

Change of Terminology? Change of Law?

An Overall Assessment of the Provisions of the *Civil Code of Québec* Relating to Prior Claims and Hypothecs

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Article abstract

The provisions of the *Civil Code of Québec* dealing with Prior Claims and Hypothecs constitute an ambitious, although only partly successful, reform of the law relating to security devices. Given the policy objectives underlying any regime of security on property, three major problems with the new Code are immediately apparent: the failure to rationalize the scheme of non-consensual priorities and legal hypothecs; the failure to provide explicitly for an imperative regime of registration and realisation recourses governing any legal transaction which in substance functions as security on property; and the failure to redefine the concept of hypothec to account for its extension to universalities, and incorporeal property. Nevertheless, ordinary canons of codal interpretation give the judiciary sufficient resources to correct, by principled reference to the basic policy goals of this area of the law, most of the textual deficiencies in Book Six of the *Civil Code of Québec*.

**La réforme du droit des sûretés réelles :
Actes du colloque de l'Association québécoise
de droit comparé**

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ABSTRACT

The provisions of the Civil Code of Québec dealing with Prior Claims and Hypothecs constitute an ambitious, although only partly successful, reform of the law relating to security devices. Given the policy objectives underlying any regime of security on property, three major problems with the new Code are immediately apparent : the failure to rationalize the scheme of non-consensual priorities and legal hypothecs; the failure to provide explicitly for an imperative regime of registration and realisation recourses governing any legal transaction which in substance functions as security on property; and the failure to redefine the concept of hypothec to account for

RÉSUMÉ

Les dispositions du Code civil du Québec traitant des priorités et des hypothèques constituent une réforme ambitieuse, bien qu'elle ne réussisse que partiellement, du droit applicable aux sûretés. Compte tenu des objectifs de principe sous-jacents à tout système de sûretés réelles, on constate immédiatement que le nouveau Code soulève trois problèmes principaux : l'omission de rationaliser les régimes des priorités non consensuelles et des hypothèques légales; l'omission de prévoir explicitement un régime péremptoire d'enregistrement et des recours en réalisation applicables à toute opération juridique qui constitue pour l'essentiel une sûreté réelle; l'omission de redéfinir la

* I should like to thank my colleagues Martin Boodman, Daniel Jutras and David Stevens, each of whom has enriched my understanding of the law of secured transactions over the years we have taught together at McGill, for their incisive comments on an earlier version of this overview. John Brierley and Nicholas Kasirer also read the penultimate draft of the text, suggesting improvements to both its form and substance.

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notion d'hypothèque pour tenir compte de son extension aux biens incorporels et aux universalités. Néanmoins, les règles normales d'interprétation du Code suffisent pour permettre aux tribunaux de corriger la plupart des lacunes du libellé du Livre 6 du Code civil du Québec en se référant aux objectifs de principe fondamentaux dans ce domaine du droit.

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INTRODUCTION

The Report of the Civil Code Revision Office on the Law of Security on Property and the provisions of the Draft Civil Code of 1977 reflected a belief that the law relating to security on property was in need of substantial redesign.¹ Similarly, the Comité d'étude sur les sûretés et la publication des droits réels of the Ministry of Justice felt that a global reform in this field was necessary, translating this reform agenda into the Draft Bill on Security on Property and Publication of Rights presented for discussion in December 1985.² And, of course, this same preoccupation is apparent in the provisions of Books Six and Nine of the *Civil Code of Québec*.³

The various proposals presented during the fifteen year legislative gestation of this part of the Civil Code clearly reveal that the intention of the government was to modernize the law of security on property along the general

1. See CIVIL CODE REVISION OFFICE, *Report on the Civil Code* (1977), volume I, p. xxxiv, and volume II, tome I, pp. 346-372.
2. See F. FRADETTE, "Les sûretés réelles : aperçu des principales nouveautés proposées par la réforme du Code civil", (1987) 89 *R. du N.* 732.
3. For general commentary both on the Draft Bill of 1985 and on the *Civil Code of Québec* as initially tabled in December 1990 see R.A. MACDONALD, "The Counter-Reformation of Secured Transactions Law in Quebec", (1991) 19 *C.B.L.J.* 239 (which has a particular focus on moveables) and D. STEVENS, "The Reform of Immoveable Security in Quebec" in *Current Problems in Real Estate [:] Meredith Memorial Lectures* (1989 Series), Cowansville, Les Éditions Yvon Blais Inc., 1990, p. 419 (which discusses proposals relating to immoveables).

functionalist lines of Article 9 of the U.C.C., but to retain as an overarching framework the existing civil law approach to the subject.⁴ The attempt in Book Six to reorganize and rationalize security devices (especially — but not exclusively — insofar as moveable property was concerned), and to consolidate and simplify creditors' remedies (especially — but not exclusively — the remedies open to creditors holding consensual security), illustrate these twin policy objectives.

While the provisions of articles 2644-2802 are a significant improvement over existing law, and indeed are an improvement over both the Draft Bill of 1985 and the initial text of Bill 125 tabled in 1990, they nevertheless fall short of the standard set by the Draft Civil Code of 1977. Unfortunately there remain in the new *Civil Code of Québec* a number of design flaws which courts will be required to correct in developing the jurisprudence of secured lending over the next few years. In this short overview I shall briefly discuss some of the more important areas where such a judicial effort is needed.

