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# EXPLOITING THE PLEDGE AS A SECURITY DEVICE

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Article abstract

Plusieurs auteurs soutiennent que le régime québécois des sûretés mobilières présente de graves défauts. En particulier, ils prétendent que les sûretés nécessitant la dépossession du débiteur sont désuètes et inefficaces et qu'il y a lieu d'adopter le plus tôt possible la nouvelle hypothèque mobilière proposée par l'Office de révision du Code civil. Le but de cet article sera d'examiner le bien-fondé de chacune de ces propositions à partir d'une analyse de la sûreté mobilière de droit commun, soit le gage.

Dans une première partie, on approfondira la notion de sureté mobilière selon ses caractéristiques, son utilité économique et ses diverses espèces. Cette étude démontrera non seulement que les prétendus avantages des sûretés réelles pour le développement du commerce sont illusoires, mais aussi que le système québécois n'est ni illogique, ni incohérent. En effet, le principe directeur du régime actuel, selon lequel les sûretés constituent un mode de réglementation économique dont la forme et l'étendue relèvent du législateur et non des parties contractantes, demeure préférable à celui des régimes dits « modernes » des sûretés conventionnelles.

Le deuxième chapitre a trait au régime actuel des nantissements mobiliers. Après un relevé des attributs fondamentaux du gage, les diverses espèces de gage et quasi-gage sont examinées en détail. L'étude expose ensuite les conditions de forme et de fond qui sont propres au gage de droit commun et à son principal sous-type, soit le gage documentaire. La question de possession du créancier fait ici l'objet d'un traitement particulier. Le chapitre se termine par une étude comparative entre le gage et le gage déguisé, ce qui permet d'établir l'étendue et la portée du véritable gage.

Ces deux premiers chapitres mènent à l'évaluation du gage en fonction des avantages que le créancier veut s'attribuer en exigeant une sûreté de son débiteur. Ces avantages sont au nombre de trois : le créancier désire maximiser ses chances d'obtenir de son débiteur et de ses ayants droit le paiement de sa créance (i.e. un droit de satisfaction); il veut obtenir la meilleure préférence vis-à-vis les autres créanciers de son débiteur (i.e. un droit de priorité); il cherche à se protéger contre les agissements frauduleux ou négligents de son débiteur (i.e. un droit de contrôle). L'étude de chacun de ces droits démontre que le gage ordinaire et le gage documentaire offrent à certains créanciers la protection maximale contre les risques d'insolvabilité du débiteur et qu'il y a parfois lieu de préférer ces sûretés au nouveau régime de cessions de biens en stock.

L'essai se termine par un jugement favorable non seulement sur les caractéristiques fondamentales du gage actuel, mais aussi sur les principes directeurs du système québécois des sûretés mobilières. Diverses modifications législatives mineures paraissent souhaitables, ainsi que quelques correctifs jurisprudentiels en matière de gage documentaire, de disposition consensuelle d'un gage, de quasi-hypothèque (nantissements agricoles et commerciaux) et de gages dit « déguisés ». On retrouve en appendice trois espèces-types de contrat de gage.

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by Roderick A. MacDONALD*

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* Dean, Faculty of Law, McGill University. I should like to thank my colleague Ralph L. Simmonds for his helpful comments on earlier drafts of this essay. I also profited from discussions with Me Michel Deschamps of the firm Clarkson, Tétrault. Neither should be held accountable for any views expressed herein.

This study, along with the essays cited in footnotes 13, 30, 31, 37, 88, 231 and 266, will be revised for inclusion in larger work on the law of secured transactions in Quebec.

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## SUMMARY

## INTRODUCTION

One of the most striking features of the general rethinking of commercial law in the post-War period is the absence of empirical research into the nature and effects of security upon moveable property. This absence has often contributed to recommendations for wholesale reforms of the law such as those proposed by the Civil Code Revision Office.[1] It has also led to a deprecation of various traditional forms of security in favor of purely documentary transactions ostensibly designed to facilitate commercial financing.[2] In particular, much contemporary writing about the modernization of security upon moveables assumes the backwardness or archaicness of possessory security instruments.[3]

Recently, however, a revisionist perspective has emerged in the United States. Many authors now suggest that developments such as the Uniform Commercial Code are at best only equivocally justified, and at worst economically inefficient.[4] These observers bring sophisticated micro-economic analysis to bear upon the law of secured transactions, and typically find modern legislative regimes to be

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1. See CIVIL CODE REVISION OFFICE, *Report on the Civil Code*, vol. II, tome 1, 1977, pp 343-376, 425-504, being the commentaries on Book Four, Title Five: "Security on Property" of the Draft Civil Code.

2. See BRIERE, "La propriété mobilière et le commerce", (1958) 18 *R. du B.* 169; BAXTER, "On the Development of Commercial Law", (1964) 24 *R. du B.* 241; ZIEGEL and FELTHAM, "Federal Law and a Uniform Act on Security in Personnal Property", [1966] *Can. Bar J.* 35; AUGER, "Les sûretés réelles et personnelles à travers la jurisprudence récente", [1982] *C. P. du N.* 123.

3. See, for example, LÉGARÉ, "Le Rapport sur les sûretés réelles: un droit futur emballant", (1977) 79 *R. du N.* 433; LEBEL et LEBEL, "Observations sur le Rapport de l'Office de Révision du Code civil sur les sûretés réelles", (1977) 18 *C. de D.* 833; RENAUD, "La cession de biens en stock: deux régimes, deux sûretés de même nature", (1984) 86 *R. du N.* 253, 409, 509; AUGER, "Les sûretés mobilières sans dépossession sur des biens en stock en vertu de la *Loi sur les banques* et du droit québécois", (1983) 14 *R.D.U.S.* 221; PLEAU, "Commentaires sur la *Loi sur les cessions de biens en stock*", [1983] C.P. du N. 269; ZIEGEL and CUMING, "The Modernization of Canadian Personal Property Security Law", (1981) 31 *U.T.L.J.* 249.

4. See SCHWARTZ, "Security Interests and Bankruptcy Priorities: A Review of Current Theories", (1981) 10 *J. Legal Stud.* 1; JACKSON and KRONMAN, "Secured Financing and Priorities Among Creditors", (1979) 88 *Yale L.J.* 1143; BAIRD and JACKSON, "Possession and Ownership: An Examination of the Scope of Article 9", (1983) 35 *Stan. L. Rev.* 175; BAIRD, "Notice Filing and the Problem of Ostensible Ownership", (1983) 12 *J. Legal Stud.* 53; BAIRD and JACKSON, "Information, Uncertainty, and the Transfer of Priority", (1984) 13 *J. Legal Stud.* 299.

regressive. While economic analysis of security devices is in its infancy (and its hypotheses have not been fully tested) this approach suggests at a minimum that the goal of modernizing regimes of security upon moveables need not be pursued exclusively on the model of Article 9 of the Uniform Commercial Code. In fact, if these recent criticisms are valid, it may well be that the continuing reluctance of the Quebec legislator to depart from the basic policy of the Civil Code of 1866 (whether or not this reluctance flows from any conscious economic calculus) has been on the whole beneficial. In any event, the rethinking of developments elsewhere suggests the utility of re-examining the traditional assumptions governing the law of security on moveables in Quebec.

