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CONTRACT LAW, COHERENT LEGAL THEORY, AND SOUND COMMERCIAL PRACTICE: THE NEED FOR A BALANCE

GEOFF R. HALL

Contract law requires a careful balance between coherent legal theory and sound commercial practice. Contract rules that accord with commercial practice but do not fit within a coherent legal theory risk arbitrariness; rules that accord with theory but do not fit with commercial practice can have the effect of altering business behaviour without good reason.

The balance is not always easy to achieve, as two recent appellate decisions illustrate well. One, the decision of the Ontario Court of Appeal in *Downey v. Ecore International Inc.*,[1] achieved the right balance. The other, the decision of the Supreme Court of Canada in *Southcott Estates Inc. v. Toronto Catholic District School Board*,[2] missed the mark. *Downey* interpreted one contract by looking to an interrelated one that was between different parties, achieving a commercially sensible result when the legal theory of privity of contract, if applied without regard to commercial practicalities, might have mandated a different outcome. *Southcott* applied the doctrine of mitigation in a theoretically pure but commercially impractical manner, resulting in

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an outcome that virtually ignored the commercial context and created a legal rule that will likely have the effect of altering otherwise unobjectionable corporate behaviour without a sound reason.

A Good Balance: *Downey*

It is well established that when interpreting a contract the document must be read as a whole, without considering the disputed words or phrase in isolation from the rest of the contractual text.[3] In recent years, the Ontario Court of Appeal has expanded this principle to the interpretation of interrelated contracts[4] such that, if (as commonly happens) a transaction is given effect by a series of contracts, all of the contracts in the series must be considered when interpreting any one of them (the interrelated contracts principle)—even if the contracts in question were entered into by different parties.

Paul Downey is an engineer. He was hired away from a competitor to work for Ecore International, a manufacturer based in Pennsylvania. For tax reasons, and at Mr. Downey's request, the arrangement was structured not as an employer-employee relationship but as a consulting agreement between Ecore and a company owned by Mr. Downey, known as CSR Industries Inc. ("CSR"). The arrangement was put into effect by two contracts—namely, a consulting agreement between CSR and Ecore and a confidentiality agreement between Mr. Downey personally and Ecore. Mr. Downey was not a party to the consulting agreement, and CSR was not a party to the confidentiality agreement.

The confidentiality agreement contained a forum selection clause choosing the courts of Pennsylvania for any action "that arises out of or in any way relates to the Company's [Ecore's] business relations with Employee [Mr. Downey]." Mr. Downey sued Ecore in Ontario in connection with the assignment

of certain intellectual property rights created during the course of work for Ecore. Ecore moved to stay the Ontario proceedings on the basis of the forum selection clause. At first instance, the stay was denied on the basis that the confidentiality agreement (containing the forum selection clause) failed for lack of consideration, since it was CSR (not a party to the confidentiality agreement), not Mr. Downey, who received confidential information from Ecore. The Ontario Court of Appeal reversed, finding the confidentiality agreement and its forum selection clause to be effective.[5]

The Court of Appeal applied the interrelated contracts principle, holding that "[t]he contours of the exact bargain between the parties may sometimes require consideration of more than one contract."[6] The court quoted *Salah v. Timothy's Coffees of the World Inc.*,[7] for the proposition that "[w]here a transaction involves the execution of several documents that form parts of a larger composite whole—like a complex commercial transaction—and each agreement is entered into on the faith of the others being executed, then assistance in the interpretation of one agreement may be drawn from the related agreements."[8] The consulting agreement and the confidentiality agreement formed part of a single transaction, such that "[i]t is only when the two agreements are read together … that the intentions of the parties and the true business reality of their relationship emerge."[9]

Thus the consulting agreement and the confidentiality agreement had to be read together with assistance in the interpretation of each one drawn from the other. Read together, proprietary information was to be protected in the hands of Mr. Downey. The *de facto* relationship was between Ecore and Mr. Downey. The arrangement with CSR was simply a tax device, a critical business reality of the relevant factual context. As such, it was irrelevant that CSR had not signed the confidentiality agreement.

The result accords with commercial realities and well reflects what the business people were attempting to achieve in business terms. The result is coherent from the perspective of legal theory, applying well-established principles of contract interpretation. Yet it does not let legal theory take the analysis somewhere that does not make commercial sense. Thus the doctrine of privity of contract, which might suggest that a contract entered into between one set of parties should not inform the interpretation of a contract entered into by another set of parties, was not allowed to get in the way of an approach that accords with commercial practice.

Missing the Mark: *Southcott*

Contrast the approach in *Downey* with the approach in *Southcott*. In *Southcott*, the Supreme Court of Canada[10] applied theoretically pure models of contract and corporate law to conclude that the victim of a breach of contract had failed to mitigate its damages. The victim of the breach was therefore denied its damages, which had been assessed at trial at $1.9 million. But, in applying pure theory, *Southcott* ignored commercial reality and the underlying economic context. *Southcott* represents a triumph of theory over commercial reality and is a troubling decision as a result.

