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SCC confirms application of anti-deprivation rule

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In *Chandos Construction Ltd. v Deloitte Restructuring Inc.*, the Supreme Court of Canada confirmed the application of the common law anti-deprivation rule in the context of a *Bankruptcy and Insolvency Act* (BIA) proceeding.

The anti-deprivation rule applies to clauses that are triggered by insolvency and that have the effect of removing value from the insolvent company's estate. Under the rule, such clauses are void and unenforceable. This case has implications for commercial parties seeking to protect themselves should their counterparty file for bankruptcy or insolvency protection during the performance of the contract.

Facts

Chandos Construction Ltd. entered into a subcontract with Capital Steel Inc. relating to the construction of a condominium project in St. Albert, Alberta.

The Stipulated Price Contract between Chandos and Capital Steel included a clause that was triggered "in the event the Subcontractor commits any act of insolvency, bankruptcy, winding up or other distribution of assets, or permits a receiver of the Subcontractor's business to be appointed" amongst other events.

If the clause was triggered, then four consequences occurred, the fourth of which contravened the anti-deprivation rule. That consequence required Capital Steel to "forfeit 10% of the within Subcontract Agreement price to the Contractor as a fee for the inconvenience of completing the work using alternate means and/or for monitoring the work during the warranty period" (the forfeit clause).

When Capital Steel filed for bankruptcy, Chandos sought to rely on the forfeit clause to reduce the amount it owed to Capital Steel under the subcontract. Chandos owed Capital Steel $149,618.37, but argued that it was entitled to set-off against this amount the amount required to complete the contract ($22,800) as well as the 10% forfeit ($137,330.05). Chandos therefore argued that it owed Capital Steel nothing, but rather that Capital Steel owed Chandos $10,511.66.

The Trustee applied to the Alberta Court of Queen's Bench for directions as to whether the

forfeit clause was valid.

The Application Judge found the clause to be valid, concluding that "so long as the provision was not an attempt to avoid the effect of bankruptcy laws, the anti-deprivation rule does not prevent contracting parties from agreeing that upon the insolvency of one party, the other party can make a liquidated damages claim."

On appeal, the majority of the Court of Appeal of Alberta provided an overview of the anti-deprivation rule within Canadian common law. Ultimately, the majority found the clause to violate the anti-deprivation rule, noting that "a provision can be invalid if it violates either the anti-deprivation rule or the penalty clause rule."

Majority decision: Confirming the two-step effects-based test

The majority of the Supreme Court confirmed that the appropriate test to determine whether the anti-deprivation rule has been violated is to determine whether

1. the relevant clause has been triggered by an event of insolvency or bankruptcy; and
2. the effect of the clause is that it removes value from the insolvent's estate.

In confirming this test, the majority refused to adopt the appellant's request to move to a *bona fide* commercial purpose test, as was adopted by the U.K. in *Belmont Park Investments Pty. Ltd. v. BNY Corporate Trustee Services Ltd.*

Writing for the majority, Justice Rowe noted that adopting a *bona fide* commercial purpose test would

- frustrate Parliament's statutory scheme that all of a bankrupt's property is to be collected in the trustee, as set out in section 71 of the BIA;
- cause potential commercial uncertainty since applying such a test would require courts to determine the intention of the contracting parties long after the fact and detract from the efficient administration of corporate bankruptcies; and
- encourage parties who can plausibly pretend to have a *bona fide* intention to create a preference over other creditors by inserting such clauses.

Justice Rowe also noted that an effects-based test would also be consistent with the *pari passu* rule founded on section 141 of the BIA.

Finally, Justice Rowe noted that there are nuances within the application of the anti-deprivation rule such that contracting parties can protect themselves from potential risks relating to an insolvency or bankruptcy. To that end, parties can include clauses in an agreement that

- eliminate property from the estate, but do not eliminate value;
- apply where the effect is triggered by an event *other than* insolvency or bankruptcy; or
- take security, require insurance or require a third-party guarantee.

Dissent: Moving towards an objective *bona fide* commercial purpose test

Justice Côté delivered the dissenting opinion, noting that while she agreed with the overall

description of the existence of the anti-deprivation rule in Canadian common law, she did not agree that the effects-based test set out by the majority should prevail.

Rather, Justice Côté preferred the *bona fide* commercial purpose test used in the U.K., whereby courts would examine the agreement between the contracting parties to determine whether there is a presence or absence of a legitimate commercial basis of the transaction or contractual provision at issue and, if so, then there is no basis to find it offends the anti-deprivation rule.

By adopting this test, Justice Côté reasoned that the commercial freedom of parties would be better respected by the courts and legitimate commercial clauses would be upheld.

It remains to be seen whether the effects-based test endorsed by the majority in *Chandos* will result in more commercial agreements being struck, or whether the nuances identified by Justice Rowe will be more heavily leveraged in order to circumvent the anti-deprivation rule.