Buying a Bankrupt's Business

by Albert S. Frank, LL.B.

Judicial decisions in Britain, the United States, and various Canadian provinces deal with the law of buying and selling a business belonging to a person who has gone bankrupt. These cases are brought together and followed in the Ontario decision of ***Engels v. Richard Killen & Associates Ltd.*** (2002), 60 O.R. (3d) 572.

In 1994 Klaas Engels, "Engels," an insurance broker, had his own brokerage firm, J.M. Dixon Insurance Brokers Inc., "Dixon." Engels made an exclusive brokerage agreement with Merit Insurance Brokers Inc., "Merit," in October of 1994. Under the exclusive brokerage agreement Engels' "book of business," the client list from his own brokerage business, would belong to Merit for seven years. After seven years it would belong to Engels again.

At around the time of making the exclusive brokerage agreement with Merit, Engels was in divorce litigation with his wife. His wife got a Court Order for temporary control of Engels' business, Dixon, so that she could collect support payments owing to her. She took money from Dixon but did not forward any money from Engels' clients to the insurers. The result was that when Engels regained control of Dixon there were arrears owing to the insurers of between $50,000 and $60,000.

As Engels could not borrow money to pay the arrears, he entered into the exclusive brokerage agreement with Merit. Merit agreed to pay the Dixon debt to the insurers. Engels' problems continued, and he had to borrow more money from Merit. Engels petitioned himself into bankruptcy in March of 1997.

Engels was discharged from bankruptcy in late January of 1998. There is no room in this article for a blow-by-blow description of what the various parties did, but clearly Merit was a disgruntled creditor. In July of 2000, without notice to Engels, Merit reopened the bankruptcy before the Superintendent in Bankruptcy, appointed a new trustee, and claimed that Engels had failed to disclose his book of business as an asset in his bankruptcy.

Merit bought the book of business from the new trustee, at a price that was "far more favourable to Merit than a sale at fair market value." The key issue in the case was whether Merit was entitled to an Order preventing Engels from soliciting his former clients.

Non-solicitation in Bankruptcy

Canadian courts are hostile to agreements that prevent former employees from soliciting business, and will only uphold them if the terms are reasonable and not too broad. But the Courts see the sale of a business differently.

When it comes to the voluntary sale of a business the Courts will impose non-solicitation obligations even if the sales agreement did not specify that there should be a restriction on solicitation. This is because it is implied that if you sell a business you intend to sell the benefit of the business's goodwill, including the client list. Otherwise, persons wishing to sell businesses could be unable to obtain a reasonable price – why pay for customers who could be solicited by the former owner? As one judge put it, the seller "may not sell the custom and steal away the customers…"

That is the common rule for the voluntary sale of a business, but what about a sale made not by the owner but by a trustee in bankruptcy? A line of English cases starting with ***Walker v. Mottram*** (1881), 19 Ch. D. 355 (C.A.) distinguishes between these situations, stating that there is no common law obligation not to compete if there was a compulsory alienation of the bankrupt's business by the trustee in bankruptcy.

Walker was followed by other English cases and by the Manitoba Court of Appeal. The same point was made in various American cases and in a decision in the Quebec Court of Appeal. Now, in the ***Engels v. Richard Killen & Associates Ltd.*** case, an Ontario judge has agreed with these earlier cases.

Note that usual law on the sale of a business would have applied if Merit had been seeking to enforce a voluntary sale made by Engels before bankruptcy, but here the sale was made by the trustee after bankruptcy. So Engels was free to solicit.

The fact that Engels assigned himself into bankruptcy rather than being petitioned by his creditors made no difference.

Conduct of Trustee and Counsel

In his submissions counsel – i.e. the lawyer – for the trustee in bankruptcy suggested that the trustee in bankruptcy owes no duties to the bankrupt person. The Court disagreed, saying:

A trustee in bankruptcy and its counsel are officers of the court…. The trustee and his or her counsel must be neutral and evenhanded with all classes of creditors, **and with the bankrupt.** (emphasis added)

The Court criticised the counsel for the trustee, saying he "stepped into the fray, by protecting Merit's interests as purchaser of the book of business in priority to any equitable obligation he owes to the bankrupt."

Conduct by the Third Party Purchaser

Merit sought to prevent Engels from soliciting. This would be equitable relief, and there is a maxim that "He who seeks equity must do equity…. Merit must come to court with 'clean hands'…." The Court found that Merit's conduct was inequitable, so it would have refused to give Merit what it wanted even if the case law discussed above were different.

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Research has NOT been done to see if this article is still good law. Also, this is general information that might not apply to your particular situation.

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Albert S. Frank is a business and trial lawyer with over 30 years of experience.

Phone: 416 929 7202
Email: afrank@FrankLaw.ca
Web: www.FrankLaw.ca