

August 11, 2015

Only Clear Exceptions to the "Fresh Start" Principle Need Apply

The Court of Appeal for Ontario, in *Korea Data Systems (USA), Inc. v. Amazing Technologies Inc.*, 2015 ONCA 465, recently affirmed that exceptions to the "fresh start" rule in bankruptcy must be construed narrowly and applied only in clear cases. The Court grounded its ruling in what it characterized as the "twin" goals of the *Bankruptcy and Insolvency Act*: (1) the equitable distribution of the bankrupt's assets among the bankrupt estate's creditors; and (2) the financial rehabilitation of insolvent individuals (para. 1).

A central means by which these goals are achieved is through the discharge procedures provided for under Part VI of the Act and, in particular, section 178(2). This section provides that, "subject to subsection (1) [a list of enumerated exceptions], an order of discharge releases the bankrupt from all claims provable in bankruptcy." In other words, upon discharge, all claims against a bankrupt are "swept into bankruptcy" and released, unless this result is clearly excluded or exempted by law (paras. 58-59).

One such exemption is set out in section 178(1)(d), which provides that,

An order of discharge does not release the bankrupt from [...] any debt or liability arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity [...].

In *KDS USA*, the Court was asked to determine, as a matter of first impression, whether a creditor of a bankrupt may rely on section 178(1)(d) in any case in which the debt in question arose of fraud, embezzlement, misappropriation or defalcation, while the bankrupt was acting in a fiduciary capacity, even if the bankrupt did not owe a fiduciary duty directly to the creditor bringing the claim. The Court declined this approach, finding that the purpose of the exception set out in section 178(1)(d) is to protect the relationship between a vulnerable creditor and a fiduciary debtor. The absence of clear statutory language indicating an intention to expand the scope of this provision beyond this purpose precludes the Court from permitting creditors, to whom the bankrupt owes no fiduciary duty, from bringing their claims within this exception (para. 66).

The Court's interpretation further respects the scheme of the *BIA* as whole, which, pursuant to sections 172(2) and 173, already ensures that dishonest debtors do not benefit from their wrongdoing by requiring the court to refuse or suspend a bankrupt's discharge in bankruptcy, or grant a conditional discharge, where there is proof that the bankrupt is guilty of "any fraud or fraudulent breach of trust" (para. 77-78).

While the outcome of applying a strict approach to the exceptions set out in the *BIA* may, at times, appear unfair to creditors, the overall policy objectives of the *BIA* ought not be diluted by overly expansive applications of exceptions to the "fresh start" principle.