I. GENERAL POLICY OVERVIEW OF THE LAW OF SECURITY ON PROPERTY

The law of security on property, and *a fortiori*, the law of consensual security on property, is but one facet of the law relating to the compulsory performance of obligations and of the execution of judgments. Yet, from the point of view of legislative design, it is probably the most important. For once the basic rules about the composition of a debtor's patrimony and about non-consensual execution priorities are settled, it is the facilitative rules of consensual security which are the key to an efficient and effective regime of secured credit.⁵

The general theory of any system of consensual security is easy to state, as are the legislative policies which should inform its expression. Security is designed to make credit more widely available; to reduce its cost; and to minimize the risk of debtor bankruptcy by isolating assets upon which enforceable claims may be efficiently exercised. How it does so has been demonstrated by economists. Apart from transaction costs associated with the contract in view, the cost of credit has two main components: the time value of money, and the insurance premium charged to borrowers to spread the risk of default. The time value of money is a constant for all debtors at any given time. But by permitting creditors to realize efficiently and by priority on specific assets whose value is known, and hence by lowering the risk of non-payment associated with the granting of credit, consensual security serves to reduce its cost (at least in connexion with the loan for which security is given).⁶

4. The best study of this question remains Yves CARON's classic contribution: "L'article 9 du Code Uniforme de Commerce peut-il être exporté?" in J. ZIEGEL and W. FOSTER, eds, *Aspects of Comparative Commercial Law*, Montreal, Institute of Comparative Law, 1969, p. 374.

5. For general discussion of these points see R. A. MACDONALD, "Le droit des sûretés mobilières et sa réforme: principes juridiques et politiques législatives" forthcoming in P. LEGRAND, ed., *Common Law: d'un siècle à l'autre*, 1992, sous presses.

6. It is unnecessary at this point to determine whether a regime of secured lending (seen globally) is economically efficient. For discussion see A. SCHWARTZ, "A Theory of Loan Priorities", (1989) 18 *J. Leg. Stud.* 209, and P. SHUPACK, "Solving the Puzzle of Secured Transactions", (1989) 41 *Rutgers L. Rev.* 1067.

In view of this policy goal, the legal principles which should inform a regime of consensual secured lending are both few and simple. To begin, transaction costs in the *granting* of security should be kept to a minimum. This means that the logic of the regime should be as simple as possible: 1. the monitoring and realization prerogatives, and especially the rank, of the creditor should be fixed as of the date security is granted; 2. no creditor should be able to claim a consensual right which defeats a pre-existing priority; and 3. any regulation of the recourses of secured creditors should apply to all creditors attempting to acquire a priority, regardless of the legal device they deploy in that effort. In addition, transaction costs in the *enforcement* of security should also be kept to a minimum. This means that the rights granted should be designed to maximize realization values upon a legitimate default: 1. rules should not encourage defensive or anticipatory enforcement by risk-averse creditors; 2. rules mandating the presumption of an implicit intention — for example, to cede rank — should be avoided; and 3. rules relating to the process of realization should be designed to encourage responsible behaviour by both debtor and creditor upon realization and sale.

It is hardly surprising, given its 19th century origins, that the regime elaborated in 1866 often worked directly contrary to this logic. A number of specific critiques were advanced by the Civil Code Revision Office. Some were technical; many were substantive; all were thought to require correction. As supplemented by analyses undertaken since 1977, these critiques can be summarized as follows. *First of all*, the Code shows little awareness of modern commercial practice (which, to be fair to the codifiers, was not well developed in 1866), and is rooted in assumptions which fit only the financing of property (immoveable as well as moveable) for the purpose of its ultimate consumer acquisition. *Second*, the Code is overladen with a number of archaic privileges, both in relation to moveables and immoveables. *Third*, the main financing regimes over moveables are either unfortunate calques on existing Codal devices (such as the agricultural and commercial pledge regimes), or are extraordinary legal devices found in special statutes (trust deed security, transfer of property-in-stock). *Fourth*, the Code does not deal adequately with the consensual title-transaction as a way of overcoming the prohibition on hypothecs over moveables. *Fifth*, the regime of construction privileges is inadequate to the variety and complexity of transactions relating to the development of immoveables. *Sixth*, the Code rests on an inadequate system of creditor's remedies: judicial sales are an inefficient way of raising money to pay a debt, but the giving in payment clause confers an undue bonus to the creditor whenever it is used to expropriate construction privileges, or to take back property upon which a substantial portion of the debt owing was already paid. *Seventh*, the regime is ill-adapted, in its selection of those to whom the law should give a non-consensual insolvency preference, to the realities of the late twentieth century: little attention was paid to the claims of workers who lost back wages and future opportunities when a company went bankrupt; nor was attention paid to alimentary claimants whenever a personal bankruptcy ensued.

Presumably these critiques would have led one to expect that whatever else was done, all the obvious deficiencies of the 1866 regime would have been corrected in the new Civil Code. They were not. Having participated in the law reform process (more recently at its margins) off and on since 1984, I am convinced that the main reason for the current confusion flows from a lack of understanding about what the possibilities and prospects for a renewed law of security on property really were. In other words, I believe that had the ministerial and legislative

committees had a better sense of what the fundamental purposes of consensual security were, who the basic categories of debtor and creditor were, what the functional categories of property available to support a security right were, and how possessory and property rights in that property could have been allocated, the regime they recommended would have been substantially different.

