Hail the ROFR: Another Non-Compete Bites the Dust at the Ontario Appeal Court

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Last January, the Court of Appeal for Ontario (Appeals Court) provided judicial clarity on the interplay between specific real estate documentation and broader commercial agreements in the context of a share purchase transaction. In *Goodlife Fitness Centres Inc. v. Rock Developments Inc*.,1 the Appeals Court emphatically overturned a lower court's decision, and in clear language pronounced that:

- in the absence of express wording to the contrary, a specific right of first refusal (ROFR) cannot be superseded by a related and broadly worded non-competition agreement (Non-Compete Agreement); and
- courts should not rely on evidentiary material from the parties' negotiations when interpreting final executed agreements.

Background

In June 2014, Goodlife Fitness Centres Inc. (GFC), as operator of health and fitness facilities across Canada, entered into an agreement to purchase the shares of a Windsor-based competitor, Lifestyle Family Fitness Centre Inc. (LFF). At the time, LFF's principal was Rocco Tullio (Tullio). In addition, Tullio was an owner and the controlling mind of Rock Developments Inc. (RDI) and of certain other entities. RDI was the registered owner of the property known as 650 Division Rd, Windsor, Ontario (Property 1); the other entities controlled by Tullio owned two other commercial sites in the Windsor area (Property 2 and Property 3, respectively).

Before the closing date of the share purchase deal (November 30, 2014), GFC requested assurances from Tullio that he would not engage in competing fitness club operations in the Windsor area. GFC initially sought to place restrictive covenants on each of Property 1, 2 and 3, prohibiting the use of these properties as health and fitness facilities. Tullio accepted the restrictions on Property 2 and 3, but not on Property 1. Instead of a restrictive covenant on Property 1, Tullio executed a ROFR in favour GFC. Under the ROFR, GFC had the option to lease Property 1 on the same terms as those contained in a lease offer made by a third-party fitness facility operator; if GFC declined to so exercise the option, Tullio could then lease it to the third-party offeror.

On the closing of the share purchase transaction, Tullio also executed an Non-Compete Agreement in favour of GFC, pursuant to which Tullio would be barred from (among other things) having a "business or financial interest" in a fitness-related business, and from "providing … development services … to any person engaged in" a fitness-related business. The Non-Compete Agreement had a 5-year term (expiring on November 30, 2019), and designated all of Canada as the restricted territory.

Prior to the expiry of the Non-Compete Agreement, on July 30, 2018, Tullio (via RDI) entered into a lease agreement with a competing gym operator, Movati Athletics Group (Movati), for the leasing and development of a fitness facility on Property 1. In accordance with the ROFR terms, GFC was notified and given the opportunity to lease Property 1 on Movati's terms, but declined to exercise the lease option. Tullio then proceeded to lease Property 1 to Movati, and readied the site for Movati by providing certain grading and landscaping services.

Shortly thereafter, GFC brought an application with the Ontario Superior Court (the Lower Court) to have Movati's lease declared void on the basis that it breached the Non-Compete Agreement, and sought an injunction to stop Tullio from providing services to Movati.

Lower Court's Decision

In its decision,2the Lower Court allowed GFC's application, declaring Movati's lease void *ab initio* and granting an injunction requiring Tullio to refrain from providing any further services to Movati.

In its reasoning, the application judge of the Lower Court focused on the parties' negotiations prior to the signing of the Non-Compete Agreement and the ROFR. In so doing, he concluded that the Non-Compete Agreement was paramount over the ROFR and that the ROFR was intended to "supplement" the Non-Compete Agreement by "adding an additional layer of protection" for GFC. For the Lower Court, there was no doubt that when the share transaction closed, the parties' intention was for Tullio to "play no role whatsoever in facilitating the start-up and operation of a fitness facility" on Property 1 during the term of the Non-Compete Agreement. According to the Lower Court, by declining to exercise its lease option under the ROFR, GFC did not forfeit the protection conferred to it by the Non-Compete Agreement in respect of Property 1. Rather, the restrictions in the Non-Compete Agreement would remain intact in respect of Property 1, unless GFC consented or until the Non-Compete Agreement expired. In other words, during the term of the Non-Compete Agreement, the ROFR could only operate to create an opportunity for GFC to purchase Property 1, and not as a mechanism to sidestep the Non-Compete Agreement.

