Equity Among Secured Creditors: Article 2049 (2) C.C. Re-examined

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Synopsis

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Introdnction

From the perspective of legal policy, the manner in which the respective rights of competing creditors holding non-coextensive security upon their debtors' assets are integrated, constitutes one of the more interesting issues in the law of security on property.[1] A particular example of this arises when a creditor with security over several assets proposes to realize his guarantee upon collateral which is charged with subsequent security, and not upon collateral over which no other secured creditor has a claim. At least four distinct interests are involved: (1) the interest of the first ranking secured creditor to realize efficaciously upon his debtor's assets; (2) the interest of lower ranking secured creditors to derive the maximum utility from their security whenever their debtor becomes insolvent; (3) the interest of unsecured creditors to minimize the preferential treatment of secured creditors in order to increase the mass of property to be distributed to chirographic creditors; and (4) the interest of the debtor to foreclose the possibility of realization upon all his assets when he has fallen into default towards one creditor only. Moreover, the framework within which these interests must be accomodated has two separate elements: the law may simply elaborate principles of distribution of the proceeds of any sale of a secured creditor's collateral; or the law may establish a mechanism controlling the manner in which secured creditors may realize upon their debtors' property. Determining both which interests should prevail from a policy perspective, and which juridical devices should be employed to effect this policy requires careful analysis of the theory of secured financing.

The civil law of Québec has not heretofore reflected a comprehensive approach to the resolution of these issues, but rather has left the details of the law of secured financing to be elaborated by debtors and creditors in their individual agreements. One may trace the reasons for this result in part to the general spirit of freedom of contract which pervades the Civil Code; in economic matters, the law assumes that the best judges of the

[1]For a general discussion see G. Gilmore, *Security Interests in Personal Property* (1965), vol. 1, 1181-280.

needs of contracting parties are the parties themselves. This result also flows from the Code's prohibition of non-possessory security on moveable property; it is not frequently the case that ordinary debtors possess a plethora of immoveables and deal with them in such a manner that competing non-coextensive claims of secured creditors will arise. Finally, the 1866 Code envisions the hypothec as the primordial legal institution for obtaining security on property. Consequently, a competition between secured creditors is likely to arise only with respect to the distribution of proceeds upon the sale of secured assets.

In view of these assumptions, it is not surprising that neither the legislature nor the judiciary has shown much concern for problems of integrating the divergent and typically conflicting claims of secured creditors. The former has regulated the question of non-coextensive securities exclusively in art. 2049 C.C.[2] The first paragraph of this article confirms a consequence of the rule that hypothecs are indivisible.[3] It states:

> A creditor who has a hypothec upon more than one immoveable belonging to his debtor may exercise it upon such one or more of them as he deems proper.
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> Le créancier qui a une hypothèque sur plus d'un immeuble appartenant à son débiteur, peut l'exercer par action ou saisie sur celui ou ceux de ces immeubles qu'il juge à propos.

In other words, the Code contemplates that, in principle, neither the debtor nor any other individual has a right to stipulate to a secured creditor the particular assets upon which he may realize his security.

The second, and for present purposes more important, paragraph of art. 2049 C.C. raises difficult questions of interpretation. While both commentators and judges are divided as to its precise effect, all agree that its general thrust is to establish an exception to the principle of indivisibility.[4] This paragraph provides:

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[2]The *Code Napoléon* has no such provision, although the doctrine and jurisprudence seem to have arrived at a similar position. See, *e.g.*, H., L. & J. Mazeaud, *Leçons de droit civil,* 5th ed. (1977), T. 1, 440 *et seq.* Article 2049 is completed by the provisions of the Code of Civil Procedure. See, in particular, arts 721-3 C.C.P. A recent elaboration of their interrelation is contained in *Bousco Inc.* v. *Motel St-François Inc.* C.S. (Montréal, 500-05-004447-791), 8 January 1982.

[3]Art. 2017 (1) C.C. provides:

Hypothec is indivisible and subsists in entirety upon all the immoveables made liable, upon each of them and upon every portion thereof.

L'hypothèque est indivisible et subsiste en entier sur tous les immeubles qui y sont affectés, sur chacun d'eux et sur chaque partie de ces immeubles.

[4]The principal doctrinal sources are: F. Langelier, *Cours de droit civil de la province de Québec* (1911), T. 6, 286-7; P. Mignault, *Le droit civil canadien* (1916), T. 9, 132-3; W. Marler, *The Law of Real Property* (1931), nos 791 and 830; C. Demers, *Traité de droit civil du Québec* (1950), T. 14, 259-61; Y. Caron & S. Binette, "Des hypothèques" in Chambre des Notaires, *Répertoire de droit* [:] *Sûretés* (1980), nos 207-11 and 305-7.

> If however all or more than one of the immoveables thus hypothecated be sold, and the procceds have to be distributed, his hypothec is divided rateably upon so much of their respective prices as remains to be distributed, when there are other subsequent creditors holding hypothecs upon someone or other only of such immovcables.
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> Si néanmoins tous ces immeubles, ou plus d'un des immeubles hypothéqués sont vendus et que le prix en soit à distribuer, son hypothèque se répartit au pro ratâ de ce qui reste à distribuer sur leurs prix respectifs, lorsqu'il existe d'autres créanciers postérieurs qui n'ont hypothèque que sur quelqu'un de ces immeubles.

It might seem at first glance that here the Code sets out a limited right of lower ranking secured creditors to direct higher ranking creditors to specified assets when realizing upon their debtors' property. In effect, however, this paragraph merely establishes an order of collocation of proceeds to be imposed upon certain secured creditors in specified circumstances. It does not formulate a general theory about how secured creditors may exercise their security.

Unhappily, neither paragraph of art. 2049 C.C. has generated an abundant jurisprudence. Since the 1925 decision in *Crown Realty Ltd* v. *Putnam et Beriau*[5] this article has been mentioned in only one reported judgment: *Central Factors Corp.* v. *Imasa Ltd.*[6] In both instances the Court of Appeal was required to determine the meaning of paragraph two of art. 2049 C.C. and in both it came to the conclusion that the article was not directly applicable to the case under consideration. Furthermore, in both judgments the Court declined to elaborate a theory either of the article or the problem it addresses. As a consequence the second paragraph of art. 2049 C.C. remains an enigma and this aspect of the law of secured financing retains an inchoate character.

Apart from the exercise of doctrinal exegesis — itself an important element of civil law methodology when laconic codal provisions have not been jurisprudentially developed — there are several other reasons for re-examining art. 2049 (2) C.C. at this time. First, the structure of secured financing has undergone considerable evolution since 1866. A

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[5](1925) 38 B.R. 331, *rev'g Crown Realty Ltd et al. et Putnam* (1924) 62 C.S. 199. The judgment of the Court of Appeal is difficult to interpret since the official report contains only extracts from the notes of four of the five judges who sat on the case: Howard, Tellier, Letourneau and Greenshields JJ.A. The views of Allard J.A. and the judgment of the Court are not reported, although the latter was drafted by Howard J.A. and is available under file number: C.A. (Montréal, 531-163) 5 March 1925.

[6]This reference was, however, only by way of comparison and did not influence the disposition of the case: (1979) C.A. (Montréal, 09-000-245-779, 12 March 1979), *aff'g Imasa Ltd* v. *Artitex Knitting Mills Inc.* [1977] C.S. 531. This case involved a competition over the proceeds arising from the sale of moveable property between the assignee of a s. 88 security, an unpaid vendor and the holder of security given under a trust deed. See Payette, *Les sûretés mobilières et le "Marshalling"* (1979) 39 R. du B. 306.

variety of legal institutions other than hypothecs are today routinely employed as security devices; it is therefore important to consider whether the principle of art. 2049 (2) C.C. is also applicable to these other devices. Second, the commercial practice of secured financing has evolved considerably in the past 100 years. The respective interests of competing creditors can no longer be adequately protected by the simple invocation of distributional principles after collateral has been seized and sold. Secured creditors need to be able to assert some control over the seizure and disposition of collateral prior to realization and distribution of the proceeds of sale. Third, the Civil Code Revision Office has proposed a radical revision of the law of security on property. With the extension of hypothecs to moveable property the problem of competing creditors becomes even more acute in that commercial debtors typically recur to numerous financers; with the increased flexibility of the hypothec, its mechanics of realization assume increased significance. Each of these reasons suggests that a close analysis of the meaning of art. 2049 (2) C.C. is desirable. Since the article has never been amended, a rethinking or reformulation of its underlying theory also would not be misplaced.

To these ends this study will focus first upon the conditions of application and the juridical effects of the present codal provisions. Following an assessment of the role in a regime of security on property of rules regulating the rights of secured creditors *inter se,* a critique and suggested re-interpretation of the current law will be offered as a prelude to analysis of the proposals of the Civil Code Revision Office.[7] Throughout, the discussion will attempt to highlight the functions of art. 2039 (2) C.C. and the evolution of secured financing since the Code was promulgated in 1866.

I. Conditions of Application of Art. 2049 (2) C.C.

Presently, the Code elaborates four conditions essential for the application of art. 2049 (2): (1) it is necessary that a creditor hold a hypothec over more than one immoveable belonging to his debtor; (2) all or at least more than one of the immoveables affected by the hypothec must be sold; (3) the proceeds of the sale or sales must remain to be distributed; (4) there must be at least one lower ranking hypothecary creditor whose hypothec affects some one or other of these immoveables. Although these preconditions appear relatively straightforward, in view of the absence of detailed doctrinal exposition and the paucity of jurisprudence, it is helpful to examine each closely prior to assessing the

[7]By way of anticipation, it is worth noting that the Draft Civil Code proposes no major modification to the text of the existing art. 2049 C.C.: see art. 423 of Book IV, "Property".

effects of art. 2049 (2) C.C. Such an explanation is also useful in exposing various lacunae in the conception and redaction of the article.

