Alberta Court of Appeal sets negotiation parameters in interpreting contracts

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In *Sattva Capital Corporation v Creston Moly Corporation*, 2014 SCC 53 (*Sattva*), the Supreme Court of Canada conclusively endorsed the principle of contractual interpretation that courts must always consider the 'surrounding circumstances' (*i.e.* background facts) known to both parties at the time a contract was made. However, another longstanding principle of contractual interpretation is that evidence regarding the parties' pre-contractual negotiations is generally inadmissible when interpreting a contract, unless the contract is found to be ambiguous. These principles can contradict each other. In practice, what the parties communicated to each other while negotiating a contract is often relevant to establishing the background facts that were known to both parties when the contract was made...

In *Alberta Union of Provincial Employees v Alberta Health Services*, 2020 ABCA 4 (*AUPE*), the Alberta Court of Appeal provided some clarity on the role that pre-contractual negotiations should play by focusing on the overriding principle that such evidence can never be used, directly or indirectly, to show the parties' subjective intentions about the meaning of contractual language.

Background

The central issue in this case was about the meaning of the words "Operational Restructuring" in a collective agreement between the Alberta Union of Provincial Employees (the Union) and Alberta Health Services (AHS). AHS had implemented a program called Operational Best Practices (OBP) and had made public promises that the OBP would not result in job losses for unionized employees.

The Union was one of three public sector unions which sought to formally confirm these public statements by negotiating labour agreements to the effect that the OBP would not result in layoffs to their respective members. While the other two unions ultimately entered into agreements which stated that the Operational Best Practices program would not result in adverse job consequences, the letter of understanding (the LOU) between the Union and AHS instead stated that "Operational Restructuring" would not result in adverse job consequences.

A number of months after entering into the LOU, AHS announced it would be closing a facility, resulting in a number of layoffs of the Union members. It was undisputed that this closure was not a result of the OBP program, but a dispute arose as to whether it was captured by the words “Operational Restructuring” and was therefore a breach of the LOU. The dispute went to arbitration. AHS took the position that Operational Restructuring referred solely to the OBP, while the Union took the position that the phrase applied broadly to any type of organizational restructuring.

In approaching the interpretation of the LOU, the arbitrator considered himself bound by the long line of labour arbitration cases, which hold that an arbitrator must first determine that a collective agreement is ambiguous before considering any evidence beyond the words of the agreement itself, including evidence of the surrounding circumstances. The arbitrator found that the phrase “Operational Restructuring” was ambiguous, such that he could consider extrinsic evidence.

The arbitrator then considered evidence of the LOU’s surrounding circumstances (the Surrounding Circumstance Evidence), which included evidence that:

- AHS was implementing the OBP, and had publicly stated that it would not result in layoffs to unionized workers;
- AHS had been directed by the government to enter into agreements with the unions to confirm that there would be no layoffs, and the parties were meeting to negotiate such agreements;
- AHS and the Union were sophisticated parties with a long history of collective bargaining and collective agreements;
- Prior to the negotiation meetings, the Union proposed an agreement to AHS which utilized the words “Operational Best Practices;” and
- Also prior to the negotiation meetings AHS had entered into an agreement with a different union, which utilized the words “Operational Best Practices.”

The arbitrator also considered specific evidence of the actual negotiations (the Negotiation Evidence) between the Union and AHS, which showed that:

- AHS communicated to the Union that their mandate and intention was to limit the negotiations to the adverse job consequences arising from the OBP program only;
- The Union communicated to AHS that they were not prepared to limit the negotiations in this way, because AHS could control the timing of when the OBP program applied, and could also simply rebrand the program to call it something else. AHS acknowledged that such rebranding was possible;
- The Union then proposed a revised draft of the agreement which utilized the words “Operational Restructuring” as opposed to OBP; and
- Union representatives offered no explanation for the meaning of “Operational Restructuring” and AHS representatives did not ask any questions about what it meant.

The arbitrator characterized the Negotiation Evidence as “facts,” which were admissible as evidence of ‘surrounding circumstances’ of the LOU.[1]

Partly on the basis of the Negotiation Evidence, but also on the basis of a textual analysis of the LOU, the arbitrator determined that the phrase “Operational

Restructuring" was intended only to apply to the OBP program or any rebranding of that program, and did not apply broadly to any type of organizational restructuring whatsoever. The Union sought judicial review of this decision, which was dismissed by the chambers justice on the basis that the arbitration decision was reasonable both in process and outcome. The Union appealed to the Court of Appeal.

The Decision

The Court of Appeal found that it was unreasonable for the arbitrator to consider the Negotiation Evidence in interpreting the meaning of the phrase "Operational Restructuring." The court concluded that it was unable to assess the extent to which the arbitrator's reliance on the Negotiation Evidence determined the result of the arbitration and, accordingly, it quashed the arbitrator's decision and remitted it to the parties for further action.

As an initial note, the court found that the labour arbitration jurisprudence holding that an arbitrator must first determine that a collective agreement is ambiguous before considering any extrinsic evidence is no longer applicable in light of *Sattva*. Rather, following *Sattva*, labour arbitrators **must** consider evidence of surrounding circumstances relevant to interpreting a collective agreement, regardless of whether the agreement is ambiguous. The court did not disturb the arbitrator's finding that the LOU was ambiguous on the facts of this case, in the sense that the words "Operational Restructuring" were reasonably capable of more than one interpretation.

