November 2020

'But to What Effect?' The Supreme Court of Canada clarifies the anti-deprivation rule in *Chandos*

In its recent decision in *Chandos Construction Ltd. v Deloitte Restructuring Inc.*, the Supreme Court of Canada (the **"SCC"**) affirmed the place of the 'anti-deprivation rule' in Canadian common law and provided guidance on its application.[1] This rule invalidates contractual terms that would remove value from a debtor's estate and reduce the assets available for distribution amongst creditors. It protects creditors of an insolvent or bankrupt party by limiting the debtor's freedom to contract.

A majority of the SCC held that the anti-deprivation rule is to be applied using an *effects*-based test rather than an analysis of the parties' intentions. The Court also acknowledged that the rule is subject to important exceptions and nuances.

The anti-deprivation rule

The anti-deprivation rule has roots in a long-standing principle in the United Kingdom that prohibits "fraud on the bankruptcy law". The principle restricts parties' ability to contract out of the effects of insolvency legislation.[2] In *Belmont Park Investments PTY Ltd. v BNY Corporate Trustee Services Ltd. & Anor*, the UK Supreme Court held

[1] 2020 SCC 25 [*Chandos*].

[2] Aditya Badami & Meghan Parker, "Canada's Tired Anti-Deprivation Rule: Capital Steel Inc v Chandos Construction Ltd" in Janis P Sarra, ed, *Annual Review of Insolvency Law 2019* (Toronto: Thomson Reuters Canada, 2020), online: WestlawNext Canada.

that the principle consists of two rules: (1) the anti-deprivation rule and (2) the *pari passu* rule.[3] The former voids contractual terms that would reduce the total value of a debtor's estate while the latter ensures that creditors do not receive more than they are entitled under the statutory scheme of distribution.[4] The SCC in *Chandos* confirmed that both rules form part of Canadian common law.[5]

Prior to *Chandos*, Canadian courts considered and applied the "fraud on the bankruptcy law" principle. For instance, in *Canadian Imperial Bank of Commerce v Bramalea Inc.*, an Ontario Court deemed a purchase option in a partnership agreement that was triggered by a partner's insolvency to be invalid because it removed value from "the reach of the insolvent [partner]'s creditors."[6] In *Aircell Communications Inc. (Trustee of) v Bell Mobility Cellular Inc.*, the Ontario Court of Appeal relied on *Bramalea* to void a clause that would allow one party to withhold commissions it owed to a debtor once the debtor entered bankruptcy proceedings.[7] The Court held that the clause was triggered by the debtor's insolvency and was "contrary to the overriding public policy that requires equitable and fair distribution among a bankrupt's creditors."[8]

The *Chandos* decision: the effects-based test

Chandos involved a subcontract between Chandos Construction Ltd. (**"Chandos"**) and its subcontractor, Capital Steel Inc. (**"Capital"**). The agreement included a clause that required Capital to pay an inconvenience fee to Chandos worth 10% of the subcontract price plus certain other costs if Capital became insolvent or bankrupt. Capital filed an assignment in bankruptcy prior to completing the subcontract. Chandos sought to set-off the amount it still owed to Capital by the amount of the inconvenience fee and the additional cost it incurred to find a replacement subcontractor. This set-off

[3] [2011] UKSC 38 at para 1 [*Belmont*].

[4] *Ibid.*

[5] *Chandos*, *supra* note 1 at paras 12-13.

[6] [1995] OJ No 4884 (Ct J (Gen Div)) at para 6 [*Bramalea*].

[7] 2013 ONCA 95.

[8] *Ibid* at para 12.

would result in Chandos having a claim provable in Capital's bankruptcy rather than owing a debt to Capital's estate.[9]

Capital's trustee in bankruptcy sought advice and directions from the Alberta Court of Queen's Bench as to the validity of the payment clause. The application judge applied a *purpose*-based test to determine whether the clause offended the anti-deprivation rule. He held that it was a valid liquidated damages clause and not a penalty, and that it was not an attempt to circumvent the *Bankruptcy and Insolvency Act*. Accordingly, he upheld Chandos' set-off of the inconvenience fee. The decision was reversed on appeal by a majority of the Alberta Court of Appeal, which applied an *effects*-based test to determine whether the anti-deprivation rule was engaged.

The majority of the SCC upheld the Court of Appeal's decision, including the effects-based test for the anti-deprivation rule. It affirmed that the rule has long formed part of Canadian common law and held that it was not extinguished by provisions in Canadian insolvency legislation added in 2009 to void *ipso facto* clauses (provisions in agreements that allow one party to terminate an agreement or receive a benefit upon the other party's insolvency). The SCC noted that the *ipso facto* provisions in insolvency statutes protect debtors, whereas the common law anti-deprivation rule protects their creditors.[10]

The SCC articulated a two-part test to engage the anti-deprivation rule:[11]

(1) The relevant clause must be triggered by an event of insolvency or bankruptcy, and

(2) The effect of the clause must be to remove value from the insolvent's estate.