Southcott Estates Inc. ("Southcott Estates") is part of a group of companies (the Ballantry Group) that is in the land development business in southern Ontario. As is common in the industry, Southcott Estates is a single-purpose company. Its sole purpose was to undertake one specific transaction—namely, the acquisition of a parcel of land that had been put up for sale by a school board and the construction of a residential development on the site. The deal to buy the land fell through as a result of

the school board's breach of contract. Southcott Estates sued for damages.[11]

After the deal fell through, the Ballantry Group made no effort to have Southcott Estates acquire another piece of land in mitigation of its losses. This was for very sensible commercial reasons. The Ballantry Group was always in the market for new land and, in fact, purchased seven parcels of land for development in the period between the date of breach and the date of trial. In accordance with industry practice, it used separate corporate vehicles for those purchases instead of a corporation that was embroiled in litigation (Southcott Estates). As explained by one of Ballantry's principals at trial, Ballantry would not have bought in the name of Southcott Estates because "it doesn't make sense … I can't imagine my lawyer ever letting me do that … I don't need the headaches." He explained that Ballantry would never use a company that was involved in litigation, and, in fact, "generally we wouldn't buy anything in another company if it's still involved in something."[12]

While the approach is eminently sensible from the commercial perspective of someone running a group of real estate development companies, the Supreme Court of Canada, on the basis that Southcott Estates had failed to mitigate its damages, found it to be legally fatal to an effort to collect damages for breach of contract. The court reasoned that "[a]s a separate legal entity, [Southcott Estates] was required to mitigate by making diligent efforts to find a substitute property. Those who choose the benefits of incorporation must bear the corresponding burdens …."[13] Southcott Estates "is entitled to the benefits of limited liability, but it is also saddled with the responsibilities that all legal entities have. The requirement to take steps to mitigate losses is one such responsibility."[14]

This is excellent legal theory, entirely consistent with the theoretical exposition of the doctrine of mitigation and with corporate law theory, which of course holds as a foundational principle that a corporation is its own legal entity separate from its shareholders.[15] But the approach is entirely divorced from both business and economic reality. The true purchaser of the land was not a shell company without other assets; it was the Ballantry Group. The decision not to use Southcott Estates for another land purchase was not a device to run up the damages on the defendant school board; it was the way the Ballantry Group, and indeed the entire industry, always did business. Since the Ballantry Group was in the market for as much land as it could acquire and actually did acquire other land at the relevant time (transactions that would have been undertaken even if the Southcott Estates transaction had proceeded), the loss of this particular deal was a real loss to the Ballantry Group that could not have been avoided by undertaking a mitigatory transaction.

The result is that a breaching defendant (the school board) that caused $1.9 million in damages gets off scot-free. Moreover, a large development group faced with a breaching seller must now either waive its right to sue for damages or go out into the market and use a shell corporation that is embroiled in a lawsuit to purchase another property—an act that heretofore would have been considered to be something approaching malpractice if recommended by a lawyer and would likely be difficult to convince a lender to accept, given the general reticence to advance funds to a company with limited assets that is embroiled in litigation. Thus, legal theory is apt to change corporate behaviour for no good reason other than to achieve theoretical purity.

Even from the perspective of legal theory, the result is somewhat baffling. In a multitude of different legal scenarios the Supreme Court of Canada has repeatedly emphasized that Canadian law mandates a contextual approach.[16] Indeed, in *Southcott* itself, the court explained that the doctrine of mitigation requires a contextual analysis: "Mitigation is a doctrine based on fairness and common sense, which seeks to do justice between the parties in the particular circumstances of the case."[17] Yet in *Southcott*, the court ignored the most important economic context underlying the case—the nominal plaintiff was, in fact, just the vehicle by which a large development group was undertaking a particular development project, such that going out into the market and using the same corporation for another purchase would not in fact have avoided a loss for the group as a whole. The court's analysis may have been perfectly sensible had the single-purpose company been a company incorporated by an investor to undertake a one-off transaction, but in the context of a large development group undertaking multiple transactions, it makes little sense.

This is not to say that the corporate veil should simply be ignored in the mitigation analysis. There is considerable force to the court's comment that one who seeks the benefits of incorporation must also bear the corresponding burdens, and, no doubt, the Ballantry Group would be the first to object if a plaintiff suing one of its companies tried to get access to the assets of the entire Group by pointing to the economic context. But looking to the entire economic context, assessing whether damages have been mitigated, is different from piercing the corporate veil. In mitigation, the issue is whether losses could reasonably have been avoided, such that it is unfair to make the defendant pay them. Viewed at that level, it is difficult to see why the analysis should end at the corporate veil.

The Contrast

Downey and *Southcott* present a stark contrast. *Downey* carefully balanced competing considerations—namely, two legal principles that pointed in somewhat different directions (the interrelated contracts principle and the doctrine of privity of contract) and the need to achieve commercial practicality by giving effect to what the business people intended to achieve. The result is a decision that is consistent with legal doctrine but also respects how sophisticated commercial parties intended to order their business affairs and does not allow theoretical purity to interfere with such ordering when there is nothing offensive about that ordering from a policy perspective. *Southcott*, on the other hand, allowed legal principle (the trite proposition that corporations are separate legal entities) to trump commercial practicalities, holding that an inoffensive commercial practice that did not have the effect of running up damages on a contract breaker was nevertheless a failure to mitigate. The result is a decision that will likely cause business people to alter their behaviour[18] to achieve nothing other than theoretical purity.

In contract law, the balance between legal theory and commercial practicality is sometimes not an easy one. But when the balance must be made, the courts should strive to do as *Downey* did and eschew the theoretically pure but commercially awkward approach of *Southcott*.

[*Editor's note*: This article is based on two blog entries Mr. Hall posted on McCarthy Tétrault LLP's Canadian Appeals Monitor blog, <www.canadianappeals.com>— namely, "Interpretation of Interrelated Contracts in a Commercially Effective Manner: Clarification of Two Important Principles of Contractual Interpretation," posted on July 11, 2012, and "A Doctrine of Mitigation in the Supreme Court

of Canada: A Triumph of Theory over Commercial Reality," posted on October 17, 2012.]