A. *A creditor who has a hypothec upon more than one immoveable belonging to his debtor*

Implicit in the above proposition, drawn from the first paragraph of the article, are several discrete limitations on the scope of art. 2049 (2) C.C. First, the immoveable given as security must belong to the creditor's *debtor*. The sense of the word "debtor" may initially appear unclear because there is no antecedant for the noun: does the article contemplate debtors on the obligation guaranteed by the hypothec, or hypothecary debtors? In the title "Of Privileges and Hypothecs" the Code customarily distinguishes between debtors and holders.[8] Debtors are bound both personally and hypothecarily towards their creditor, whereas holders are bound only hypothecarily. It would appear therefore that art. 2049 C.C. envisions the more limited usage of the term "debtor". This view is confirmed in the examples given by Langelier,[9] which expressly treat the case where the collateral seized is in the possession of an individual who is personally liable to the creditor. However, those offered by Mignault,[10] Marler,[11] and Caron and Binette[12] are not sufficiently elaborate to permit a conclusion to be drawn on this point.

If the term "debtor" were to limit the application of art. 2049 (2) C.C. to only those immoveables held by an individual personally liable to the creditor, as the usage of the Code would suggest, its effectiveness as a restriction on the principle of indivisibility might appear to be compromised. There are at least three hypotheses where an immoveable of a holder could be affected by hypothec to a debt for which immoveables of the principal debtor are also affected: (1) whenever an immoveable is made liable for the payment of another's debt as part of an ordinary suretyship agreement in which the surety personally agrees to fulfil the obligation of the principal debtor; (2) whenever an immoveable is offered by way of real security as an additional guarantee for another's

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[8]In art. 2053 C.C., which refers to "debtor or other holder", the term "debtor" seems to be seen as a subset of the category holder. In arts 2062-80 C.C., however, the term "holder" is used in reference to an individual who is in possession of an immoveable but who is not indebted personally to the creditor. Throughout, the term "debtor" is used exclusively in reference to those personally liable on the debt. One can conclude, therefore, that in principle, the term "debtor" is to be reserved for those bound hypothecarily *and* personally.

[9]*Supra*, note 4, 286-7.

[10]*Supra*, note 4, 132.

[11]*Supra*, note 4, no. 830.

[12]*Supra*, note 4, no. 306.

debt; and (3) whenever an immoveable is sold by the debtor to a third party who does not also assume the principal debt. In each of these examples, however, the principle of indivisibility would never be applicable. In each case, other articles of the Code expressly override the principle and direct the seizing creditor towards certain specific immoveables. Thus, a simple surety who has affected his immoveable in guarantee of his suretyship obligation may compel the prior discussion of the principal debtor's property under art. 1941 C.C.[13] The creditor would be obliged to realize upon a hypothec granted by the principal debtor prior to seizing the surety's immoveable. Similarly, both the individual who offers a hypothec on his immoveable as an additional guarantee for the debt of another, and the third party acquirer who is a mere holder are entitled to invoke the exception of discussion established by art. 2066 C.C.[14] In these cases the creditor would be obliged to realize upon any immoveables of the principal debtor prior to seizing the immoveable of a third party. It follows that an interpretation of "debtor" which restricts its meaning to individuals personally liable as principals upon an obligation is most coherent with the theory of hypothecary recourses elaborated by the Code. It is also most coherent with the likely expectations of other creditors who have taken lower ranking security only upon the assets of the principal debtor.

Of course, the applicability of art. 2049 (2) C.C. is also subject to the various rules relating to undivided ownership,[15] conditional ownership,[16] or possession under insufficient title.[17] Unless, by act of partition, realization of a condition, or acquisition of sufficient title the principal debtor becomes owner of an immoveable, it cannot be said to "belong" to him in the sense required by art. 2049 C.C. for the purposes of seizure and sale. Only where the individual in possession of an immoveable as owner is a true debtor will art. 2049 (2) C.C. be applicable.

A second limitation on the scope of art. 2049 (2) C.C. may be implied from the fact that the Code states that the security held by the creditor must be a *hypothec.* While the codifiers may have contemplated the hypothec as the sole means of obtaining consensual security over property, there are today several means by which a creditor may achieve a preference upon an immoveable: these include privileges, hypothecs, or

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[13] Of course, the surety loses this right if he has bound himself jointly and severally with the debtor to the creditor. In such cases, however, art. 2049 (2) C.C. would be applicable.

[14] Once again, the third party will lose this right if he has bound himself personally to the creditor. Here also, however, art. 2049 (2) C.C. would be applicable.

[15] Art. 2021 C.C.

[16] Art. 2038 C.C.

[17] Art. 2043 C.C.

security under certain provisions of the *Bank Act.*[18] Moreover, creditors may protect their right to assert an advantageous position upon realization by having recourse, in a variety of cases, to other juridical institutions which do not, strictly speaking, constitute a preference. Among these are giving in payment clauses, resolutory clauses, sales with a right of redemption, sale and leaseback, promise of sale, *antichrèse* and the right of retention. Yet art. 2049 (2) C.C. mentions only hypothecs expressly.

If literally construed, the article ought not to apply whenever the higher ranking creditor has a preference resulting from the provisions of the *Bank Act*[19] or a general privilege on immoveables, *e.g.*, that for general law costs, funeral expenses, expenses of the last illness and servants' wages.[20] Nevertheless, several good arguments may be advanced in support of the proposition that art. 2049 (2) C.C. also applies to privileges. First, like hypothecs, privileges are indivisible by their nature under art. 1983 C.C. Second, the priority provisions of arts 2048 and 2051 C.C. which appear in the same section of the Code as art. 2049 C.C. may easily be made applicable to privileges. Third, the priority rules of arts 2130 C.C. and 2094 C.C. speak generally of privileged rights, thus assimilating privileges and hypothecs for the purpose of establishing rank through registration. Finally, whenever a relative valuation under arts 721-2 C.C.P. is required and there are general privileges ranking

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[18]S.C. 1980-1, c. 40, s. 178 (1) (d) - (h).

[19]While some jurisprudence suggests that the bank's security is hypothecary in nature (see, *e.g., Toronto Dominion Bank* v. *Druker* [1957] C.S. 389, 391 *per* Demers J.), it is clear that this characterization is misplaced. Moreover, the rights of the bank upon realization are those provided for by the *Bank Act* and not those of the Civil Code, except to a supplementary degree.

[20]Marler believes that the article also applies to privileges. See Marler, *supra,* note 4, no. 791. He gives the following example: "A contractor has built for the proprietor under the one contract, a number of houses, and has registered his privilege, as he may, for what is due to him against the whole property. One of the houses is sold; the price is insufficient to pay all the claims against it; the contractor is entitled to be paid his claim out of and to the extent of the additional value given to that house by his work and materials, even though, in consequence there is not enough left to pay the claims of subsequent creditors. But if all of the houses or more than one of them are sold as a unit and the proceeds have to be distributed, and the houses are charged with different claims, a relative valuation has to be made so as to determine how much of the price represents the value of each house, and how much of the price attributed to each house represents the additional value given to the property by the claim of the privileged creditor who has registered it against the whole of the debtor's property, C.P. 805." This illustration is poorly chosen. The construction privilege is divided not because of art. 2049 (2) C.C. but in virtue of the rule that the privilege is valid only for the value added to the immoveable. The problem is merely to determine the "unité d'exploitation" in order to fix the *situs* of the privilege. See *Munn and Shea Ltd* v. *Hogue Ltée* [1928] S.C.R. 398; *Gadbois* v. *Boileau* [1929] S.C.R. 587.

higher than specific privileged claims the prothonotary must proportionally attribute the proceeds of the sale. Yet no principle of distribution is elaborated by the Code of Civil Procedure, and presumably the only means to achieve a "relative" valuation is to prorate claims in the manner suggested by art. 2049 (2) C.C.[21] Consequently, it would seem that the underlying principle reflected by art. 2049 (2) C.C. might well be applicable to general privileges, even though the specific provisions of the article only refer to hypothecs.

In any event, the article is clearly inapplicable in situations where a creditor obtains security by other devices such as resolutory and giving in payment clauses, promise of sale or sale and leaseback. For example, art. 2049 (2) C.C. could not be invoked if a creditor has a hypothec on one immoveable and a resolutory clause on others; nor where the creditor has a security other than a hypothec over several immoveables. In such cases the article would not be capable of invocation because its mechanism — the distribution of proceeds — presupposes the generation of monies.[22]

A third restriction on the range of application of art. 2049 (2) C.C. arises because the Code speaks only to the case where the collateral affected is an *immoveable.* The fact that the concept of a hypothec or other non-possessory security over moveable property was unknown at the time of codification undoubtedly explains this restriction in the codal text.[23] Today, however, the idea of non-possessory security on moveables has been incorporated into the civil law,[24] and it is arguable that at least in the case of the *Special Corporate Powers Act*[25] the juridical institution contemplated is the hypothec. In support of this view, one can cite the text of s. 27 of the *Act*, which provides [emphasis added]:

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[21] A similar relative valuation is necessary in the case of moveables. Arguments against the applicability of art. 2049 (2) C.C. to privileges are all textual. (1) Articles 2050 and 2052 C.C. expressly mention privileges; if art. 2049 C.C. were to apply to privileges this should be expressed. (2) The title of the section is "Of the order in which hypothecs rank"; while the *Code* often uses the expression "privileged claim" to include both legal privileges and hypothecs, it does not typically use the expression "hypothec" so as to include legal privileges. (3) Article 1983 states that a privilege is indivisible by nature, whereas art. 2017 C.C. provides merely that hypothec is indivisible; the consensual basis of the latter is the reason art. 2049 (2) C.C. is required.

[22] See *infra,* Part I (D).

[23] Article 2022 C.C. contemplates that apart from the case of merchant vessels, moveable property is not subject to hypothecation.

[24] Apart from title transactions such as double sales, sale and leaseback, conditional sales and sales with a right of redemption, these are genuine security devices such as commercial pledge defined in arts 1979e-k C.C., security under the *Bank Act,* S.C. 1980-1, c. 40, s. 178, or the *Special Corporate Powers Act,* L.R.Q., c. P-16, ss. 27-31.

[25] L.R.Q., c. P-16. Some argue that the commercial pledge is evolving in this direction. See Desjardins, *Du nantissement commercial à l'hypothèque mobilière* (1968) 71 R. du N. 88. No one asserts, however, that the commercial pledge is now an hypothecary right.

> Notwithstanding any existing law, any joint stock company... may... *hypothecate,* mortgage or pledge any property, *moveable* or immoveable....
>
> Nonobstant toutes dispositions à ce contraire, toute compagnie à fonds social... peuvent... *hypothéquer,* rantir ou mettre en gage,... leurs biens *mobiliers* ou immobiliers... .

