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"There is no Afterlife for Administrative Monetary Penalties after Bankruptcy"

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A securities broker may be alleged to have defrauded investors by making false statements regarding the use of their funds, and by using invested funds for improper purposes.[1] In the regulatory context, the securities broker may face restrictions on professional activities or an administrative monetary penalty ("AMP") of not more than a $1 million for each failure to comply.

Following the imposition of a significant AMP, the same securities broker may think that she was fortunate that she was not prosecuted for fraud under the *Criminal Code*. She may also take some solace in the thought that the AMP, unlike a criminal fine in relation to fraudulent conduct, would not survive a pending bankruptcy. This would enable her to get on her feet again. Regulators may take a different view, and will likely argue that extinguishing the AMP would undermine the deterrent effect of the penalty imposed. If the penalty does not survive bankruptcy, the person in contravention of the law need only declare bankruptcy to avoid the consequences of their bad conduct.[2]

a. Overview

The question of AMPs in the afterlife of bankruptcy was addressed by the Alberta Court of Appeal in late 2021 in the decision in *Alberta Securities Commission v. Hennig*.[3] The Court held that AMPs for contraventions of securities laws related to misrepresentations are extinguished by a bankruptcy. The Court of Appeal majority (Watson and Khullar JJA) held that exceptions to the release of liabilities under s. 178(1) of the *Bankruptcy and Insolvency Act* ("BIA") "should be construed narrowly and applied only in clear cases."[4]

There are policy implications of the finding that there is no afterlife for AMPs, unlike criminal fines for fraudulent conduct, after a bankruptcy. From a policy perspective, if regulators choose to pursue the AMP route in relation to fraud or other potentially criminal conduct instead of laying criminal or regulatory charges, they risk not being able to collect the AMP.

b. Facts in *Hennig*

The details of the *Hennig* decision offer insight into the comparison of AMPs to criminal offences. A panel of the Alberta Securities Commission ("ASC") imposed on Mr Hennig a

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[1] *Meharchand (Re)*, 2019 ONSEC 7, 42 O.S.C.B. 1135, 2019 CarswellOnt 1504 (Ont. Securities Comm.)
[2] *Alberta Securities Commission v. Hennig* [2021] A.J. No. 1667 | 2021 ABCA 411 at para 100 [*Hennig*].
[3] *Ibid*.
[4] *Ibid* at para 25.

permanent ban from serving as a director and/or officer of any issuer; a 20-year cease trade and denial of exemptions order; and required payment of an administrative penalty of $400,000 and hearing costs of $175,000.

The administrative penalty arose from the findings of a panel of the ASC that Hennig was responsible for misrepresentations in the financial statements of a public company of which he was a director and officer. Hennig was alleged to have obtained financial benefits as a result of non-disclosure of material facts. It was claimed that he participated in market manipulation that resulted in artificial prices for another company, and that he made ongoing misrepresentations to Commission staff, all contrary to the public interest. After 38 hearing days and testimony from 24 witnesses, an ASC Panel concluded that Mr Hennig had contravened Alberta securities laws or acted contrary to the public interest or both. Specific findings of fact included that financial statements that were not prepared in accordance with Canadian generally accepted accounting principles ("GAAP") contained misrepresentations and that Hennig made misrepresentations to staff.

An important point, with respect to the potential precedent set by this case, is that at “no time did the ASC specifically allege that Mr Hennig or the other respondents engaged in fraud. Section 93(1) of the Securities Act creates a statutory prohibition of fraud, and counsel for the ASC confirmed during the hearing of this appeal that the ASC could have alleged that Mr Hennig breached this provision at the relevant time.”[5]

The decision of the Commission was filed and certified by the Court of Queen's Bench and thus had the same force and effect as if it were a judgment of the Court of Queen's Bench pursuant to s. 200 of the *Securities Act*.

An application by the ASC sought a declaration that the administrative penalty levied against Hennig survived his discharge as a bankrupt pursuant to ss. 178(1)(a), (d) and (e) of the *BIA*.[6] The application was granted at first instance and then reversed on appeal. Accordingly, the debt was released upon discharge.

c. Bankruptcy and Insolvency Act

As a basic principle, a bankrupt is released from all claims provable in bankruptcy by an order of discharge: s. 178(2) of the *BIA*. However, s. 178(1) of the BIA sets out eight classes of exceptions to that rule. Relevant to the application in *Hennig* were ss. 178(1)(a), (d) and (e) of the BIA, which provide that an order of discharge does not release the bankrupt from:

> (a) any fine, penalty, restitution order or other order similar in nature imposed by a court in respect of an offence, or any debt arising out of a recognizance or bail;

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[5] *Ibid* at para 34.
[6] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.

