Financial Services Flash

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October 23, 2013

Contractual Clause a "Fraud Upon the Bankruptcy Law" and Declared Unenforceable

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The Court of Appeal for Ontario (the "**Court**") held recently that an otherwise valid contractual clause between parties was unenforceable on the basis that it was a "fraud upon the bankruptcy law." This equitable principle operates to invalidate any part of an agreement that provides for an unfair distribution of a bankrupt's assets among its creditors.

The case, *Aircell Communications Inc. (Trustee of) v Bell Mobility Cellular Inc.*, involved an independent dealer agreement (the "**Agreement**") under which Bell appointed Aircell as an independent dealer of telecommunication products and services. Aircell would purchase inventory from Bell and collect commissions once the products and services were sold. Aircell, however, experienced financial difficulty. At the time, Aircell owed Bell approximately $64,000 for inventory and Bell owed Aircell approximately $188,981 for commissions.

The Agreement contained a provision entitling Bell to terminate it on notice if, among other things, Aircell defaulted on any payments or commenced any proceedings under the *Bankruptcy and Insolvency Act* (the "**BIA**"). Aircell met with certain of its stakeholders, including Bell, to discuss restructuring options. Unbeknownst to Bell, Aircell had already filed a Notice of Intention to Make a Proposal under the BIA. After the meeting, Bell notified Aircell that it was terminating the Agreement due to Aircell's failure to pay amounts outstanding to Bell. The termination of the Agreement became effective in 30 days pursuant to its terms. However, Aircell was deemed bankrupt before the 30 days elapsed.

The Trustee in Bankruptcy of Aircell asserted a claim against Bell to the extent that the unpaid commissions exceeded the amount owed to Bell by Aircell for inventory. In turn, Bell relied on a relieving clause in the Agreement which provided that Bell's obligations to pay commissions "shall cease immediately" upon termination of the Agreement.

The trial judge held that Aircell's failure to pay Bell was due to Aircell's insolvency and, relying on the "fraud upon the bankruptcy law" principle, declared the relieving clause in the Agreement void. Bell appealed the decision to the Court.

The Court upheld the trial judge's ruling and held that the Agreement's termination was triggered because of Aircell's insolvency. The Court determined that the relieving clause provided a windfall to Bell. In the context of an insolvency, this type of clause is inequitable because it runs contrary to the overriding public policy that requires an equitable and fair distribution of a bankrupt's assets among its creditors. In other words, the relieving clause was a "fraud upon the bankruptcy law" and was declared invalid by the Court.

The relieving clause, which was engaged upon any default of Aircell, may have been valid outside of an insolvency proceeding. However, contracting parties should be cognizant of the overriding effects of insolvency on otherwise valid agreements and properly take those effects into account to ensure the rights they bargained for remain intact.

The Financial Services Group at Aird & Berlis LLP has a great deal of experience in advising clients on the drafting and negotiating of contractual clauses dealing with counterparty risk as well as on priority disputes. For more information, please contact any member of the Financial Services Group. Details can be found on our Financial Services, Insolvency and Restructuring web page, by clicking on members. Click here to view our other newsletters or visit www.airdberlis.com.