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The Superior Court clarifies the concept of Novation

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The Superior Court considered two interesting issues in the case of *Banque Laurentienne du Canada v. Yuan*.[1] First, it had to determine whether a term loan that was used to payout an existing term loan had resulted in the novation of the first debt. Second, it had to determine what the effect the contract titled (translation) "Credit Facility Secured by Hypothec"[2] had on the survival of the disputed hypothec.

FACTS

The Court's decision describes the circumstances of the dispute. On October 9, 2007, the Laurentian Bank of Canada (the "Bank") granted a term loan in the amount of $600,000, and issued a corporate Visa credit card with a credit limit of $25,000 to 9154-1912 Québec Inc. ("9154-1912"). On October 18, 2007, the Bank and 9154-1912 entered into a *Credit Facility Secured by Immovable Hypothec* in the amount of $850,000. The hypothec charged an immovable owned by 9154-1912, and the deed of hypothec contained the following clause:

> The borrower undertakes to maintain this hypothec for the term of the loan, and in all cases in which the borrower contracts new obligations in favour of the lender, for any such obligations or commitments to the lender as well, until such time as this hypothec is discharged. (our emphasis)

On July 14, 2008, the Bank granted a demand loan in the amount of $75,000 to 9154-1912. Finally, on March 5, 2009, it granted to 9154-1912 a $75,000 line of credit and a term loan of $675,000, which, among other things, was to be used to pay off the term loan of $600,000 granted on October 9, 2007.

On June 16, 2011, 9154-1912 borrowed $150,000 from Mr. Zhou Yuan ("Mr. Yuan"), which was secured by a second hypothec on the same immovable. Mr. Yuan contended that he would not have agreed to make this loan if he had known that the Bank's claim could have exceeded $575,000, and the evidence showed that there were contradictory e-mails in the file on this point.

Mr. Yuan registered a prior notice of the exercise of a hypothecary right (May 8, 2012) and served a motion to institute proceedings for a forced surrender and taking in payment (May 24, 2012). On May 28, 2012, the parties to that action signed a "Consent to Judgment" "in accordance with the conclusions of the action as instituted" and, on June 21, 2012, the Court declared Mr. Yuan to be the owner of the immovable.

In a new court action, the Bank presented a motion for an order enjoining Mr. Yuan to surrender the immovable on which the Bank held a first hypothec, and for a declaration that it was the owner thereof as a result of the taking in payment. Mr. Yuan contested the motion on the grounds that the

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Bank's first hypothec ought to have been canceled because there had been a novation of the debt when the second term loan was granted and, therefore, the Bank could not claim the total amount it was owed from him, which then stood at $801,229.28.

JUDGMENT

Justice Godbout rejected Mr. Yuan's arguments. He found that there had been no novation because the second loan granted to 9154-1912 had not replaced the first loan, which had simply been repaid.[3] He stated as follows :

> [43] In this case, it is evident that the $675,000 term loan granted by the Bank on March 5, 2009 (credit facility E) (exhibit P-1) constitutes a new obligation.
>
> [44] However, this new obligation did not have the effect of extinguishing the first obligation, i.e. the $600,000 term loan granted on October 9, 2007 (credit facility A) (exhibit P-1). That loan was simply repaid.
>
> [45] The second term loan of $675,000 (credit facility E) did not therefore cause the extinction of the first term loan of $600,000 (credit facility A); that obligation was extinguished by the repayment thereof and not the creation of a new obligation.
>
> [46] The argument that there was a novation of the $600,000 term loan (credit facility A) cannot be upheld because there was not at the same time "an extinction of the original debt and […] the creation of a new debt substituted for the old one."

The judge also as adds the following:

> [47] Furthermore, the deed of immovable hypothec (exhibit P-2) explicitly states that:
>
> The borrower undertakes to maintain this hypothec for the term of the loan, and in all cases in which the borrower contracts new obligations in favour of the lender, for any such obligations or commitments to the lender as well, until such time as this hypothec is discharged (our emphasis).
>
> [48] This undertaking by the borrower, here 9154-1912, constitutes the reservation referred to in article 1662 C.C.Q., in respect of the creditor Bank.

The Bank's first hypothec against the immovable was therefore valid. Novation is not presumed (article 1661 C.C.Q.),[4] and the discussions which the parties had had on the amount of the balance of the Bank's loan do not allow for a different conclusion when there is a clear clause to the contrary effect.

COMMENTS

This decision confirms the validity of a hypothec granted in relation to future undetermined obligations, thus following the line of jurisprudence that started with the case of *Banque HSBC Canada c. 9082-3659 Québec inc.*,[5] as well as the prevailing opinion in the doctrine which we endorsed in 2006.[6] The judge relied on the wording of the clause in the deed of immovable hypothec to justify his conclusion. This highlights the importance of having a deed of hypothec that is drafted in sufficiently clear terms to determine the parties' real intention and ensure that the grantor of the hypothec assumes the obligation with full knowledge of its effects.

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In this case, the judge confirmed the existence of the first hypothec on the basis of (1) the fact that there had been no novation of the first debt within the meaning of article 1660 C.C.Q., and (2) the reservation contemplated in article 1662 C.C.Q.,[7] which the Bank took advantage of, as expressly provided in the terms of the deed of hypothec.

We agree with the final conclusion reached by the judge, but nevertheless question whether his reasoning was properly founded on article 1662 C.C.Q. Indeed, this article applies in the context of a novation, i.e. when a new claim is substituted for the old one. However, the judge precisely rejected the existence of such novation.

In finding that there was no novation, the judge could instead have based his reasoning on article 2797 C.C.Q.[8]

However, this decision does show the importance of getting proper advice before granting loans and incurring significant costs to institute hypothecary remedies that do not achieve the desired results.

Finally, it will be interesting to follow the further developments in this case, which has been appealed.

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1. 2014 QCCS 3948, an appeal was filed on September 8, 2014.
2. All the quotations cited herein from the Court decision in French are English translations.
3. Article 1660, para. 1, of the *Civil Code of Québec*: "Novation is effected where the debtor contracts towards his creditor a new debt which is substituted for the former debt, which is extinguished, or where a new debtor is substituted for the former debtor, who is discharged by the creditor; in such a case, novation may be effected without the consent of the former debtor."
4. Article 1661 of the *Civil Code of Québec*: "Novation is not presumed; the intention to effect it must be evident."
5. [2005] R.D.I. 339 (Sup Ct).
6. We outlined our position at the 6th Annual Conference on Secured Lending, held in Montreal on September 12, 2006, in the presentation entitled "Hypothec for present and future debts".
7. Article 1662 of the *Civil Code of Québec*: "Hypothecs attached to the former claim are not transferred to the claim substituted for it, unless they are expressly reserved by the creditor."

   [8]Article 2797 of the *Civil Code of Québec*: "A hypothec is extinguished by the extinction of the obligation whose performance it secures. In the case of a line of credit or in any other case where the debtor obligates himself again under a provision of the act constituting the hypothec, the hypothec, unless cancelled, subsists notwithstanding the extinction of the obligation."

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