Why are Books Six and Nine a flawed attempt at reform? Simply because, quite apart from infelicities of style, minor conceptual confusion, misplacement of certain articles, and a degree of incoherence among basic principles intolerable in a Code,⁷ there are at least seven major substantive criticisms which may be advanced against its overall schema. Any one of these would be sufficient to send the project back to the drawing board. Together they suggest an insufficiently well-thought-out proposal which will guarantee employment for advocates, notaries and law professors for many years to come. I propose to list summarily these defects here, and to discuss three in greater detail later in this overview. Before doing so, however, it is helpful at least to consider at least some of the policy options which were open to the National Assembly. This exercise will demonstrate that the current Book Six is far from the only one that could have been drafted, and that its defects are not, as some have suggested, inherent (and therefore inevitable) in this complex field of law.

A first policy choice relates to the *origin* of the security : did the drafters give adequate attention to the question why (and which) creditors should get a legal *ex post facto* non-consensual priority? A second policy choice goes to the *scope* of the security : how extensively should a creditor be permitted to control a debtor's patrimony prior to default through techniques like subrogation into proceeds and the taking of security over a universality of property? A third policy choice goes to the theory of *publicity and priorities* governing security interests : should there be any unregistered priorities, and if a first-in-time rule is adopted as the basic principle should certain superpriorities be given to any particularly vulnerable creditors? A fourth policy choice relates to the allocation of *possessory and property rights* between lender and borrower : how should one decide whether to prefer security devices which leave a borrower in possession (hypotheque (*hypotheca*) and instalment sale), over others which do not (pledge (*pignus*) and sale with right of redemption (*fiducia cum creditore*))? or to prefer devices which would allow a borrower to remain owner (hypotheque, pledge), over those which do not (instalment sale, sale with a right of redemption)? A final policy choice relates to the conditions of *default and enforcement* : should all security devices give the creditor the right to stipulate whatever default conditions it wishes, and to stipulate any remedies — foreclosure, private sale, judicial sale — it wishes, without either *ex ante* or *ex post* judicial control?

Surprisingly, the new Civil Code does not take a consistent view of any of these policy questions, and often resolves one in a manner which is contradictory with the manner in which it attempts to resolve another. Thus the Code limits non-consensual and hidden priorities (preferred claims and legal hypothecs) but does little to control consensual hidden priorities (title transactions). Again,

7. For an enlightening discussion of these features of a Code, as applied to the Uniform Commercial Code in the United States, see B. FRIER, "Interpreting Codes", (1991) 89 *Mich. L. Rev.* 2201; see also, A.-F. BISSON, "A Comparison Between Statutory Law and a Civil Code" in E. CAPARROS and R. LANDRY, eds., *Essays on the Civil Codes of Québec and St. Lucia*, Ottawa, U. of Ottawa Press, 1984, p. 225.

the Code consolidates creditor recourses (especially the use of the giving in payment clause), and gives an incentive to lower ranking creditors to bid the realization price up to the approximate market value of the secured property (articles 2779-80; 2788-90), but maintains fictional valuations of property for purposes of extinguishing the debt (articles 1695-1698; 2782; 2791). This inconsistency, I believe, is at the root of most of the design defects in the regime of prior claims and hypothecs set out in articles 2644-2801. What then are these specific problems?

First of all, the reform should have provided a better statement of the preliminary regime of execution of judgements. In fact, the equivalent of articles 1585 *et seq.* C.C.L.C. governing the regime of judicial sales nowhere appears in the new Code, and it is not even clear if there is to be an additional regime of judicial sale on top of what appears to be the hypothecary recourse of "sale by judicial authority" (articles 2791-2794). Articles 2646 and 2748 suggest that an additional regime (the ordinary seizure in execution and sale) will be elaborated but, if such is the case, why is it necessary to set out two distinct regimes of private creditor realization by sale? What is the advantage of specifying altogether three types of creditor sale: the private sale (articles 2784-90), the "semi"-private sale (articles 2791-94), and the regular judicial sale? Would not the first and third have sufficed? On the other hand, if the idea was to make the procedures of the ordinary judicial sale more supple through their replacement by the "sale by judicial authority", why was this recourse not placed earlier in Book Six and explicitly made available to all judgment creditors? Regardless of whether a separate "judicial sale" regime is to be created, these basic principles are far too central to be relegated to the *Code of Civil Procedure*.

Second, and as a complement to the first point, the reform should have clearly identified and sought a coherence with those patrimonial exclusions which are established in other sections of the Code. For example, there is nothing in the overall logic of articles 2644-49 which accounts for special rules relating to certain types of community property regimes and especially for those dealing with the family patrimony and the moveables and immoveables comprised by the notion of family residence. Nor does the Code provide a general theoretical context which accounts for various attenuations to the creditors' common pledge such as exemptions from seizure and legislative techniques like deemed trusts. Only an enumeration of these devices would make it clear how courts should control creditor attempts to establish parallel consensual security instruments by manipulating the composition of a debtor's patrimony.

Third, the policy of the law in respect to preferred claims and legal hypothecs should be reconsidered. Given the proposal to add a register of certain rights in moveables, are there still any good policy reasons for maintaining regimes of unregistered preferred claims? If so, has the National Assembly selected the right claims for special treatment, or should it have been more sensitive to those very limited "personal claims" that arise in an alimentary or employment context? I consider this point in greater detail below.

Fourth, notwithstanding the opposition of many segments of the legal community in Quebec, the reform should have included an article establishing what the Civil Code Revision Office infelicitously called the "presumption of hypothec". Without an explicit regulation of title devices many of the advantages gained by modernizing the regime of true security of property will be compromised. I will also develop this point more fully later.

Fifth, the false symmetry of both the hypothec over moveables and immoveables and the hypothec over corporeals and incorporeals is pernicious. The

Code should explicitly recognize the different policy considerations which bear on each of these types of assets, both in terms of the way in which they are offered as security, and in the way in which creditors seek to realize upon them. This is the third point to which I return for further discussion.