This study undertakes such a re-examination by considering the potential of the ordinary possessory pledge as a security device. Chapter One explores the major characteristics of security on property as well as the economic context of secured transactions, and develops various axes for classifying and evaluating security devices. In a second chapter the general principles of the civil law pledge and its usual variants will be analyzed in order to determine the scope of the true possessory pledge in Quebec. Chapter Three reviews the major uses and advantages of this transaction in the light of modern economic thinking. The study concludes with an overall assessment of the pledge; it recommends three or four minor reforms to Codal texts governing possessory security, and suggests a few areas where existing jurisprudential solutions should be reconsidered. An Appendix reproduces several clauses from pledge agreements currently in use.

## CHAPTER ONE: SECURITY DEVICES IN A MODERN ECONOMY

Because of the general disrepute of traditional security devices, few modern definitions provide much insight into the basic characteristics of security or set into relief the various forms under which a security interest may be created. In common law jurisdictions, for example, security has been defined as: "a transaction whereby a person to whom an obligation is owed by another person called a 'debtor' is afforded in addition to the personal promise of the debtor to discharge the obligation, rights exercisable against some property of the debtor in order to enforce discharge of the obligation."[5] Similar broad definitions usually are given by civil law scholars. The

5. SYKES, *The Law of Securities*, (3d ed., 1978), p. 1.

following is typical: "on appelle sûretés les garanties accordées au créancier contre les risques d'insolvabilité du débiteur."[6]

Of course, in civilian legal theory security devices are further classified as either personal security (*les sûretés personnelles*) or security on property (*les sûretés réelles*).[7] While in Roman legal theory the former was more significant than the latter, today suretyship is little used outside the corporate context (*e.g.* when directors are required to stand surety for loans to closely-held companies). Because, with the exception of the *caution réelle*, suretyship constitutes a right exercisable solely against the overall patrimony of a third party or third parties, it gives a creditor no special claim to identifiable collateral. Moreover, in choosing to bargain only for personal security creditors implicitly are showing no great concern for execution and bankruptcy priorities or rights to control how a debtor deploys his patrimony. For these reasons, suretyship does not exactly correspond to the notion of security developed in contemporary economic literature; that is, to the idea of affecting particular assets by preference to the claim of discrete creditors.[8] Hence, in the discussion which follows the term security will be employed in reference to security on property exclusively.

### A. Characteristics of Security on Property

It is instructive to begin an assessment of the basic characteristics of security on property with a review of civil law doctrinal perspectives. French authors typically assert that the Codal listing of securities is exhaustive: the only types of security interest known to the civil law are the right of retention, the pledge, the privilege and the hypothec.[9] Three main features of security interests are then deduced: (i) security is a right in *another's property*, which gives a creditor (ii) a right of *preference*, and (iii) a right *to follow*.

While these attributes capture the essence of each of the securities listed, from a functional perspective they reflect an inadequate conception of the realm of secured transactions. In the first place, because creditors frequently desire a much greater protec-

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6. The quotation is from WEILL, *Les sûretés*, (Précis, Dalloz, 1979), p. 5.

7. See DAGOG, *Les sûretés*, (Thémis, 1981), pp. 23-26.

8. See, for an overall economic assessment of property regimes, POSNER, *Economic Analysis of Law*, (2nd ed., 1977), pp. 27-64.

9. See MAZEAUD, *Leçons de droit civil*, 5th ed., tome III, volume 1, pp. 6-9. See also BINETTE, "La réalisation des garanties", [1983] *C.P. du N.* 135.

tion of their rights than that afforded by a mere right of preference coupled with a right to follow, they stipulate for a variety of additional covenants to enhance the enforceability of their guarantee against third parties. Second, there are a number of other contractual transactions, typically involving the manipulation of title, which are deployed as security devices. In other words, a functional analysis would suggest not only a lengthier inventory of characteristics of ordinary security devices, but also a greater variety of legal instruments which can be deployed to establish a security interest. These points require brief elaboration.

Modern theorists would assign to a security device (in its most complete form) the following attributes.[10] *First*, to be effective a security interest must be universal; more than a relative claim which is enforceable merely against the debtor, it may be set up against all other parties.[10a] A *second* attribute of the security interest is that it is an accessory right. Because it has no validity apart from guaranteeing another obligation, the rights it gives to a creditor cannot be interpreted as being only alternative to that obligation.[11] A *third* important feature of security is that it should give its titulary a realization priority. While classical civil law theory would limit this priority to a preference in the proceeds of a judicial sale and to a preferential distribution by a trustee in bankruptcy, economists would argue for extending this priority even to non-judicial realizations.[11a] Yet another characteristic of security is, *fourth*, that the creditor obtains rights in property which permit him to monitor and control the manner in which the debtor uses or otherwise deals with the security.[12] A *fifth* and final attribute of an effective security interest is

10. See BAIRD and JACKSON, *Cases and Materials on Security Interests in Personal Property*, (1984), pp. 1-3; 354-67; SCHWARTZ and SCOTT, *Commercial Transactions: Principles and Policies*, (1982), pp. 507-509; 556-568.

10a. In this sense, a true security interest in the civil law must necessarily be a real right. See GHESTIN, *Traité de droit civil: Introduction générale*, (1980), Tome I, pp. 167-181.

11. It is the feature of a security interest which preserves a creditor's deficiency claim. Compare articles 1093-1099 C.C. with articles 1972, 1975 and 1976 C.C. See also SYKES, *op. cit.*, note 5, 1-25.

11a. See notably, JACKSON, "Avoiding Powers in Bankruptcy", (1984) 36 *Stan L. Rev.* 725; EISENBERG, "Bankruptcy Law in Perspective", (1981) 28 *U.C.L.A. L. Rev.* 953; JACKSON, "Bankruptcy, Non-bankruptcy Priorities and the Creditors' Bargain", (1982) 91 *Yale L. J.* 857; McCOID, "Bankruptcy, Preferences and Efficiency: An Expression of Doubt", (1981) 67 *Va. L. Rev.* 249.

12. See LEVMORE, "Monitors and Freeriders in Commercial and Corporate Settings", (1983) 92 *Yale L.J.* 49; JACKSON and KRONMAN, *loc. cit.*, note 4.

the creditor's right to insist upon consensual or private enforcement. That is, the creditor himself should be permitted to determine default without obtaining judicial confirmation; he should be entitled to seize and to enter into possession of the object of his security without a judicial order; and he should be authorized to dispose privately of his guarantee by any means whatever without the assistance of the sheriff.[12a]

It is obvious that many so-called security devices lack some one or other of these characteristics. In fact, none of the four Codal security interests noted above is possessed of all these attributes. For example, the right of retention does not permit private enforcement (except as regards jewellers, carriers and hoteliers); again, the pledgee has only a limited right to assert a priority in any non-judicial realization; the privilege gives the creditor no right to monitor which is superior to that of ordinary creditors vested with Paulian or oblique actions; and the hypothec does not allow for non-judicial taking of possession and private realization. Of course, it is precisely to overcome these limitations that many contractual adjustments (*e.g.* the giving-in-payment clause in hypothecary deeds and the *pacte commissoire* in deeds of pledge) have been engrafted onto existing security instruments. To understand the first inadequacy of the classical conception of security, therefore, it is only necessary to note the extent to which creditors contractually manipulate title to the object of their guarantee in order to amplify their rights.

This conventional manipulation of title suggests a second deficiency in traditional views of security devices. Restrictive enumerations fail to account for the variety of possessory rights, title transactions, and rights of private realization which may be stipulated for by contract outside the framework of Codal security instruments.[13] On this point the analysis of the Civil Code Revision Office is quite helpful. Simply because a particular legal transaction does not describe itself as a security does not mean that it cannot have the effect of generating a security interest. Today, devices such as the conditional sale, the sale with a lease back, the right of redemption, the resolutory condition, the financial lease and the usufruct with charges often are deployed as security instruments. In other words, it

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12a. For an inventory of these creditor rights, see ZIEGEL and GEVA, *Commercial and Consumer Transactions*, (1981), c. 24.