In other words, since the *Act* appears to contemplate a hypothec over moveables and since the Code knew only of hypothecs over immoveables in 1866, any reference in art. 2049 (2) C.C. to immoveables should not be taken to so restrict the article, but only as a confirmation of the existing law. While this argument has a certain appeal, ultimately it must fail because the later provisions of s. 29 of the *Act* suggest that the word "hypothec" in s. 27 is intended to apply only to immoveables and that the security obtainable on moveable property is a privilege.[26] It follows that art. 2049 (2) C.C. is only applicable where the collateral in question is an immoveable.[27]

The upshot of the above analysis is that the Code explicitly envisions an exception to the principle of indivisibility only in respect of a limited range of persons (debtors), a limited range of security devices (hypothecs) and a limited range of collateral (immoveables). Nevertheless, as Louis Payette observes, the analogical spirit of exegesis may be called in aid of a broader viewpoint:

> L'article... [2049 (2) C.C.] ne réfère qu'aux hypothèques et ne vise que des immeubles. Ce n'est donc que par analogie qu'on peut recourir quant aux sûretés mobilières. Néanmoins, comme c'est la seule règle du Code sur le sujet on pourrait se croire bien fondé d'y recourir.[28]

This theme will be taken up later in Part IV of this essay.

B. *All or more than one of the immoveables thus hypothecated be sold*

In addition to restrictions on the scope of art. 2049 (2) C.C. arising from the nature of the security taken and the collateral affected, several limitations on this article appear to arise from the terms employed to

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[26]L.R.Q., c. P-16, 29 (1) speaks of rights given by the hypothec or mortgage on immoveables and establishes a ranking by date. Section 29 (2) speaks of a mortgaging or pledge of moveables conferring a privilege and establishes a ranking by the nature of the claim. In other words, the realization provisions of the *Act* differentiate between security available over moveables and immoveables.

[27]The Court of Appeal decision in *Central Factors, supra,* note 6 supports this view. Crête J.A. notes at p. 5 of his judgment that art. 2049 (2) C.C. is exceptional, that it applies only to hypothecs and concerns only security over immoveables.

[28]Payette, *supra,* note 6, 309. If Payette is merely suggesting that an analogy can be drawn to art. 2049 (2) C.C. there can be no objection to his remarks. In fact this is precisely how a ventilation of moveables, where there are both general and special privileges, is effected.

describe the manner in which a creditor may realize upon his security. Because the Code envisions only hypothecs in this instance, it is not surprising that art. 2049 (2) C.C. speaks solely to the case of seizure in execution and sale of collateral; this is the mechanism established by arts 2057, 2061, 2075, 2077 and 2079 C.C. for pursuing an hypothecary action. By contrast, various other juridical devices contemplate alternative modes of realisation. For example, under the *Bank Act* or the *Special Corporate Powers Act,* in addition to proceeding to judicial seizure and sale a creditor may simply take possession of and administer the collateral, deriving the fruits therefrom; or he may, after following the required formalities, dispose of his debtor's immoveable by private sale. Again, under a right of redemption, a resolutory clause or a giving in payment clause, a creditor may realize upon his security by exercising a right to become absolute owner of the collateral. Finally, a creditor may provoke a bankruptcy in order to have a trustee liquidate his debtor's property and collocate his claim under the *Bankruptcy Act.*[29]

As noted, the Code contemplates only the situation where the debtor's immoveables are "sold". It would seem to follow that the exercise of a right of redemption, a resolutory clause, a giving in payment clause or the simple taking of possession and administration under the *Bank Act* or the *Special Corporate Powers Act* will not lead to the application of art. 2049 (2) C.C. In none of these hypotheses can the mode of realization appropriately be characterized as a sale; in none are any proceeds generated for which the secured creditor will be held accountable.

On the other hand, "sale" is an appropriate description of the mode of realization under the *Bankruptcy Act,* under various statutes such as the *Winding-Up Act*[30] which contemplate forced sales other than by ordinary processes of execution, or under the *Bank Act, Special Corporate Powers Act,* and *Winding-Up Act* where the creditor or trustee proceeds to the private sale and disposition of the collateral. Nevertheless, sales by a trustee in bankruptcy would not lead to the application of art. 2049 (2) C.C. since the *Bankruptcy Act* establishes its own scheme of collocation and distribution which overrides any provincial priority rules.[31]

The situation in respect of forced and voluntary sales through which security is realized is more complex. In *Crown Realty Ltd* v. *Putnam et*

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[29]R.S.C. 1970, c. B-3. Since this hypothesis lies outside the framework of the ordinary principles of civil law, it will not be considered at length in this essay.

[30]L.R.Q., c. L-4.

[31]See *Larue* v. *Royal Bank of Canada* [1928] A.C. 187 (P.C.).

Beriau, a first immoveable was seized in execution and sold judicially; a second immoveable later was sold as part of the process of winding up the Crown Realty Company. The Court of Appeal found the principle of art. 2049 (2) C.C. to be applicable in such circumstances and ordered the distribution of the proceeds of both sales to be made on a *pro rata* basis. Letourneau J. held that the article was applicable to all sales having the effect of purging real rights.[32] Thus, while certain public sales other than by ordinary process of seizure in execution may be contemplated by art. 2049 (2) C.C., by implication private sales in the course of realization would not give rise to the *pro rata* distribution set out by the article. It also follows that more than one immoveable must be disposed of by a sale purging real rights; for example, if only one immoveable be sold, and one or more other immoveables be taken in payment, art. 2049 (2) C.C. cannot apply.[33]

Although the Code requires that the immoveables be sold by sale effecting a purge of real rights, it does not demand that the higher ranking creditor with the hypothec on several immoveables himself seize his debtor's property and sell the immoveables. Once any creditor — hypothecary, privileged or chirographic — provokes the judicial sale of more than one immoveable, the principle of art. 2049 (2) C.C. is brought into play.

These observations suggest that the protection afforded to lower-ranking secured creditors by art. 2049 (2) C.C. can be illusory in the face of many of the mechanisms by which secured parties customarily realize upon the assets of their debtors. It follows that lower ranking secured creditors typically are at the mercy of higher ranking creditors who have taken security by way of a title transaction. Unless they are able to provoke a judicial sale the practical utility of art. 2049 (2) C.C. as a means for protecting their security is negligible.[34]

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[32]*Supra*, note 5, 350-1. Howard J.A. also felt that the principle of the article should apply, although the article itself envisions only the case of judicial sales in execution, at pp. 344-7.

[33]If two immoveables be sold and a third taken in payment, the article remains applicable. It is obvious that difficult problems of valuation arise in such cases since the hypothec cannot guarantee an amount greater than the principal obligation. The solution in such cases is to effect the proration on the basis of the amount owing to the creditor once the value of the immoveable taken in payment has been subtracted. Of course, one assumes here that the loan agreement provides that the giving in payment clause does not totally extinguish the principal obligation. See *Remy* v. *Gagnon* [1971] C.A. 554.

[34]See *infra*, Part III (C) for an examination of techniques open to lower ranking creditors to compel the application of art. 2049 (2) C.C.

C. *The proceeds have to be distributed*

Two distinct difficulties of interpretation arise from this requirement: is it necessary that the proceeds be generated from one and the same judicial sale? And is it necessary that the total price of all sales remain to be distributed at the same time?

Some authors seem to hold that the seizure and sale of the immoveables must take place at the same time in order for the *pro rata* distribution of money received envisioned by art. 2049 (2) C.C. to be obligatory.[35] While such a requirement is not set out in the Code itself, the French text tends in this direction by its usage of the singular term "*le prix* soit à distribuer". Nevertheless, since the object of art. 2049 (2) C.C. is the distribution of proceeds upon realization, it need not follow that these be generated at one and the same time. If, for example, a first immoveable is sold, but because the order of collocation is contested, or because of a re-sale for false bidding, or for any other reason, the price remains to be distributed by the prothonotary at the time the second immoveable is sold, art. 2049 (2) C.C. may be invoked. This second sale may occur even several years after the first sale.[36]

By contrast, it may be necessary for the total price of all the sales to remain undistributed. The phrase "the proceeds have to be distributed" appearing after the requirement that "all or more than one of the immoveables be sold" would suggest that all the proceeds be available for distribution. In other words, since art. 2049 (2) C.C. envisions distribution, one should be contemplating a single order of collocation.[37] In the *Crown Realty* case the various judges were divided on the point. Rinfret J. in the Superior Court and Tellier and Greenshields JJ.A. in dissent in the Court of Appeal explicitly held that the distribution of all the proceeds must occur in the same judicial order.[38] Conversely, in the Court of Appeal, Howard J.A. and presumably Allard J.A. concluded that the underlying principle of art. 2049 (2) C.C., if not the article itself, could be invoked in certain cases of a partial distribution.[39] Letourneau J.

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[35]Marler, *supra*, note 4, no. 830; Langelier, *supra*, note 4, 287. *Semble* Demers, *supra*, note 4, 260; and Mignault, *supra*, note 4, 132.

[36]In *Crown Realty, supra,* note 5, the first immoveable was sold on 8 March 1918 and the second was sold at an indeterminate date between 13 January 1919 and 12 April 1921. *Supra*, note 5, 345 *per* Howard J.A.: "this paragraph [art. 2049 (2)] contemplates the case where, in a situation such as that disclosed in this appeal, the two portions of the property, both of which are affected by an overlying hypothec and each separately by second hypothecs, are brought to sale at the same time *or at least the proceeds are distributed at the same time.*" [Emphasis added.]

[37]The narrower hypothesis of art. 721 C.C.P. supports this viewpoint.

[38](1924) 62 C.S. 199, 205 *per* Rinfret J.; (1925) 38 B.R. 331, 335 *per* Tellier J.A.