Sixth, the regime of construction hypothecs needs to be completely rethought. The device proposed — the legal hypothec — is simply a copy of the existing construction privilege. It is both insufficiently nuanced, and insufficiently tied to the market for financing construction projects (articles 2724(2); 2726-28). Even the Civil Code Revision Office, which preferred the abolition of the privilege, recognized in its fall-back position that anything remotely resembling the current regime was to be avoided. Most other jurisdictions have a multi-faceted regime of “construction liens” involving hold-backs, project trustees, construction liens and so on, all quite variable according to the nature and the scope of the construction in view. Is there any reason to believe the construction market in Quebec is any less complex?

Seventh, the regime of creditor recourses and priorities should be restructured so as to make clear the overall policy of maximizing realization values. At a number of points responsibility for under-realization can be passed off by a creditor onto an innocent third-party who is given no recourse to force the realizing creditor to proceed more effectively. This problem is just one feature of the sometimes curious priority system which emerges from the integration of the various priority rules scattered throughout the Books Six and Nine (articles 2657, 2670, 2673, 2721, 2945-56). All these rules should be assembled in the Book on Prior Claims and Hypothecs, where they logically belong, given their function as substantive controls on creditor entitlements. These rules should, moreover, also make absolutely clear who has authority to control the process of realization and who is liable for any deficiencies in its exercise (*cf.* article 2750, with articles 2782, 2790, and 2793).

It is, I realize, the office of an academic to criticize legislation, no matter how good that legislation may be. I trust, nevertheless, that this inventory of design defects will not be perceived only in that light. It is intended to illustrate just how much work needs to be done in order to make the provisions of Book Six work reasonably well. In pursuit of this purpose, and to show in greater detail the seriousness of the problems here identified summarily, I should now like to focus on three particular difficulties, which I believe indisputably make the general point.

II. THE ILLOGIC OF PREFERRED CLAIMS AND LEGAL HYPOTHECS

There are currently six distinct types of security or quasi-security which may be claimed in Quebec, each of which is responsive to a different underlying logical structure. These six types are: simple execution priorities (the privilege); non-consensual possessory security (the right of retention); the seller's non-consensual possessory and title rights (retention, revendication and dissolution); consensual possessory security (the pledge); consensual, non-possessory security devices (the commercial pledge, the transfer of property-in-stock); and consensual title transactions (the instalment sale, the sale with a right of redemption, the contract of leasing). Unfortunately, despite the concerns expressed by the Civil Code Revision Office about the incoherence of maintaining all devices, the new Code reveals no overall logic in its choices about which of these are retained, and how they are to be integrated into a comprehensive scheme of priorities.

The Code has been advertized by its partisans as having achieved a rationalization of security by transforming the diverse existing security devices into a uniform mechanism, to be known as the hypothec. This, as I hope to make clear, is false advertizing. While the hypothec would, in principle, be a consensual device, the new Code also retains some non-consensual hypothecs, some non-consensual execution priorities, and some non-consensual patrimonial and possessory priority techniques derived from the law of property and obligations. The maintenance of some of these non-consensual preferences can, no doubt, be justified theoretically on the grounds that neither 1. are all types of claim equally worthy, nor 2. are all patrimonial objects of equal significance to debtors, nor 3. ought all categories of creditor and debtor to be treated simply as marketplace agents. But in practical terms such a justification demands, as a first step, an inventory of these various creditors and their claims, as well as a theory of why their particular claims merit this exceptional type of protection.

Who exactly are these various creditors? First, there will be *ordinary lenders* such as banks, trust companies, credit unions, finance companies, family, friends, and, unfortunately, usurers. Second, most people will usually be indebted to one or more *sellers* of moveables or of an immoveable. Third, some buyers will have advanced funds to their seller through deposits or long-term warranty or service contracts and will be *contract creditors*. Fourth, *employees* normally will have advanced at least a week's labour, and may have deferred compensation packages, vested pension rights, severance pay entitlements and other "opportunity cost" claims. A fifth category of creditors includes *delict claimants and judgment creditors* in ordinary contract disputes. The *Crown* and other *statutory claimants* such as the Unemployment Insurance Commission, the Quebec Pension Plan, the Worker's Compensation Commission, and so forth constitute a sixth category of creditors whose claims are wholly or in part executory. Seventh, both *lessors* and creditors with a *right of retention* comprise a special subset of contract claimants. Finally, creditors of *alimentary obligations*, be these executory (say, following a judgment or contract) or contingent (say during the course of marriage or minority) are also important creditors, at least of non-corporate debtors. Once this full range of potential creditors has been identified, the key issue in designing a non-consensual regime, is to determine which of them: 1. merit protection; and 2. are unable to negotiate for a priority; or 3. having negotiated for a priority, are compelled by a more powerful creditor to waive or renounce it.

