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HYPOTHECARY CLAIMS, FACTORING AND PRIORITIES

BENJAMIN DAVID GROSS and ÉTIENNE GUERTIN

IN A RECENT DECISION¹, THE SUPERIOR COURT RULED IN FAVOUR OF GE, COMMERCIAL DISTRIBUTION FINANCE CANADA ("GE") IN A DISPUTE AGAINST THE NATIONAL BANK OF CANADA ("NBC"). BOTH INSTITUTIONS HAD A COMMON CLIENT, NEW WORLD ZANOTTI TRANSBLOCK INC. ("ZANOTTI"), WHICH HAD GRANTED TO EACH OF THEM A HYPOTHEC SPECIFICALLY CHARGING ITS RECEIVABLES. NBC HAD AGREED TO GRANT GE'S HYPOTHEC A PRIOR RANK TO ITS OWN. IN ORDER TO REDUCE ZANOTTI'S INDEBTEDNESS TO IT, NBC NEVERTHELESS COLLECTED THE PROCEEDS RESULTING FROM THE SALE OF ZANOTTI'S RECEIVABLES, WHICH WERE THEMSELVES ENCUMBERED BY GE'S HYPOTHEC, AND DEPOSITED THOSE PROCEEDS INTO ZANOTTI'S OPERATING BANK ACCOUNT. THE PROCEEDS WERE PAID BY NATEXPORT, A SUBSIDIARY OF NBC, THAT HAD PURCHASED THE RECEIVABLES PURSUANT TO A FACTORING AGREEMENT ENTERED INTO BETWEEN IT AND ZANOTTI. GE CLAIMED DAMAGES FOR AN AMOUNT EQUAL TO THE PROCEEDS USURPED BY NBC ON THE GROUNDS THAT NBC HAD CONTRACTUALLY ACKNOWLEDGED GE'S PRIORITY OVER THOSE ASSETS.

THE FACTS

When it assigned its assets, Zanotti, a Corporation specialized in the sale of refrigeration units, had several sources of financing. In particular:

- ▶ an inventory financing plan pursuant to which GE financed the purchase of refrigeration units by instalment sale contracts;
- ▶ various operating lines of credit granted by NBC, which bank was also responsible for managing all of Zanotti's bank accounts;
- ▶ a factoring program governed by an agreement entered into with NatExport.

To guarantee its contractual obligations, Zanotti granted to NBC various movable hypothecs on its inventory and receivables. It also granted a hypothec in favour of GE on the universality of its corporeal and incorporeal movable property. The cession of priority agreement between GE and NBC acknowledged GE's priority over the inventory financed by it under a master instalment sale agreement and in respect of which it had a reservation of ownership, as well as its priority over the rights and claims resulting from the proceeds of sale of said inventory.

Subsequent to the cession of priority and without GE's knowledge, NatExport, a subsidiary of NBC, entered into a factoring agreement with Zanotti pursuant to which it acquired the receivables resulting from the sale of the inventory financed by GE's instalment sales. The purchase price remitted by NatExport was paid directly to the order of Zanotti and deposited in its operating bank account, which was managed by NBC. NBC in turn immediately imputed the balance of the account to repayment by Zanotti of advances granted to it by NBC as operating lines of credit.

¹ *GE, Financement commercial aux détaillants Canada v. Banque Nationale du Canada*, 2012 QCCS 2681.

A search at the Register of personal and movable real rights (the "RPMRR") under Zanotti's name reveals several entries namely, and in a chronological order, three hypothecs in favour of NBC, one hypothec in favour of GE, a reservation of ownership by GE respecting inventories financed by a master instalment sale agreement, a cession of rank by NBC in favour of GE and, lastly, a withdrawal (by NBC) of Zanotti's authorization to collect its claims (initially granted to Zanotti under NBC's three hypothecs).