The lynchpin of the Court of Appeal's reasoning was its finding that the Negotiation Evidence "was adduced primarily to show what the parties subjectively understood by the phrase 'Operational Restructuring.'"[2] Such subjective intention evidence can never be considered as part of the 'surrounding circumstances, which are limited to "*objective* evidence of the background facts at the time of the execution of the contract … that is, knowledge that was or reasonably ought to have been within the knowledge of *both parties* at or before the date of contracting "[3] The court noted that such background facts are likely to be uncontroversial to the parties, and should be "capable of affecting how a reasonable person would understand the language of the document."[4]

The court noted that while the phrase "subjective intention" is often referred to, "few cases explain its meaning."[5] Subjective intention evidence can be direct, and easy to identify in some cases. For example, a witness might testify that "I think that the phrase means X" or "at the time we entered into the contract, I thought that the provision meant Y."[6] However, subjective evidence can also be indirect and less obvious. For example, a party might adduce evidence that certain language was proposed by a party "to resolve a specific problem – which it would resolve only if the language had a certain meaning."[7]

The court found that the Negotiation Evidence fell "on the wrong side of the line between evidence of surrounding circumstances […] and evidence of the parties' subjective intentions about the meaning of the phrase "Operational Restructuring."[8] Specifically, the court held that the Negotiation Evidence was indirect subjective intention evidence. For example, the evidence that the Union had stated that they would not enter into an agreement that was limited to the OBP was indirect evidence that they did not intend "Operational Restructuring" to mean the OBP.

Had the arbitrator not found that the LOU was ambiguous, the finding that the Negotiation Evidence was subjective intention evidence, and thus not part of the LOU's surrounding circumstances, likely would have been sufficient to dispose of the appeal. Absent such ambiguity, the Negotiation Evidence would simply have been inadmissible. Because the LOU was found to be ambiguous, the arbitrator was permitted to consider such evidence of negotiations to help in the interpretive exercise. However, the Court then found that the way the arbitrator used the Negotiation Evidence in the interpretive exercise was problematic and unreasonable.

First, the court found that the arbitrator effectively reasoned backwards from the parties' subjective intentions by identifying a point at which they overlapped (both parties intended "Operational Restructuring" to include, at the very least, the OBP program) and finding this point of overlap to be the objective meaning of "Operational Restructuring." This contravened the principle, confirmed in *Sattva*, that extrinsic evidence cannot override the text of the agreement.

Secondly, the court noted that the arbitrator's use of the Negotiation Evidence was unbalanced because he focused solely on the Union's concerns about rebranding, while ignoring the evidence that the Union was also concerned about AHS' ability to control the timing of the OBP program, and the effect that such timing might have on layoffs.

Finally, the court noted that although the parties may have agreed to include the term "Operational Restructuring" in the LOU, there was no evidence that they ever attempted to come to an agreement regarding what these words meant. Indeed, the court found that it appeared that both parties "deliberately avoided clarification of the language in order to achieve an agreement."[9] In these circumstances, there was no basis for preferring the subjective intention of one party over the other, such that the Negotiation Evidence was of little relevance to the interpretive exercise.

Implications

This case provides some clarity for commercial litigators regarding the role that pre-contractual negotiation evidence should play in contractual interpretation disputes. The general rule that pre-contractual negotiations are inadmissible may have reduced utility as a result of *AUPE*. Instead, courts may seek to draw a line between admissible surrounding circumstances evidence on one side, and inadmissible subjective intention evidence on the other, with evidence derived from pre-contractual negotiations potentially falling on either side. For example, both the inadmissible Negotiations Evidence and much of admissible Surrounding Circumstances Evidence in *AUPE* appears to have been derived in some way from pre-contractual negotiations.

AUPE is a reminder that pre-contractual negotiations may be a necessary source of objective evidence that the parties' shared knowledge of certain facts is relevant to understanding the language used in the contract. However, the court also took pains to emphasize that if the pre-contractual negotiation evidence does not meet the objective test for surrounding circumstances, then its admission requires ambiguity. In other words, the court in *AUPE* rejected the proposal that surrounding circumstances should be defined "so broadly as to include all pre-contract negotiations, so long as evidence of subjective intentions is excluded."[10]

The most impactful repercussion of *AUPE* may be its caution that pre-contractual negotiations are often a rich source of inadmissible subjective intention evidence, much of which may be indirect and not necessarily obvious. For example, litigants may present evidence that both parties were aware of a certain problem or obstacle in the negotiations, and then seek to frame this problem or obstacle as a fact known to the parties at the time the contract was formed. Once the problem or obstacle is framed as fact which is part of the surrounding circumstances, litigants may attempt to argue that certain contractual language should be interpreted to resolve this problem or obstacle in a particular way. *AUPE* calls upon courts to scrutinize such arguments carefully.

Finally, *AUPE* is specifically notable in the labour arbitration context because it abolishes the longstanding rule that an arbitrator must establish that an agreement is ambiguous before considering any extrinsic evidence, in favour of the modern rule that the surrounding circumstances must always be considered when interpreting any contract.

[1] *AUPE* at para 48 and 52.

[2] *AUPE* at para 51.

[3] *AUPE* at para 25, citing *Sattva* at para 58.

[4] *AUPE* at para 25.

[5] *AUPE* at para 31.

[6] *AUPE* at para 31.

[7] *AUPE* at para 31.

[8] *AUPE* at para 51.

[9] *AUPE* at para 57.

[10] *AUPE* at para 32.

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