

THE SUPERIOR COURT APPLIES RESTRICTIVE INTERPRETATION TO ADDITIONAL HYPOTHECS

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THE SCOPE OF ADDITIONAL HYPOTHECS WAS EXAMINED BY THE SUPERIOR COURT ON SEPTEMBER 6, 2011 IN THE CASE OF *BANQUE NATIONALE DU CANADA V. LAROUCHE*.¹

AT ISSUE IN THIS CASE WAS WHETHER THE ADDITIONAL HYPOTHEC PROVISION CONTAINED IN THE DEED OF HYPOTHEC GRANTED BY MR. LAROUCHE ("LAROUCHE") IN FAVOUR OF THE NATIONAL BANK OF CANADA (THE "BANK") ENTITLED THE BANK TO RECEIVE ANY PROCEEDS FROM THE SALE BY JUDICIAL AUTHORITY OF AN IMMOVABLE OWNED BY LAROUCHE, OVER AND ABOVE WHAT HAD BEEN ATTRIBUTED PURSUANT TO THE PRINCIPAL HYPOTHEC ALSO CONTAINED THEREIN.

THE FACTS

The Bank had extended certain loans as well as a line of credit to 4387228 Canada Inc. ("4387228") in order to finance the purchase of machinery. In addition to obtaining a movable hypothec over the purchased machinery, the Bank also obtained from Larouche, as shareholder of 4387228, both a personal guarantee in the amount \$275,000 and, in order to secure same, a second-ranking immovable hypothec in the amount of \$125,000 on Larouche's immovable (the "Charged Property"). The deed of hypothec contained the following clauses:

"[Our translation]"

1. THE GUARANTEE

[...] All the sums due or which are to become due by the Debtor to the Bank pursuant to this guarantee, as well as pursuant to any other guarantee which the Debtor may grant to the Bank to guarantee the obligations of [4387228] are hereinafter collectively called the "Debt."

2. HYPOTHEC

- 2.1 To secure the payment of the Debt and the performance of his obligations in virtue of the present deed, as well as to guarantee the performance of all other obligations owing to the Bank, present or future, direct or indirect, the Debtor hypothecates the following immovable for the sum of one hundred and twenty-five thousand dollars (\$125,000.00), with interest thereon at a rate of twenty-five percent (25%) per annum as of the date hereof.

[...]

7. ADDITIONAL HYPOTHEC

- 7.1 To secure the payment of interest which is not already secured by the hypothec created at Article 2, as well as to further secure the performance of his obligations under the present deed, the Debtor hypothecates the immovable and all other property mentioned in Article 2 for an additional amount equal to twenty percent (20%) of the principal amount of the hypothec created pursuant to Article 2.

[Our emphasis]

¹ 2011 QCCS 5387.

As at November 2010, 4387228 had defaulted on its loans. The Bank, in addition to realizing on its other security, brought a motion before the Superior Court requesting the sale by judicial authority of the Charged Property. On March 16, 2011, the Superior Court granted this motion and the Charged Property was subsequently sold for \$228,501.

Upon the sale of the Charged Property, the officer prepared a scheme of collocation outlining the order of priority of creditors for the purposes of distributing the proceeds of sale. After collocating both the fees associated with the sale and the claim by the first-ranking secured creditor, a balance of \$141,013.06 remained. This amount was granted to the Bank, which had asserted that it was entitled to recover up to \$150,000 pursuant to the principal and additional hypothec provisions.

While Larouche did not object to the Bank's claim for \$125,000 under the principal hypothec, he brought a motion before the Superior Court challenging the merits of the collocation of the Bank's remaining claim for \$16, 013.16 under its additional hypothec.²

THE JUDGMENT

At the hearing, the Bank argued that, due to the additional hypothec provision, its security guaranteed the entire debt owing by Larouche to the Bank. Justice Bellavance, however, disagreeing with this point of view, decided that the additional hypothec was not an extension of the principal hypothec and that its scope was in fact very limited:

"[Our translation]"

[16] With respect, the interpretation provided by the Bank regarding the scope of the additional hypothec is incorrect. The additional hypothec is not a simple extension of the principal hypothec or an "open buffet". If that were the case, it would be difficult for potential subsequent hypothecary creditors to verify the true value of any prior security.

