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Keeping Estate Assets Out of the Hands of a Beneficiary's Creditors: The Power of Discretionary Trusts – Part 2

By *Suzana Popovic Montag* - October 2022

Last month, we reviewed discretionary trusts as a tool that might assist in addressing the scenario in which a beneficiary named under a Will is insolvent or bankrupt at the time that an intended distribution is to be made. This month, we continue to explore considerations relevant to discretionary trusts in the context of beneficiary bankruptcy.

The Anti-Deprivation Rule

The anti-deprivation rule is a common law rule that was recently confirmed and extensively discussed by the Supreme Court of Canada in *Chandos Construction Ltd. v. Deloitte Restructuring Inc., 2020 SCC 25* [*"Chandos"*]. According to the Supreme Court, "[t]he anti-deprivation rule renders void contractual provisions that would prevent property from passing to the trustee [in bankruptcy] and … that, upon insolvency, remove value that otherwise would have been available to an insolvent person's creditors", thereby frustrating the scheme of the *BIA* (paras 30-31).

A clause will be void for breaching the anti-deprivation rule if:

1) the clause is triggered by an event of insolvency or bankruptcy; and
2) the clause has the effect of removing value from the insolvent's estate.

Complying With the Anti-Deprivation Rule

In light of the Court's decision in *Chandos*, a protective discretionary trust that purports to end a potential beneficiary's interest in a bequest if the beneficiary goes bankrupt may be invalid. As noted by Frank Bennett in his article, "The Effects of Bankruptcy on Estate Planning," this type of clause has not been judicially tested in any reported case in Canada.[1] While it has been suggested that a protective discretionary trust "does not amount to a fraud on insolvency law because the insolvent never has any property rights in or rights to acquire any property of the trust corpus,"[2] the Ontario Court of Appeal's recent decision in *Richards (Re), 2022 ONCA 216* demonstrates that such a trust may offend public policy and be rendered void under the anti-deprivation rule if a court finds that it enables a testator to place his or her assets out of the reach of a beneficiary's creditors in the event of a bankruptcy (see para 13).

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[1] Frank Bennett, "The Effects of Bankruptcy on Estate Planning," (2009) 61 C.B.R. (5th) 163, at heading 2. Wills, (e) Spendthrift Trusts.

[2] David R. Wingfield, "The Attachment of Charitable Property at Law and in Equity: Or, Why the Ontario Court of Appeal In Re Christian Brothers of Ireland in Canada is Rights and its Critics are Wrong," (2004) 83:3 *Canadian Bar Review* 805, 2004 CanLIIDocs 99 at 842, footnote 118.

To ensure that a protective discretionary trust complies with the anti-deprivation rule, a beneficiary's potential interest in a bequest ought to be conditional on a criterion other than bankruptcy. For example, a clause could require the trustee to consider factors such as whether the potential beneficiary is reckless or improvident with money before exercising his or her absolute discretion to pay income and/or capital to the potential beneficiary. As long as the final decision of whether to advance funds remains a matter of discretion, left in the hands of the trustee, such a clause should not violate the anti-deprivation rule. In *Chandos*, the Supreme Court noted at paragraph 40 that provisions whose effects are triggered by an event other than insolvency or bankruptcy may not offend the rule.

A trust clause which appears to be overtly designed to defeat the rights of a beneficiary's creditors may invite litigation and, in turn, result in a finding that such a clause is void for violating the anti-deprivation rule. To prevent this outcome, solicitors should instead consider recommending utilizing a discretionary trust that does not offend public policy and clearly puts control in the hands of the trustee as to whether payment will be made to potential beneficiaries.