[39]*Supra*, note 5, 345-6 *per* Howard J.A.: "[T]he first hypothec should be apportioned rateably upon both portions of the hypothecated property even though they be brought to

went so far as to hold that art. 2049 (2) C.C. was directly applicable even to cases of partial distribution.[40]

Some support for the broader view can be garnered from the phrase "upon so much of their respective prices as remains to be distributed", although the context of this provision more logically suggests that it contemplates the remainder in the order of collocation, and not the remainder after a partial distribution has occurred at an earlier date.[41] On the other hand, the possibility of disrupting an already settled collocation order to the prejudice of various secured creditors might seem to counsel against the position adopted by the majority in the *Crown Realty* case. However, insofar as the first ranking creditor is concerned, such a disruption could never occur. By applying a *pro rata* distribution to the second order of collocation the court could not affect the value of the general hypothec; rather, it would be notionally augmenting the share taken by the higher ranking creditor in that distribution and notionally diminishing the share he took in the first distribution. This prorating could only work to the benefit of secured and potentially unsecured creditors of the first distribution as it would notionally generate more revenue to be divided among them. Applying the principle of art. 2049 (2) C.C. to partial distributions, however, could well prejudice a secured or unsecured creditor looking uniquely to the proceeds of the second sale for satisfaction of their claims.[42] Balancing the equities between competing lower ranking creditors on various immoveables thus requires close analysis of ideas such as reliance and estoppel.[43]

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sale and the proceeds distributed at different times." Caron & Binette, *supra*, note 4, no. 305 accept this solution. They state: "Les tribunaux semblent accepter l'idée que les ventes des immeubles différents ne doivent pas nécessairement se faire au même moment. En effet l'article 2049 continue de s'appliquer tant qu'il y a encore de l'argent à être distribué à même le produit de l'une quelconque des ventes en justice."

[40] *Supra*, note 5, 350-1 *per* Létourneau J.A.: "Le cas qui nous est soumis n'est pas le cas classique et simple... . [L]a seule condition d'application ne paraît être que tous les immeubles aient été vendus, qu'il y ait une distribution de prix à faire et qu'il soit encore possible d'appliquer les prescriptions du second alinéa de l'article 2049 C.C."

[41] See *infra*, Part II (B) for an elaboration of the meaning of the phrase "upon so much of their respective prices as remains to be distributed."

[42] These creditors may well have taken a lower ranking hypothec on the second immoveable or brought it to sale at the moment selected on the basis of information about the reduced amount of money still outstanding on the higher ranking creditors' loan. Nevertheless, given that hypothecs are indivisible and also given that their value is specified in the contract, subsequent creditors should not advance monies on the assumption that actual indebtedness is less than the face value of the hypothecary obligation.

[43] For example, if the lower ranking secured creditor advanced monies on the basis of a partial *mainlevée* of hypothec in which the first ranking hypothecary creditor renounced his hypothec up to the amount received from the prior sale, it would be inappropriate to

As the majority of the Court of Appeal in *Crown Realty* held, art. 2049 (2) C.C. would seem to apply even where monies are generated from more than one sale, but only on the condition that the proceeds from all the sales remain to be distributed by the same order of collocation. Nevertheless, the Court appeared prepared to invoke the underlying principle of art. 2049 (2) C.C. whenever any proceeds from any judicial sale remain to be distributed.[44] In this interpretation one can see a tentative step towards a general theory of protection of the rights of creditors holding non-coextensive security.[45]

D. *There are other subsequent creditors holding hypothecs upon some one or other of such immoveables*

This final clause of art. 2049 (2) C.C. imposes several limitations on the creditors who avail themselves of the benefit of a *pro rata* distribution. First, it should be noted that the Code speaks only of creditors who have a *hypothec.* Creditors holding other lower ranking

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increase his claim on the proceeds of the second sale by applying the principle of art. 2049 (2) C.C. It would also be unfair to maintain the *mainlevée* and apply art. 2049 (2) C.C. so as to reduce retroactively the amount of money the first ranking creditor could claim.

[44]The following hypothesis illustrates an application of the principle apparently enunciated by the Court of Appeal. Suppose that a first creditor, A, has a hypothec affecting lots 1 and 2 for an amount of $100,000. A seeond creditor, B, has a hypothec affecting lot 2 for an amount of $50,000. At the time lot 2 is sold for $75,000 creditor A receives the whole price, and creditor B receives nothing. The first creditor then seizes lot 1 and sells it for $150,000. If art. 2049 (2) C.C. is applied as written, A would get $25,000 and $125,000 would be distributed to chirographic creditors, of which B is one, for a claim of $50,000. But if one follows *Crown Realty, supra,* note 5, A would take $66,666 from lot 1, *i.e.,* two-thirds of his claim. Of this, A would get $25,000 (the amount remaining to be paid on his $100,000 claim) and $41,666 would be distributed to lower ranking hypothecary creditors on lot 2. In our example, since B's claim is for $50,000 he would receive all of it, and would be chirographic for $8,333. He would be collocated, along with all other unsecured creditors, upon the $83,333 remaining from the sale of Lot 2. Of course, any lower ranking secured creditors on Lot 2 would take their claims from the $83,333 by preference over B and other unsecured security.

[45]One should not extrapolate too far from the judgment of Howard J.A. He notes, *supra,* note 5, 346, that although the first sale had taken place when the Crown Realty Co. went into liquidation, the judgment distributing the proceeds of that sale postdated the liquidation order. In other words, "If the liquidator, when taking over the assets of the company in liquidation, had also taken over from the sheriff the proceeds of the sale of the 8th of March, which were then in his hands, the distribution of the amount realized from the entire property covered by the appellant's [sic] would have been governed by 2049 C.C., and there would have been no occasion for the present litigation." An attempt to develop a general theory along the lines suggested by Howard J.A. will be set out, *infra,* Part IV.

security such as privileges registered out of time[46] or not registered at all[47] as well as creditors holding security over immoveables under the *Bank Act*[48] or a right of redemption, giving in payment clause or *antichrèse,* presumably cannot invoke this article. However, if the argument raised in Part I (B) is valid, a lower ranking privileged creditor might be able to plead the principle of art. 2049 (2) C.C. by analogy.[49]

The Code also requires that the hypothec of these subsequent creditors affect some *one or other only* of the immoveables seized and judicially sold. If, for example, a first ranking creditor has a hypothec on three immoveables, but only seizes two immoveables over both of which a second ranking creditor has a hypothec, art. 2049 (2) C.C. cannot apply.[50] Of course, one might argue that the lower ranking creditor ought to be permitted to compel the higher ranking creditor to seize the third immoveable, but the Code as currently drafted does not contemplate this possibility.

A final requirement flowing from the above clause is that the creditor who has the hypothec on some one or other immoveable occupy a *subsequent* rank. Thus, a higher ranking creditor who believes himself prejudiced by the actions of a creditor holding a general hypothec of inferior rank cannot invoke art. 2049 (2) C.C. Since the Code appears to contemplate the invocation of this article as an exception to the principle of indivisibility only at the stage where proceeds are to be distributed, it is difficult to see how lower ranking creditors with a general hypothec may prejudice the rights of higher ranking creditors. Yet, in combination with other procedural rules the principle of indivisibility can have this effect, as the following example illustrates. Article 689 C.C.P. requires, as a general principle, that the purchaser of an immoveable at a judicial sale pay the purchase price within five days, and art. 730 C.C.P. contemplates a resale for false biding if the value of superior claims is not paid within five days of the homologation of a collocation. In other words, the Code of Civil Procedure contemplates the expeditious payment of secured claims. However, art. 689 (2) C.C.P. permits an hypothecary creditor who

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[46]Article 2130 (2)-(3) C.C. establishes their rank on a temporal basis so that hypothecs having a prior registration date would rank ahead of those privileges with a posterior registration date, when they are registered out of time.

[47]Article 2094 C.C. states that all privileged or hypothecary claims which have been registered will rank ahead of unregistered claims.

[48]S.C. 1980, c. 40, ss. 178-9 establish a temporal ranking of these claims.

[49]See *supra*, notes 20 and 21, and accompanying text.

[50]This is not an unfair result in any event since the lower ranking creditor's position could not be improved even were art. 2049 (2) C.C. to apply. The lower ranking creditor would benefit from the distribution envisioned by art. 2049 (2) C.C. only when the first ranking creditor's hypothec may be partially spread to an immoveable over which he has no rights.

purchases an immoveable affected by his hypothec to retain money to the extent of his claim until the judgment of distribution is served upon him. Hence, if a claim is worth $500,000, and the creditor purchases the three immoveables affected by his hypothec for $400,000 each he may invoke the principle that hypothecs are indivisible to sustain his assertion that the amount of his claim on each immoveable is $500,000. Since he need not prorate his claim he is not required to advance any monies on the $1,200,000 total purchase price until the judgment of distribution is served upon him. The principle of indivisibility consequently means that in certain hypotheses a higher ranking secured creditor must wait much longer than the ordinary five days in order to be paid for his claim.[51]

Interesting problems of collocation can arise when a creditor occupies a subsequent rank on some immoveables, but not on others. For example, suppose that a first creditor has a hypothec on lots A, B and C, registered against lots A and B on January 1 and against lot C on January 3, while a second creditor has a hypothec on lots B, C and D registered against all three lots on Jaunary 2. If a third creditor had a hypothec registered on January 5 against lots B and C, it would appear that in the event all four immoveables were sold this third creditor would be entitled to invoke the distributional schema established by art. 2049 (2) C.C. and both higher ranking creditors conceivably be compelled to prorate their claims.[52]

E. *Conclusion*

The above observations illustrate the restricted scope of art. 2049 (2) C.C. as a device for ensuring equity between secured creditors in the realization of their claims against their debtors' property. In part as a result of developments in secured financing and in part as a result of omissions or oversights in the text of the article itself the exception to the rule of indivisibility of hypothecs which it establishes is more illusory than real. Nevertheless, in one of the two Court of Appeal decisions in which the article was raised, an attempt was made to view the article as a specific example of a broader principle capable of being applied by analogy in various circumstances.[53] This theme will be considered again in Part IV.

II. Juridical Effects of Art. 2049 (2) C.C.

The effects of art. 2049 (2) C.C. are set out by the clause "his hypothec is divided rateably upon so much of their respective prices as

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[51] See *Compagnie Montreal Trust* v. *Jori Investments Inc.* (1980) 13 R.P.R. 116 (C.S. Qué.) for an example of this hypothesis.

[52] See *infra,* Part II (B) and *supra,* note 46.