---

[9] *Chandos*, *supra* note 1 at para 6.

[10] *Ibid* at para 28.

[11] *Ibid* at para 31.

Notably, the majority's effects-based test departs from the purpose-based test that the UK Supreme Court used in *Belmont*. The purpose-based test looks to the parties' intentions, so the anti-deprivation rule would not invalidate terms of *bona fide* commercial transactions where neither party had the predominant purpose of circumventing insolvency legislation.[12] The majority of the SCC rejected the purpose-based test on grounds that it would create commercial uncertainty and "detract from the efficient administration of corporate bankruptcies."[13] It also noted that a purpose-based approach "would require courts to determine the intention of contracting parties long after the fact."[14] One could argue that this aspect of the majority's reasons ignores the very goal of contract interpretation under Canadian common law, which is "to ascertain the objective intent of the parties."[15]

The majority of the SCC held that the anti-deprivation rule prevents the set-off of debts owed by a bankrupt that were triggered by their insolvency. Such debts are void and cannot be set-off to reduce a party's obligations to the debtor's estate.

The application judge, as well as dissenting judges at the Alberta Court of Appeal and the SCC, favoured a purpose-based approach. Justice Côté, in dissenting reasons at the SCC, cited a summary of English jurisprudence in *Belmont* that indicates "a deliberate intention to evade the insolvency laws is required" to engage the anti-deprivation rule.[16] She also pointed to earlier Canadian jurisprudence that supports an analysis of parties' intentions when applying the rule. She located the public policy supporting the rule within the common law, rather than the statutory public policy reflected in the *Bankruptcy and Insolvency Act*, which is cited by the majority.[17] Accordingly, she favoured an objective *bona fide*

---

[12] *Ibid* at para 32.

[13] *Ibid* at para 34.

[14] *Ibid*.

[15] *Creston Moly Corp. v Sattva Capital Corp.*, 2014 SCC 53 at para 49, cited in *Chandos*, *supra* note 1 at para 58, Côté J, dissenting.

[16] *Chandos*, *supra* note 1 at para 64, citing *Belmont*, *supra* note 3 at para 78.

[17] *Chandos*, *supra* note 1 at paras 105-107, 109.

commercial purpose test to balance the policy objectives of upholding parties' freedom to contract and protecting third party creditors.[18] In her view, the payment clause in *Chandos* had such a purpose – it addressed a substantial risk to the general contractor in the event of Capital's bankruptcy.[19]

Be aware of 'nuances'

The majority of the SCC did recognize that the anti-deprivation rule is subject to important nuances.[20] The rule is not offended by all transactions that remove property from an estate. It is not offended by the granting of security. Nor is it offended by clauses triggered by events other than the debtor's insolvency or bankruptcy. The majority declined to review the full breadth of nuances and exceptions to the anti-deprivation rule. These may prove to be important guardrails given that the effects-based test is a significant impairment of parties' contractual freedom.

It is easy to conceive of a wide range of business relationships where the application of the anti-deprivation rule will have to be resolved. Many contractual arrangements allocate risks between parties, which could be affected by the rule. For instance, the majority in *Chandos* did not turn its mind to 'make whole' or 'prepayment premiums' in commercial loans that entitle a lender to additional compensation in the event that a loan is terminated before the end of its term. Often the debtor's insolvency will accelerate the requirement to pay such premiums. Case law in the United States suggests that the enforceability of such premiums will depend heavily on the text of the contract and the facts giving rise to the obligation. The effects-based anti-deprivation rule has the potential to confuse this analysis even further. It might add an arrow to the quiver of debtors negotiating with their creditors or to court officers overseeing restructuring proceedings.

---

[18] *Ibid* at para 116.

[19] *Ibid* at para 136.

[20] *Ibid* at para 40.

Another area of 'nuance' may be found in joint-operatorships in the oil and gas sector. Joint-operator agreements often permit one operator to be replaced in the event of its insolvency to preserve the value of the operation.[21] Prior to the SCC's decision in *Chandos*, the anti-deprivation rule was considered in various decisions of the Alberta Court of Queen's Bench where a solvent operator sought to lift a stay of proceedings to permit it to replace the insolvent operator. This jurisprudence suggests that courts will look closely at the surrounding circumstances to determine whether a deprivation would occur so as to engage the rule. This appears to be consistent with the effects-based test articulated in *Chandos* but further judicial consideration will be necessary to clarify how such arrangements are affected by the anti-deprivation rule.

by Stephen Brown-Okruhlik, Tushara Weerasooriya
and Courteney Rickert (Articling Student)

For more information on this topic, please contact:

Toronto	Stephen Brown-Okruhlik	416.865.7043	stephen.brown-okruhlik@mcmillan.ca
Toronto	Tushara Weerasooriya	416.865.7890	tushara.weerasooriya@mcmillan.ca

[21] See Robyn Gurofsky & Tiffany Bennett, "Anti-Deprivation Rule in Canada: An Alberta Perspective" I.I.C. Art. Vol. 9-3, online: WestlawNext Canada.