13. For an attempt at an exhaustive listing see MacDONALD, "Privileges and Other Preferences Upon Moveables in Quebec: Their Impact Upon the Rights and Recourses of Execution Creditors", *in* GERTNER and SPRINGMAN, eds., *Essays on Debtor-Creditor Law in Canada*, (1985), chapter 7.

is functionally irrelevant whether a creditor obtains a guarantee by being able to assert rights in his debtor's property, or whether he secures his claim by stipulating for a right of ownership himself.

If the traditional doctrinal characterization of security devices is inadequate because it neither accounts for the full panoply of prerogatives which a creditor seeks to marshall when taking security, nor captures the variety of legal devices apart from rights of retention, pledge, privilege or hypothec by which these prerogatives may be gained, nevertheless it does focus attention on two of the main attributes of a security interest: the property right and the priority right. Moreover, this civil law perspective suggests that, notwithstanding the modern elaboration of five basic features of a security interest, there are really only three broad analytical criteria which need be deployed in evaluating any legal institution which is intended to function as a security device: (i) *satisfaction* — a secured creditor desires the most expeditious remedies for realizing against his debtor upon default; (ii) *priority* — a secured creditor wants to obtain rights opposable to third parties, and to be paid by preference upon realization; (iii) *control* — a secured creditor seeks to maximize his rights by closely policing (or monitoring) how his debtor deals with and disposes of the secured collateral.

As a positive thesis one may observe that the utility of any given security device to any given creditor can be assessed according to the particular mix of these rights and recourses he seeks to achieve. As a normative thesis it follows that whenever the law attaches differing consequences to security instruments, the creditor will determine (to the extent the law permits him to choose) which security to demand from his debtor on the basis of these three criteria.[14]

### B. The Economic Context of Secured Financing

Civil law doctrine to date has not been especially concerned with developing a comprehensive economic analysis of secured financing. That is, despite the Code's treatment of security as an aspect of patrimony (or property), usually authors are content to advance a variety of empirically unverified *inter partes* (or contractual) explanations for the existence of security devices. They assert, first, that security either enables high-risk debtors to obtain access to credit they otherwise would not have, or permits trustworthy debtors to

14. See SAUVEPLANE, "Introduction" and SAUVEPLANE, "Title to Goods", *in* SAUVEPLANE, ed., *Security Over Corporeal Moveables*, (1974), pp. 3-6 and 9-21 for an early suggestion to this effect.

benefit from preferential interest rates. Second, they claim that creditors take security because it gives them better protection in the event of their debtor's default.[15] To these general "economic" justifications for the existence of all regimes of secured financing, authors often add a panoply of "moral" explanations of dubious validity for individual preferences. For example, certain commentators argue that the privilege for funeral expenses or for expenses of the last illness is given for the purpose of maintaining public sanitation; or that rights of retention and the vendor's privilege are merited because the preferred creditor either preserves the existing value, or increases the value of the debtor's patrimony.[16]

By contrast, most modern American commentary begins with a micro-economic claim: the only real justification for secured transactions ought to be empirically demonstrable economic efficiency.[17] There are two facets to this efficiency standard: an internal (or positive or *inter partes*) dimension and an external (or normative or third party) dimension. The internal analysis parallels that advanced in contemporary civil law literature. The well-informed creditor takes security because he hopes to enhance his chances of obtaining satisfaction should his debtor default, and because he hopes to maximize his priority position in any bankruptcy distribution of his debtor's assets. For his part, the efficient debtor will avail himself of secured credit whenever this permits him to obtain a preferential interest rate or otherwise to reduce his cost of borrowing (*e.g.* by negotiating favourable repayment terms).

Let us assume for the moment that the internal explanation of the economics of secured transactions is valid. It would follow that the wise legislator should establish a legal regime to promote the low-cost granting and taking of security. Ideally, such a regime would make it possible for a secured creditor (i) to obtain accurate information about the status of property to be secured, (ii) to complete easily the necessary documentation for such a transaction, and (iii) to enforce his security agreement as cheaply as possible. The

15. See MAZEAUD, *op. cit.*, note 9, 4-5.

16. See, for example, DESLAURIERS and POUDRIER-LEBEL, *Les sûretés: notes de cours*, (1979), pp. 107-138. See also LEMAY and ROY, "Privilèges Immobiliers", *in C.F.P.B.Q.*, tome 6, 1982, p. 117, and CIOTOLA, *Droit des sûretés*, (1984), pp. 159-160.

17. For a detailed exposition see SCHWARTZ, *loc. cit.*, note 4. This thesis also underlies Jackson's discussion of the powers of a trustee in bankruptcy. See JACKSON, *loc. cit.*, note 11a.

reason for enacting such a regime is simple. If the transaction costs of taking security can be reduced to a minimum, so can the additional interest required by the creditor to pay for the cost of granting and policing his loan. It is precisely this kind of "efficient credit market" reasoning that justifies calls to modernize, rationalize and computerize the Quebec regime of security on moveable property.[18]

But as with conventional civil law explanations, these internal (or positive or *inter partes*) justifications rest on untested hypotheses about market influences upon the cost of credit. There is currently no data which demonstrates that the availability of security actually results in significant reductions to most borrowers' interest costs. In fact, some U.S. studies suggest that the existence or non-existence of security, or the relative efficiency of security devices has no measurable impact of the cost of commercial credit.[19] More importantly, the "efficient credit market" explanations for secured transactions are suspect from an external (or normative or third party) perspective because they presuppose the most important question of all: namely, is a system of secured credit itself socially and economically optimal when the interest of all debtors and creditors is weighed?

To resolve this larger question it is necessary to consider the effect of secured credit upon the cost of a debtor's unsecured credit. Proponents of secured credit usually claim that the gains to debtors and secured creditors from the granting of additional credit exceed the sum of the costs of maintaining a legal regime of secured credit plus the costs that security imposes on unsecured creditors. These latter costs are the converse of the gains security creates for the secured creditors: security means that unsecured creditors realize less than they might otherwise in the event of their debtor's default.

There is a lengthy literature in the United States on whether in a market of perfect information the availability of secured credit actually reduces the overall cost of money for debtors. Most analyses conclude that, in such a market, security has no beneficial impact on the total cost of credit. Whatever reduction in interest is offered by secured creditors is more than compensated by increases in the cost of credit advanced by knowledgeable unsecured creditors. Only where some creditors are operating with imperfect information will

18. See the comments in CARON, "L'article 9 du Code Uniforme de commerce peut-il être exporté?", *in* ZIEGEL and FOSTER, eds, *Aspects of Comparative Commercial Law*, (1969), pp. 374 *et seq*.