Further, the Lower Court rejected Tullio's alternative argument that, even if the Non-Compete Agreement was paramount, the language of the Non-Compete Agreement itself did not prohibit the lease to Movati or the grading and landscaping services it provided to Movati. Because Tullio was not just collecting rent from Movati, but also preparing Movati's fitness facility to compete with GFC and influencing the schedule of preparations, the Lower Court found the specific leasing arrangement put in place with Movati to be in violation of the overall purpose of the Non-Compete Agreement. Moreover, the Lower Court found the grading and landscaping services Tullio provided

to Movati to fall within the meaning of “development services”, which were prohibited under the Non-Compete Agreement.

Court of Appeal Ruling

In a unanimous ruling, the Appeals Court unequivocally overturned the Lower Court’s decision. More specifically, the Appeals Court took the application judge to task on three fronts.

First, it disagreed with the application judge’s finding that the Non-Compete Agreement had paramountcy over the ROFR. According to the Appeals Court, there was no language in either of these documents indicating which had supremacy over the other. On a plain reading, the two documents could and should be read together, as creating concurrent obligations for Tullio: he was required to abide by the Non-Compete Agreement, while at the same time having an independent obligation under the ROFR to give to GFC the option to lease Property 1, which he did. In the Appeals Court’s view, nothing more could be derived from the contractual wording as to the interplay between these two agreements.

Second, the Appeals Court held that the application judge made “a palpable and overriding error of fact”, by misconstruing the substance of the parties’ negotiations, on which he relied for his conclusions. More particularly, the applications judge had omitted from his analysis the correspondence where Tullio’s specifically refused to make Property 1 subject to the requested restrictive covenant. According to the Appeals Court, this was a fateful oversight by the Lower Court, as it failed to account for the fact that the ROFR in respect of the Property 1 was agreed to, precisely as a substitute to the requested restrictive covenant.

Third, the Appeals Court found the applications judge to have “erred in relying on the negotiations to interpret the agreements”. The Appeals Court noted that in its own rulings over the years, it has frequently discouraged the use of negotiations as an aid to interpreting contracts. From a review of some of the Appeals Court‘s recent rulings on this point, the overall contractual interpretation principle that emerges is that, while reference may be had to the objective evidence of the “factual matrix” that characterizes contract negotiations, evidence of negotiations generally falls outside the “factual matrix”. The Appeals Court concluded that the application judge made findings of fact that were both “erroneous and not open to him”, when he relied on negotiations to interpret the ROFR.

Instead, the Appeals Court held that the plain wording of the ROFR must prevail. That wording clearly contemplated Tullio’s right to lease Property 1 to a third-party gym operator, if GFC declined to exercise the ROFR (as it did in this case). So long as Tullio acted within the scope of the ROFR, the broader restrictions contained in the Non-Compete Agreement would have no application. Having found the Movati lease to be valid, the Appeals Court also agreed with Tullio’s submission that his services to Movati were legitimate, as falling within the scope of what a landlord may ordinarily provide to a tenant. In the Appeals Court’s view, it would be a “commercial absurdity” and an indirect “invalidation of the lease” to prohibit Tullio from preparing a site that is being rented pursuant to a valid lease.

Legal Practice and Commercial Implications

Distilled to its essence, some of the key takeaways that emerge from this fresh and emphatic ruling are:

- Legal practitioners and business principals should be mindful of how interweaving contracts may handicap a Non-Compete Agreement, if they are hoping to rely on one. While Non-Compete Agreements have traditionally attracted judicial disfavour because they tend to impose undue restraints on trade, in this particular case, reliance on the Non-Compete Agreement was unsuccessful due to the existence of another interacting agreement – the ROFR – which provided clear rights that ran counter to the general wording of the Non-Compete Agreement.
- No agreement in a transaction will be deemed paramount over another unless there is express wording to that effect. In the absence of such wording, the parties' rights and obligations contained in a contract that is narrower in scope (as in the case of a ROFR), will not be negated by the language of a contract that is broader in scope (such as the Non-Compete Agreement).
- As a general proposition, material pertaining to negotiations will be excluded as an aid to contractual interpretation. This is a welcome clarification for legal practitioners, as it removes a considerable amount of uncertainty that has long been lingering on this point.3
- There is no substitute for clear and precise contract drafting, if businesses wish to minimize the prospects of costly litigation and undesirable judicial outcomes. At least in Ontario, courts will be reluctant to venture outside the four corners of the agreement if the contract in question provides sufficient commercial certainty.

1 2019 ONCA 58, 2019 CarswellOnt 1034.

2 *Goodlife v. Rock Developments et al.,*2018 ONSC 6755, 2018 CarswellOnt 19196.

3 See Geoff R. Hall,*Canadian Contractual Interpretation Law,*3rd ed. (Toronto: LexisNexis Canada Inc., 2016) at 101

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