The factoring agreement contained the following clause:

[Translation:]

"12. Any amount owing by the Corporation to the Vendor further to a discount is payable by cheque jointly to the order of the Vendor and, as the case may be, any financial institution to which the Vendor granted a general assignment of receivables or a movable hypothec covering the receivables [...]."

GE applied to the Superior Court for recognition of its prior rights over the proceeds of the sale of the inventory that it had financed, maintaining that NBC (through the factoring agreement) collected the proceeds of disposition of said inventory in contravention of the cession of priority agreement.

JUDGMENT

The Court therefore had to determine if NBC had committed a fault rendering it liable to GE. In order to make that determination, the Court had to assess the extent of GE's rights over Zanotti's receivables, in light of the cession of priority agreement, its hypothec and its reservation of ownership.

To that end, GE claimed that clause 12 of the factoring agreement constituted a stipulation for the benefit of a third person of which it was the beneficiary. According to GE, it was entitled to directly demand performance of the obligation stipulated in its favour, namely joint payment of the proceeds from the sale of the receivables pursuant to article 1444 of the *Civil Code of Québec*:

"1444. A person may make a stipulation in a contract for the benefit of a third person.

The stipulation gives the third person beneficiary the right to exact performance of the promised obligation directly from the promisor."

² *Supra*, note 1, at para 20.

³ Nicole L'Heureux, Édith Fortin and Marc Lacoursière, *Droit bancaire*, 4th ed., Éditions Yvon Blais, p. 266.

⁴ *Supra* note 1, paras 33 and 34.

In usurping the proceeds of the sale of Zanotti's receivables (i.e. amounts owed by the purchasers of the refrigeration units sold by Zanotti) without GE's knowledge, NBC prevented GE from asserting the stipulation for the benefit of a third person while contravening its undertakings under the cession of priority agreement.

NBC argued that the factoring agreement was entered into in the ordinary course of Zanotti's business and that GE was not entitled to collect the receivables resulting from the sale of refrigeration units by Zanotti, given GE's failure to implement its own collection mechanism for the receivables encumbered in its favour under its movable hypothec (namely its failure to withdraw Zanotti's right to collect its own receivables).

The Court was of the view that the factoring agreement substantially modified the financing arrangements granted to Zanotti. As NBC was aware of GE's rights under the cession of priority agreement, it could not impute the funds disbursed by NatExport in purchasing the receivables encumbered in favour of GE in order to reduce Zanotti's indebtedness to NBC:

[Translation:]

"The purchase of receivables under a factoring agreement rendered illusory the possibility, respecting the accounts thus purchased, that GE could claim any right whatsoever in the proceeds of disposition of the goods financed under an instalment sale agreement, with the very knowledge of [NBC] and in contravention of the cession of priority²."

Stating a recognized principle in legal doctrine, the Court noted that the factor under a factoring agreement could not acquire from the Vendor more rights than this Vendor actually holds³. Applying that principle to this case, the Court stated as follows:

[Translation:]

"By accepting the existence of the factoring agreement here, [NBC] had acknowledged the existence of a new legal relationship between the parties concerned and in such circumstances had to respect GE's acknowledged prior right respecting the proceeds of disposition of the goods financed under the instalment sale agreement.

To agree to factoring without considering the cession of priority rendered fruitless and ultimately illusory GE's purported entitlement to the proceeds of disposition in the event of the sale of the inventory covered by the instalment sale contract⁴."

COMMENT

This Superior Court decision addresses various important principles, notably that a secured creditor that imputes the proceeds from the sale of its debtor's receivables under a factoring agreement, commits a fault if it previously had acknowledged the priority of another secured creditor over such proceeds.

However, this decision could be viewed from an entirely different perspective.

