other relevant surrounding circumstances.

Of these factors, the Court noted that the purpose of the contractual provision is “an important contextual feature in contractual interpretation”. Accordingly, in assessing the Escrow Clause, the Court put much weight on what its purpose was in the context of the entire agreement.

The Purpose of the Escrow Clause in the Contract

The Court held that the purpose of the Escrow Clause was to allow the parties to vary the ultimate purchase price for the apartment buildings by measuring their value according to how much rental income the properties would generate:

The purpose of a provision is an important contextual feature in contractual interpretation. I begin with the purpose behind the Escrow Provision. The value of the properties, to 228, at least in part, lay in the properties’ ability to produce rental income on an ongoing basis. The parties were aware of the monthly income being generated at the time of the purchase (about \$70,000). [The principal of Starrcoll] had represented that the rental incomes would increase over time as leases expired, and the

units were renovated and re-leased. Given the variables that could impact on the increase in rental income, one could not predict exactly how or when increases would occur. The Escrow Provision provided the means by which the agreed upon purchase price could be varied, albeit in a relatively minor amount...depending on the increase in income producing performance of the apartment buildings during the three-year Performance Period.

Taking this purpose into account, the Court held that rental income, for the purposes of determining if the \$960,000 threshold had been reached, was to be determined at the end of the three year performance period.

The parties chose to measure income performance at the end of the three years and not over time with the three year period, as 228 suggested. The parties intended that rent would be measured in accordance with the rent rolls for May, 2014, being the last month in the performance period. The provision required that the parties determine if the \$960,000 threshold were met by requiring an

annualization of the monthly rent for the last rent roll in the performance period.

According to the Court, “[t]his interpretation achieves the purpose of the Escrow Provision by providing 228 with some security for [the vendor’s] representations that income from the properties would increase over the Performance Period”.

The Purpose of the Contract Provision is Important

The Court of Appeal’s reasoning in *Starrcoll* reveals that Courts will place much weight on the purpose of the contractual provision in order to interpret it.

The question of why the parties agreed to a particular clause in an agreement becomes the core of the Court’s analysis.

In many ways, this approach to contractual interpretation makes sense. If, as *Sattva* holds, the objective intention of the parties matters in interpreting a contract, then the purpose of the contract, and its specific provisions, will no doubt assist the Court in achieving this end. The “why” of the contractual provision helps to discern its meaning.