1 [2012] O.J. No. 3086 (Ont. C.A.) [*Downey*].
2 [2012] S.C.J. No. 51 (S.C.C.) [*Southcott*].
3 *Tercon Contractors Ltd. v. British Columbia (Transportation and Highways)*, [2010] S.C.J. No. 4, at para. 64 (S.C.C.).
4 *3869130 Canada Inc. (c.o.b. I.C.B. Distribution 2001) v. I.C.B. Distribution Inc.*, [2008] O.J. No. 1947, (Ont. C.A.); *Salah v. Timothy's Coffees of the World Inc.*, [2010] O.J. No. 4336, at para 16 (Ont. C.A.).
5 The decision was authored by Cronk J.A. on behalf of a unanimous panel of Feldman, Simmonds and Cronk JJ.A.
6 *Downey*, *supra* note 1 at para. 38.
7 *Supra* note 4.
8 *Downey supra* note 1 at para 38, citing *Salah v. Timothy's Coffees of the World Inc.*, *supra* note 4 at para. 16.
9 *Downey*, *supra* note 1 at para. 63.
10 The majority decision was authored by Karakatsanis J. on behalf of herself, LeBel, Deschamps, Abella, Rothstein, and Cromwell JJ. McLachlin C.J.C. dissented.
11 Southcott Estates also sought specific performance, which was denied on the basis that the land was not unique.
12 This evidence is cited in the Ontario Court of Appeal's decision: *Southcott Estates Inc. v. Toronto Catholic District School* Board, [2010] O.J. No. 1772 at para 18.
13 *Southcott*, *supra* note 2 at para 30.
14 *Ibid.*
15 *Solomon v. Solomon & Co.*, [1897] AC 22 (HL).
16 For example, see *R. v. Oakes*, [1986] S.C.J. No. 7 (the test under s. 1 of the Charter of Rights) (S.C.C.); *Bell ExpressVu Limited Partnership v. Rex*, [2002] S.C.J. No. 43 (the proper approach to statutory interpretation); *Dunsmuir v. New Brunswick*, [2008] S.C.J. No. 9 (determining the standard of judicial review in administrative law); *R. v. Grant*, [2009] S.C.J. No. 32 (the test for exclusion of evidence under s. 24(1) of the Charter of Rights) (S.C.C.); and *R. v. Nasogaluak*, [2010] S.C.J. No. 6 (criminal sentencing). Indeed, a search of the word "contextual" on the website containing decisions of the Supreme Court of Canada conducted on January 6, 2013, generated 382 hits, <http://csc.lexum.org/decisia-scc-csc/scc-csc/en/nav.do>.
17 *Southcott, supra* note 2 at para. 25.
18 Consider the choice an innocent party in the position of Southcott Estates is now faced with: use a tainted corporate vehicle or walk away from a claim for damages for breach of contract. A rational party in that position will likely depart from its usual practices in order to preserve the claim for damages.

REVISITING APPEAL RIGHTS: AN ARGUMENT IN FAVOUR OF RESPECTING PARTY AUTONOMY

BRYAN C. DUGUID AND DEBORAH BOOK

Introduction

In 1990, the Uniform Law Conference of Canada developed a *Uniform Arbitration Act*.[1] This has resulted in the enactment of similar legislation governing arbitrations in Alberta, Saskatchewan, Manitoba, Ontario, and New Brunswick. However, the provinces diverge in their approaches to party autonomy and rights to appeal. While the legislatures in Alberta, Manitoba, and New Brunswick stipulated that parties cannot vary or exclude the right to apply for leave to appeal on a question of law, Saskatchewan and Ontario enacted legislation that allows for the exclusion of any right to appeal.

Twenty years after the enactment of the *Arbitration Act*,[2] the Alberta Law Reform Institute ("ALRI") is reviewing the appeal provisions of that statute.[3] Among other things, ALRI is seeking input on whether "the *Alberta Act* [should] continue to provide an appeal on a question of law by leave of the court, regardless of the parties' agreement."[4] We believe that it should not, both to ensure clarity in the law and to respect party autonomy.

While certain provincial arbitration statutes provide for a right to seek leave to appeal on a question of law regardless of the parties' agreement,[5] it is not uncommon for arbitral agreements to include a clause purporting to exclude all appeal rights. Courts have thus had to wrestle with the extent of permissible intervention, resulting in lines of decisions that are not always clear. In Alberta, for in-

stance, there is continuing jurisprudential tension surrounding the extent to which a public interest element is required to obtain leave to appeal an arbitral award on a question of law. This confusion has not arisen in provinces where parties can exclude rights to appeal by clear agreement.

Parties who choose to arbitrate agree upon the terms for resolution of their disputes. Arbitral agreements often include privative language with the intent of restricting court intervention to situations justifying setting aside an arbitral award. In light of the continuing use of such agreements, the Alberta legislature has a choice to make: 1) respect party autonomy and allow parties to agree to exclude appeals to the courts or 2) develop a clearer and more comprehensive code for the availability of leave to appeal under the *Alberta Act*. The former approach best reflects the contractual foundation of arbitration proceedings and has been successfully applied in other Canadian jurisdictions.

The Tension in Alberta

Taken together, ss. 3 and 44(2) of the *Alberta Act* provide an invariable right to seek leave to appeal an arbitral award on a question of law. Yet Alberta arbitration agreements often include privative language stating that the award will be final and binding and purporting to revoke any right of appeal. It is thus highly appropriate that ALRI is currently revisiting this legislation.

The *Alberta Act* recognizes the autonomy of contracting parties to an arbitration agreement within certain bounds:

> The parties to an arbitration agreement may agree, expressly or by implication, to vary or exclude any provision of this Act except sections 5(2), 19, 39, 44(2), 45, 47 and 49.[6]

In addition to the right to apply to the court to set aside an arbitration award (s. 45),[7] the Alberta legislature has protected a right to seek leave to appeal on a question of law. Section 44(2) provides:

> If the arbitration agreement does not provide that the parties may appeal an award to the court on a question of law, a party may appeal an award to the court on a question of law with leave, which the court shall grant only if it is satisfied that
>
> (a) the importance to the parties of the matters at stake in the arbitration justifies an appeal, and
>
> (b) determination of the question of law at issue will significantly affect the rights of the parties.[8]

As parties cannot contract out of s. 44(2), it is not possible to negate all rights of appeal in Alberta. Privative language is commonly used, however, suggesting that many parties seek finality and would welcome the ability to exclude all appeal rights. The dissonance between parties' interest in finality and the *Alberta Act*'s limits on party autonomy is only exacerbated by the conflicting jurisprudential record as to how s. 44(2) should be applied.