19. See VAN HORNE, *Financial Management and Policy*, (5th ed., 1980), pp. 487-523.

security reduce the debtor's total cost of money, but it does so by redistributing wealth from uninformed creditors (who fail to increase the cost of the credit they extend) to debtors and informed creditors.[20]

The reasons for these two conclusions can be explored in short compass. One may begin by identifying who are a debtor's creditors. In a commercial context, these would be: (i) general financers; (ii) sellers and trade creditors; (iii) buyers and customers who have given deposits, or who have purchased service contracts, or who may have warranty claims against a manufacturer or retailer; (iv) employees who have claims for their wages and other employment benefits; (v) delict claimants either asserting product liability claims (*e.g.* for latent defects) or seeking compensation for non-product related damages (*e.g.* for pollution or nuisance); and (vi) the state, for taxes, pension levies, workmen's compensation assessments and so on.[21]

Taking first the hypothesis of a perfect information market, it is doubtful that the aggregate cost of a debtor's credit will be reduced if some of his creditors are secured. First, it costs money to issue secured debt. Because of these transactions and monitoring costs it follows that the secured creditor will not give the debtor the full benefit of the interest reduction which the market would otherwise dictate. Second, by issuing secured debt the borrower reduces his ability to borrow further, to sell his assets or otherwise conduct his business in the way he deems most efficient. That is, he suffers a net efficiency loss independently of the cost of money. Third, it is unlikely that secured credit reduces the monitoring costs of unsecured creditors sufficiently to enable them to offer significantly lower interest rates. Even though the creditor who has an interest in specified property will pay closer attention to what the debtor is doing with that property and therefore reduce the monitoring costs for other creditors who may be unsecured, the cost reductions flowing from such freeriding are probably not even sufficient to cover the transaction costs of issuing secured debt.[22]

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20. See SCOTT, "Bankruptcy, Secured Debt and Optimal Capital Structure", (1977) 32 *Journal of Finance* 1.

21. See BAIRD and JACKSON, *op. cit.*, note 10, 354-367. See also BAIRD and JACKSON, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy", (1984) 51 *U. Chi. L. Rev.* 97 for a discussion of the rights of tort claimants. In a non-corporate situation in Quebec one might also add alimentary creditors.

22. See LEVMORE, *loc. cit.*, note 12.

Nevertheless, when not all creditors are operating with perfect information, secured credit may well produce lower overall interest costs for debtors. In other words, secured credit may be efficient only because it exploits uninformed, unsecured creditors who are either unaware of secured debt or unable to adjust their own credit costs in consequence. Two examples will illustrate the point. Under conditions of perfect information one would expect employees of firms issuing secured debt to demand higher wages since their chances of recovering wages, severence pay and other lost opportunity costs in the event of bankruptcy would be reduced. One would also expect customers who purchase warranted goods to demand a lower price from firms issuing secured debt in order to compensate for their reduced chances of obtaining warrantee satisfaction upon their seller's bankruptcy. Usually, however, neither employees nor customers are able to adjust their contractual demands to compensate for secured credit. (*A fortiori*, neither are delict claimants nor the state, whose claims cannot be negotiated.) In consequence, the secured creditor and debtor simply split between them the reduced "cost of credit" benefit expropriated from employees and customers.[23] From the external (or normative or third party) perspective, therefore, any efficiency gains resulting from secured credit do not occur because secured transactions are themselves economically efficient.[24]

If modern micro-economic analysis are correct, and if, as a result, a system of secured financing always exploits unsecured creditors, the major premise underlying modern developments in the law of secured transactions (*i.e.* the "efficient credit market" hypothesis) is a chimera. That is, even if on efficiency grounds it may be argued that computerized regimes are preferable (*i.e.* they reduce transaction costs)[24a] it is far from obvious either that the new

23. See SCHWARTZ and SCOTT, *op. cit.*, note 10, 565-578.

24. It may be argued that employees and customers base all their credit decisions on the premise that their employer or seller has issued secured debt. But if this is so, then the debtor who does not issue secured debt (and many do not) will be paying a premium to unsecured creditors for a benefit he doesn't obtain. On this explanation, the mere possibility of secured debt automatically increases a borrower's cost of money. Once again secured debt is shown to be inefficient. See *ibid.*, 575-578.

24a. Serious doubts even on this point are beginning to emerge in Canada. See, for an analysis of recent amendments as well as for further reform proposals, CUMING, "Second Generation Personal Property Security Legislation in Canada", (1982) 46 *Sask. L. Rev.* 5; CUMING, "Modernization of Personal Property Security Registries: Some Old Problems Solved and Some New Ones Created", (1983-84) 48 *Sask. L. Rev.* 189; *Report of the Minister's Advisory*

"Transfer of Property in Stock" legislation should be welcomed or that the agenda of the Civil Code Revision Office ought to be embraced. Given the external dimension of secured credit, the traditional Codal limitations on security over moveables (which restrict the class of creditors who may take security and which impose constraints upon an ordinary debtor's capacity to give security) may well be both economically and morally more justifiable. For they at least have the virtue of acknowledging the important social interest in regimes of secured transactions, and of regulating the extent to which contractual freedom between the debtor and one of his creditors may be invoked to the detriment of all other creditors.[25]

### C. Axes for Classifying Security Devices

To this point, the question of how a legislature ought to structure various security instruments has not been canvassed directly. Yet, to understand the special features of divergent security devices and to analyze the economic utility of each is a prerequisite to developing a general theory of how possessory security may be best deployed in a modern commercial economy. There are four major policy axes for assessing legislative choice. These concern: (i) the origin of the security; (ii) the scope of the security; (iii) the theory of priorities; and (iv) the property and possessory rights of parties to the transaction.

A first axis sets into relief the question whether or not debtors and creditors should be free to stipulate contractually for a security device and if so, under what restrictions.[26] Consensual security arises when debtors and creditors bargain for the existence of a security relating to their obligation. In the civil law, the classic examples of consensual security would be the pledge in moveable property and the hypothec in immoveable property. By contrast, non-consensual security is that which arises solely by virtue of some disposition of the law. While the privilege is usually seen as the paradigm case of a non-consensual security it is, however, a somewhat misleading example. Some privileges are merely priorities for payment and do

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*Committee on the Personal Property Security Act*, (Ontario Ministry of Consumer and Commercial Relations, 1984).

25. For a discussion of the regulatory effect of private law ordering regimes see MacDONALD, *Regulation by Regulations*, (1984), a paper prepared for the Royal Commission on the Economic Union and Development Prospects for Canada.

26. See WHITE ad SUMMERS, *Uniform Commercial Code*, (2d ed., 1980), pp. 1-21.

not constitute true security devices. Nevertheless, by virtue of other rights associated with the privilege (namely the right of revendication and the right of retention), the claims of the unpaid vendor and the retention creditor can be seen as examples of legally imposed security interests. A similar conclusion is indicated in respect of various statutory trusts and other rights of preemption in favour of the state.[27] Determining the appropriate domain for consensual and legal security and developing a principle for integrating the two continues to be a fundamental policy issue even in "modern" legislative regimes.

A second axis would be one which distinguishes security devices according to their scope. Here one is concerned to determine how extensive a creditor's interference in a debtor's patrimony is to be.[28] The most elementary type of security interest would be that which attaches only to the original corporeal property made subject to it; the seller's right to revendicate can only be exercised against property still lying untransformed in the hands of the buyer. By contrast, some security is structured so as to survive the manufacture or other transformation of the property, as long as it remains corporeal and identifiable; the commercial pledge remains valid even if an object is immobilized by destination. Further, the law permits certain security interests to continue even when property is sold to a third party; the right of retention may be opposed to both the debtor and to all third parties. Lastly, many modern security mechanisms survive both factual and judicial transformation of the asset base; the right of the transferee of property-in-stock passes into insurance proceeds, into proceeds of sale and into replacement property. The extent of a creditor's rights over subject collateral is, consequently, a major issue confronting analysts of secured transactions.[29]

Yet another dimension along which types of security can be located relates to the nature of the priority afforded to the creditor and the basis upon which it is determined.[30] Many different priority

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27. One might also add separation of patrimonies, the wife's veto under certain community of property regimes, and the judicial and legal hypothec as other examples of non-consensual security.

28. See the discussion in LeDAIN, "Security Upon Moveable Property in the Province of Quebec", (1956) 2 *McGill L.J.* 77, 77-79.

