

# LIMITING RIGHTS OF FIRST REFUSAL NOT AN EASY BUSINESS

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The recent decision of the Ontario Court of Appeal in *1440825 Ontario Inc. v Lenco Investment Ltd.*<sup>[1]</sup> sends a clear message to the landlord community (and perhaps more broadly) that courts will go to great lengths to give effect to a tenant's right of first refusal ("**ROFR**"), even where the lease contains language purporting to limit such ROFR. In particular, this judicial inclination will be more pronounced where facts suggest an absence of good faith on the part of the landlord in its dealings with the tenant.

## **Facts in Lenco**

The landlord and tenant entered into a lease on February 7, 2013 that contained a ROFR in favour of the tenant to purchase the leased property. The ROFR obligated the landlord to notify the tenant in the event the landlord received a third party offer to purchase the property. The tenant was allowed 30 business days from receipt of the purchase offer to elect whether it wants to match the third party offer and purchase the property.

However, the ROFR also contained a limitation in that it could be terminated if either the landlord or tenant gave notice to terminate the lease pursuant to the lease's termination clause. Among other things, the termination clause provided that, should the property become subject to an agreement of purchase and sale with a third party, the landlord had the right to terminate the lease (including the ROFR) after March 1, 2014, upon providing the tenant with 3 months' written notice to terminate.

On February 26, 2014, the landlord received a third party offer to purchase the property, but never gave notice of it to the tenant. Instead, the landlord accepted the third party offer, entered into an agreement of purchase and sale with the third party, and on March 21, 2014 sent a notice of lease termination to the tenant, attaching therein a copy of the agreement of purchase and sale that was entered into between the landlord and the third party. The notice of termination stipulated that the tenant had until June 30, 2014 to vacate the leased premises in order to provide vacant possession of the property to the landlord.

On March 27, 2014, the tenant wrote to the landlord advising that it intended to enforce its rights under the lease and on April 24, 2014, the tenant submitted notice of its election to exercise the ROFR.

## **The Lower Court Decision**

The parties brought applications to the Ontario Superior Court of Justice (the "**Lower Court**") to interpret the ROFR. The Lower Court held that the landlord had properly terminated the lease and the ROFR. The application judge concurred with the landlord's actions and found that the intention of the parties was for the ROFR to be specifically limited by the lease termination provision. The lease made the ROFR subject to the landlord's termination right, provided that the termination notice was given after March 1, 2014.

The application judge agreed in principle with the tenant's submission that there is considerable case law stating that once the third party offer is received, the ROFR crystallizes into an option to purchase, giving the tenant an equitable interest over the property. However, the application judge distinguished those cases from the case at hand on the basis that, unlike in *Lenco*, the ROFRs there were not subject to a specific limitation and that neither party there had the ability to end the relationship.

According to the Lower Court, the existence of the specific ROFR limitation gave the landlord a categorical right to terminate the ROFR and the tenancy after March 1, 2014, once the agreement of purchase and sale was in place with the third party. In the Lower Court's view, the right to so terminate the ROFR and the lease would have been available to the landlord even if it had first given proper notice of the third party offer to the tenant (which it had not done). Based on the foregoing, the Lower Court concluded that the landlord was correct in its interpretation of the lease and the manner in which it conducted its actions.

### **The Appeal Court Decision**

The Appeal Court overturned the Lower Court's decision and ruled in favour of the tenant. The Appeal Court did not specifically focus on the question of whether the tenant's ROFR was limited by the wording of the termination provision. Instead, it adopted a contextual approach to interpreting the lease provisions as a whole. According to the Appeal Court, the ROFR and the termination provisions "must be read together and, to the extent possible, meaning must be accorded to each in accordance with the intentions of the parties as reflected in the language of the lease".<sup>[2]</sup>

Through this interpretive approach, the Appeal Court read the tenant's ROFR and the landlord's termination rights as sequential rights. Upon the landlord's receipt of the third party offer to purchase, first came the tenant's right to know of the existence of the offer and to decide whether it wants to match such offer. It was only after the tenant was given an opportunity to match the third party offer (and its election to not match it) that the landlord was "free to unconditionally accept a third party offer", thereby enabling the landlord to terminate the lease (including the ROFR) pursuant to the termination provisions therein.