[53] See *supra,* note 5; *cf. supra,* note 6.

remains to be distributed." There is substantial disagreement, not to say confusion, among commentators as to the scheme of distribution which this article contemplates. Both the expression "divided rateably" and the clause "upon so much of their respective prices as remains to be distributed" are open to several interpretations. Each, therefore, requires careful elucidation.

A. *His hypothec is divided rateably*

The phrase "divided rateably" reveals the true nature of art. 2049 (2) C.C. as a principle of distribution. As such it is directed to the prothonotary who draws up the order of collocation of the proceeds of the judicial sale or sales. It presupposes that the sale of the immoveables has produced sufficient money to pay the claim of the first ranking creditor in full.[54] In such an event art. 2049 (2) C.C. requires the higher ranking creditor to be collocated on a *pro rata* basis upon each immoveable sold. This rateable division takes place in proportion to the respective value of the immoveables sold and is not influenced by either the number of lower ranking creditors or the value of their claims.

An example will illustrate the scheme of distribution envisioned by art. 2049 (2) C.C. Suppose that at a judicial sale, immoveable A brings in $100,000 and immoveable B brings in $50,000. A first ranking hypothecary creditor having a claim of $75,000 will be collocated on immoveable A for $50,000 and upon immoveable B for $25,000. He cannot, as the principle of indivisibility would have it, exercise his hypothec for the amount he wishes upon each immoveable. A second ranking creditor having a hypothec upon only immoveable B for $50,000, will receive the remaining $25,000 of the sale price by preference and will be a chirographic creditor for the other $25,000 owing on his debt. The $50,000 remaining from the sale of immoveable A will fall into the mass of property to be shared *pro rata* by all chirographic creditors.[55]

Nevertheless, some commentators seem to misconceive the sense of the word "rateably" and advocate alternative principles of distribution. For example, Mignault suggests that art. 2049 (2) C.C. operates a cession of priority in the name of equity. As long as enough money remains to pay the higher ranking creditor in full, he believes that, to the extent possible, the first hypothec should be divided to maximize the chances that lower ranking secured creditors can be paid in full. Thus, in the example given above, Mignault would hold that the higher ranking

[54]If not, all the proceeds would be paid to the first creditor by virtue of his higher rank.

[55]This example illustrates the interpretation of art. 2049 (2) C.C. advocated by a majority of authors. See Langelier, *supra*, note 4, 287; Marler, *supra*, note 4, no. 830; Caron & Binette, *supra*, note 4, no. 306; and Payette, *supra*, note 6, 310.

creditor is obliged to take his $75,000 uniquely from the $100,000 brought in by immoveable A, in order that the second ranking creditor receive his full $50,000 by preference from immoveable B.[56] Although certain considerations of equity might induce one to accept this solution, it is contrary to the very terms of art. 2049 (2) C.C. which speaks of a rateable division.[57] While the distribution actually ordered in the *Crown Realty* case makes it difficult to know with certainty the precise method of calculation adopted by the Court of Appeal it is clear that Mignault's theory was rejected.[58]

An even more radical, and implausible, thesis is advanced by Demers, who asserts that art. 2049 (2) C.C. establishes an absolute cession of priority in favour of the second creditor, even where this may mean that the first-ranking creditor cannot be paid in full.[59] One can only conclude that the author has misunderstood the meaning of the terms of the Code. Although art. 2049 (2) C.C. appears in a section of the Code entitled "Of the Order in which Hypothecs Rank" nowhere does the text of the article suggest any modification to, or inversion of, the rank of hypothecs established by arts 2046, 2047, 2050, 2051, 2052 and 2130 C.C. Such an inversion would totally undermine the whole theory of security on property and is in no way inferable from the expression "divided rateably".[60]

Article 2049 (2) C.C. must be regarded as a principle of distribution which requires the prothonotary to divide the hypothec of the higher ranking creditor in a *pro rata* fashion having regard to the proceeds generated by each immoveable sold. Unlike the common law theory of

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[56]*Supra*, note 4, 132. See also J. Deslauriers, F. Frenette & L. Poudrier-Lebel, *Les sûretés* (1979), 257-8. In the 1980 edition, however, the view of Caron & Binette, *supra*, note 4, is adopted.

[57]Mignault's solution, *supra*, note 4, resembles the distributional principles of the common law doctrine of "marshalling". Marshalling requires a creditor having two funds from which to realize his security to exhaust the fund not encumbered by a subsequent security prior to seeking payment from the encumbered fund. *Trimmer* v. *Bayne* (1803) 9 Ves. Jun. 209, 32 E.R. 582 (Ch.). See *Halsbury's Laws of England*, 4th ed. (1973), vol. 16, para. 1428. For a discussion relating to the law of Québec see Payette, *supra*, note 6. It should also be observed that the "marshalling" solution favours all preferred creditors over all chirographic creditors, whereas the principle of art. 2049 (2) C.C. is applicable in a uniform manner regardless of the value of subsequent secured claims. See also the comments of Crête and Monet JJ.A. in *Central Factors*, *supra*, note 6, on the theory of marshalling.

[58]*Supra*, note 5, 346-7 *per* Howard J.A.

[59]*Supra*, note 4, 260.

[60]Nevertheless in *Central Factors*, *supra*, note 6, the Court of Appeal cites only Demers as a doctrinal source. Given that the Court found art. 2049 (2) C.C. not to be applicable, one should not perhaps interpret this citation as an endorsement of Demers' peculiar theory.

"marshalling", its application with respect to the higher ranking creditor cannot be affected by either the number of subsequent secured creditors or by the respective value of their claims.

B. *Upon so much of their respective prices as remains to be distributed*

This clause sets out an important clarification of art. 2049 (2) C.C. Here the Code provides that the rateable division is to be determined according to the amount of the proceeds which remains to be distributed to the creditor holding the general hypothec at the moment his claim is collocated. It does not speak of the amount of the proceeds brought in by the judicial sale.

The difference between these possibilities can be shown with the aid of an example. Suppose a claim of $100,000 is guaranteed by a hypothec affecting three immoveables. Upon judicial sale, immoveable A brings in $100,000, immoveable B brings in $200,000 and immoveable C brings in $300,000 for a total of $600,000. If there were no higher ranking security the creditor holding the general hypothec would get one-sixth of his claim, or $16,666 from the proceeds of immoveable A; one-third of his claim or $33,333 from those of immoveable B; and one-half of his claim or $50,000 from those of immoveable C.

However, a hypothecary creditor will never have a first ranking security: law costs and other perfected privileges will always outrank his claim. Therefore, let us imagine that after payment of higher ranking creditors the prothonotary has the following amounts remaining to be distributed to the creditor with the general hypothec: from the $100,000 brought in by immoveable A, a sum of $50,000; from the $200,000 brought in by immovcable B, also a sum of $50,000; and from the $300,000 brought in by immoveable C, an amount of $200,000. Because art. 2049 (2) C.C. states "so much of their respective prices as remains to be distributed" the rateable division must be calculated on the basis of respective valuations of $50,000, $50,000 and $200,000 and not on the basis of the initial proceeds of $100,000, $200,000 and $300,000. Hence the creditor with the general hypothec will receive one-sixth of his claim, or $16,666 from immoveable A, a further one-sixth of his claim from immoveable B, and two-thirds of his claim or $66,666 from immoveable C.

From this principle it also follows that if a first ranking creditor holding a general hypothec cedes or assigns priority upon one immoveable to a subsequent hypothecary creditor, his *pro rata* share upon that immoveable is calculated in relation to the amount remaining to be distributed after the assignee has been paid.[61]

[61] See Marler, *supra*, note 4, no. 830, for analogus suggestions.

C. *Conclusion*

It flows from the language of art. 2049 (2) C.C. that the exception to the rule of indivisibility of hypothecs it elaborates is to apply only at the time of collocation. Moreover, the distribution contemplated by the Code is not designed to maximize in all cases the secured claim of creditors holding lower ranking security. Rather, it is intended to establish a *pro rata* distribution so that the mechanism of collocation elaborated in art. 721 C.C.P. may be effected.[62] To this end the article does not envision either the absolute preference of secured creditors over unsecured creditors implicit in the common law theory of "marshalling", or any direction to the first ranking creditor with respect to the means employed to realize upon his security. He remains free to invoke the rule of indivisibility in selecting the collateral which is the target of his seizure.

III. A Critique of Art. 2049 (2) C.C.: Distribution and Realization in a Regime of Security on Property

The majority of commentators agree that art. 2049 (2) C.C. is poorly drafted.[63] Almost all have tried to explain its scope by means of examples rather than through analysis of its underlying principles. None have attempted to elaborate a general theory of the relationship between competing creditors holding non-coextensive security upon their debtor's property. Nevertheless, in the interpretation of the article, two main jurisprudential and doctrinal tendencies are present: first, a strict thesis which adheres to the language of the article itself and, seeing the

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[62]The following table illustrates an application of this principle:

	Immoveable A	Immoveable B	Immoveable C
Sale price	$100,000	$200,000	$300,000
1st creditor's claim: $100,000 hypothec on immoveable A, B and C	$16,666	$ 33,333	$ 50,000
	$83,333 (balance)	$166,666 (balance)	$250,000 (balance)
2nd creditor's claim: $200,000 hypothec on immoveable A and B	$66,666	$133,333	—
	$16,667 (balance)	$ 33,333 (balance)	
3rd creditor's claim: $100,000 hypothec on immoveable A only	$16,667	—	—
	0 (balance)		
Chirographic creditors	0	$ 33,333	$250,000

In this example, the third creditor is chirograhic for an amount of $83,333 despite the fact that a sum of $283,333 remains to be distributed from the price of the immoveables.