29. To a certain degree, classical civil law doctrine undertakes this analysis in asking whether certain security interests such as the privilege are real rights and whether they permit of real subrogation. See MAZEAUD, *op. cit.*, note 9, 150-154.

30. On the question of priority regimes in general see MacDONALD and SIMMONDS, "The Financing of Moveables: Law Reform in Quebec and

schemes can be envisioned. For example, one might decide no more than that all secured creditors should rank *pari passu* above all unsecured creditors. Or, one might argue that priority should be determined uniquely by a legal ordering or ranking such as that enacted in articles 1984-1985 C.C. Or, one might well take the position that a regime of secured credit should rest on temporal priority principles, or even upon temporal principles subject to possible exceptions for vendors' claims and other purchase money security. Finally, one might claim that a creditor should be able to bargain freely for his relative priority position (insofar as this does not affect already acquired rights) without fear that subsequent creditors might obtain higher or *pari passu* priority. Deciding what type of priority regime should be enacted, and integrating the various rights of competing creditors is yet another key challenge for policy-makers.[31]

A final rubric for classifying security devices concerns the assignment of property and possessory rights among the various parties to the transaction.[32] On this classification, most security interests can be grouped under one of three categories —(i) mortgage (or title) transactions, (ii) possessory securities, and (iii) hypothecations (or charges) — categories which correspond roughly to the Roman Law transactions of *fiducia*, *pignus*, and *hypotheca*. The Roman security *fiducia* contemplated the transfer of property to the creditor who then assumed an obligation (resting on contract only) to retransfer the object to the debtor upon full repayment of the debt. Thus, the creditor obtained both possession and an unencumbered right of *dominium* which was not tied to any default by the debtor. By contrast, in an agreement of *pignus* the debtor did not transfer to the creditor the sum total of proprietary rights comprehended under the term ownership, but merely his right of possession. The pledgor, consequently, retained the residue of proprietary rights and had *dominium*. Under the third type of security, *hypotheca*, a property right was appropriated to the creditor so that upon default he would be entitled to pursue certain remedies against the property and not merely against the debtor, who again retained *dominium*. But while

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Ontario", (1980) 11 *R.D.U.S.* 47, revised and reprinted in [1981] *Meredith Memorial Lectures* 246.

31. It is worth observing that with the advent of Bill 97 Quebec now has enacted competing priority regimes, one temporal and one based on the nature of the creditor's claim. See MacDONALD, "Inventory Financing in Quebec After Bill 97", (1984) 9 *C.B.L.J.* 153, 171-178.

32. See SYKES, *op. cit.*, note 5, 12-17.

these hypothecary remedies were not dependent upon the creditor going into possession, they could only be exercised in the event of default. Today, the arrangement of these two rights — title and possession — is at the centre of the major policy conflicts in the law, and remains the principal doctrinal criterion for identifying one or another type of security interest.[33]

Assessing current law along these four axes not only suggests how various contemporary security devices were originated, but also highlights the policy choices reflected in the Civil Code of 1866. In this sense these axes illustrate why courts have struggled when creditors and debtors deploy various ruses to establish parallel regimes of secured transactions. For example, the use of conditional sales and leases to avoid the basic rules of articles 1980-1982 C.C. confronts courts with the dilemma of determining the range of consensual security; the use of title transactions to preserve a creditor's rights as against third parties raises the problem of scope and fungibility of security (*subrogation réelle*); the stipulation of negative pledge covenants is an assault on the "nature of the claim" priority rules of articles 1984-1985 C.C.; and the use of double sales, sales with leaseback, consignments and sales with a right of redemption compels courts to determine whether article 2022 C.C. prohibits only hypothecation of moveables (*hypotheca*) or whether it also prohibits the mortgaging of moveables (*fiducia*).

Today it is more difficult to discern a coherent theory of secured transactions. As the underlying policy of the 1866 Code has suffered successive attacks by way of the *Special Corporate Powers Act*, the agricultural, forestry and commercial pledges, the assignment of a universality of book debts, financial leasing, and most recently, the transfer of property-in-stock, it is perhaps worth asking whether the traditional rules which reflect that underlying policy merit retention. In other words, given the multiplicity of security interests, their diverse origins, their varying scope, their competing priority regimes, and their non-uniform allocation of debtor and creditor rights, ought the legislature simply to acknowledge that its exceptions have swallowed up its rules, and modify those rules?

Subsidiarily, one might wonder whether courts ought to reassess their attitude towards the various parallel contractual security regimes so as to bring it into line with the evolving policy which recent legislative initiative witnesses. To put the issue bluntly, ought Quebec to abandon piecemeal tinkering with the law, and explicitly acknow-

33. For a modern civil law analysis of these archetypes, see DAGOT, *op. cit.*, note 7, 68-268, especially pages 248-268.

ledge the inevitability of a uniform, universal, non-possessory consensual security interest in moveables?

### D. The Place of the Pledge in the Civil Law

When viewed from the perspective of the various rights and prerogatives which creditors seek to monopolize when taking security, from the perspective of micro-economic theory, and from the perspective of the underlying policy choices which ought to be present in a legislature's mind as it elaborates a regime of security on moveable property, the current system in Quebec is neither as archaic nor chaotic as often believed. To be sure, certain contemporary criticisms are well-founded.[34] Many non-consensual privileges such as those for tithes, funeral expenses, expenses of the last illness, and mutual fire insurance companies are ripe for abolition. Again, certain rights of retention (*e.g.* that given to circus and theatrical workers) have outlived their use. Further, an argument can be made for abolishing the lessor's privilege outright. Finally, there is room for rationalizing and consolidating the law relating to Crown tax claims and other statutory privileges. But none of these criticisms goes to the fundamental policy choices and assumptions of the Civil Code itself. Moreover, none meets the challenge of modern micro-economic analysis, in that none addresses the question whether the law should facilitate all forms of secured lending to the detriment of unsecured creditors.

In attempting to evaluate the current legal regime of security on moveable property in Quebec it is worth restating at the outset the obvious point that a legal system has purposed other than merely giving debtors and creditors what they apparently want. Thirty years ago, addressing this issue, LeDain noted:

> Most creditors understandably share one weakness, and that is the desire to be secured against the failure or incapacity of their debtor to pay what he owes them at due date. It is the task of law, not merely in the interest of equity and justice, but of commerce itself, to determine which creditors shall enjoy this favour and under what conditions, and what shall be the order of preference among them. The free flow of commerce requires not only that certain persons or institutions be encouraged to extend credit by the guarantee which they are able to obtain of being paid, but that the ordinary unsecured creditor should not be driven from the field by the unreasonable extent to which others have by law or contract been given a preference over him..Among the considerations which must influence the legislator are the types of credit to be encouraged, the protection to be given to the creditor, the debtor and third persons, and the

34. See the *Report of the Civil Code Revision Office*, *supra*, note 1, 343-376.

practical necessities of daily life and trade which will determine the kind of collateral offered and the appropriate security device for giving it.[35]

Bearing in mind, then, that any regime of secured transactions is a reflection of public regulatory choices,[36] what are the distributive goals inherent in the Quebec Civil Code and how do they bear upon the role which the ordinary pledge has been assigned to play?[37] Four such goals may be identified. To begin with, the Code discourages long term general financing on the security of moveable property except in very limited conditions, and subject to quite moderate priority and property benefits.[38] A second premise is that any departures from the rule of *pari passu* distribution of a debtor's assets should be authorized by the legislator and not imposed by creditors.[39] Yet another policy is reflected in the judgment that as between a regime of absolutism of ownership and freedom of contract, the protection of alienability and owner *dominium* over moveables should be paramount.[40] Fourth, the Code is organized on the assumption that it should not be left to individual creditors acting in their private interest to obtain satisfaction of their security.[41]

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35. LeDAIN, *loc. cit.*, note 28, 77. See also GOODE, "Is the Law Too Favourable to Secured Creditors?", (1983) 8 *C.B.L.J.* 53.

