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Chandos: Supreme Court affirms anti-deprivation rule and confirms rule is triggered by effects of contractual provisions, not purpose

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In *Chandos Construction Ltd v. Deloitte Restructuring Inc*, 2020 SCC 25, the Supreme Court addressed the anti-deprivation rule, a common law principle invalidating contracts that affect the distribution of proceeds in bankruptcy. A unanimous Court held that the rule is a long-standing part of Canadian law that has not been displaced by the courts or legislation. A majority of the Court also confirmed that the anti-deprivation rule is effects-based. As such, it invalidates any contract provision triggered by a party's insolvency that removes value from a bankrupt's estate, even if the provision reflects a *bona fide* commercial purpose.

Background

This case arose in the bankruptcy proceedings of Capital Steel Inc. Before its bankruptcy, Capital Steel entered a fixed-price construction subcontract with Chandos Construction Ltd. Clause VII Q(d) of the subcontract said that if Capital Steel committed any act of bankruptcy before completing its work then it would forfeit 10% of the subcontract price to Chandos.

Capital Steel assigned itself into bankruptcy before completing the subcontract. At the time, Chandos owed Capital Steel $149,618.39. Chandos invoked clause VII Q(d) and asserted that Capital Steel owed it a debt of $137,330.05 (10 percent of the subcontract price of $1,373,300.47). Chandos purported to set off that and certain other debts against the amounts owed to Capital Steel.

Lower Court Decisions

Capital Steel's trustee in bankruptcy applied to the Alberta Court of Queen's Bench. It argued that clause VII Q(d) was invalid because it violated the anti-deprivation rule and was a penalty clause.

The application judge found that clause VII Q(d) was valid. In his view, the anti-deprivation rule only applied to provisions that attempted to avoid bankruptcy laws and clause VII Q(d) was not such a clause. He also found that the provision was a valid liquidated damages clause and not an invalid penalty clause.

On appeal, a majority of the Court of Appeal of Alberta held that clause VII Q(d) was invalid because it infringed the anti-deprivation rule. Justice Rowbotham, for the majority, held that the anti-deprivation rule is a part of Canadian common law and it invalidates contractual

provisions triggered by an insolvency that have the effect of removing value from an insolvent estate. She found that clause VII Q(d) met that test and was therefore invalid.

Justice Wakeling wrote a lengthy dissent. In his view, the anti-deprivation rule was never part of Canadian common law and, even if it was, it was displaced by 2009 amendments to the *Bankruptcy and Insolvency Act* (the "*BIA*") and the *Companies' Creditors Arrangement Act* that addressed contractual provisions and rights triggered by an insolvency. In the alternative, Wakeling J.A. would have adopted the approach of the U.K. Supreme Court in *Belmont Park Investments Pty Ltd v. BNY Corporate Trustee Services Ltd*, [2011] UKSC 38, which held that the anti-deprivation rule did not invalidate contractual provisions that had a *bona fide* commercial purpose. Justice Wakeling also held that clause VII Q(d) was not a penalty clause and would have upheld the application judge's decision.

Supreme Court Decision

Chandos appealed to the Supreme Court. Among other things, it argued that Rowbotham J.A. had erred by finding that the anti-deprivation rule is a part of Canadian common law or by declining to adopt the purpose-based test from *Belmont*.

Justice Rowe, for an eight-member majority, agreed with Rowbotham J.A. and dismissed the appeal. Justice Côté, dissenting by herself, would have allowed the appeal.

Majority Reasons

Justice Rowe first addressed the existence of the anti-deprivation rule. He held that the rule is part of Canadian common law and has not been eliminated by the Supreme Court or Parliament. In particular, he explained that the 2009 amendments cited by Wakeling J.A. and Chandos did not evidence any intention to displace all related common law. According to Rowe J., the most relevant legislation was s. 71 of the *BIA*, which provides that all property of a bankrupt vests in the trustee. This provision reflects a policy of maximizing the assets available for the trustee to pass to creditors and the anti-deprivation rule voids contractual provisions which would frustrate that statutory objective.

Justice Rowe then addressed the content of the anti-deprivation rule. He held that the rule was an effects-based test and declined to follow *Belmont* in adopting a purpose-based test. In Rowe J.'s view, an effects-based test respected Parliament's policy choice in s. 71 of the *BIA* that all of a bankrupt's property should vest in a trustee. It also avoided commercial uncertainty and the risk that parties may undermine the *BIA*'s statutory scheme by asserting plausible *bona fide* intentions. Justice Rowe added that his approach was consistent with the effects-based test for the related *pari passu* rule (which prohibits contractual provisions that give creditors more than their statutorily-prescribed share) and provisions in the *BIA* prohibiting the exercise of certain contractual rights and remedies. Finally, Rowe J. also rejected Chandos' invocation of general principles of contractual freedom, its argument that a purpose-based test was acceptable because unsecured creditors tended to receive little in most bankruptcies, and its

argument that the anti-deprivation rule was inconsistent with the *BIA* preserving the law of set-off in bankruptcy proceedings.

Dissenting Reasons

Justice Côté agreed with Rowe J. that the anti-deprivation rule is part of Canadian law and has not been eliminated by the Supreme Court or legislation. However, she did not agree with the effects-based test. Instead, she said that the anti-deprivation rule should not prohibit contractual provisions which serve a *bona fide* commercial purpose for three reasons.

First, unlike Rowe J., Côté J. found that case law from the U.K., the Supreme Court, and other Canadian courts showed that courts applying the anti-deprivation rule had not just relied on the effects of offending clauses and had generally inquired into the presence or absence of a *bona fide* commercial purpose for any deprivation.

Second, Côté J. said there was a basis for distinguishing the anti-deprivation rule from other effects-based prohibitions like the *pari passu* rule. According to Côté J., those other prohibitions were implied statutory prohibitions whereas the anti-deprivation rule originated in the common law public policy against agreements entered into for the unlawful purpose of defrauding or otherwise injuring third parties. Thus, Côté J. said that the anti-deprivation rule could be interpreted to accommodate parties' *bona fide* commercial purposes.

Third, Côté J. believed that the considerations supporting an effects-based rule could not override the strong countervailing public interest in the enforcement of contracts and the freedom to contract. And as Parliament had occupied much of the ground formerly covered by the common law and added statutory protections in the *BIA* to safeguard the interests of creditors, there was less need to expand the anti-deprivation rule by adopting an effects-based test.

Like Wakeling J.A. and the U.K. Supreme Court in *Belmont*, Côté J. would have found that the anti-deprivation rule does not apply to contractual provisions with a *bona fide* commercial purpose. She would have upheld the application judge's finding that clause VII Q(d) had a *bona fide* purpose and allowed the appeal.

Conclusion

There are two main takeaways in *Chandos*.

First, the anti-deprivation rule is part of Canadian law. While most authorities already reached that conclusion, some like Wakeling J.A.'s dissent had created doubt. However, the Supreme Court unanimously confirmed that the rule is a long-standing principle of Canadian common law that has not been displaced.

Second, the anti-deprivation rule is purely an effects-based test. A strong majority declined to follow the purpose-based approach from *Belmont* and confirmed that the anti-deprivation rule

will invalidate contractual provisions triggered by insolvency that have the effect of removing value from a bankrupt's estate even if the provision is animated by a *bona fide* commercial purpose.