Under the new Code the bizarre list of 21 execution preferences over moveables and 13 over immoveables of the 1866 Code is reduced to a list of five: legal costs and expenses incurred in the common interest; the unpaid vendor's claim over moveables; the claim of persons having a right of retention over moveables; the claim of the State for amounts due under fiscal laws; and the claim of municipalities and school boards for property taxes on taxable immoveables (arts. 2650-2659). In itself, this pruning of anachronistic non-consensual priorities is to be welcomed. But it is not obvious that the exercise was all that well thought out. To take only one example from the proposed list — "the claim of the State" — why should this claim now be extended beyond the historic right of the government to monies collected by an insolvent debtor on its behalf, where its rights are less those of a creditor than those of a trust beneficiary? And, on such an hypothesis, why should this claim not also include non-tax remissions due to contributory schemes such as unemployment insurance, pensions and worker's compensation? (I am assuming here that the expression "fiscal laws" does not include the statutes setting up these agencies and providing for contributory remis-

sions, although I acknowledge that since the terminology is new to the Code, it may receive such an extended application.) In other words, while the logic of a modern regime of security on property would support the retention of a limited number of pure non-consensual priorities either to protect legally vulnerable creditors in the sense noted above (is the state really a vulnerable creditor?), or to replicate standard negotiated preferences (in which case they should be not be subjects to waiver), the choices made in the new Civil Code seem more responsive to “special pleading” or “rent seeking” than to any underlying policy coherence.⁸

A similar point can be made about the various non-consensual hypothecs remaining in the Code. Of the four⁹ different types it retains, only two have a reasonable policy justification: — the claim of the State for monies dues under fiscal laws, *etc.*, and that of the syndicate for co-owners (where the difficulty of negotiating consensual hypothecs among diverse co-owners argues for a legal regime). The legal hypothec of persons having taken part in the construction or renovation of an immovable is too unsubtle a device to protect adequately the various interests in play, and resolves few of the difficulties of application of the present law.¹⁰ Finally, the legal hypothec relating to a claim which is the subject of a simple judgment is overbroad, and unenforceable in bankruptcy anyway.¹¹

The retention of various features of the law of property and obligations which generate the equivalent of an execution priority can be justified both in theory and, with two exceptions, in practice. In other words, the general principles sustaining the patrimonial specificity of property held by trustees, institutes of substitutions, administrators of the property of another, and partners (article 2221), the rules of compensation (articles 1672-82), the *exceptio non adimpleti contractus* (article 1591), exemptions from seizure in execution (article 2648), and stipulations of unseizability (article 2649) are all consistent with the overall logic of non-

8. There may be good policy reasons (*i.e.* a variation on the greatest good for the greatest number theme) for giving the State a priority, although if it remains unregulated this priority will drive lenders to use title transactions which remove assets from their debtor's patrimony as a means to avoid the claim of the State. This is an extremely complex topic which requires an analysis going well beyond the scope of this overview. As for the claim for law costs, these have an entirely different rational not at all related to vulnerability, but rather to insuring efficiency in the realization process.

9. In the first draft of Bill 125 there were five legal hypothecs. The elimination of the legal hypothec for vendors (proposed article 2707(3)) is an improvement, and the rule retaining priority for the vendor's hypothec over immovables (article 2948) is sufficient protection for such vendors. Yet the codal scheme gives no similar protection for the vendor of moveables, establishing only a weak preferred claim (article 2651), and this in very limited cases. Moreover, the Code nowhere deals with the claim of the purchase-money financier who is not actually a vendor. This latter category of creditor will, presumably, have no preferred recourse against moveables, and will be required to take an assignment of the vendor's immovable hypothec once it is constituted, an unnecessary complication given the frequency of such purchase-money arrangements.

10. While I do not necessarily recommend the system established in Ontario under the *Construction Liens Act*, it is worth noting that in that jurisdiction the legislature came to the conclusion that a wide variety of security mechanisms (including trusts, holdbacks, and refinancing rights) were necessary to deal with the range of competing claims arising in the construction context. For discussion see D. MACKLEM and D. BRISTOW, *Construction Liens in Canada*, 6th ed., Toronto, Carswell, 1990.

11. Again the elimination of the hypothec for judicial suretyships is an improvement over the initial draft of Bill 125, but the scheme of article 2731, which allows the courts to limit such hypothecs is curious given that they can affect both moveables and immovables (article 2370), thus paralyzing a debtor's entire patrimony.

consensual preferences elaborated in articles 2650-59. But given its radically changed scope, this is not true of the right of retention, which no longer is constrained by a *numerus clausus* (articles 1592-93). If any creditor may hold property (including immoveable property) against all parties for a claim “directly related” to the property, then all a creditor need do to obtain a superpriority outranking all others is to take custody of the property in question. The new right of retention thus can be used to generate a disruptive and hidden priority regime open to a wide range of creditors. The same is also the case with devices such as the “legal right of resolution” of the unpaid seller — a non-consensual title-based priority attached to a consensual arrangement (article 1740-43).¹² A consensual hypothecary regime of purchase-money superpriority would have obviated the need to retain this dysfunctional relic of the former law.

If the underlying theory of why one should enact non-consensual priorities is as stated, and if the remainder of the Civil Code is taken as evidence of the central policy choices informing the new law, this suggests the opportunity not only to eliminate some of the preferred claims and legal hypothecs actually established by Book Six, but also to confer one or two other non-consensual priorities in addition. Without attempting to generate an exhaustive list, let me suggest some of the more worthy claimants, and the type of protection they could be offered.

Many types of non-consensual claims need neither the formality, nor the legal weight of a hypothec, but could be adequately protected by a preferred claim. The most obvious candidates would include, for example, the claim of employees for wages owing, severance pay and pension contributions, and the claim of a present spouse and dependents for a capitalized sum impressed with an affectation to guarantee say, twelve months maintenance and support should the family’s principal wage earner go bankrupt.¹³ A similar preference could be established for judgment creditors of actions in delict relating to personal injuries (especially those caused by defective products or toxic substances). The legal hypothec device (that is, security which also has a right to follow) may be necessary, however, in other circumstances. One thinks immediately of creditors of judgments or registered agreements for maintenance and child support, where a secured right in the debtor’s property would go a long way to ameliorating the dislocations caused by marriage breakdown, delinquent payment of alimentary obligations, and abuses of donative and testamentary freedom. Such a hypothec would also relieve the pressure to develop substitute devices, such as a separate charge on family assets and an extended type of Paulian claim should they be disposed of, which function as security but which do not fit comfortably with the logic of Book Six.

