

The admissibility of extrinsic evidence



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Commercial contracts are not created in a vacuum. In the event of a dispute, can parties adduce evidence outside the “four corners” of the document (e.g. prior drafts, negotiations) to support their interpretation?

As a starting point, the goal of every interpretative exercise is to determine objectively the intention of the parties at the time of execution based on the words chosen by the parties. To this end, courts are always entitled to take into account the commercial context, or surrounding circumstances, of a written agreement: *Deserres v. Brault*, [1906] S.C.J. No. 36. This is so regardless of whether the contract is ambiguous.

Commercial context includes the genesis of the contract, its business purpose and the market in which the parties operate. It does not, however, encompass evidence of the subjective intention of the parties, the negotiations and the parties’ conduct after the contract was formed: *Telecommunication Employees Assn. of Manitoba Inc. v. Manitoba Telecom Services Inc.*, [2012] M.J. No. 52.

The policy rationale for disallowing evidence of the parties’ subjective intention is twofold: commercial certainty and relevance. Commercial certainty requires enforcement of the contract as written, not as it was intended or hoped to operate. Given the objective approach to contractual interpretation and the presumption that the parties intended the legal consequences of their words, what the parties respectively understood the contract to mean is irrelevant. As the Supreme Court of Canada stated in *Eli Lilly & Co. v. Novopharm Ltd.*, [1998] S.C.J. No. 59, “The contractual intent of the parties is to be determined by reference to the words they



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used in drafting the document... Evidence of one party’s subjective intention has no independent place in this determination.” Moreover, one would be hard-pressed to find a litigant testifying on the stand that their understanding was the same as the opposing party. If direct evidence of subject intent were allowed, contract interpretation cases would become credibility contests, rendering the written contract almost an afterthought.

Evidence of the negotiations, prior drafts and subsequent conduct are similarly not admitted because they are irrelevant when the final instrument is clear and unambiguous. A concession given early on in the negotiations might have been withdrawn later. Subsequent events might have caused a party to regret the agreement, and behave in such a way that conflicts with what they bargained for.

Such evidence may also be excluded by the parol evidence rule, which provides that if there is a contract in writing, extrinsic evidence is not admissible to add

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to, subtract from, vary or contradict the written terms. The rule is effectively a common law codification of the “entire agreement” clause contained in many commercial agreements.

As with most rules, the parol evidence rule is not without exceptions. Parol evidence may be

admitted for the following purposes, even if it tends to vary, add to or subtract from the contract:

(1) to show that the contract was invalid because of fraud, misrepresentation, mistake, incapacity, lack of consideration, or lack of contracting intention;

(2) to dispel ambiguities, to establish a term implied by custom, or to demonstrate the factual matrix of the agreement;

(3) in support of a claim for rectification;

(4) to establish a condition precedent to the agreement;

(5) to establish a collateral agreement;

(6) in support of an allegation that the document itself was not intended by the parties to constitute the whole agreement;

(7) in support of a claim for an equitable remedy, such as specific performance or rescission, on any ground that supports such a claim in equity, including misrepresentation of any kind, innocent, negligent or fraudulent;

(8) in support of a claim in tort that the oral statement was in breach of a duty of care.

Ambiguity is one of the most commonly invoked exceptions. If there remain two reasonable alternative interpretations after examining the contract itself in its commercial context, resort may be had to extrinsic evidence, including evidence of the facts leading up to the contract, the circumstances as they existed at the time of contracting, and post-contractual conduct. Extrinsic evidence may also be admitted to reveal a latent ambiguity.

The parol evidence rule should not be confused with the rule excluding evidence of subjective intention. The former rule is concerned with the effect of the evidence, rather than its nature. The latter, in contrast, is directed at the nature of the evidence sought to be tendered, irrespective of whether it tends to vary, add to or subtract from the language of the document.

You are not alone if you find the tangled mass of principles to be confusing, for judicial application of these principles is less than uniform. Some courts have swept in evidence of negotiations apparently as part of the “surrounding circumstances” of the agreement (*Kentucky Fried Chicken Canada, a Division of Pepsi-Cola Canada Ltd. v. Scott’s Food Services Inc.*, [1998] O.J. No. 4368 (C.A.); and *Dilcon Constructors Ltd. v. ANC Developments Inc.*, [1996] A.J. No. 574 (Q.B.), for example). Other courts have held that evidence of negotiations is inadmissible, not even to resolve ambiguous terms: e.g. *Horn Ventures International Inc. v. Horn Plastics Inc.*, [2007] O.J. No. 1590 (S.C.J.).

The takeaway from all this is that precision in contract drafting is in the best interests of all parties to an agreement, since vague language will not only fuel disagreement, but threaten costly and uncertain litigation as parties fight about what is and is not admissible in court. ■

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Inquire as to reason for information demand

Fishing

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insurance leveraging strategy where the investor pays 10 per cent interest on a life insurance policy’s corresponding loan and receives an eight per cent return on the investment in the life insurance policy,

resulting in the 10 per cent being tax-deductible as it is being used to produce investment income and the eight per cent being tax-exempt as part of the policy.

In its decision the court held that the true reason for the s. 231.2 order was not to audit the participants but to send a

message to the insurance industry in order to chill the use of the 10-8 plans. Further, the court held that the Crown failed to make a “full and frank disclosure” as when the order was obtained it had neglected to produce internal documents suggesting that the 10-8 plans comply with the Act.

In light of the above, when a business receives a demand from the minister for information that relates to a third party, it ought to first inquire into the reason(s) for the demand. Once that has been provided, the business may still wish to challenge the demand. Even if it is upheld as proper, challenging

the demand can still prove beneficial in terms of forcing the minister to show her cards. ■

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