First, it is a long-standing principle in Quebec law that a subsequent-ranking hypothecary creditor who exercises its right to collect receivables owed to its debtor before a prior-ranking creditor is entitled to collect and retain the monies thus collected until such time as the prior ranking creditor exercises its rights. If this principle applies where rank is determined exclusively by the original order of registrations at the RPMRR, should it not also apply where a cession of priority determines the rank of the creditors, unless of course the cession of priority specifically prohibits this, or either requires the junior creditor to notify the senior creditor of its intention to collect the receivables or requires the junior creditor to obtain the consent of the senior creditor in order to withdraw said authorization to collect claims and the junior creditor does not do so. NBC made this argument before the Court, that rejected it, possibly suggesting that by ceding its priority, NBC had implicitly waived its right to collect Zanotti's receivables first.

Secondly, the Court based its holding on clause 12 of the factoring agreement and the argument that there existed a stipulation for the benefit of a third person. However, this clause provides for a joint payment to the Vendor and to its hypothecary creditor, "as the case may be", for the receivables thus purchased. Could it honestly be argued that this clause entitles a financial institution holding a hypothec over Zanotti's receivables to a joint payment where it has not withdrawn Zanotti's authorization to collect its claims under its hypothec? How else could this hypothecary creditor assert its entitlement to a joint payment? Moreover, even if it were possible for GE to obtain payment without withdrawing Zanotti's authorization to collect its claims, it was in fact NatExport that failed to comply with its obligations under clause 12 and not NBC, which was not a party to the factoring agreement.

The decision would appear to be founded in equity, the Court frowning on NBC's course of action – imputing the proceeds of receivables to its repayment when it had already formally acknowledged GE's priority therein. It must be borne in mind that Zanotti's financial health may have influenced NBC's actions: it is

plausible that, seeing its debtor's imminent bankruptcy looming, NBC hastened to appropriate the proceeds of Zanotti's receivables and impute them to the repayment of the operating lines of credit it had granted to Zanotti, in such manner as to pre-empt a prior-ranking creditor from imputing such proceeds to the repayment of its debt should bankruptcy of Zanotti thereafter occur. In that regard, it is revealing that NBC subsequently filed a petition for Zanotti's bankruptcy.

The Court seems to have substantiated its decision by implying that NBC acted in bad faith in the transaction and by treating NBC as the *alter ego* of its subsidiary NatExport, while adopting a theory based on a stipulation that, in our view, does not cover GE's situation.

It is well established that a hypothecary creditor does not have title to the assets charged by its hypothec merely because it has a hypothec. This begs the question: in the circumstances of this case, could it be, even though it was never mentioned in the judgment, that the Court implicitly considered GE to be the legitimate owner of the proceeds from the sale of the refrigeration units because they were covered by the reservation of ownership created under the instalment sales contracts between Zanotti and GE?

The first paragraph of article 1745 of the *Civil Code of Québec* provides as follows:

"1745 . An instalment sale is a term sale by which the seller reserves ownership of the property until full payment of the sale price."

However, recent case law has never specifically held that the proceeds from the sale of assets covered by a reservation of ownership belonged to the conditional seller. To our knowledge, Quebec decisions have only treated that issue indirectly, generally preferring to find that where the proceeds of the sale of such assets have been paid into the conditional buyer's general account, those monies are then no longer traceable and identifiable and, hence, not subject to the conditional seller's reservation of ownership.

Despite the fact that it does not deal with it, perhaps the Court ultimately found itself before a factual situation where distinct and identifiable receivables were purchased by NatExport from the Vendor, Zanotti, which was no longer the real owner of those receivables, and hence NBC could not appropriate the proceeds of their sale. The Court's statements, when suggesting that Zanotti could not sell to the factor any rights greater than those it actually had in the receivables covered by the factoring agreement would seem to imply that its primary motivation was that GE was the real owner of the receivables through its reservation of

ownership. However, we are of the view that this decision does not allow for the unqualified conclusion that a conditional seller's reservation of ownership extends to the proceeds of disposition of the assets it has financed.