12. The effects of this right in respect of immoveables are palliated somewhat by articles 1743-44, requiring registration of an express stipulation of a resolutory clause and subjecting its exercise to the hypothecary enforcement regime. But no similar controls exist for sellers of moveables, who may exercise their rights even after the goods have been seized judicially (article 1742).

13. Obviously, the decision to use the vehicle of the legal hypothec as a means of generating substantive matrimonial law raises difficult policy considerations. One need only look to the experience with the “legal hypothec of married woman” (former art. 2029) for evidence. But the point in the text is different. It is simply that contingent claims arising from personal decisions implying enormous “opportunity costs” (marriage, employment) ought to be factored into any scheme of prior claims and hypothecs.

III. THE SO-CALLED “PRESUMPTION” OF HYPOTHEC

Despite the modernizing goal which dominated all aspects of the reform of preferences and hypothecs, the Civil Code does not successfully organize a coherent regime for consensual security: indeed, not only does it continue to permit traditional title manipulation devices such as instalment sales, finance leases, double sales, sales under resolutive condition, and sales with a right of redemption, but it also does not require the registration of many of them. As a result, even though the Code provides for a rationalized publicity, enforcement and priority regime relating to consensual hypothecs, the informed creditor will continue to recur to the unregulated regime of title transactions wherever possible. Title to property still remains trumps, and when deployed as a security device, it gives greater possessory flexibility, greater realization rights and greater opposability to third parties, all with less formality than the modernized regime of hypothecs elaborated by Book Six.

There are diverse ways of controlling creditor attempts to avoid the hypothecary regime of consensual security. One is to adopt a mechanism like the “presumption of hypothec” proposed by the Civil Code Revision Office. Many good arguments may be advanced for such a policy, and in fact several other civil law jurisdictions have already made just this choice. But there are even stronger arguments for a variation of this idea, which may be characterized as a “substance of the transaction” rule. Such a solution is not only just as civilian as the “presumption of hypothec”, but is much more in keeping with the civil law tradition than the *ad hoc* specific remedial (dare I say common law) orientation directed to particular transactions now adopted in the Civil Code.¹⁴ However, since many commentators understand neither the scope nor the effect of a “substance of the transaction” rule, it is important to begin by briefly explaining what such a provision would do.^{14a}

As to scope, the “substance of the transaction” rule does not apply to any *non-consensual* devices by which a “possessory” security is generated; it catches only *consensual* security. Of course, like article 1040a C.C.L.C., the rule may partially constrain the enforcement prerogatives of lenders and sellers who seek to manipulate title as a means of generating a security device not subject to controlled realization procedures. But a “substance of the transaction” rule does not affect their freedom in such circumstances to stipulate an ordinary suspensive or resolutive condition, to set up a leasing contract, or to deploy some other device such as the trust, to control the locus of title to property. In other words, the rule does not limit the freedom of parties to locate titles (for reasons of risk, insurance, tax consequences, *etc.*) wherever they wish.

14. See, for example, in a reprise of part of current article 1040a *et seq.*, articles 1263 (the trust), the right of dissolution (article 1744), instalment sales (1749), and the right of redemption (article 1756), each of which subjects the title transaction in question to the hypothecary regime of publicity and enforcement. Surprisingly, the new code is less comprehensive than article 1040a(1) C.C.L.C. which set out a general “substance of the transaction” rule. For a careful discussion of the underlying policy of articles 1040a *et seq.* C.C.L.C. and its application to a situation not expressly contemplated by article 1040d C.C.L.C., see *Nadeau v. Nadeau*, [1977] C.A. 248.

14a. I discuss the questions raised in the section in greater detail in my article “Faut-il s’assurer d’appeler un chat un chat?” (forthcoming in the *Mélanges Germain Brière*).

As to effect, the idea is simple. A “substance of the transaction” rule operates to compell creditors who seek to secure the performance of an obligation by means of a charge placed on the property of their debtor, or by means of affecting their own property to the use of the debtor, to register the secured transaction in the register of moveable rights, and to exercise only those recourses granted to hypothecary creditors.

It is hardly surprising that there is now in the Code, as there has been in the *Civil Code of Lower Canada* since 1938, a widespread recognition of the merits of the idea of producing a uniform regime of publicity, registration and realization recourses for creditors who use title as security. But in most cases where the Code subjects title-creditors to the hypothecary regime — the trust, the right of dissolution, instalment sales, the right of redemption — the extension of the rule to the transaction in question followed the exploitation in practice or the revelation by commentators of how the transaction could be exploited as security were such a rule not adopted.¹⁵ But there are other transactions for which no such specific provision applies, and which, therefore, can be deployed as title security. This is true, for example, of both contracts for use, and translatory contracts. Thus, the contract of leasing (articles 1842 *et seq.*), ordinary leases (articles 1851 *et seq.*) and the loan for use (articles 2317-26) are not subject to control over their mechanics of enforcement — although, to be sure, the finance lease must be registered in order to be opposable to third parties (article 1847). Similarly, variations on sale such as the promise of sale (article 1710) and the security assignment (article 1637-50), and all other onerous translatory contracts such as the contracts of exchange (article 1789) and loan for consumption (article 2327-29) are not subject to any special regime of publicity and enforcement when used as security.¹⁶ The real impact of the absence of a “substance of the transaction” rule, therefore, is the invitation it gives to creative creditors to use variants of translatory contracts and contracts for use as new forms of security. No *ad hoc* and *ex post* amendments to the Code will ever suppress the inventiveness of creditors seeking security, especially over moveables.