(b) any debt or liability arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity; or

(c) any debt or liability arising from obtaining property or services by false pretenses or fraudulent misrepresentation.

The importance of the *Hennig* decision is underscored by the observation by the Alberta Court of Appeal that whether an administrative penalty and costs order imposed by a securities commission and registered as a judgment with a superior court can survive discharge of a bankrupt debtor has not been addressed by a Canadian appellate court until now.

Within the context of the *BIA* there are two general goals: to provide for the equitable distribution of a bankrupt's assets among creditors and to facilitate a bankrupt's financial rehabilitation. The purpose of s. 178 has been described as giving the debtor “a fresh start and enabling the debtor to become a contributing and useful member of the community, including the business community”.[7]

d. Fines and penalties imposed by a Court in respect of an offence

Section 178(1) a) of the *BIA* provides that an order of discharge does not release the bankrupt from “any fine, penalty, restitution order or other order similar in nature imposed by a court in respect of an offence, or any debt arising out of a recognizance or bail”. The Court in *Hennig* comments that exempting criminal fines and penalties from the ordinary operation of bankruptcy proceedings is justified because "as a matter of principle, criminal courts should not be subjected to the control of the civil courts."[8]

The Alberta Court of Appeal reviews the jurisprudence concerning the characterization of AMPs as being neither remedial nor punitive, but preventative: “First, the administrative penalty is neither remedial nor punitive, but preventative: *Cartaway Resources Corp (Re)*, 2004 SCC 26 at paras 55, 60.”[9] Accordingly, the ASC did not impose the administrative penalty and the costs order to punish Mr Hennig but to prevent future misconduct, nor did it impose them in criminal or quasi-criminal proceedings.

The Court notes that the ASC could have referred the matter to the Crown to lay charges against Mr Hennig for the offence of contravening securities laws under s 194 of the *Securities Act* - a quasi-criminal proceeding - but it chose not to. Instead, it took the regulatory path.

The reference in section 178(1)(a) to any fine, penalty, restitution order or other order similar in nature imposed by a ***court in respect of an offence*** reminds the reader that an offence

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[7] *Hennig, supra* note 2, at para 16.
[8] *Ibid* at para 49.
[9] *Ibid* at para 50.

would have been proved beyond a reasonable doubt. Moreover, any type of offence qualifies under this section.

e. Debts or liabilities arising out of fraud or fraudulent misrepresentation

Sections 178(1) (d) and (e) do not refer to offences. By distinction, they must apply to something else, such as a civil court finding of fraud in a fiduciary capacity or finding of fraudulent misrepresentation. Subsections (d) and (e) do not specify the mechanism or vehicle for a finding in relation to fraudulent conduct. The Court of Appeal in *Hennig* points out that debts imposed by provincial regulatory bodies are not specifically identified in s. 178(1).[10]

In a finding under ss. 178(1) (d) and (e), in the absence of an offence, arguably the balance of probabilities standard applies. Even though fraud is involved, this does not mean that there is a higher "clear and compelling standard" of proof, as this standard has been subsumed within the balance of probabilities standard unless legislation specifies otherwise.[11]

The comparison between ss. 178(1)(a) and (d) and (e) thus create some inconsistency with respect to the standard of proof required. While section (a) refers to offences that must be by definition proven beyond a reasonable doubt (or at least the *actus reus* in regulatory offences) sections (d) and (e) refer to fraudulent conduct, but the inference is that it need only be proven on the balance of probabilities standard.

If the finding of an administrative tribunal would qualify under ss. 178 (1) (d) and (e), it must be remembered that such a finding would be made with lower procedural protections than those in a court, including different standards for the receipt of evidence. There may also be a constitutional division of powers issue. It might be asked, how can a provincially appointed administrative tribunal make an order that is binding under federal legislation such as the *BIA*? (This does not of course impact federal Tribunals such as the Competition Tribunal).

f. Three issues under section 178(1)(e)

The Court of Appeal in *Hennig* reviewed the potential application of s. 178(1)(e) of the *BIA* which provides that an order of discharge does not release the bankrupt from "any debt or liability resulting from obtaining property or services by false pretences or fraudulent misrepresentation, other than a debt or liability that arises from an equity claim."

