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The Supreme Court of Canada Affirms the Anti-Deprivation Rule in Bankruptcy

In *Chandos Construction Ltd v Deloitte Restructuring Inc* ("*Capital Steel*") a strong majority of the Supreme Court of Canada affirmed the continuing relevance in Canada of the common-law anti-deprivation rule in insolvency. The rule invalidates any provision in an agreement providing that upon an insolvency (or bankruptcy), value is removed from the reach of the insolvent person's creditors which would otherwise have been available to them, and places that value in the hands of others. It is a rule protecting the strong public policy in favour of the fair distribution of an insolvent person's assets among unsecured creditors.

The case arose out of a construction subcontract. Chandos Construction Ltd ("Chandos"), a general construction contractor, entered into a subcontract with Capital Steel Inc ("Capital Steel"). A provision of the subcontract provided that Capital Steel was to pay Chandos 10% of the subcontract price, ostensibly as a fee for the inconvenience of monitoring Capital Steel's work and its subcontract in the event of Capital Steel's bankruptcy. When Capital Steel filed an assignment in bankruptcy prior to completing its subcontract with Chandos, Chandos sought to enforce the 10% fee by setting it off against amounts owing to Capital Steel under the subcontract. The application judge found the provision to be a valid liquidated damages clause, but a majority of the Court of Appeal reversed the decision, finding that it violated the anti-deprivation rule.

The majority found that the anti-deprivation rule pre-existed the enactment of federal bankruptcy legislation and has not been supplanted by specific provisions of, for example, the *Bankruptcy and Insolvency Act*. It is a general principle that prevents private parties to a bilateral arrangement from frustrating the scheme of distribution in insolvency by providing clauses in contracts for payments or other benefits triggered by bankruptcy.

The majority held that the test under the anti-deprivation rule has two parts: the relevant clause must be triggered by an event of insolvency or bankruptcy, and the effect of the clause must be to remove value from the insolvent's estate. The majority found that Chandos' arrangements with Capital Steel

were a "direct and blatant" violation of the rule, effectively depriving Capital Steel's other creditors of amounts owing to it.

It also stressed that the test is effects-based, not purpose-based. What should be considered is whether the effect of the contractual provision is to deprive the estate of assets upon bankruptcy, not whether the intention of the contracting parties was commercially reasonable. The majority rejected a purpose-based test because it would require courts to determine the intention of contracting parties long after the fact, detract from the efficient administration of corporate bankruptcies, and encourage parties who can plausibly pretend to have bona fide intentions to create a preference over other creditors by inserting such clauses.

The result in *Capital Steel* is coherent and enunciates the paramount importance of a single scheme of distribution in insolvency governed by principles of positive law. It also aligns the Court's jurisprudence concerning private contracts that upset the scheme of distribution with its jurisprudence on stipulations of provincial law that do so.

It is difficult to argue in principle with the approach taken by the majority. The anti-deprivation rule does not reflect some moral or value judgment concerning the contractual terms it invalidates. Rather, it is a pragmatic rule that protects the efficacy of a system founded on a scheme of collective action by creditors. Moreover, the rule is not, as some contend, an interference with freedom of contract. Freedom of contract protects the parties' freedom to decide for themselves how to regulate their commercial affairs and rights inter se. Clauses that offend the anti-deprivation rule in reality have nothing to do with the bilateral exchange that freedom of contract protects. A party imposing on itself burdens that operate on bankruptcy does not really bargain away its own rights – it bargains away the rights of its other creditors. It stands to reason that the decision to do so should be subject to rules that protect the rights of other creditors.

In this, the Court's strong affirmation of the anti-deprivation rule avoids what could have become an arms race of contractual provisions in which parties may feel compelled to bargain for outcomes on insolvency out of the fear that others may be seeking to do the same thing.