[17] The role of the additional hypothec is limited and is described as follows by Professor Denise Pratte in *Priorités et hypothèques* [*Les Éditions Revue de Droit, Université de Sherbrooke, 1995, p.74*]:

*" [...] In regards to surplus interest due, it shall only be secured by the hypothec once a notice indicating the amount claimed is registered (Art. 2960 para. 1 CCQ). This hypothecary claim shall not crystallize its rank until the date at which such notice is registered. ¹⁸⁵ However, a practice has developed to include in the deed of hypothec an additional hypothec provision securing, at the same rank as the principal hypothec, the surplus interest which is not automatically covered. ¹⁸⁶ [...] "*³

[...]

[19] Mr. Louis Payette [*Les Sûretés réelles dans le Code civil du Québec, 3e édition, Éditions Yvon Blais, p. 301*] provides an interpretation that is along the same lines:

"E. Amounts secured by the hypothec

1. The capital and interest of the secured obligations

² As noted by Justice Bellavance, Larouche's underlying reason for challenging the amount granted pursuant to the additional hypothec was that he believed that he did not owe the Bank more than \$125,000 pursuant to his personal guarantee. In a separate court action involving a motion brought by the Bank for recovery of the debt under the personal guarantee (*Banque Nationale du Canada v. Louis-Philippe Larouche*, C.S. Bedford n° 460-17-001388-115), Larouche raised the defense that he did not personally owe the Bank \$150,000 (i.e. the difference between the personal guarantee and the principal hypothec) given that the Bank, in realizing on its security against the machinery, erroneously sold the machinery at a low price. That case had not yet been heard before the Superior Court at the time of this present hearing.

³ See also *CIBC Mortgage Corporation v. Vasquez*, [2002] 3 S.C.R. 168, para. [5], wherein the majority of the Supreme Court of Canada accepted Professor Pratte's view on additional hypothecs.

⁴ Para. [21].

662. The hypothec secures the capital of the principal obligation (art. 2667 C.C.Q.) in addition to the interest due during the year in which the hypothecary recourse is exercised as well as that due for the preceding three years (art. 2959 CCQ). As for the surplus of interest, the code provides a creditor with the following choices: to claim it under the title of unsecured claim¹⁰¹³ (subject to extinctive prescription) or protect it by means of a new registration¹⁰¹⁴ (the hypothec securing this portion of interest shall rank from its date of registration). Nevertheless, the creditor may claim said surplus as a secured creditor, having the same rank as the initial registration of the hypothec, if the hypothec has, in the constating document, secured the payment of interest beyond what is provided for by law and if the total amount of the principal hypothec or additional hypothec¹⁰¹⁵ can cover these arrears. This explains the practice of creating an additional hypothec, in an amount of fifteen, twenty or twenty-five percent of the principal amount, to secure, among other things, the surplus of interest [...]"

In rendering his decision, Justice Bellavance concluded that there was no evidence that Larouche owed the Bank any interest, which was not already covered by the principal hypothec (i.e. excess interest), and that the expression "[Our translation] to further secure the performance of his obligations under the present deed" stipulated in the additional hypothec provision could not be considered as a "catch-all" by which the Bank could claim any and all amounts owing to it by Larouche. Mr. Justice Bellavance further added that: "[Our translation] [t]he additional hypothec should not, through a broad interpretation, easily alter the amount of the security originally chosen by the parties. Its scope is very limited."⁴

The Superior Court ultimately granted Larouche's motion and ordered that the scheme of collocation be amended to reduce the Bank's claim to the amount of the principal hypothec of \$125,000.

COMMENTS

This decision clearly enunciates that courts should apply a restrictive interpretation when analyzing additional hypothec provisions so as to ensure that such provisions do not circumvent the true intention of the parties by effectively increasing the agreed upon amount of the security.

It is important to note, however, that not all additional hypothec provisions are drafted similarly and that the courts, when faced with the analysis of such provisions, will take into account the circumstances surrounding the granting of the security. Although in this particular instance, the Superior Court concluded that, on the facts, the additional hypothec could not secure obligations which were already secured under to principal hypothec, it is uncertain whether the court would have come to a similar conclusion under different circumstances.

Given the uncertainty surrounding the scope of additional hypothec provisions, a practical solution to avoid this issue is to simply not include such provisions in the loan and security documentation and to increase the amount of the principal hypothec, from the outset, by a certain percentage (e.g. 20%) to cover all obligations owing by the debtor to its creditor in connection with the given transaction.

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