(a) Option One—A Judicial Override

In many cases, adherence to s. 44(2) has required the court to overrule the express language of the parties' agreement.

In *Zaharko v. Milton*,[9] despite rules providing that a decision of the Calgary Real Estate Board's ("CREB") Arbitration Panel may not be appealed, the court entertained a leave application under s. 44(2). The court wrote that the "CREB's Rules and procedures, which have a strong privative cast, cannot exclude [the] right to ask for leave to appeal [an] arbitral award: s. 3, [the *Alberta Act*]."[10] The CREB Rules provided that arbitrations would be "conclusive and binding" and that members submitting to arbitration agreed to abide by the arbitral award.[11] Additionally, the CREB Rules included a provision that "A decision of an Arbitration Panel may not be appealed."[12] The court held that the "CREB Rules and procedures

cannot prevent the parties from exercising their rights under s. 44(2) of the *Arbitration Act*."[13]

This is not the only case where the court found a right to seek leave to appeal under s. 44(2) despite strong privative language. For example, the court readily entertained an application for leave to appeal in *Rudiger Holdings Ltd. v Kellyvone Farms Ltd*[14] despite the parties' agreement that:

> [t]he award to be made by the Arbitrator shall be final and binding on the parties hereto and shall in all respects be kept and observed by the parties. There shall be no right of appeal from the award of the arbitrator.[15]

Under s. 44(3), parties may not appeal an award to the court on a question of law that the parties expressly referred to the arbitral panel for decision. Therefore, the court's analysis focused on whether there was a question of law, not expressly put to the arbitral panel, for which leave was appropriate under s. 44(2). Finding none, the court declined to grant leave to appeal. Application to the court and the resulting awkward analysis could have been avoided and the same result could have been reached if the legislation allowed the court to respect the parties' expressed intent to negate all rights of appeal.

The arbitration agreement in *Ron-Dee Holdings Ltd. v. Ewanchuk*[16] manifested a similar intent. The parties agreed to final and binding arbitration, including no appeal to any court in the Province of Alberta.[17] Again, the court assessed rights for leave to appeal before finding that the arbitrator's decision rested on findings of fact and declining to grant leave to appeal under s. 44(2).

There are no reported decisions of the Alberta courts where privative language has been upheld in the face of s. 3 of the *Alberta Act.* As the above cases demonstrate, however, the same result is being achieved by the courts in an indirect manner.

(b) Option Two—Avoiding the Question

In other cases, courts have expressly avoided the issue, perhaps not wanting to trample on party autonomy. For example, in *New Way Homes Ltd v. Bateman*,[18] the arbitration was "expressly agreed" to be "final and binding on the Parties."[19] The court denied the Applicant leave to appeal the lower court's decision,[20] holding that the Applicant received due process in the Court of Queen's Bench and no appeal was warranted. The court chose not to address "the effect on the ability to appeal of the privative clauses in the Agreement, the Rules and the parties' arbitration agreement, given section 3 of the Act."[21]

Similarly, in *Knox v. Conservative Party of Canada*,[22] a full panel of the Alberta Court of Appeal heard submissions on the interaction of these provisions. However, the court found it unnecessary to determine whether an agreement that arbitration would be final and binding precludes an application under s. 44(2) for leave to appeal on a question of law, as no such application was brought in time to meet the limitation in s. 46 of the *Alberta Act*.[23]

(c) Inconsistency and Confusion

The protection of an invariable right to seek leave to appeal sits at odds with the inherent importance of party autonomy in the arbitral process. This tension appears to have hindered judicial efforts to develop a clear test for leave to appeal on a question of law.

Alberta courts have held that "the Legislature intended to restrict judicial intervention in decisions by privately appointed arbitrators."[24] Or, more expansively:

> It is clear that the legislature has chosen to limit the Court's intervention in arbitration decisions, emphasizing that where parties have chosen arbitration they should not have access to the Courts except in limited circumstances. This approach is intended to produce final and binding decisions in a quick and inexpensive proceeding.[25]

To give effect to this legislative intent, Alberta courts have imported a public interest requirement into the test for leave to appeal under s. 44(2), even though the statutory provision references only the importance *to the parties* and the rights *of the parties*. That requirement has been the subject of considerable judicial debate. The requirement was first advanced in *Warren*, where the court held that "some public interest or some resolution of some public issue must be triggered sufficient to warrant overriding the mutual agreement of the parties."[26] Subsequently, courts have denied leave to appeal on a question of law pursuant to s. 44(2) on the basis of the Applicant's failure to establish that the question engages a matter of public interest.[27] Other decisions have expressed "grave doubts" that the legislature intended a public interest requirement[28] and noted that nothing in the actual language of the legislation imposes a public interest requirement.[29] Recently, after determining that leave was inappropriate as the impugned question dealt with matters of fact and law, the court suggested that counsel forward the matter of the public interest requirement to the appropriate government department for review.[30] Whether or not the public interest requirement is appropriate is one of the primary questions addressed in the *ALRI Report*.

There is a better way to ensure limited judicial intervention. Arbitrations are governed by the terms of the parties' agreement. Allowing parties to exclude appeals to the court contractually (absent improprieties justifying an application to set aside the award) would not only respect party autonomy; it would also ensure that arbitration serves as a dispute resolution mechanism that is an alternative to the judicial system.

The *Alberta Act* currently provides for overbroad review. It allows parties access to two layers of dispute resolution venues rather than holding them to their choice of dispute resolution mechanism. Furthermore, it has resulted in litigation to determine an appropriate legal test for leave, which must of course be followed by applying the test to the facts of a given case.