36. A powerful statement of this thesis may be found in CALABRESI and MELAMED, "Property Rules, Liability Rules and Inalienability: One View of the Cathedral", (1972) 85 *Harv. L. Rev.* 1089, who argue that the only non-regulatory social rule is "might makes right". Any other rule (including "freedom of contract") must be legislatively imposed, and is a regulatory choice.

37. For an outline and critique of these assumptions see MacDONALD and SIMMONDS, *loc. cit.*, note 30, 249-252. A revised view may be found in MacDONALD, "Modernization: What Next?", an address delivered to the *Annual Workshop on Consumer and Commercial Law*, on October 20, 1984 and to be published in the proceedings of that Workshop.

38. The limited class of debtors who may give whole-undertaking security, the restricted rights of the trustee for bondholders and his last-ranking privilege are clear evidence of this policy.

39. Only the regime of transfers of property-in-stock substitutes a contractual priority system (*i.e.* the first in time rule) for a nature of the claim priority system where moveables are concerned.

40. This policy can be seen in the courts' reluctance to accept disguised chattel mortgages and in their insistence that negative pledge covenants cannot be set up against third parties. It is also apparent in their hesitation to accept the creation of contractual accessory real rights.

41. To date only special pledgees, the trustee for bondholders and the transferee of property-in-stock have been given private realization rights. But note the possibility of the ordinary pledgee stipulating a *pacte commissoire*.

These choices are evident in the various Codal articles which set out the fundamental structure of property rights in moveables. The most important provisions are: (i) article 2268(1) C.C. which states that actual possession of a corporeal moveable creates a presumption of lawful title; (ii) articles 1980-82 C.C. which limit the kinds of preference obtainable by creditors; (iii) article 2022 C.C. which prohibits the hypothecation of moveables; (iv) articles 1966 and 1970 C.C. which require debtor dispossession in contracts of pledge; (v) article 1971(1) C.C. which does not permit private creditor realization in ordinary pledge contracts; (vi) article 1972 C.C. which makes the pledge creditor a depositary of the pledgor; and (vii) article 1027(2) C.C. which permits a seller in possession to pass good title to a second purchaser to whom he delivers the objects sold. In combination these rules operate so as to afford the possessory pledge a central role in the Quebec law of security on moveable property. They also suggest as a corollary that any exceptions to the regime of the ordinary pledge (*e.g.* no dispossession in commercial pledge; title transactions; contractual priorities for transferees of property-in-stock) should be strictly construed.

The centrality of the ordinary pledge is, for many commentators, the single most important defect in the current law.[42] Their critique is based on three perceived "disadvantages" of the pledge, which serve to limit its usefulness as a security device. First, they claim that it may be inconvenient or impossible for the debtor to give up possession of the object over which he proposes to grant security: he may need the object to earn his livelihood; it may be a revenue producing asset such as a bond; or he may require the collateral for manufacture and resale. Second, critics argue that the creditor should not be forced to take on responsibility for caring for the object pledged to him: he may not have the warehousing facilities necessary to store the collateral safely; or he may not have the expertise to keep the object in a good state of repair. A third disadvantage of the pledge is thought to reside in the fact that the creditor in possession may exploit his possession in an abusive manner: he may himself use the object; he may skim off the fruits produced by the collateral; or he may simply expropriate it to his own use in payment.[43]

While these features of the pledge do in fact serve as a brake on certain forms of secured lending, because they often make the granting of security inconvenient, other commentators suggest that

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42. A representative criticism may be found in CARON, *loc. cit.*, note 18.

43. See DAGOT, *op. cit.*, note 7, 105-109.

this result is not undesirable. In their view, the restrictive rules of the pledge should not be understood simply as haphazard obstacles to be overcome. Rather they should be seen as a reflection of carefully developed criteria for determining which classes of creditor should be permitted to take security and underwhat conditions.[44] This point requires further development.

The universe of persons issuing secured debt may be divided roughly into four main sets: the consumer borrower; the consumer purchaser; commercial purchasers and borrowers — typically manufacturers, wholesalers and retailers; and primary producers, including farmers.[45] It is apparent that certain types of debtor will be better able to exploit the pledge than others; chattel paper, securities and insurance policies are easily pledged by a commercial borrower; farmers have no such luxury with their cows; nor most wholesalers with their inventory; nor consumers with automobiles and other durables. What is more, the entire regime of secured financing in Quebec (including various non-Codal securities and title transactions) clearly favours certain classes of borrowers.

Viewed in a larger perspective, the legislature's substantive policy choices about the availability of secured credit are easily divined. Credit secured upon moveable property is to be available only (i) where the debtor is willing to tolerate a loss of use over the object given in security and the creditor is willing to take actual possession of it; or (ii) where the relationship of debtor and creditor is one of vendor/purchaser and an unpaid vendor's lien is asserted or a title transaction is feasible; or (iii) where the businesses of the debtor and creditor are such that they may avail themselves of one of the many special regimes such as the financial lease, the commercial pledge, the security under the *Bank Act*, the trust for bondholders under the *Special Corporate Powers Act*, the general assignment of accounts receivable and, latterly, the transfer of property in stock under the *Bills of Lading Act*; or (iv) where debtor and creditor have the financial resources and expertise to exploit a non-standard form of possessory pledge such as the documentary pledge.

The first and fourth of these types of security device will be the focus of this study. For they reflect (in their various legal and contractual permutations) not only the basic economic wisdom of the

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44. GOODE, *loc. cit.*, note 35, draws a slightly different conclusion about the desireability of these obstacles.

45. This list is derived from LeDAIN, *loc. cit.*, note 28, 85.

current Quebec regime of security over moveable property, but also the flexibility of the pledge as a specialized security device giving selected creditors the optimal mix of satisfaction, priority and control rights.[46] In other words, even in modern computerized regimes a significant role is still played by possessory security instruments.[47] The nature and characteristics of the pledge, as well as its most usual forms and variations, will be reviewed in the next chapter. Subsequently, modern commercial uses of the pledge will be worked out around the themes of satisfaction, priority and control.

## CHAPTER TWO: THE LEGAL REGIME OF THE PLEDGE

If it is true that the pledge type transaction[48] is the only consensual security device over moveables available for non-vendor secured financing in Quebec,[49] it is also true that it is a juridical device of many different forms. Although at an abstract, theoretical level the nature and characteristics of the pledge appear to be uniform, because of the different kinds of property which may be pledged (moveables, immoveables; corporeals, incorporeals; consumeables, non-consumeables) there are various permutations to its mode of constitution and its mode of enforcement. Moreover, as a result of the prohibition of article 2022 C.C., whenever the legislature wished in the past to establish a new type of security over moveables, it did so by analogy to the pledge. Hence, in some of its modern nominate forms, the pledge transaction has become in reality no longer a pledge, but rather a mortgage (*fiducia*) or a hypothecation (*hypotheca*). It is, therefore, important to review the nature and attributes of the pledge as a preliminary to investigating the diverse forms and exact limits of the possessory pledge.

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46. For a detailed treatment of these issues in the common law see GILMORE, *Security Interests in Personal Property*, volume 1, (1965), Chapter 14.