Why then the resistance in the professions to the concept of a “substance of the transaction” rule which merely generalizes the provisions of article 1040a C.C.L.C.? In my view the basic cause is the proposal of the Civil Code Revision Office to enact a “presumption of hypothec”. Jurists attavistically committed to concepts like “absolute freedom of contract” and the “absolute unity of ownership” have great conceptual difficulty with the idea of a “presumption of hypothec”. They find it inconceivable that parties (especially sellers) cannot stipulate for a right of dissolution, or an instalment sale, or a hire/purchase agreement. But, as noted, this critique simply does not apply to a “substance of the transaction” rule. The difficulty, therefore, is essentially with the notions : 1. that an instalment seller or finance lessor, for example, could be both owner and hypothecary creditor; and 2. that a purchaser or lessee could have sufficient rights in the

15. In addition to subjecting certain transactions to the hypothecary regime, the new Code also attempts to control creditor abuse by prohibiting the use of certain transactions as security (giving in payment — article 1801).

16. It is, in fact curious that the Code maintains both the ordinary assignment (articles 1637-50) and the hypothec of claims (articles 2710-13), subjecting the latter to the hypothecary regime, but in no way limiting the use of the former as a security device not subject to such restrictions.

property to grant security over it (as opposed to over the personal right relating to the object) to another creditor; and 3. that involuntary surrender of the property for less than its full value to another creditor of the purchaser or lessor could be compelled.

But this is, in fact, a false difficulty. Already the Code provides that, to be enforceable against third parties, an owner's title in certain transactions intended to secure the performance of a credit obligation has to be registered, and the owner's rights are subject to the enforcement regime for hypothecs. All that is required is to state this principle as a general rule in Book Six. That is, it is not necessary either to re-order basic principles of property law so as to convert these devices into hypothecs, or to provide for a deemed transfer of the property to the purchaser or lessor upon default so as to rationalize the execution remedies of all creditors. The only problems with enacting a general "substance of the transaction" rule are that it complicates processes of consensual realization by compelling other creditors to advance money to the owners whose rights they are extinguishing even before disposition of the assets, and by also requiring them to advance money to such owners even in cases where they seek to take over and manage a business temporarily with a view to maximizing its liquidation value or to re-establishing it as a going concern. Nevertheless, these are minor wrinkles which can be easily ironed out once a general "substance of the transaction" rule is adopted.

IV. THE NATURE OF THE HYPOTHEC

The third major problem in the Civil Code traceable to misconceptions of the logic of regimes of secured transactions flows from the manner in which it attempts to produce the functional equivalence of security devices. Rather than generate coherence by establishing a single publicity, enforcement and priority regime of secured transactions — that is by specifying the forms and the consequences of the hypothec — the new Code seeks to impose a uniformity in the legal nature of the hypothec by characterizing it as a real right. This misguided specification occurred, I believe, because the hypothec of existing law is characterized as a real right (article 2017 C.C.L.C.), because in Quebec doctrine many authors (starting with Mignault) have been incapable of understanding insolvency priorities such as the privilege as other than real rights, and because of the belief that the essence of security on property can be captured by the notion of an "accessory real right".¹⁷

There can be, it is reasonably clear, no symmetry between moveables and immoveables, and between corporeals and incorporeals in the law of security on property. To appreciate this point it is only necessary to examine the list of different types of assets which any debtor (and especially any commercial debtor operating an enterprise) will have available upon which to grant security to a creditor. These assets are : *First* : — immoveables (a house, or a plant — including capital equipment and fixtures), and immoveable real rights (for example, emphy-

17. See P.-B. MIGNAULT, *Le droit civil canadien*, tome 9, Montréal, Wilson et Lafleur Ltée, 1916, p. 9, and P. CIOTOLA, *Droit des sûretés*, 2nd ed., coll. Mémentos Thémis, Montréal, Les Éditions Thémis, 1987, p. 227 *et seq.*; for statements that privileges are a form of security on property which confer a real right. Presumably, at least in the latter case, the didactic organisation of the work (in which the general characteristics of both moveable and immoveable privileges are presented together) explains the ellipsis.

teusis and superfiary rights). *Second* : — moveables (consumer durables, or inventory — consisting of raw materials, partly manufactured goods and stock on hand). *Third* : — revenues (salary and any interest payments due, or receivables — be these in the form of promissory notes, cheques, credit agreements or simple unpaid accounts, or cash on hand, or set offs against accounts payable). *Fourth* : — contract and delict claims, be these litigious rights or the present value of advantageous executory contracts and options to purchase labour or raw materials, as well as to sell or supply goods and services. *Fifth* : — incorporeals and intellectual property (stocks and bonds, or intangibles such as licenses, patents, trademarks, franchises, information, insurance policies, and even goodwill).