Keeping It Simple

There is a better way. In Ontario and Saskatchewan, the courts have recognized parties' ability to resolve their agreement within the bounds of arbitration and to restrict court intervention to improprieties and injustices justifying the setting aside of an award.

The right to seek leave to appeal on a question of law, contained in s. 45 of the *Ontario Act*, is not included in s. 3 of that Act, which lists provisions the parties may neither vary nor exclude.[31]

Thus, in Ontario, the parties can agree to a final and binding arbitration with no appeal to the courts. Indeed in both *1210558 Ontario Inc v. 1464255 Ontario Limited*[32] and *Weisz v. Four Seasons Holdings Inc.*,[33] the court found that agreements providing for final and binding arbitration with no rights of appeal precluded the parties from seeking leave to appeal a question of law under s. 45.

As in Ontario, the provision governing rights to appeal in Saskatchewan is not included in the list of those that cannot be varied or excluded.[34]

Although the Saskatchewan Court of Queen's Bench had expressed some reluctance to find that parties had contracted out of rights to appeal,[35] more recent jurisprudence suggests a move toward (and perhaps even beyond) the Ontario approach. A clause providing that the arbitration "shall be binding upon the parties" and "conducted in accordance with [the *SK Act*]" was held sufficient to remove the right to judicial review implicitly under the *SK Act*.[36] The court was satisfied:

> … that the absence of a right of appeal provision in the Lease, a lengthy document covering all aspects of the tenancy arrangement in detail, confirms the parties did not intend awards made under s. 25.04 to be subject to appellate review.[37]

Even though the parties did not expressly agree to negate all appeal rights, the court found that this intent was implied. That is the proper approach to arbitration agreements containing privative language. Where parties develop lengthy or comprehensive arbitration agreements, including clauses expressly seeking to restrict or remove recourse to the courts, there is evidence of a deliberate intent and desire that the arbitral process decide the dispute(s) under the agreement in a final manner. That intent should be respected.

Conclusion

When the Alberta legislature enacted legislation modeled on the *Uniform Arbitration Act*, it chose to trump any agreement by the parties to negate all rights of appeal. Experience in Alberta and other Canadian jurisdictions with similar legislative schemes illustrates a need for change.

Parties who choose to arbitrate set forth the terms for the resolution of their disputes. Those terms often include privative language with the intent of restricting court intervention to the assurance of certain fundamental rights (violations of which justify setting aside an award). Clauses containing privative language should be respected. Doing otherwise impinges on the parties' freedom to contract. It is also counter productive.

Alternative dispute resolution mechanisms like arbitration aim to relieve the burden on our judicial system and to ensure finality of disputes. Overriding those goals with a paternalistic clause like s. 3 of the *Alberta Act* results in extensive, unintended, and unnecessary court proceedings. Cases still come before the court that would otherwise end with arbitral awards. Worse, the need to define tests for leave and apply them while minimally interfering with parties' freedom to contract has led to extensive and conflicting jurisprudence and a corresponding murkiness in commercial dealings.

One might argue that, in the area of consumer protection, public policy goals weigh in favour of a statutory provision such as s. 3. Any such goal could be achieved in a much more specific way instead of a provision such as s. 3 that applies in all instances, regardless of equality of bargaining power, sophistication of the parties, and their intention that there be only one shot at the outcome in a dispute. For instance, parties might agree to exclude any and all rights to appeal to the courts because they believe that the subject matter of the dispute is best decided in a final manner by an individual with certain qualifications, background, or experience stipulated by the parties. Alternatively, the parties may agree on a three-member arbitral panel of individuals specifically chosen in light of the dispute at hand, thinking that there will be more confidence in the decision resulting from that process. Confidentiality concerns may be paramount, meaning that the parties do not want to have the otherwise confidential arbitral award filed on the public court record, including as part of an application to seek leave to appeal.

Whatever the considerations, parties often have deliberate and considered reasons for wanting to exclude all appeal rights as part of the overall decision to submit disputes to arbitration.

As ALRI reviews the *Alberta Act* 20 years later, it is time to respect party autonomy by allowing parties to exclude all appeal rights. Parties would retain the right to set aside an award where improprieties or infringements on fundamental rights justify it, but they would also have the ability

to rely on a final process of their choosing to resolve their disputes appropriately.

[*Editor's note*: Bryan C. Duguid and Deborah Book are colleagues at Jensen Shawa Solomon Duguid Hawkes LLP in Calgary, the largest Canadian litigation boutique outside of Ontario. A substantial proportion of Bryan's practice is as counsel or arbitrator in arbitral proceedings involving business disputes of all kinds. Deborah has enjoyed significant experience with arbitration proceedings, primarily in the field of Energy Law.]

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1 Law Reform Commission of Canada *Uniform Arbitration Act* (Law Reform Commission of Canada, 1990), <http://web.archive.org/web/20110828165030/http:/www.ulcc.ca/en/us/Arbitrat_En.pdf>.

2 RSA 2000, c. A-43 [*Alberta Act*].

3 See *Arbitration Act: Stay and Appeal Issues*, Alberta Law Reform Institute, (Edmonton: The Institute, August 2012), <http://www.law.ualberta.ca/alri/docs/RFD24.pdf> ("*ALRI Report*").

4 *ALRI Report* at 44 [italics added].

5 This article will focus on the Alberta experience with an invariable right to seek leave to appeal. The provinces of Manitoba and New Brunswick have similar legislation. An extensive discussion of the law in those provinces is beyond the scope of this article. Readers wishing to inquire further may wish to consult *Stardust Enterprises Ltd v. Rubin's Realty Ltd*, [2000] N.B.J. No. 307 (N.B.Q.B.–T.D.), for New Brunswick jurisprudence on point.

6 *Alberta Act*, *supra* note 2 at s. 3.