The Court set out three issues involved in the s.178(1)(e) analysis:

(1) Did Mr Hennig make fraudulent statements for the purpose of s. 178(1)(e)?

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[10] *Ibid* at para 72.

[11] Todd Archibald and Kenneth Jull, "Clear and Convincing Evidence Cannot Reside in the House of Balance or Probabilities: A Scientific Approach" (2021) 51 *The Advocates Quarterly* 315.

(2) What kind of link is required between the debt and the fraud? Is that link made out in this case?

(3) Given that property must be transferred as a result of the fraudulent statement, must it be transferred by the creditor relying on s. 178(1)(e)? Was there a relevant transfer here?

The Court addressed these issues in turn.

(A) Did Mr Hennig make fraudulent statements?

The ASC acknowledged during the oral hearing of the appeal that at the relevant time, it had the ability to allege fraud against Mr Hennig but chose not to do so. The majority in Hennig observed that "It is also clear that the ASC is prepared to allege fraud where it thinks it is appropriate: *Alberta Securities Commission v Brost, 2008* ABCA 326." Given that the ASC Panel made no express findings of fraud against Hennig, the majority in *Hennig* somewhat caustically commented: "Almost two decades after the impugned conduct the ASC is claiming Mr Hennig made fraudulent statements, when it never chose to do so before."[12]

The majority concluded that the ASC could not bring itself within the first element of s. 178(1)(e) and does not get the benefit of the exemption. That conclusion in effect ended the matter. The Court goes on, however, in obiter, to answer the next two questions as posed. This is fertile ground for precedent, as the question hangs out there: if staff had alleged fraud and the Securities Commission had found that false pretenses or fraudulent misrepresentation had occurred, would the AMP then survive a bankruptcy?

The Court was clear in shaping the obiter debate: "For ease of exposition, and contrary to the finding in the section above, the following section assumes that the first requirement of s 178(1)(e) was met and Mr Hennig did indeed make fraudulent statements."

(B) What kind of link is required between the debt and the fraudulent behaviour? Is that link made out in this case?

The majority found that in addition, the ASC could not meet the second element of s. 178(1)(e)[13] that there must be a "link" between the debt or liability and the fraudulent statement. That link was broken or not tenable in the *Hennig* case because the Securities Commission imposed the AMP only after the impugned conduct had already occurred:

To conclude, the proper interpretive approach to s. 178(1)(e), the policy underlying it and the bulk of the decided cases support the view that the debt is sufficiently linked to the fraud only if the debtor made the fraudulent statements to the creditor who is relying on s. 178(1)(e). A regulatory body imposing an administrative penalty for conduct contrary to the public interest

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[12] *Hennig, supra* note 2, at para 71.
[13] *Ibid* at para 75.

will rarely be able to establish such a link, as typically it only becomes involved after the impugned conduct has already occurred.[14]

The test set out in the above passage sets the bar very high: a regulatory body imposing an administrative penalty for conduct contrary to the public interest "will rarely be able to establish such a link."[15] This high bar leaves the door ajar only slightly, and the Court does not specify what those rare circumstances might be.

The Court in *Hennig* then set a second high bar: the required link between the fraudulent statement and the debt is established only if the debtor makes the fraudulent statement to the creditor relying upon s. 178(1)(e).[16] The Ontario Court of Appeal cited the decision in *Hennig* in relation to this required link, but stated that it was not necessary to consider which view is correct. This case did not involve a regulator.[17]

The majority also dismantled any potential link to misrepresentations made by Hennig and the AMP, as the AMP was based on the underlying misconduct in the market:

> In my view, the fact that Hennig lied to ASC staff does not establish the required link between the fraudulent statements and the ASC's debt. Reading the ASC Panel's decisions realistically, the ASC's debt against Mr Hennig is not based on Mr Hennig's lies to ASC staff. It is based on Mr Hennig's misleading statements in the capital markets and other market wrongdoing.[18]

Perhaps this leaves to another door being open just slightly. If in the future a Securities Commission based its AMP on misrepresentations made to the Commission, as a separate head of liability, this might potentially satisfy that link.

