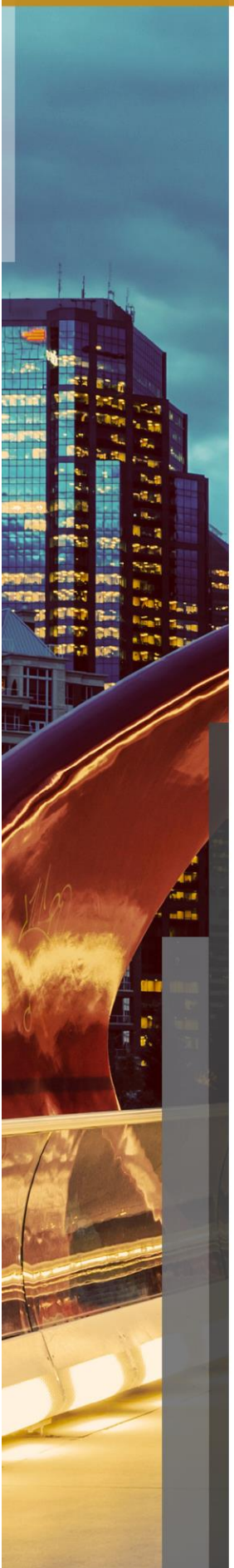

Restructuring companies or restructuring contracts: Lessons from *Chandos Construction Ltd v Deloitte Restructuring Inc.*

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In *Chandos Construction Ltd v Deloitte Restructuring Inc*., 2020 SCC 25, the Supreme Court of Canada affirmed the common law anti-deprivation rule. This rule prevents parties from agreeing to contractual provisions that, upon insolvency, remove property that would otherwise vest in the trustee of a bankrupt's estate. The Decision from the Supreme Court acts as a reminder to construction contractors of the importance of ensuring their contracts are properly structured.

Background

Chandos Construction Ltd. (**Chandos**, referred to as **Contractor** in the Subcontract), the general contractor, entered into a subcontract (the **Subcontract**) with Capital Steel Inc. (**Subcontractor**) valued at approximately $1.37M, which contained the following clause:

> VII.Q 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, or ceases to carry on business or closes down its operations, then in any of such events:
>
> …
>
> (d) The Subcontractor shall forfeit 10% of the within Subcontractor Agreement price to the Contractor as a fee for the inconvenience of competing the work using alternate means and/or for monitoring work during the warranty period.
>
> (the **Disputed Clause**)

While performing the Subcontract work, but near the end of the work, the Subcontractor filed an assignment in bankruptcy. At the time of the assignment, Chandos owed the Subcontractor $149,618.39, but incurred $22,800.00 in increased costs to complete the Subcontract work. There was no dispute that under the *Bankruptcy and Insolvency Act* (the ***BIA***) and at common law, Chandos was entitled to set-off the $22,800.00 from the amount owing. However, Chandos also claimed a debt of approximately $137,000.00 arising from the Disputed Clause, which would mean Chandos did not owe the Subcontractor any amount, after setting off this debt.

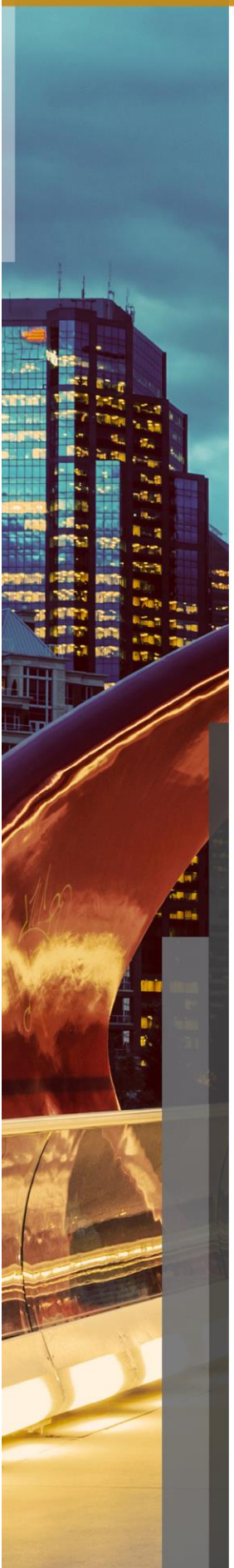
Holdings of the Supreme Court of Canada

Five issues were presented to the Supreme Court of Canada, but the Court's decision focused on three.