7 The legislation empowers parties to apply to set aside an arbitration award where significant concerns of natural justice and proper procedure are at stake. For example, in Alberta, these include issues of capacity to contract, validity and scope of the arbitration agreement, whether the subject may properly be put to arbitration, unfair or unequal treatment, reasonable apprehension of bias, want of jurisdiction, improper procedures, and fraud (see s. 45 of the *Alberta Act*). Similar protections have been enacted across the country. These rights to apply to set aside an arbitral award are properly included in the provisions that cannot be varied or excluded by the parties' agreement.

8 *Alberta Act*, *supra* note 2 at s. 44(2).

9 [2012] A.J. No. 256 (Alta. Q.B.).

10 *Ibid.* at para. 3.

11 *Ibid.* at para 11.

12 *Ibid.* at para. 15.

13 *Ibid.* at para. 18.

14 [2002] A.J. No. 835 (Alta. Q.B.) [*Rudiger*].

15 *Ibid.* at para. 4.

16 [1993] A.J. No. 1274.

17 *Ibid.* at para. 4.

18 [2009] A.J. No. 219 (Alta. Q.B.).

19 *Ibid.* at para. 4.

20 The Chambers Judge's decision was not reported.

21 *Ibid.* at para. 20.

22 [2007] A.J. No. 1046 [Alta. C.A.].

23 *Ibid.* at para. 31.

24 *Frank v. Vogel & Co. LLP*, [2012] AJ No 718, at para. 17 (Alta. Q.B.).

25 *Fuhr Estate v. Husky Oil Marketing Co.*, [2010] A.J. No. 884, at para. 99 (Alta. Q.B.) [*Fuhr Estate*].

26 *Warren v. Alberta Lawyers' Public Protection Association*, [1997] A.J. No. 1041, at para. 17 (Alta. Q.B.).

27 See *Heredity Homes (St. Albert) Ltd. v. Scanga*, [2009] A.J. No. 435 (Alta. Q.B.); and *Alenco Inc. v. Niska Gas Storage US, LLC*, [2009] A.J. No. 351 (Alta. Q.B.).

28 *Rudiger*, supra note 14 at para. 39.

29 *Fuhr Estate*, *supra* note 25 at paras. 99–103.

30 *Milner Power Limited Partnership v. Coal Valley Resources Inc.*, [2011] A.J. No. 211, at para 22 (Alta. Q.B.).

31 *Arbitration Act*, S.O. 1991, c. 17 [*Ontario Act*].

32 [2011] O.J. No. 5143 at para. 4 (Ont. Sup. Ct.).

33 [2010] O.J. No. 3689 at para. 7.

34 *Arbitration Act*, *1992*, S.S. 1992, c. A-24.1, s. 45 [*SK Act*].

35 *Earth Vision Productions Inc. v. Saskatchewan Wheat Pool*, [1996] S.J. No. 664, at paras. 4–5 (Sask. Q.B.).

36 *Bank of Nova Scotia v. Span West Farms Ltd.*, [2003] S.J. No. 489, at para. 4 (Sask. Q.B.).

37 *Ibid.* at para. 18.

EXPERT WITNESSES AND ASSUMPTIONS: DON'T ASSUME THERE IS CONSENSUS

PETER STEGER

At a recent CICBV[1] workshop on the topic of experts and the use of assumptions, the presenters and audience had a lively debate about how assumptions should be handled as between experts and instructing counsel in commercial litigation matters. In one exchange, one of the presenting litigators declared: "I will give my expert all the assumptions he/she needs." This view resonates, in my experience, with many other commercial litigators. A number of valuation experts in the audience, however, took exception citing professional practice standards that impose stipulations on the use of assumptions in expert and valuation reports. Who's right? Both sides are.

This apparent divide stems from lumping all experts and assumptions together into one basket—the crux is to specify the type of expert and the type of assumptions being considered.

This article addresses the assumptions debate in the following sections: (i) liability experts versus quantum experts, (ii) CICBV and CICA-IFA[2] standards, (iii) use of scenarios, (iv) establishing facts, (v) where counsel-provided assumptions make and don't make sense, and (vi) conclusion.

Liability Experts versus Quantum Experts

Liability experts in commercial cases may include, as examples, GAAP/GAAS[3] experts in financial statement misrepresentation cases or investment suitability experts in rogue investment advisor cases. In such cases, counsel will usually provide, and the expert will be asked to assume, a set of facts regarding a sequence of events as well as evidence of who said/did/knew what. These types of experts need not be concerned with proving or assessing these historical facts. Rather, this expert will be asked, based on the set of assumed facts (which will be counsel's job to prove at trial), to opine whether the incumbent accounting treatment or investment strategy met professional standards.[4]

In contrast, quantum experts in commercial cases are tasked with quantifying the damages suffered by an aggrieved party, say, in a breach of contract case or the value of a business in a shareholder dispute. In such cases, a necessary assumption is that liability will be found at trial—that is, the contract was breached or that a shareholder buyout event was triggered. However, the quantum expert provides no representation as to legal interpretation. If no liability is found, then the loss assessment will not be necessary.[5]

To quantify damages or determine business value, the quantum expert will generally consider myriad business issues such as estimating the level of "but-for" or future sales, gross margins thereon, other relevant variable and fixed costs, normalizing adjustments, tax rates, cost of capital, and an appropriate discount rate to account for the time value of money and risk in relation to future amounts. Other factors such as the level of overhead costs saved as the result of a contract termination, the amount of offsetting mitigation, or other contingencies may also be considered. Finally, the quantum expert will consider the overall context and direction of the industry in question, competition, and the parties' positions within that industry.

Should a commercial litigator or the client party ever instruct, and should the quantum expert ever

accept, to assume significant business assumptions without the expert doing independent corroboration and diligence? The standards of CICBV and CICA-IFA say no (see the next section). Most importantly, the courts say no, and there are plenty of cases where judges have been critical of quantum experts relying on unfounded and speculative assumptions, as the following examples illustrate.