[63]See Mignault, *supra*, note 4, 132; Demers, *supra*, note 4, 260; Caron & Binette, *supra*, note 4, no. 211.

provision as exceptional and one designed only to protect lower ranking hypothecary creditors in very precise circumstances, advocates a narrow interpretation of its terms;[64] second, a more liberal view which sees in the article "a broad, equitable principle"[65] which should be found to apply whenever necessary to protect lower ranking creditors from the abusive exercise of rights by a higher ranking creditor. Writing for the majority in the Court of Appeal in the *Crown Realty* case, Letourneau J.A. accepted the second view and held that the object of the provision was to "rendre justice aux créanciers postérieurs en établissant en leur faveur un mode équitable de distribution lorsque la chose est possible."[66]

From the perspective of commercial financing, however, neither the narrow nor the liberal thesis sets out an acceptable theory of secured lending. For once it is accepted that the rule of indivisibility of hypothecs should suffer an exception in certain instances of distribution — and given the practical requirements of preparing an order of collocation under art. 721 C.C.P. one could hardly suggest otherwise — the Code should elaborate a general theory governing the attribution of secured claims upon affected collateral. In other words, art. 2049 (2) C.C. should be seen as merely a particular example of a more general principle, that principle being that no secured creditor should be prejudiced solely because another secured creditor attempts to invoke the rule of indivisibility to select target collateral in a way that compromises his rights. In this light, it should be irrelevant whether or not the creditor is secured or chirographic,[67] whether or not the security taken by either party is technically speaking a hypothec, whether or not the other party is a higher or lower ranking creditor, whether or not the property affected is immoveable or moveable, and whether or not the proceeds of all the sales remain to be distributed. Since none of the above requirements are necessary to the ordinary operation of seizures in execution, from a commercial point of view art. 2049 (2) C.C. reveals elliptical draftsmanship if it is to be taken as the broadest conception of the applicable principle.

But there is another level at which this article of the Code may not have achieved effectively the goal of equitably regulating the relations between creditors holding non-coextensive security. As drafted the article

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[64]This viewpoint is shared by Rinfret, Tellier and Greenshield JJ.A. in *Crown Realty, supra*, note 5; by Crête J.A. in *Central Factors, supra,* note 6; and by Marler, *supra*, note 4, and Langelier, *supra*, note 4.

[65]*Supra*, note 5, 346 *per* Howard J.A.; Mignault, Demers and Caron & Binette seem to share this perspective, *supra*, note 4.

[66]*Ibid.*, 350.

[67]If the creditor is chirographic the principle of art. 2049 (2) C.C. makes no difference since all the property of the debtor is the common pledge of his creditors: arts 1980-1 C.C.

addresses only one of the two main issues which arise whenever secured creditors attempt to realize upon their security, namely, how the proceeds generated by a judicial sale are to be distributed. A second and perhaps more important question relates to the manner in which a secured creditor chooses to realize upon his security. Unless a creditor with security on some one or other only asset of his debtor is able to bring himself within the conditions of art. 2049 (2) C.C. (even as extended by analogy) the rateable distribution of proceeds there contemplated is of no use to him. In other words, unless a creditor has the means to compel the seizure and sale of sufficient collateral to pay off all claims prior to his own the principle of *pro rata* distribution is of little assistance. There is now no mechanism short of obtaining judgment by which such a creditor may provoke the seizure of assets other than those over which he himself has security. Nor does the civil law permit a secured creditor to compel other secured creditors holding general hypothecs to realize their security either by simultaneously seizing all assets covered by the general hypothec or by seizing only that collateral not affected to other secured claims.[68]

By tolerating a right of secured creditors to select without limitation their target collateral upon default, the law facilitates machinations between debtor and creditor or creditor and creditor which may have the effect of unjustly prejudicing competing creditors holding non-coextensive security. Two possibilities deserve special mention. A debtor who foresees the possibility of falling into default to his creditors is encouraged by the current law to negotiate a default with creditors holding general hypothecs, a pattern of realization which will profit certain lower ranking secured creditors and prejudice others, or which will insulate particular assets from immediate execution.[69] Similarly, a higher ranking creditor with a general hypothec is encouraged to bargain with lower ranking secured creditors and prejudice others, or which will insulate particular assets from immediate execution. Similarly, a higher ranking creditor with a general hypothec is encouraged to bargain with lower ranking creditors for the most favourable pattern of seizure and sale.[70] In either hypothesis the law facilitates manoeuvring between various parties to security agreements designed neither to expedite

[68]It is to be noted that this particular problem will arise most often in commercial, rather than real estate financing. The giving in payment clause is a principal reason.

[69]For example, a debtor may negotiate a default with a financer of certain equipment not to realize until inventory has been produced and sold. Here, the raw materials financer suffers while the accounts receivable financer profits.

[70]For example, an unsecured creditor may negotiate with a creditor holding a general hypothec to realize exclusively on heavily encumbered property so as to reduce the claims of lower ranking secured creditors to chirographic status.

realization nor maximize proceeds generated, but simply to benefit or oppress certain lower ranking creditors holding non-coextensive security.[71] It follows from this discussion that the principle of art. 2049 (2) C.C., even interpreted by analogy to its greatest breadth, is only marginally successful in equitably regulating relations between creditors holding non-coextensive security.

Of course, a secured creditor has a variety of recourses other than that elaborated in art. 2049 (2) C.C. by which to protect his rights from prejudicial realization, or execute upon his security in a most beneficial fashion. One may highlight two which require elaboration: the outright purchase of the oppressing creditor's rights in order to exercise these in a non-prejudicial manner; and the negotiation of a renunciation, a cession of priority or a similar arrangement. Moreover, an apprehensive secured creditor may adopt any number of strategies to bring himself within the conditions of application of art. 2049 (2) C.C. Finally, he may petition his debtor into bankruptcy in order to profit from the scheme of distribution set out in the *Bankruptcy Act*.[72]

A. *Purchasing the Rights of Higher Ranking Creditors*

A creditor who fears that his security may be compromised by the manner in which another secured creditor proposes to realize upon his guarantee may always attempt to purchase the rights of the latter. This option is expressly recommended by Marler,[73] but Langelier[74] seems to suggest that such arrangements are not permitted. It is difficult to see upon what basis this latter opinion is founded, since arts 1571 *et seq.* C.C. impose no restrictions on the purchase of creditors' rights. Thus, in anticipation of default any individual may purchase a claim which is secured by a hypothec,[75] and then invoke the principle of indivisibility to exercise the rights so purchased in a manner most beneficial to himself.

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[71] In *Crown Realty, supra,* note 5, 345-6, Howard J.A. clearly saw this issue. He observed: "I cannot bring myself to believe that it was the intention of our codifiers to leave the decision of the vital question, whether the holder of a second hypothec on one of the separate portions of the property should be paid his claim in full or receive nothing at all, to the mere chance that his security should be brought to sale before that of the holder of the other second hypothec, and still less that it was their intention to penalize the one who should act with the greater diligence in executing upon his security."

[72] R.S.C. 1970, c. B-3. His rank will then be established according to that law, and not the Civil Code. This hypothesis will not be discussed here.

[73] *Supra,* note 4, no. 830. See also *Crown Realty, supra,* note 5, 348, *per* Greenshields J.A.

[74] *Supra,* note 4, 287.

[75] Article 1574 C.C. See, however, the special rules relating to registration set out in art. 2127 C.C.

That is, the purchaser would exercise the newly acquired hypothec primarily, if not exclusively, on those immoveables not affected by his original hypothec.[76]

Would the situation be the same if the first ranking creditor had already seized the immoveable prior to the transfer of the claim?[77] In *Crown Realty* it appears that the Court would have permitted the purchase of a higher ranking creditor's right even after the seizure of the immoveable, as long as the order of collocation and distribution had not been drawn.[78] In such a hypothesis, however, the purchasing creditor would not immediately seize the second immoveable. Rather, he would renounce the exercise of his new hypothec in order to have his original claim paid first. Then, invoking the principle of art. 2049 (1) C.C. he would seize another immoveable affected by the recently purchased general hypothec in order to liquidate the claim it guaranteed.

It would appear, therefore, that a lower ranking creditor who fears oppression from another secured creditor may purchase the latter's rights either prior to or after the seizure and sale of the immoveable affected by his own hypothec. In both cases he will not be invoking the principle set out by art. 2049 (2) C.C. but, on the contrary, that of art. 2049 (1) C.C., namely, that hypothecs are indivisible. A similar solution is to be recommended whenever a first ranking creditor attempts to exercise a giving-in-payment clause. Invoking art. 1040b C.C., the second creditor would purchase the rights of the first creditor in order to avail himself of art. 2049 (1) C.C., as above.

All these solutions, however, have their inconveniences. First, the lower ranking creditor must have enough money to buy out the first ranking creditor. Second, apart from the case where art. 1040b C.C. is applicable, it is necessary either to wait until seizure of the collateral, or to obtain the co-operation of the first ranking creditor in order to intervene. Third, each presupposes that no lower ranking creditor in a similar predicament in respect of another immoveable has previously taken the same step.

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[76]Article 2049 (1) C.C. The purchaser will be subrogated in all the vendor's right by virtue of art. 1156 (1) C.C. See also arts 1986-7 C.C. to which art. 2052 C.C. refers.

[77]This is precisely what a third ranking creditor unsuccessfully attempted to do in *Central Factors, supra,* note 6.

[78]In *Crown Realty, supra,* note 5, the Court of Appeal refused to permit this solution because the second ranking creditor (the purchaser) did not renounce his rights in proper form or in sufficient time. See the judgment of the Court by Howard J.A. (unreported), in its second paragraph, which states: "[T]he renunciation made by the appellant... was not made in proper time or form".

B. *Renunciations, Cession of Priority and Similar Devices*

A second path open to a lower ranking creditor who fears that his rights may be prejudiced is to negotiate an agreement whereby the first ranking creditor promises not to realize his security upon assets affected to the lower ranking creditor's guarantee in a manner prejudicial to the latter. Probably the easiest manner of achieving this result is to have the higher ranking creditor renounce his rights to invoke the indivisible nature of his hypothec under art. 2049 (1) C.C. in the event of a seizure. While there is some suggestion in *Crown Realty* that this is not permissible, no article in the Code seems expressly to prohibit such agreements.