47. See SCHWARTZ and SCOTT, *op. cit.*, note 10, 716-767.

48. The expression pledge-type transaction refers to any arrangement where the debtor retains ownership and the creditor obtains actual or notional possession of the collateral. See WEILL, *op. cit.*, note 6, 1-8; 74-77.

49. The use of non-pledge transactions such as the double sale, sale-leaseback and financial lease mechanisms, while now available to lenders under certain conditions, will not be considered directly. But see *infra*, Chapter Two, Section D.

### A. The Nature and Attributes of the Pledge

The basic elements of the pledge can be derived from article 1966 of the Civil Code, which states in its first paragraph:

> Pledge is a contract by which a thing is placed in the hands of a creditor, or, being already in his possession, is retained by him with the owner's consent, in security for his debt.

This codal definition suggests five essential features of the pledge: it is a security device; it has a contractual foundation; it is a real contract; it is a unilateral contract; and it is an accessory agreement.[50]

To note that the pledge is a true security is to draw attention to the fact that it presupposes a division of the prerogatives of ownership between debtor and creditor. By contrast with a mere privilege or execution priority, a security interest implies (regardless of where ownership is vested) that both debtor and creditor have real rights in the secured collateral.[51] Two important practical consequences flow from this attribute of the pledge. First, both debtor and creditor may bring actions in revendication against third parties and both may protect their rights by means of an opposition to seizure. Second, both may assign or otherwise transfer their rights to third parties who may then exercise the assigned rights directly upon the pledged assets.

The pledge is also a conventional security mechanism. Examples of non-conventional pledge arise only by exception — notably under article 1963 C.C. which permits the pledge of assets where a judicial surety is required but cannot be found. In all other cases, the constitution of a pledge presupposes an agreement between debtor and creditor to create the pledge. This feature of the pledge permits it to be contrasted with a somewhat analogous possessory institution, the right of retention, which is a security interest arising solely by operation of law.[52] The contractual foundation of the pledge also means that there cannot be a tacit or implied pledge: a creditor put into possession under some other contract cannot unilaterally intervert his possession into that of a pledgee.[53]

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50. See MAZEAUD, *op. cit.*, note 9, 69.
51. See *Chamandy* v. *LeBlanc*, [1977] C.S. 176.
52. See MAZEAUD, *op. cit.*, note 9, 118.
53. Some argue that the continuation of a pledge under article 1975(2) C.C. is an implied pledge. See MAZEAUD, *op. cit.*, note 9, 83. But this result probably flows more from the indivisible character of the pledge rather than from a tacit pledge. Compare MIGNAULT, *Droit Civil Canadien*, tome 8, p. 411 who

A third attribute of the pledge is that, unlike sale, it is a real contract: the simple meeting of minds between parties is insufficient to establish a pledge. It follows that if the debtor never remits the collateral to the creditor, no rights opposable to third parties can arise. Even though the creditor would be entitled to compel delivery of the pledge *corpus* by means of an action in revendication or an interim injunction taken against the promising pledgor, the agreement itself remains a mere "promise of pledge".[54] A further consequence of the real nature of the pledge is that property not actually capable of being put into the hands of a creditor cannot be pledged. Hence, future property and intellectual property not yet patented, copyrighted or registered as a trade mark can only be made the object of a promise of pledge.[55]

The pledge is also a unilateral contract. Once the debtor has remitted the object pledged to the creditor he has discharged all his obligations under the contract. The only subsisting obligation is that assumed by the pledgee to preserve the object and to return it to the debtor once the latter has fulfilled the principal obligation which the pledge secures.[56] Nevertheless, in view of the pledgor's obligation to pay the creditor's expenses under article 1973 C.C. certain authors view the pledge as an imperfect synallagmatic contract.[57] This position is highly debatable, however, since the pledgor's obligation to repay is not the concomitant of the creditor's duty to take possession of the object pledged; it flows from the additional obligation imposed upon the creditor under articles 1972 and 1973(1)

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considers the rule of article 1975(2) C.C. to create not a new pledge, but rather a mere continuing right of retention for the pledgee. For early cases denying the possibility of a tacit pledge see: *Thompson* v. *LaPierre*, (1934) 72 C.S. 460; *Savard* v. *Schwartz*, (1938) 64 B.R. 479. See *infra*, Chapter Two, Section C.

54. *Savard* v. *Tremblay*, (1906) 30 C.S. 423; *Canadian Terrazo and Marble Co. Ltd.* v. *Kaplan Construction Co. Ltd.*, [1966] C.S. 505; *Cary* v. *The Canada Paper Co.*, (1979) 10 R.L. 501 (C.A.). See also CORDEAU, "La prise de possession par le fiduciaire en vertu d'un acte de fiducie", (1983) 24 *C. de D.* 531, 564-566 for a discussion of the uses of injunctive relief in similar circumstances.

55. See RIEG, A., "Gage", *Juris-classeur Notarial*, 1980, pp. 6 *et seq.* Of course, various special regimes such as the transfer of property-in-stock, banker's security or the pledge of a universality of receivables under article 1966(3) C.C. depart from this requirement.

56. *Banque Provinciale* v. *Lapierre*, [1952] C.S. 142; *Smith* v. *Savard*, [1962] C.S. 625.

57. See, for example DESLAURIERS and POUDRIER-LEBEL, *op. cit.*, note 16, Supplement, p. 5.

C.C. to preserve the object as a depositary.[58] This is an important point because it means that the pledgee cannot raise the defence of *exceptio non adimpleti contractus* against a claim for restitution by a pledgor who has repaid the principal obligation.

A final feature of the pledge is that it is an accessory contract. In other words a pledge cannot subsist in the absence of a principal debt which it secures: the extinction or nullity of the principal obligation produces the nullity of the pledge.[59] The reverse, of course, is not true, since there may be causes of nullity or extinction of the pledge totally foreign to the validity of the principal obligation.[60] The rule which provides that a pledge is extinguished upon the extinction of the obligation which it secures is subject to the exception set out in article 1975(2) C.C. This article creates a continuing pledge independently of the pledgor's expressed intention when the pledgor contracts a second obligation which becomes due prior to the obligation for which the pledge was given.[61] But article 1975(2) C.C. speaks only to cases where the original principal obligation is extinguished; a pledgee cannot claim continued possession of objects remitted under a pledge agreement securing a void obligation because in this situation there never was a valid first debt to support the pledge as an accessory. The rule of article 1975(2) C.C. also cannot be invoked by a creditor to prolong the pledge indefinitely under a revolving line of credit; the debtor must explicitly agree to the continuing pledge.[62] A second consequence of the accessory nature of the pledge is that the pledge will be civil or commercial according to whether the principal obligation is civil or commercial. This, of

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58. *Bruneau* v. *Dansereau*, (1927) 66 C.S. 91. What is more, the parties may agree to relieve either the creditor of his obligation to preserve, or the debtor of his obligation to reimburse costs of preservation.

59. RIEG, *loc. cit.*, note 55, 37. See also *In re Belleau, Donaghue and Lefaivre*, (1928-29) 10 C.B.R. 273 (C.S.).

60. These include the loss or destruction of the object pledged, its return to the pledgor, or the abuse of the object pledged by the creditor. See *Pacaud* v. *La Banque du Peuple*, (1893) 3 C.S. 8. Moreover, the accessory character of the pledge means that should the creditor realize upon the pledge without obtaining complete satisfaction of the principal obligation, he retains a deficiency claim against his debtor.

61. *Hénault* v. *Bourgeau*, (1916) 22 R.L. n.s. 330 (C. Rév.). This, of course, is consistent with article 1161 C.C. which would impute any payment by the debtor to the debt first due.