In *Love v. Acuity Investment Management Inc.*,[6] the judge was critical of the plaintiff's expert who took the plaintiff's damages model and "put it forward unchanged in any material respect conceptually and un-audited for accuracy of the facts assumed within the model." Further, the judge found that the expert's growth assumptions, which were provided by the client party and considered reasonable by the expert, were "startlingly unreasonable."[7]

In *Virani v Dhami*,[8] the judge found that: "[The defendant's expert] properly centered his estimate of [business] value on what I would call generally accepted accounting practices and avoided [the opposing expert's] exaggeration based on exuberance and out-and-out speculation."[9]

It is imperative that the quantum expert lay out the basis for the estimates and assumptions used. Each of them should be tested against business reality. So, in a terminated contract case, if an expert estimates that but-for sales would have been $100 million with an annual growth rate of 2 per cent for the next five years, then this estimate should be rooted in an independent review of relevant information such as the average historical sales and growth rates of the company, the budgets and forecasts of the company, benchmark levels of comparable companies, general market forecasts, or estimates made by other qualified experts.[10] Using numbers that appear to be plucked from the sky is a recipe for disaster and is of no assistance to the court.[11]

CICBV and CICA-IFA Standards

The CICBV and the CICA-IFA have both promulgated standards for its members in respect of the use of assumptions in expert's reports.[12] The CICBV Practice Standards in respect of Expert Reports[13] stipulate the following:

> 310.9.2. At a minimum, all Expert Reports that will (or likely will) be disclosed publicly (e.g. in open court, in a prospectus, etc.) shall include the following information …
>
> E. Assumptions used and the procedures followed to determine the reasonableness and appropriateness of key assumptions; (*Explanatory comments*: the expert should classify the assumptions used as:
>
> (i) those assumptions that the Expert is directed to take, that are not within his/her area of expertise;
>
> (ii) those assumptions made by the Expert, within his/her area of expertise and based on scope of work executed by him/her; and
>
> (iii) those assumptions that the Expert is directed to take on matters that are within his/her area of expertise, but where the Expert was not provided the opportunity to execute a scope of work appropriate to add assurance to the assumption.)
>
> 320.5.D. The Expert shall consider key assumptions used and determine the reasonableness and appropriateness of key assumptions. (*Explanatory comment:* The Expert is not required to determine the reasonableness and appropriateness of assumptions that fall outside the Expert's area of expertise. These assumptions may include facts to be proven in court and non-financial information presented by other specialists.)

The CICA-IFA rules are similar and require the IFA to assess the reasonableness of estimates and assumptions, including those provided to the IFA. For example, the CICA-IFA Standard Practices stipulate that IFA practitioners should:

(i)"evaluate the reasonableness and consistency of all estimates and assumptions" (400.10);

(ii)"consider the reasonableness of those estimates and assumptions" that are outside their expertise but being relied upon (400.11);

(iii)"consider and address reasonable alternative theories, approaches and methodologies that may be relevant to their work" (400.13); and

(iv)"evaluate the nature and level of intended reliance on the work and/or information of others … [including] … (e) the overall reasonableness of their assumptions, methodologies, findings and conclusions" (400.15).

Establishing Facts

Two additional areas worth mentioning relate to establishing facts.

First, quantum experts are often retained after the "facts" of productions and examinations for discovery have been completed and there is no prospect for re-opening the examinations. Often, because of this or other inherent limitations where financial data is unavailable, ambiguous, or contradictory, experts must necessarily make reasoned assumptions in order to fulfill their quantification mandate. However, a quantum expert should be careful not to use blind assumptions as an excuse for not seeking out facts.

In *DeBora v. DeBora*,[14] a matrimonial dispute involving the valuation of the husband's business interests, the husband did not produce many documents and did not answer many questions relating to his business interests. The husband's expert thus prepared his valuation without this information, making assumptions where information was missing. The wife's expert dug deeper to arrive at a coherent picture of the financial facts by putting together "bits and pieces of often contradictory disclosure made over a prolonged time period."[15] The judge found that the "husband's deliberate obfuscation and failure to disclose infected [his expert's] work"[16] and, therefore, preferred the wife's expert's evidence in most cases.[17]

Second, a common rule is that an expert's mandate never usurps the trier of fact's purview to weigh evidence and make findings of fact. But, what about the forensic accountant who has been tasked to determine the quantum of losses suffered in an inflated invoice scheme? In these cases, the expert is providing a measure of financial fact finding.

For example, in a case involving alleged collusion between a purchasing manager and colluding vendors to create dummy invoicing or inflate the value of services provided to the manager's corporate employer, the forensic accounting expert will seek out relevant purchase orders, supplier invoices, cheque requisitions, cancelled cheques, the company's general ledger, and various other related documents that indicate the quantum of loss and how the scheme was perpetrated. In my view, these are financial facts and their presentation to the court by the forensic accounting expert does not usurp the trier of fact; rather, it assists the trier of fact who will then determine whether these financial facts, being part of the totality of evidence at trial, constitute fraud in a civil or criminal context.

Use of Scenarios

Another related area is whether the use of alternative scenarios developed by the expert or provided by counsel is viewed positively or negatively by the courts. On the one hand, it is generally accepted within valuation practice that a low and high range be provided in the valuation of a business interest (the valuator will often conclude on the mid-point). In damages cases, the quantum expert may also prepare a conclusion on quantum that reflects scenarios that reflect different, but plausible, alternatives for which the trier of fact will weigh the evidence including expert testimony as to the most appropriate scenario.[18]

But, as noted in the previous section, the use of scenarios should not be used as an excuse not to seek relevant facts and support.