(C) **Who must transfer property as a result of the fraudulent statement? Was there a relevant transfer here?**

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[14] *Ibid* at para 93.
[15] *Ibid* at para 93.
[16] *Ibid* at paras 78, 90-93.
[17] *Shaver-Kudell Manufacturing Inc. v. Knight Manufacturing Inc.* [2021] O.J. No. 7199 | 2021 ONCA 925. Justice Zarnett states in footnote 5: "There is a view that even for the false pretences branch of s. 178(1)(e), the deceitful statement must have been made to the creditor: see *Alberta Securities Commission v. Hennig, 2021 ABCA 411*, at paras. 90-93. It is not necessary to consider which view is correct. The appellant presented his case on the basis that false pretences could include a deceitful statement to a third party, as did the respondent who does not point to any false statements made to it." In *Shaver-Kudell* the Court held that although the liability arose from morally unacceptable conduct of the appellant, that is insufficient to fit it within the exception in s. 178(1)(e) of the BIA. No matter how reprehensible telling falsehoods on examination for discovery may be, it does not turn a debt or liability into one resulting from obtaining property or services by deceitful statements.(paragraph 22). Although lying on examination for discovery reflects on whether the appellant was honest, it is not the type of false statement that satisfies s. 178(1)(e), which requires a deceitful statement by which the debtor obtained property or services, causing the debt or liability of the creditor to arise.(paragraph 44).
[18] *Hennig, supra* note 2, at para 96.

The final element of s 178(1)(e) relates to the transfer of property. It is clear from the language of s 178(1)(e) that the debt must result from "obtaining property" by false pretences or fraudulent misrepresentation.

The majority of the Court ruled that it was unnecessary to address this issue because the conclusions to this point established that neither 178(1)(a) nor (e) applied to the ASC's debt. Since the parties' submissions did not cover this topic in detail, the Court adopted the wiser course to leave its determination to another appeal where it would make a difference to the outcome.

Pentelechuk JA concurred in the result. She agreed with the majority's holding that s 178(1)(a) was not engaged by the ASC's administrative penalty. She disagreed with the majority's holding that the ASC had not established fraud by Mr. Hennig within the contemplation of s 178(1)(e), however, she agreed with the majority's holding that s 178(1)(e) was not engaged because the ASC was not itself victimized by Mr. Hennig.

g. Policy implications

The Alberta Court of Appeal went beyond basic statutory interpretation and grappled with the policy implications of AMPs not having an afterlife after bankruptcy:

> The ASC argued that a potential negative impact of allowing the appeal would be to undermine the deterrent effect of an administrative penalty imposed on those who breach securities law. If the penalty does not survive bankruptcy, Mr Hennig, or anyone in his position, need only declare bankruptcy to avoid the consequences of their bad conduct.[19]

The majority of the Court of Appeal articulates two responses to this concern:

> First, the ASC has many remedial options available to it under the Securities Act, and as in this case, the administrative penalty was only one of the sanctions imposed. The other non-monetary sanctions survive bankruptcy. There is a permanent ban on Mr Hennig serving as a director and/or officer of any issuer, and a 20-year cease trading in or purchasing any securities or exchange contracts and denial of using any exemption order.
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> Second, finding that a bankrupt debtor contravened securities legislation and acted contrary to the public interest usually entails morally bad conduct by the debtor. And as has been discussed above, alone that is not enough to bring the debt within s 178(1)(e). It seems that what the ASC is seeking is a general exemption from release upon discharge for the administrative penalties imposed by a securities regulator. This would create a new category of exemption under s 178(1) which falls within the purview of Parliament, not this Court.

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[19] *Ibid* at para 100.

> The ASC's debt is neither "a fine, penalty, restitution order or other order similar in nature ... imposed by a court in respect of an offence" (s 178(1)(a)) nor a "debt or liability resulting from obtaining property or services by false pretences or fraudulent misrepresentation" (s 178(1)(e)). Accordingly, it was released when Mr Hennig was discharged from bankruptcy.[20]

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In summary the decision in *Hennig* clarifies four main points:

1. the exceptions to the release of liabilities under s 178(1) of the BIA should be construed narrowly and applied only in clear cases;

2. a fine or penalty is only likely to engage s 178(1)(a) if it is imposed in a criminal or quasi-criminal proceeding;

3. section 178(1)(e) applies to liabilities owing to creditors who are directly victimized by the bankrupt debtor's fraudulent statements. There may be a narrow opening to argue in future cases that a regulator can establish such a link. Moreover, if in the future, a regulator based its AMP on misrepresentations made to the regulator, as a separate head of liability, this might potentially satisfy that link.