Another manner by which a lower ranking creditor may safeguard his rights is through the mechanism of a cession of priority.[79] Such a cession could, of course, be arranged either prior to or after default and seizure. In either event the first ranking creditor who cedes his rank would then exercise his general hypothec on the other immoveables, rather than wait to see what the results of a collocation on the first immoveable might be.[80]

Once again, however, there are inconveniences to these solutions. The existence of creditors of intermediate rank will compromise both strategies. The first alternative, negotiating a renunciation from the highest ranking creditor, is otiose if the intermediate hypothec is large. The second alternative, cession of rank, will only be effective if the lower ranking hypothec is for an amount less than that of the higher ranking hypothec.[81] Moreover, just as in the case where a creditor purchases the rights of a first ranking creditor, the second creditor must have the resources to do so and must of course have the co-operation of the creditor holding the general hypothec. Finally, since neither of these alternatives involves purchasing the higher ranking creditor's claim, subrogation under art. 1156 (1) C.C. cannot be claimed and the purchaser cannot recover the amount of his payment to the vendor.[82]

C. *Strategies for Compelling the Application of Art. 2049 (2) C.C.*

The two hypotheses just mooted involve machinations by which a lower ranking creditor fearing prejudice does not avail himself of the distributional principles elaborated by art. 2049 (2) C.C. but rather, undertakes various transactions through which he himself achieves a

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[79]Article 2048 C.C.

[80]Again, some judgments in *Crown Realty, supra,* note 5, would suggest that such a strategy is contrary to public order.

[81]If not, the second ranking creditor can only protect his claim up to the amount of the first ranking hypothec. See art. 2048 C.C.

[82]See also arts 1986-7 C.C.

position from which he may invoke the principle of indivisibility to greatest benefit. However, a second creditor who is not immediately in a position to invoke art. 2049 (2) C.C. and who is not successful in either purchasing the rights of a higher ranking creditor or in making alternative arrangements is not necessarily in a precarious position. He can attempt to bring himself within the conditions of applicability of art. 2049 (2) C.C. so as to compel a proration of the higher ranking creditor's claim. Since the essential conditions of application of the article have already been elaborated, it remains only to examine the means by which a creditor may provoke its application in the two general situations of non-applicability: (1) where only assets already affected to the lower ranking creditor's security are seized, and (2) where the oppressed creditor does not meet the required description in that he is neither hypothecary nor subsequent.

Article 2049 (2) C.C. will not apply if the higher ranking creditor seizes only the immoveable or immoveables affected by the subsequent creditor's hypothec. In such a case, assuming the debtor to be in default towards him,[83] the second ranking creditor will bring an action on the principal obligation, seize before judgment the other immoveables and after obtaining judgment, sell these. At the same time he will be obliged to restrain the sale, or if a judicial sale has already taken place, restrain the distribution of the proceeds from the sale of the first immoveable. While there appears to be a suggestion in *Crown Realty* that a rateable distribution may be ordered even if only proceeds of some immoveables remain to be distributed, the only certain means of assuring the application of art. 2049 (2) C.C. is to seize and sell other immoveables affected by the higher ranking hypothec prior to distribution of the sale price of the first immoveable.

A second case where art. 2049 (2) C.C. will not apply can arise if the creditor fearing prejudice does not have a hypothec or is not of posterior rank. In order to be assured of provoking the application of art. 2049 (2) C.C. he must himself obtain a subsequent hypothec upon the property seized. However, in view of the provisions of art. 2023 C.C. such an attempt is unlikely to be successful. Even if money is advanced to the debtor, the lender would typically be found not to be in good faith.

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[83]While the Code of Civil Procedure provides in art. 716 for the collocation of the claims of secured parties to whom the debtor is not in default, upon the sale of the immoveable affected to their hypothec no general right to seize immoveables affected to another creditor's hypothec is given. Hence, a lower ranking creditor may only compel such seizure by obtaining judgment after his debtor's default. Various standard form default clauses suggest themselves as a means of ensuring this possibility.

The above solutions are, of course, artifices contrived in order to provoke the application of art. 2049 (2) C.C. as a principle of distribution. Each reveals the limits of the article as a device for ensuring a rateable distribution of the claim of the creditor holding a general hypothec upon the proceeds of a judicial sale.

D. *Conclusion*

The considerations reviewed in this section illustrate the inefficiency of art. 2049 (2) C.C. as a mechanism for equitably regulating relations among creditors holding non-coextensive security upon the property of their debtor. Even were one to take the most liberal interpretation of the underlying principle of art. 2049 (2) C.C. the fact remains that the provision elaborates only a principle of distribution and not a principle of realization. As such it only partially resolves the issues which a system of secured financing poses, and in a very real sense frustrates rather than facilitates the expeditious realization of security and the maximization of proceeds generated for the benefit of secured creditors.

IV. The Future of Art. 2049 (2) C.C.: The Limits of Indivisibility

If one accepts the desirability of legislative intervention in the market for security on property and if one accepts that some measure of control should be exercised over the manner in which secured creditors may realize upon their security, several issues of legal policy arise. The analysis of art. 2049 (2) C.C. undertaken in this essay indicates that it is, at best, a flawed juridical institution for regulating the rights of non-coextensive security holders. Five main criticisms may be directed to the conception and redaction of the article.

First, as drafted, art. 2049 (2) C.C. simply envisions hypothecs. Whatever may have been the case in 1866, it is clear that creditors today obtain security by means other than hypothecs. If the principle of art. 2049 (2) C.C. is valid, it should be made applicable to other forms of security as well.

Second, the article speaks only of immoveables. Once one admits of non-possessory security on moveables, problems of competing non-coextensive secured creditors may arise. Moreover, most secured lending today occurs in the realm of sales financing. There is no reason therefore to restrict the principle of the article to security over immoveables.

Third, art. 2049 (2) C.C. currently provides only for the protection of lower ranking creditors. It may well be that the codifiers did not have in mind the abuses which can be perpetrated by subsequent creditors holding general hypothecs. Yet in view of the impact that the principle of indivisibility may have on all secured creditors, there is a need to extend the principle to all secured creditors regardless of rank.

Fourth, this article appears to contemplate uniquely the case where a hypothec affects the property of parties personally liable. Whenever security is given to guarantee an obligation should the collateral affected to the debt not be immediately open to seizure? Unless bargained away, the right of secured parties not to postpone execution should not depend on whether the owner of the collateral is personally liable to the creditor. The relationship between holder and principal debtor is a matter for the law of obligations and not the law of secured financing.

Fifth, the article only contemplates problems of equity which arise among secured creditors at the time of distribution of the proceeds of a judicial sale. It is silent as to problems of realization even though the opportunity for oppression is equally present in the manner of realization.

In view of this inventory of defects one might wonder why the article has not generated extensive litigation. Three reasons may be offered. First, the fact that almost all real estate loan agreements today contain either giving-in-payment or resolutory clauses with retroactive effect means that upon default, a first ranking creditor may simply extinguish lower ranking claims; in such an hypothesis the need for distributional principles such as those set out in art. 2049 (2) C.C. never arises.[84] Second, the limited hypotheses in which it is conceiveable for a higher ranking creditor to have general non-possessory consensual security on moveables has restricted the range of cases for which the need of a principle such as art. 2049 (2) C.C. has been felt; the low rank of the trustee for bondholders effectively means that the kind of conflict envisioned by the article can only arise in limited cases between a bank holding s. 178 security and an unpaid vendor or commercial pledgee.[85] Finally, because the general structure of security on property elaborated in the Code is one of priorities for payment, as opposed to security devices implicating creditor supervision, attachment and tracing, and preferential payment of proceeds advocates do not seem to have generalized the specific example of art. 2049 (2) C.C. into a general theory of secured financing; hence, several situations where the principle of indivisibility leads to oppression of the sort mooted by the Code, go unchallenged.[86] In this section an attempt to illustrate the various possibilities for applying the principle of art. 2049 (2) C.C. in a variety of secured financing contexts will be undertaken.

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[84] See *Simcard Ltée* v. *Planchers Modernes Chartier Inc.* (1980) 13 R.P.R. 254 (Qué. C.A.).

[85] This was preccisely the claim raised in *Central Factors, supra,* note 6, which the Court of Appeal stated did not give rise to the application of art. 2049 (2) C.C.

[86] An analogy to art. 2049 (2) C.C. was not even drawn by counsel in either *Jori Investments, supra,* note 51, or in *Central Factors, supra,* note 6.

A. *Towards a Reinterpretation of Art. 2049 (2) C.C.*

In view of the eventual reform of the law of security on property proposed in the Draft Civil Code it might be thought otiose to suggest a reinterpretation of the principle of art. 2049 (2) C.C. in the direction of a general theory of secured financing. But if the above noted problems with the current version of art. 2049 (2) C.C. are indeed real, ought not advocates and judges seek to alleviate where possible these deficiencies through analogy or reformulation? In this sense the viewpoint of Howard J.A. in *Crown Realty* is preferable to that of Crête J.A. in *Central Factors.*

In reconsidering the range of application of the principle of art. 2049 (2) C.C., one may start with the obvious point that the article is misplaced in the Code. Rather than dealing with "The Order in Which Hypothecs Rank" it treats the question of the effect of hypothecs and the consequences of the hypothecary recourse. That is, it attempts to elaborate the consequences of the principle that hypothecs are indivisible at the time of distribution of the proceeds of a judicial sale. As such, the article should be seen as setting out an exception to the principle of indivisibility which applies regardless of the rank of the respective hypothecs and regardless of the particular consequence of indivisibility in view. It also follows that, if it is the principle of indivisibility which is contemplated, art. 2049 (2) C.C. should be applied by analogy to other forms of security, such as privileges, which attach to proceeds generated at a judicial sale. Again, since all privileges, moveable and immoveable, are indivisible, and since the idea of consensual non-possessory security along the lines of the hypothec has been incorporated into the civil law by the commercial pledge and the trust deed under the *Special Corporate Powers Act,* the principle of the article can easily be extended to the case of moveables. Finally, if art. 2049 (2) C.C. does not really address the issue of rank of claims, but rather principles of distribution, it is not a difficult intellectual step to make its principle applicable to all circumstances where the holder of a general security attempts to invoke the principle of indivisibility to the prejudice of other creditors holding non-coextensive security.