In *Independent Multi-Funds Inc. v. The Bank of Nova Scotia*,[19] the plaintiff's expert prepared five

scenarios of financial loss but did not provide an opinion as to whether any was more reasonable than the other, and, therefore, did not provide a "bottom line"[20] on the quantum of damages. The judge found "the lack of evidence at the trial to support the assumptions on which [the expert's] report is based, seriously undermines the usefulness of that document."[21] Further, the judge noted that one claim "is founded on bare hope and not on reality. In those circumstances, one must question the decision to include scenarios involving [it]."[22]

Where Counsel-Provided Assumptions Make and Don't Make Sense[23]

Based on the foregoing, assumptions provided by counsel to the quantum expert generally make sense in cases of

- liability (*i.e.*, that a breach of contract or misrepresentation occurred);
- historical facts (*i.e.*, regarding the conduct or positions of the parties);
- contractual interpretation (*i.e.*, the priority rankings of shares and debt of a company);
- length of time damages are payable (*i.e.*, the notice period of a cancelled distributorship/near-employee or contractual time limits citing the *Open Window Bakery* case);[24]
- quantification inputs that are outside the quantum expert's area of expertise (*i.e.*, oil reserves, real estate appraisal values, or zoning/construction timetables); and
- where productions (especially e-mails) are voluminous, extraneous, and focusing on liability issues and only an excerpted quantity is provided to the expert (*i.e.*, it may be unnecessary and cost-prohibitive to have a quantum expert replicate an entire review of all productions).

In contrast, counsel-provided assumptions often don't make sense in cases of

- fundamental business inputs (*i.e.*, revenue growth, cost levels, etc.);
- fundamental valuation determinations (*i.e.*, discount rate, capitalization rate);
- where productions or examinations for discovery are relevant to financial quantum but are not provided to the expert (*i.e.*, this places a scope limitation on the expert and may set up the expert for an ambush on cross-examination);
- cost-cutting considerations.

Conclusion

When dealing with liability experts, it is often the case that all significant assumptions are provided by counsel. However, when dealing with quantum experts, many of the key assumptions are those of the expert.

A quantum expert's mandate is often complex, and the methodology, estimates, and assumptions employed will be subject to intense scrutiny. The availability of financial data is often neither perfect nor uniform, thus necessitating the use of assumptions or estimates. Both the CICBV and CICA-IFA have promulgated standards to its members on the use of assumptions. And, there are many court decisions highlighting judges' criticisms of experts' use and abuse of assumptions. In the end, a quantum expert should be able to affirmatively respond to the pointed question: what work did you do to determine if this assumption or estimate is reasonable?

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quantification, business valuation, and forensic accounting.]

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1 Canadian Institute of Chartered Business Valuators.

2 Canadian Institute of Chartered Accountants–Alliance for Excellence in Investigative and Forensic Accounting.

3 Generally Accepted Accounting Principles (now, IFRS—International Financial Reporting Standards) and Generally Accepted Auditing Standards.

4 Other liability experts include, among others, medical professionals in malpractice cases, scientists in pharmaceutical patent infringement cases, and mechanical engineers in fitness-of-construction cases.

5 In bifurcated cases where liability and damages are heard separately, liability will already be established.

6 [2009] O.J. No. 2288 (Ont. Sup. Ct.).

7 *Ibid.* at paras. 140 and 142.

8 [2003] B.C.J. No. 342 (B.C.S.C.).

9 *Ibid.* at para. 76.

10 Other experts might include marketing experts on forecasted sales levels or real estate appraisers for property values, etc.

11 See "Addendum to Credibility under Scrutiny: Final Findings and Views from the Bench," Lobo/Henein, August 2012, Canadian Institute of Chartered Business Valuators. The authors cite survey responses from judges who unanimously indicated that it was "essential" to disclose an expert's significant assumptions.

12 CBV experts are often called upon to address business value as well as damages quantification. IFA experts also address damages quantification along with financial investigations.

13 The CICBV Practice Standards define an Expert Report as "any written communication other than a Valuation Report [as defined next], containing a conclusion as to the quantum of financial gain/loss, or any conclusion of a financial nature in the context of litigation or a dispute, prepared by an Expert acting independently (310.2)." The CICBV Practice Standards define a Valuation Report as "any written communication containing a conclusion as to the value of shares, assets or an interest in a business, prepared by a Valuator acting independently (110.2)." The Valuation Report standards also state that "[A]ll Valuation Reports … shall include the following information … B. A statement of the key assumptions made in arriving at the valuation conclusion (110.13.2.B)." The CICBV also has Practice Standards in respect of Limited Critique Reports and Fairness Opinions that also contain standards on assumptions.

14 [2004] O.J. No. 4826 (Ont. Sup. Ct.).

15 *Ibid.* at para. 345.

16 *Ibid.* at para. 350.

17 See further discussion in *"Credibility under Scrutiny: A Research Study of the Weight Placed on Expert Valuation and Damages Evidence in Canadian Court Judgments,"* Lobo/Henein, October 2011, Canadian Institute of Chartered Business Valuators).

18 For example, in "Section 8" cases under the *Patented Medicines (Notice of Compliance) Regulations*, a plaintiff generic pharmaceutical company may sue an innovator pharmaceutical company for losses suffered during the period that the generic was unjustly kept off the market due to a prohibition proceeding pursuant to the *Regulations*. In these cases, various scenarios may be considered regarding what market share the plaintiff generic would have achieved or when other generics would have entered the market in the hypothetical but-for delay period.

19 [2004] O.J. No. 340 (Ont. Sup. Ct.).

20 *Ibid.* at para. 129.

21 *Ibid.* at para. 131.

22 *Ibid.* In a case involving the quantification of damages suffered by a plaintiff due to the actions of a rogue investment advisor (as addressed above), a quantum expert is often provided with scenarios as to alternative investment portfolios the plaintiff would have invested in but-for the rogue trading.

23 These are not exhaustive lists.

24 [2003] S.C.J. No. 72 (S.C.C.).