All agree that because in classical civil law theory only corporeal property may be owned, it follows that only corporeal property may be dismembered into principal real rights less than ownership, or may be affected by that species of rights which the 1866 Code called an accessory real right. By contrast with the *Civil Code of Lower Canada*, however, the scheme of the new Code explicitly permits a hypothec to be taken over future property, indeterminate property, property not yet in existence, universalities of corporeal property, principal real rights, other hypothecs, book debts, computer entries, intellectual property, and intangibles such as goodwill. In respect of none of these can a present right of ownership be claimed. If the hypothec is to be permitted to cover these incorporeal or eventual assets, therefore, the panoply of rights it gives a creditor cannot logically be understood as comprising only a real right. For this would amount to conferring a real right in a personal right. In all these cases the hypothec must, rather, be analysed as conferring some species of personal right or rights (or eventual right or rights) ultimately made enforceable against third parties, or as simply conferring a priority in the distribution of the proceeds of a judicial sale.¹⁸

The paradox which a functionally integrated security system creates for the civil law flows directly from the key distinction between real and personal rights. The urge of the law reformer for rationalization does not square with key underlying concepts. But in this case, the solution proposed in the new Code is exactly the opposite to that proposed in respect of the “functional rationalization” contemplated by the “substance of the transaction” idea. The Code proposes to ignore the conceptual difficulty and to opt for “substantive rationalization” by imposing a monolithic definition of the hypothec. From a commercial point of view this may have something to commend it, but it has one major drawback : it presupposes a radical revision to basic concepts of property law in one, relatively specialized, segment of the Civil Code. In other words, unless one is prepared to abandon the basic conceptual classifications of the law of property in order to achieve a false symmetry in the characterization of all secured transactions, there is no way that the idea that all hypothecs necessarily create a real right can be coherently developed.

A like point about false symmetry can be made concerning the attempt to treat hypothecs over moveables and immoveables in an identical fashion. Given the limited number of separate things which are immoveables (after all, no new

18. Surprisingly, this logical conundrum does not seem to have troubled commentators on the Civil Code of 1866. At the same time they explain, following article 2016 C.C.L.C., that the hypothec is a real right, and then list the panoply of real rights less than ownership which may be hypothecated. See, for example, S. BINETTE and Y. CARON, *Des hypothèques*, 1991, at #10-12, and #31-58.

territory is being created), given the potential completeness of the cadastral system, and given that all immoveable rights are identified by reference to the corporeal immoveable to which they attach, it is relatively easy to maintain the principle of specificity of immoveable hypothecs even when a general hypothec has been granted (see articles 2694, 2716, 2725, 2730, 2949). But such cannot be the case with the hypothec over a universality of moveables. To begin, the register is not organized by reference to the object hypothecated, but by reference to the debtor; second, moveables, unlike immoveables, are the subject of ordinary-course-of-business disposal transactions; third, moveables may be transformed, may be mixed with other moveables, and may even be immobilized. This latter feature produces a series of rules which sometimes treat immoveables as moveables (article 2672), and sometimes treat moveables as immoveables (article 2695), and sometimes treat property according to whether it has become de-immobilized (article 2698) or has become immobilized (article 2951). In most cases, however, the Code seems to give priority to the register of immoveables (articles 2695, 2698 and 2951), a result which, unfortunately, could have been avoided by a better specification of the respective domain of each type of hypothec.

The solution to these two difficulties is surprisingly straightforward. Just as it has been unnecessary to find a universal categorization for the concept of the privilege over the past 125 years, it is unnecessary to find a universal category within which to slot all types of hypothec today. To rationalize the law of consensual and non-consensual security on property, it is only necessary to regulate the consequences which flow from the registration of a hypothec in proper form. And this technique, despite the affirmations of certain commentators to the contrary, is perfectly consistent with traditional civil law legislative methodology. The examples of well-known civil law devices where this occurs that come most readily to mind are the fiduciary substitution, the trust, the community of property regime, and the notion of family patrimony. Each of these vests rights which, depending on the asset in question, may be real, personal, or even eventual. Yet each regime functions reasonably effectively because the Code specifies in detail the attributes which the various rights afford to their titular in respect of each type of secured property.¹⁹

CONCLUSION

This brief review of three of the seven major design defects in the new *Civil Code of Québec* reveals how the twin policy objectives pursued by the National Assembly — modernization of security on property along the lines of Article 9 of the U.C.C., and retention of the overall comprehensive framework of debtor/creditor relations traditional to the civil law — have not been entirely achieved. But it also illustrates that there are no insurmountable difficulties to engineering a workable marriage of them. In fact, the structure of the Code even points the way. For this reason, were I to have only one recommendation to offer to the government it would be to compell the principal players — lenders, consumer groups, construction entrepreneurs, bar, board of notaries, justice functionaries,

19. Obviously I am not claiming that these regimes have no flaws. My point is simply that it is not necessary, once the decision has been taken to use a uniform concept (the hypothec) to cover a very diverse reality, to impose an artificial definitional specification on the concept so deployed.

registrars — to sit down together and revise Book Six so as to overcome these unnecessary obstacles to a successful law reform exercise. But even though there are likely to be still many months available for this essential *nettoyage*, especially given the time required to get the computer registry up and running, I am far from optimistic that the political will is present to undertake the task.

So I conclude with a second, fall-back recommendation, this time directed to the judiciary. The recommendation is to continue to employ traditional civil law interpretation techniques in the effort to give coherent meaning to Book Six : be neither 1. timorous about supplying general principles which the National Assembly neglected to state — for example, by deriving from the logic of the Code a general “substance of the transaction” rule; nor 2. reticent to continue to read out of the Code unnecessary (and false) definitional specifications — such as the provision that the hypothec is a real right. In this way the laudable ambition of the National Assembly to modernize and rationalize the law of security on property will be more completely realized in the years ahead.