The remaining two policy problems with art. 2049 (2) C.C. cannot, however, be overcome simply by analogical extension of the underlying principle of the article. On the one hand, extension of the principle to the case of holders not personally liable contemplates a substantial rethinking of the hypothecary action. By permitting creditors immediate access to all collateral upon their debtors' default one would be eliminating one element of a hypothec's accessory nature.[87] On the other hand, invoking

[87]Of course, lenders may insist that all hypothecs be accompanied by personal assumption of liability by the holder or by a renunciation of the benefit of discussion in which case art. 2049 (2) C.C. would be applicable.

art. 2049 (2) C.C. as a justification for controlling the manner in which secured creditors may realize upon their debtor's assets implies a new conception of the rights as between debtor and creditor, or creditor and creditor, both prior to and consequent upon default. Heretofore the civil law has not been concerned with mechanisms of realization and in consequence the chance order of seizure and sale will determine which creditors will suffer in the distribution of proceeds.[88]

It is these latter two policy problems which most cogently illustrate the limitations of the current civil law conception of secured financing. While the principle of freedom of contract may be a valid operating assumption in most commercial contexts,[89] the need for a comprehensive, integrated and coherent scheme of realization of assets suggests that in the realm of secured financing the law must take a more activist and interventionist position.[90] In particular, the law cannot simply apply various prescriptions for distribution of proceeds but must elaborate a mechanism for permitting secured creditors to direct other creditors holding non-coextensive security to various assets affected to the latter's claim.[91]

Of course, in developing a principle to this effect the legislator must be cognizant of a variety of issues: in what circumstances should a first secured creditor properly resist an attempt to compel execution on other properties? What types of property make delays in realization inevitable? In volatile markets should creditors be forced to realize when they are unsure of the amount of proceeds likely to be generated? In view of these problems it appears that the most viable mechanism for extending the principle of art. 2049 (2) C.C. to realizations as well as distributions is not to limit or restrict the right of higher ranking secured creditors to

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[88]If the purpose of secured financing, from the debtor's perspectivc, is to lower the cost of money, the possibility that the utility of a security can be affected by the chance order of realization will make the lending market more volatile. For an economic analysis of secured lending see Jackson & Kronman, *Secured Financing and Priorities among Creditors* (1979) 88 Yale L.J. 1143.

[89]See the debate as elaborated in J. Ghestin, *Les Contrats* (1979); C. Fried, *Contract as Promise: A Theory of Contractual Obligation* (1981); and I. Macneil, *The New Social Contract: An Inquiry into Modern Contractual Relations* (1980).

[90]See Gilmore, *supra,* note 1; J. White & R. Summers, *Handbook of the Law under the Uniform Commercial Code,* 2d ed. (1980), 1-21 and in particular 20-1; and Ramsay, *Book Review* [Ontario Law Reform Commission, *Report on Sale of Goods* (1979)] (1980) 57 Can. Bar Rev. 780-90.

[91]The common law doctrine of marshalling achieves this result indirectly. Rather than permitting lower ranking crcditors to force higher ranking creditors to seize particular assets of their debtor, the common law permits the lower ranking creditor to have recourse to the collateral over which he actually has no claim up to the amount realized by the first creditor from the property over which he has security. Sec R. Megarry & P. Baker, *Snell's Principles of Equity,* 27th ed. (1973), 404-5.

freely select their target collateral. Rather, the law should extend the principle of art. 1156 (1) C.C. so that legal subrogation may take place in favour of a lower ranking secured creditor whenever a higher ranking creditor holding non-coextensive security realizes upon the assets affected to the lower ranking secured creditor's claim. The lower ranking creditor should be permitted to seize and sell all other collateral affected by the first ranking creditor's guarantee and to be preferred on the proceeds generated for an amount up to the difference in the payment to the first ranking creditor had art. 2049 (2) C.C. been applicable.[92]

B. *The Proposals of the Civil Code Revision Office*

The law of security on property undergoes nothing short of a radical revision in the Draft Civil Code.[93] Notwithstanding this general tide of reform, art. 423 (2) of Book IV of the proposed Code, which corresponds to art. 2049 (2) of the present Code only slightly amends the current law. The draft article provides:

> If, however, all of such properties or more than one of them are judicially sold, and the proceeds are still to be distributed, if other subsequent creditors hold hypothecs on one of such properties, the creditor's hypothec is divided in proportion to the amount of the respective prices which remain (sic) to be distributed.
>
> Si, néanmoins, tous ces biens ou plus d'un de ces biens sont vendus en justice et que le prix en soit à distribuer, l'hypothèque se répartit, proportionnellement à ce qui reste à distribuer sur leurs prix respectifs, lorsqu'il existe d'autres créanciers postérieurs qui n'ont hypothèque que sur l'un de ces biens.

On its own, this article addresses only one of the difficulties noted with the current art. 2049 (2) C.C.: art. 423 D.C.C. no longer requires that the immoveable affected be that of the debtor of the obligation.[94] However, in combination with the other reforms to the law of security on property most of the criticisms of art. 2049 (2) C.C. have been met. For example, in view of the proposed "presumption of hypothec"[95] the principal of rateable division extends to all security on property other than financing under ss. 179 (1) (a) – (h) of the *Bank Act*, and liquidations under the *Bankruptcy Act*. That is, because no form of security on property other than a hypothec is to be permitted, the

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[92]This principle also requires an amendment to the law of release so as to prevent collusion between creditors through the prior release of security over non-seized property. In this regard the provisions of arts 1032-3 and 1039 C.C. are of particular relevance.

[93]See, for comments, Lebel & Lebel, *Observations sur le Rapport de l'O.R.C.C. sur les sûretés réelles* (1977) 18 C. de D. 833-96; Comtois, *Le nouveau droit des sûretés réelles* [1978] C.P. du N. 75; Macdonald & Simmonds, *The Financing of Moveables; Law Reform of Québec and Ontario* (1980) 11 R. de D. 45.

[94]Book IV, art. 423 (1) D.C.C. only requires that the hypothec affect more than one property. The reference to "debtor" is removed.

[95]Book IV, arts 281-5 D.C.C.

language of art. 423 D.C.C. is comprehensive. Again, because the new Code will permit hypothecs on moveable property,[96] the draft article is directly applicable to the financing of moveables. Third, even though the draft article speaks only of judicial sales, neither its scope nor its effect is limited in the manner of the former art. 2049 (2) C.C. On the one hand, in the new Code a non-judicial sale will not have the effect of purging real rights;[97] and on the other hand, the Code permits creditors to compel another who has taken collateral in payment to proceed to a judicial sale so that the collateral generates proceeds for distribution among other creditors.[98] Finally, by means of the presumption of hypothec and various imperative provisions,[99] the Draft Civil Code will reduce the likelihood of disingenuous attempts to oppress both debtors and subsequent creditors such as that which produced the retroactive giving in payment clause twenty years ago.

One may conclude, therefore, that the various provisions of the Draft Civil Code, in combination with the revised version of art. 2049 (2) C.C. elaborated by art. 423 (2) D.C.C., meet the majority of the criticisms formulated in this essay against both the drafting and the interpretation of art. 2049 (2) C.C. The only remaining difficulties lie with the fact that the Draft Civil Code still envisions this provision uniquely as a principle of distribution of the proceeds of a judicial sale: first, it continues to restrict the creditors who are entitled to invoke it to those who are of "subsequent" rank; and second, it nowhere provides that a secured creditor may either provoke the seizure of an immoveable over which he has no security in order to compel the higher ranking creditor to prorate his security or be subrogated in the anterior creditor's rights for the same purposes.

As argued earlier in this essay a coherent scheme for regulating the relationship between creditors holding non-coextensive security over the assets of their debtor is reflected best in the idea that the indivisible nature of hypothecs should not be an instrument of oppression in the hands of secured creditors and should not be permitted to justify predatory realization tactics. Consequently, it is recommended that the second paragraph of art. 423 D.C.C. be amended to expressly reflect this idea. It would then read as follows (suggested modifications are italicized):

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[96]Book IV, art. 304 D.C.C.

[97]Book IV, art. 434 D.C.C. For a discussion of this point in a different context see Payette, *Charge flottante: Privilège de la Couronne et saisie entre les mains du fiduciaire* (1980) 40 R. du B. 337.

[98]Book IV, art. 444 D.C.C.

[99]The list of imperative provisions is set out in Book IV, art. 458 D.C.C.

> If, however, all of such properties or more than one of them are judicially sold, *either concurrently or successively*, and any proceeds are still to be distributed, and if other creditors hold hypothecs on *some one or other, but not all* of such properties seized and sold *the creditor whose hypothec affects more than one immoveable cannot invoke the principle of indivisibility of hypothecs but must divide his hypothec in proportion to the amount of the respective prices which would have been available for payment of his claim.*

Moreover, it is suggested that a third paragraph be added to art. 443 D.C.C. so that the principle of art. 2049 (2) may also be reflected at the time of realization. This third paragraph would be drafted in the following terms:

> If only that property or those properties over which another creditor also holds a hypothec are seized and sold, such other creditor is subrogated in the rights of the creditor whose hypothec affects additional property and may seize and sell this additional property, imputing the proceeds of such sale or sales to the payment of secured claims as if the previous paragraph were applicable.

Conclusion

The basic principle of art. 2049 (2) C.C. is necessary in any sophisticated regime of secured financing. Yet, as this essay has shown, the current view of the provisions of the Civil Code regulating the rights of creditors holding non-coextensive security does not lead to optimism that the courts will readily analogize its principle beyond the specific codal text. While the Court of Appeal in the *Crown Realty* case did attempt to broadly apply the article, in the recent *Central Factors* case, the same Court unanimously declined to apply the principle of art. 2049 (2) C.C. to security over moveable property. Rather, it found the codal text to be exceptional, and therefore meriting a narrow interpretation.[100]

As noted, good arguments can be made for a liberal interpretation of the current article, *Central Factors* notwithstanding; moreover, the Draft Civil Code expressly corrects many of the more obvious defects in the actual text. Nevertheless, the utility of the present article and the proposed codal provision as a mechanism for ensuring equity among creditors holding non-coextensive security is limited by the fact that their underlying conception is one of distribution of proceeds and not also a mechanism of realization. In Part IV various reasons for reformulating the law so as to accomplish both objectives, and a suggested amendment to the Draft Civil Code for this purpose, were offered. It is to be hoped that, within their respective provinces, both judiciary and legislature will ensure that art. 2049 (2) C.C. and its successor promotes the goal of equitably regulating the respective rights of creditors holding non-coextensive security.

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[100]Paradoxically, the actual disposition of the appeal in *Central Factors* can only be justified if the Court were applying some principle analogous to art. 2049 (2) C.C.