

KEEPING CURRENT

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Therapists not personally liable for debts of bankrupt sports medicine clinic

By James R.G. Cook

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A creditor who sees the owners of a bankrupt company start up a new profitably-looking business while walking away from the prior company's debts may understandably feel that they have been wronged. Whether the bankrupt business had any value as a going concern is one of the many issues that a trustee in bankruptcy may consider, along with the potential for personal liability of the owners or other parties for the bankrupt company's debts. If the trustee declines to pursue any claims for recovery on behalf of the bankrupt company, a creditor may seek leave to do so.

Proof of wrongdoing, however, requires cogent evidence that establishes more than mere suspicions.

In the case of *1100 Walkers Line Inc. v. The Elliott Sports*, [2022 ONSC 6291 \(CanLII\)](#), Elliott Sports Medicine Clinic Inc. operated as a sports medicine clinic owned by two therapists. Before the COVID-19 pandemic, there were three doctors who worked through the clinic who were a major source of referrals to the clinic's therapists.

When the COVID-19 pandemic hit in

March 2020, the clinic advised its landlord that it had lost its ability to earn revenue because the regulators of the various health professions required it to close. The doctors left as well.

In June 2020, the landlord advised the clinic that the lease had been renewed for a further five-year term that had commenced in April. In response, the clinic took the position that it had not renewed the lease and that the lease would terminate on October 4, 2020.

On the same day that they heard from the landlord about the lease renewal, the two therapists incorporated a new company. In late September 2020, the clinic moved to new premises, still using the name Elliott Sports.

The landlord sued the clinic for breach of the lease and obtained summary judgment for damages of more than \$850,000. After the judgment was rendered, the clinic made an assignment in bankruptcy. The landlord was by far the largest creditor.

The landlord discovered that the signs at Elliott Sports' new premises had

been changed to *Energy Sports Medicine and Wellness Centre*, although the logo mimicked the logo previously used by Elliott Sports. While the Elliott Sports website did not expressly send customers to Energy Sports, a search of the practitioners' names did so. Energy Sports appeared to have rather seamlessly assumed the business of Elliott Sports.

As a result of these developments, the landlord sought to pursue various claims against the individual therapists and their new business under the oppression remedy in [sections 245 and 248](#) of the [Business Corporations Act](#), R.S.O. 1990, c. B.16, and additional relief under the [Fraudulent Conveyances Act](#), R.S.O. 1990, c. F.29, the [Assignments and Preferences Act](#), R.S.O. 1990, c. A.33, and [section 96](#) of the [Bankruptcy and Insolvency Act](#), R.S.C. 1985, c. B.3 (the "BIA").

The landlord argued that the respondent therapists had used their positions as directors and shareholders of Elliott Sports to flip the assets of the bankrupt company to the new business that they owned and managed. The landlord argued that the new business was operating out of the same location as the bankrupt and did not pay fair market value for the business, which amounted to fraud on the creditors of the bankrupt estate, oppression, and/or a fraudulent conveyance.

A creditor who believes that a proceeding should be brought against another party for the benefit of a bankrupt's estate may seek to do so at its own risk and expense under [section 38](#) of the [BIA](#). The creditor must first ask the trustee to pursue the proceeding, but if the trustee declines, then the creditor may then seek leave of the court to do so.

Although the landlord obtained the order to pursue the claims, the court determined that there was insufficient evidence of any actionable wrongdoing by the respondents. The

court found that there was no evidence that the business of Elliott Sports had any realizable value as a going concern on the date of bankruptcy or in the days leading thereto when Energy Sports was organized. Rather, Elliott Sports was "hopelessly insolvent".

The landlord pointed to the bankrupt company's unaudited (notice to reader) financial statements for the 2020 fiscal year which disclosed "goodwill" carrying a net book value of \$400,000, and argued that Energy Sports stepped into a going concern business rather than developing a new fledgling business. The necessary inference was that the shareholders cooked up the bankruptcy to cover the fact that they kept or gave to their own new business the valuable goodwill that was the going concern of the bankrupt company.

In the court's view, however, financial statements are not necessarily a present valuation of the business or of any of its assets. The \$400,000 entry for goodwill meant only that at some point in history, the company's accountant found that at least \$400,000 had been paid for something that then qualified as goodwill from an accounting perspective. This was insufficient evidence that there was any value to the business as a going concern on the date of bankruptcy.

Further, in a small, closely held, private company, funds could be removed by its owners in many ways, including by salary, shareholder loan accounts, interest expenses, entertainment expenses, and non-cash expenses like depreciation. The financial statements themselves did not show the true operating picture of the company.

Simply put, the claims required much more analysis than was presented at the hearing. While financial statements could be used as a starting point, expert evidence is generally required to prove the value of a business at a given point in time.

The landlord argued that the respondents ought to have put evidence before the court to explain how Energy Sports got into the position it did. However, the burden was on the landlord applicant to establish a breach of its reasonable expectations as a creditor, badges of fraud, a transfer at undervalue, or other wrongdoing.

The court did not see any badges of fraud in the circumstances. Elliott Sports disclosed its debt to the landlord in its bankruptcy filings. The trustee's report recommended that the court approve the sale of the assets to Energy Sports for \$5,405. Accordingly, the only proven non-arm's length transfer of assets occurred with court approval and full disclosure under the [BIA](#). In the court's view, there was nothing untoward about a business with a massive debt going bankrupt or the owners starting a new business at the same premises provided the law has been observed. There was no basis to reverse the onus of proof and require Energy Sports to disprove a presumption that it had a fraudulent intent on an unproven conveyance.

While the court was not blind to the practicality that Energy Sports is probably operating the business previously operated by the bankrupt, that probability alone did not mean that it unlawfully received assets with realizable value. The landlord's application was therefore [dismissed](#).

One of the court's stated concerns with the application was that the landlord did not fully engage with the bankruptcy process. As the dominant creditor of the bankrupt estate, the landlord was entitled to full transparency of the terms of the trustee's dealings with Energy Sports and the bankrupt company. The landlord did not send anyone to the statutory first meeting of creditors where it could have had sought answers from the bankrupt's officers about the bankrupt business and its relationship to Energy Sports. It did not nominate a representative to serve as an inspector of the bankruptcy estate. It did not exercise its right to change the trustee in

bankruptcy so a new trustee might look into the dealings at issue. It did not ask the trustee to operate the business to allow for a going concern sale or offer to fund operations to allow the trustee in bankruptcy to consider and undertake a going concern sale process.

The decision shows that before commencing an application under section 38 of the [BIA](#), a creditor would do well to fully engage in the bankruptcy proceedings and to avail themselves of the statutory rights and remedies therein to see if there is sufficient evidence to pursue a claim for recovery on behalf of the bankrupt business.

Contact us

If you have a litigation matter and are in need of legal advice, please do not hesitate to contact [James Cook](#), at 416.865.6628 or jcook@grllp.com.

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