4. an administrative penalty for conduct against the public interest is unlikely to survive a bankrupt's discharge under s 178(1)(e).[21]

h. Jurisprudence

The lower court decision in *Hennig* was followed by the British Columbia Supreme Court in *Poonian (Re)*.[22] The magnitude of the losses in *Poonian* were significant. The clients lost $7,102,902. The Commission ordered administrative penalties and issued disgorgement orders against the bankrupts, with the result that they owed it $19,095,362. The trustee in bankruptcy reported that their proven liability was $25,184,693. The court engaged in statutory interpretation with the following purposive analysis:

> Third, given the purpose of s 178(1)--to avoid rewarding dishonest behaviour--there is no principled basis to refuse to exempt debts imposed after a hearing before an administrative tribunal such as the Commission Panel. As discussed in the next section,

[20] *Ibid* at paras 101-103.

[21] Alberta Court of Appeal Overturns Finding that Administrative Penalty Survives Bankruptcy Steven Leitl, Aaron Stephenson and Preston Brasch January 13, 2022 https://www.securitieslitigation.blog/2022/01/alberta-court-of-appeal-overturns-finding-that-administrative-penalty-survives-bankruptcy/

[22] *Poonian (Re)*, 2021 BCSC 555, [2021] B.C.J. No. 609, leave to appeal granted, [2021] B.C.J. No. 1219 [*Poonian*].

> a debt arising from a judgment may be exempted regardless of the strict cause of action in the original pleading: a court will consider whether the bankrupt seeking exemption was an honest but unfortunate debtor, or, rather, fell into liability through reprehensible behaviour. A debt, based in reprehensible behavior, imposed by an administrative body statutorily entrusted to make findings and impose penalties and to which courts grant deference, should be treated equally in our administrative state to a debt arising from a judgment.[23]

The same purposive approach was applied with respect to s. 178(1)(e):

> This returns us to the purpose and essence of s. 178(1) generally, and s. 178(1)(e) specifically. The Court is satisfied that the Poonians' actions were morally unacceptable and harmful to society, such that they should not be rewarded with a release of those debts through the statutory discharge under the BIA. Their orchestrated market manipulation and knowing exploitation of vulnerable investors, with corrosion of public confidence in the securities markets, all evidence the deceit lying at the heart of s. 178(1)(e).[24]

The court in *Poonian* agreed with the Commission that market manipulation (particularly in the form of the multi-party elaborate scheme, involving disguise and aliases) is, at its core, a fraudulent misrepresentation and false pretense. An interesting note is the observation that in order to establish "false pretenses" under this section, the behaviour need not satisfy the *Criminal Code* definition nor satisfy the test for the tort of deceit, which is consistent with the administrative nature of the proceedings.[25]

Of relevance to the status of the AMP proceedings, the Poonians argued that they were not afforded procedural fairness and were denied natural justice before the Commission in the liability and sanctions hearings. Given that the parties in those administrative proceedings were the same parties before the Court in *Poonian*, the doctrines of issue estoppel and *res judicata* applied.

Leave to appeal was granted in *Poonian* and the British Columbia Court of Appeal has yet to weigh in.

i. Recommendations for Reform

The Court in *Hennig* characterized the position taken by the ASC as seeking a general exemption from release upon discharge for the administrative penalties imposed by a securities regulator. The Court observed that this would create a new category of exemption under s. 178(1), which falls within the purview of Parliament, not this Court.

From a reform perspective, the question arises as to whether Parliament ought to consider amending s. 178 to explicitly refer to AMPS such that they would live on in the afterlife after

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[23] *Ibid* at para 92.
[24] *Ibid* at para 112.
[25] *Ibid* at paras 105-106.

bankruptcy in the same way that fines from offences do. We would recommend against this type of amendment for all the reasons that AMPs are different from offences.

AMPs are decided with lower procedural protections than those in a court, including different standards for receipt of evidence. AMPs vary widely in type, nature, seriousness, and administrative processes.

If regulators want penalties to survive bankruptcy, the better vehicle would be to rely on existing regulatory offences or Criminal Code offences that would be prosecuted in a Court, where the actus reus at least is proven beyond a reasonable doubt. The fines obtained in these forums presently live on in the afterlife of bankruptcy under section 178 of the BIA as it now exists. The criminal and regulatory route ensures that those who commit fraud cannot simply declare bankruptcy to avoid the consequences of their bad conduct. This approach would be consistent with a restorative justice pyramid.