The Appeal Court flatly rejected the landlord's interpretation that its compliance with the ROFR provision "was entirely at its discretion". Such interpretation renders the tenant's ROFR "valueless", said the Appeal Court, as the landlord would have the final say on whether the tenant could exercise its ROFR. Further, it "fails to accord

any meaning to a key provision of the lease and is inconsistent with the landlord's obligation of good faith dealings with the tenant."<sup>[3]</sup>

On the foregoing basis, the Appeal Court concluded that (a) the tenant's ROFR had not been terminated when the landlord delivered its notice of lease termination on March 21, 2014, and (b) the tenant had validly exercised the ROFR on March 27, 2014. Hence, the landlord was ordered to enter into an agreement of purchase and sale with the tenant on the same terms offered by the third party.

### **Lenco's Practical Implications**

Canadian courts have traditionally demonstrated a readiness to find in favour of parties having the benefit of a ROFR.<sup>[4]</sup> However, the Appeal Court decision in *Lenco* takes this judicial tendency to a new level in that it effectively nullifies a specific ROFR limitation that was negotiated by the parties. If, as the Appeal Court's ruling suggests, the tenant's ROFR is invariably triggered prior to the landlord's right to terminate the ROFR under the termination clause, then the landlord's termination right has been rendered conceptually meaningless. This is in stark contrast to the Lower Court's decision which instead renders the tenant's ROFR practically meaningless.

As the Appeal Court's ruling in *Lenco* will bind the lower courts of Ontario (and will likely carry substantial persuasive weight with other Canadian courts), it is prudent for landlords (and other commercial parties) to be mindful of the ramifications of this decision when considering imposing limits on a ROFR granted to a tenant (or other counterparties).

A principal message coming out of the Appeal Court's decision in *Lenco* is that a ROFR cannot be limited in such a way that it can only be exercised at the sole discretion of the party granting it. Such a limitation has a good chance of being read down by an Ontario court. Unless there is express wording in the agreement stating that the ROFR is exercisable by the benefiting party at the sole discretion of the party granting it (query whether a counterparty would be interested in a ROFR so qualified), the judicial preference will be to avoid such interpretation as being contrary to the parties' intentions. If limiting the ROFR is an essential requirement for the party granting it, other less sweeping limitations should be considered such as limiting the timeframe during which the ROFR may become exercisable, or limiting the time the benefiting party has to match the third party offer to purchase.

Another precept to be derived from the Appeal Court's holding in *Lenco* is that bad faith on the part of the landlord will further motivate a court to neutralize a ROFR limitation. In *Lenco* the landlord had received the third party offer to purchase on February 27, 2014, and had not informed the tenant of the offer until March 21, 2014, (after March 1, 2014, the date after which the landlord could terminate the lease). Had the landlord informed the tenant of the third party offer before March 1, 2014, it would have been a non-starter for the

landlord to argue that the tenant's ROFR was limited by the landlord's termination right, as it had no such right prior to that date.

Although there is no specific finding of bad faith in *Lenco*, the landlord's delay in informing the tenant suggests to some degree an absence of good faith on the part of the landlord. This seemingly calculated conduct by the landlord appears to be informing the Appeal Court's general reference to the "landlord's obligation of good faith dealings with the tenant". It is well established in Canadian jurisprudence that a party granting a ROFR cannot defeat it by acting in bad faith.<sup>[5]</sup> This judicial position was further reinforced by the recent unanimous decision of the Supreme Court of Canada in *Bhasin v Hrynew*,<sup>[6]</sup> where a general duty of good faith in contractual performance was found to exist in Canadian law.

Given the current legal landscape, prudent landlords and other commercial parties granting a limited ROFR should recognize that their chances of successful reliance on a ROFR limitation will likely dwindle if their dealings with the counterparty amount to, or may be perceived as, acting in bad faith.

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1 2014 ONCA 903 [**Lenco**].

2 *Ibid* at para 9.

3 *Ibid* at para 11.

4 See for instance: *Landymore et al. v Hardy et al.*, 1991 CanLII 4299 (NS SC); *GATX Corp. v Hawker Siddeley Canada Inc.*, [1996] OJ No 1462; *Downtown King West v Massey Ferguson Industries Ltd.*, [1993] OJ No 1735; *Benzie v Kunin*, 2012 ONSC 1604.

5 *Ibid*.

6 2014 SCC 71.

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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