Another possible interpretation of the Court's decision is that Zanotti could only have sold the receivables subject to GE's hypothec. If the factoring occurred in the ordinary course of Zanotti's activities⁵, GE's hypothec on the receivables covered by the agreement would have extended to the proceeds of their sale under article 2674 of the *Civil Code of Québec*⁶, i.e., on the amounts paid by NatExport into Zanotti's operating bank accounts. However, the Court seems to regard the sale as having occurred outside the normal course of Zanotti's activities. Incidentally, it would have been prudent for NBC to obtain GE's prior consent and a voluntary reduction of its hypothec on the receivables.

Lastly, in our view, what is key in this judgment is that the cession of priority granted by NBC enhanced GE's rights respecting the amounts paid by NatExport further to the factoring of Zanotti's receivables. In that regard, a conditional seller often loses its rights respecting the proceeds of disposition of goods thus financed when the monies obtained upon their sale are deposited in the conditional buyer's operating bank account. According to the Court's ruling, the conditional seller could nevertheless be repaid its receivables by proving, through accounting entries or otherwise, that the funds deposited in its debtor's account constitute proceeds of sale of the items financed by the conditional seller, provided that the funds in question remain identifiable.

BENJAMIN DAVID GROSS

514 877-2983 bgross@lavery.ca

ÉTIENNE GUERTIN

514 877-2940 eguertin@lavery.ca

⁵ *First Vancouver Finance v. M.N.R.*, [2002] 2 S.C.R. 720, at paragraph 46; see the *obiter* to that effect in *Dessert & Passion inc. (Proposition de)*, 2009 QCCS 4669 (CanLII), at paragraph 96.

⁶ *Civil Code of Québec*, article 2674: «A hypothec on a universality of property subsists but extends to any property of the same nature which replaces property that has been alienated in the ordinary course of business of an enterprise. [...] If no property replaces the alienated property, the hypothec subsists but extends only to the proceeds of the alienation, provided they may be identified.»

YOU CAN CONTACT THE FOLLOWING MEMBERS OF THE FINANCING AND FINANCIAL SERVICES GROUP WITH ANY QUESTIONS CONCERNING THIS NEWSLETTER.

MARC BEAUCHEMIN 514 877-3004 mbeauchemin@lavery.ca
 DOMINIQUE BÉLISLE 514 878-5506 dbelisle@lavery.ca
 ÉTIENNE BRASSARD 514 877-2904 ebrassard@lavery.ca
 RICHARD BURGOS 514 877-2952 rburgos@lavery.ca
 GÉRARD COULOMBE 514 878-5526 gcoulombe@lavery.ca
 PIERRE DENIS 514 877-2908 pdenis@lavery.ca
 JEAN-SIMON DESCHÊNES 418 266-3075 jsdeschenes@lavery.ca
 FRANCIS DESMARAIS 514 877-2980 fdesmarais@lavery.ca
 LOUIS-MARTIN DUBÉ 514 877-2990 imdube@lavery.ca
 MARTIN J. EDWARDS 418 266-3078 medwards@lavery.ca
 BRIGITTE M. GAUTHIER 514 878-5546 bgauthier@lavery.ca
 CAROLE GÉLINAS 514 877-3061 cgelinas@lavery.ca
 BENJAMIN DAVID GROSS 514 877-2983 bgross@lavery.ca
 ÉTIENNE GUERTIN 514 877-2940 eguertin@lavery.ca
 EDITH JACQUES 514 878-5622 ejacques@lavery.ca
 JEAN MARTEL 514 877-2969 jmartel@lavery.ca
 JACQUES PAUL-HUS 514 877-2935 jpaulhus@lavery.ca
 LOUIS PAYETTE 514 878-5581 lpayette@lavery.ca
 KARINE PELLETIER 418 266-3061 kpelletier@lavery.ca
 CARL M. RAVINSKY 514 878-5594 cravinsky@lavery.ca
 FRANÇOIS RENAUD 514 878-5586 frenaud@lavery.ca
 LOUIS ROCHETTE 418 266-3077 lrochette@lavery.ca
 MARIE-RENÉE SIROIS 613 560-2530 mrsirois@lavery.ca

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