First, the Court found that the anti-deprivation rule exists in common law and has not been eliminated either by jurisprudence or by Parliament. The Court affirmed that at common law the test had two parts: "first, the relevant clause must be triggered by an event of insolvency or bankruptcy; and second, the effect of the clause must be to remove value from the insolvent's estate. This has been rightly called an effects-based test".

Second, the Court rejected the submission that the anti-deprivation rule's second prong should be amended to invalidate only clauses without a *bona fide* commercial purpose. According to the Court, substituting a "purpose based" approach would:

- undermine the express requirement in s. 71 of the BIA that all the bankrupt's property be collected in the trustee,



- create commercial uncertainty because the Courts would be required to assess parties' intentions long after the fact, and
- invite parties to create preferences under the guise of commercial purposes because the party who might become insolvent has no incentive to resist a clause that deprives its estate of value, and the creditors of that party are without a seat at the bargaining table.

Despite the above reasoning, the Court held that contractual terms that are triggered by other events, or that create other mechanisms (e.g. insurance, guarantees, security) to protect against insolvency consequences may not offend the anti-deprivation rule. In a lengthy dissent, Justice Côté would have adopted the *bona fide* commercial purpose alteration to the anti-deprivation rule.

Third, the Court acknowledged that the *BIA* incorporates common law set-off, but that set-off only applies to enforceable debts or claims, whereas the anti-deprivation rule undermines the enforceability of the debt or claim.

Applying the above considerations, the majority of the Court held that the Disputed Clause offended the anti-deprivation rule.

Implications for parties in construction

On a plain reading of the Disputed Clause, it is clear that its intention was to award Chandos a pre-estimate of damages for the actual costs of performing contractual warranty obligations that the Subcontractor ought to have performed, but failed to in breach of the Subcontract. In this regard, if Chandos had paid a replacement contractor to assume the Subcontractor's contractual warranty obligations, it is arguable that this amount would be a cost of completion that could be set-off, similar to the other costs of completion for which there was no dispute of set-off. That said, in a negotiated contract, the Subcontractor could have readily responded that given the uncertainty in pricing the assumption of a warranty, they would prefer a liquidated damages assessment of those costs in the event of breach, even a breach arising from bankruptcy. Logic such as this appears to have framed the dispute over the effects-based and *bona fide* commercial purpose based approach to the anti-deprivation rule. For the above reason, participants in the construction industry will likely view the outcome in *Chandos v Deloitte* as negative and difficult to understand.

However, despite the outcome being disappointing to construction industry participants, the reasoning allowing other mechanisms to protect these long-tail obligations is important. In this regard, parties retaining suppliers or contractors on a construction project can still consider mechanisms such as letters of credit, surety bonds, or guarantees. Similarly, another mechanism may simply be to assign a portion of the contractual price to the warranty period. For example, if Chandos and the Subcontractor had agreed to assign 10% of the contract value to the warranty period, this would mean that payment of that amount would have only been due and owing after the warranty period expired, and there would have been no Chandos debt owing to the Subcontractor in the first place.

Unfortunately, all of the above proposals, in conjunction with issues such as *Builder's Lien* holdbacks, are likely to further reduce the immediate cash flow available to any supplier or contractor on a project—and perhaps further threatening the cash flow solvency of these parties. In short, the decision appears to be less about restructuring companies, and more about ensuring participants in the construction industry properly restructure their contracts—regardless of the impacts this may have on the insolvency bar.

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