62. Unless the various debts contracted are all demand loans, in which case article 1975(2) C.C. would be applicable. See *In re Belleau, Donaghue and Lefaivre*, (1928-29) 10 C.B.R. 273 (C.S.).

course, will determine the regime of proof admissible to establish the contract.[63]

These five characteristics of the pledge are the key for determining the basic structure of rights and obligations of the parties to a pledge, a topic which is the subject of Chapter Three. Further, they provide criteria by which courts may determine whether a contract which purports to be a pledge is in fact some other transaction such as a loan, and whether an agreement purporting to be a sale, loan, deposit or lease is actually a disguised pledge. These latter issues will be addressed successively in the next two sections of this chapter.

### B. Diverse Forms of Pledge and Quasi-Pledge

For legal theorists, the most interesting facet of 20th century commercial law surely must be its overweering commitment to inherited conceptual apparati. To appreciate the influence of these atavisms it is only necessary to retrace the evolution of pledge lending. In classical Roman Law, *pignus* was a contract applicable uniquely to corporeal property, usually moveables.[64] Following this model, the Civil Code of 1866 appears by its very structure to contemplate that the pawn of corporeal moveables would be the exemplar of pledge contracts. Thus, the rules governing the pledge of immoveables (antichrèse) are developed simply by analogy to those of pawn.[65] Further, throughout Title Sixteenth of Book Three the Code speaks of "une chose" or "a thing" by contrast to "un bien" or "property".[66] Nevertheless, even at the time of codification the law permitted the pledge of incorporeals. Articles 1971(2) and 1979 C.C. contemplated what is now known as the documentary pledge; and article 1974 C.C. explicitly provided for the pledge of debts (*i.e.* incorporeal rights).[67]

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63. See CIOTOLA, *op. cit.*, note 16, p. 60. Article 1976 C.C. suggests a further consequence of the accessory nature of the pledge: its indivisibility. This feature is especially important in brokerage contracts and documentary pledge transactions. Nevertheless, indivisibility is not of the essence of pledge and may be waived by the parties: see *Desrosiers* v. *Western Assurance Company*, (1905) 33 R.J. 92 (C.S.).

64. See BUCKLAND, *Textbook of Roman Law*, (1921), pp. 650 *et seq.*

65. See article 1967(2) C.C.

66. See notably the original articles 1966, 1968, 1969, 1970, 1971(1) and (3), 1972, 1973, 1975, 1975 and 1977 C.C.

67. See *Codifier's Sixth Report*, comments on article 21, pp. 51 and 153.

What is more, various other devices for creating security over moveables have emerged over the years. One of these, the pledge of a universality of book debts under 1966(3) C.C., is at best an imperfect *pignus* since it may cover future property. Others, like the security available under section 178 of the *Bank Act* or the "Transfer of Property-in-Stock", under the *Bills of Lading Act*, even though assimilated to the pledge by articles 1971 and 1979 C.C., seem to be more in the nature of a *fiducia* or mortgage. Still others, such as trust deed security or the commercial, agricultural and forestry pledges, even though expressly labelled as pledges (and in the latter three cases actually incorporated by articles 1979a-1979k C.C. into Title Sixteenth of the Code), are in essence *hypotheca* or charges over moveables.

An underlying commitment to the idea that moveables cannot be hypothecated and to the idea that pledge must be the only consensual security device over moveables probably best accounts for the fiction that each of these modern securities is a species of pledge. Yet as others have noted, the attempt to apply ordinary pledge rules to these newer transactions can lead to unwanted consequences.[68] More importantly, these developments can distort the basic theory of pledge even in its application to ordinary corporeal property.[69] It follows that in order to develop a clear sense of the true pledge, each of its diverse forms must be analysed, and the anomalous attributes of its modern variants distinguished.

### 1. The Pledge of Corporeal Moveables

Article 1968 C.C. provides that "[t]he pledging of moveable property is called pawning". From this definition it would seem that the term pawn could cover the pledge of both corporeal and incorporeal property.[70] In professional usage, however, pawn is used

68. For example, should successive trust deeds or commercial pledges rank according to their date, or should they, following article 1985 C.C., rank *pari passu*? See PAYETTE, "Priorité entre deux charges flottantes", (1982) 42 *R. du B.* 435. Again, in view of the foundation of article 1966a C.C. in the principle of article 2268(1) C.C., should this article apply to non-possessory pledges such as the commercial pledge?

69. This is particularly true in respect of the interpretation of articles 1973 and 1977 C.C. and article 597 C.P. See PAYETTE, "Opposition à fin de distraire - nantissement commercial - droit de rétention", (1979) 39 *R. du B.* 1032; "Charge flottante: privilège de la Couronne et saisie entre les mains du fiduciaire", (1980) 40 *R. du B.* 337.

70. But see the French text: "Le nantissement d'une *chose* (emphasis supplied) mobilière prend le nom de *gage*".

to describe only a particular species of security agreement, namely, the transaction undertaken with a pawnbroker and typically involving corporeal property.[71] This, of course, is the paradigm Roman Law *pignus*: a corporeal moveable (more precisely, a tangible object) is placed physically in hands of a creditor.

Nevertheless, because of the special characteristics attributed to certain forms of commercial paper by modern statutory regimes, the civil law has had a particular difficulty in defining the boundary between corporeal and incorporeal property. For example, where incorporeal rights are subsumed into a deed, either by federal law such as the *Bills of Exchange Act*, or by non-Codal provincial statutes such as the *Bills of Lading Act*, the *Companies Act* or the *Securities Act*, they are in some measure made corporeal. Thus, negotiable paper, money, demand notes, unregistered share certificates, bearer bonds and cheques payable to bearer have been held, for the purposes of article 2268 C.C., to constitute corporeal property. For the sake of conceptual clarity at this point, however, the pledge of all types of negotiable documents and instruments will be considered as a pledge of incorporeals.[72]

### 2. The Pledge of Incorporeal Moveables

At the time of codification there were essentially only two types of incorporeal rights known to the civil law: these were adverted to by articles 1570 and 1573 C.C., which distinguished, (for the purposes of the formalities required to perfect an assignment), between ordinary incorporeal rights such as debts, and negotiable instruments, corporate debentures and shares, and documents of title. As a result, two regimes of pledge developed: the pledge of debts and rights of action, (*i.e.* incorporeal rights which are merely evidenced by a written instrument); and the pledge of negotiable instruments, (*i.e.* incorporeal rights which are actually incorporated into the instrument itself).

Today, by contrast, there are several regimes governing the pledge of incorporeals. Each is tied more or less formally to the distinction drawn in articles 1570 and 1573 C.C. The first of these regimes is that relating to the ordinary pledge of bearer instruments

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71. See articles 1971 and 1979 C.C. See also *Pawnbrokers Act*, R.S.C. 1970, c. P-15; *Licenses Act*, L.R.Q. 1977, c. L-3; *Sale of Unclaimed Goods Act*, L.R.Q. 1977, c. V-3.

72. The true character of such pledges becomes important in the case of the involuntary dispossession of the pledgee and his rights to recover from third parties. See *Leclerc* v. *Perreault*, [1970] C.A. 41.

under articles 1573, 1578 and 1966(1) C.C. where possession of the instrument is equivalent to possession of the right.[73] A second regime is that applicable to the pledge of non-bearer negotiable instruments. Here, possession of the right depends upon the holder of the instrument also being the payee or the endorsee of the payee.[74] In both these cases negotiability collapses much of the distinction between the instrument itself and the right it represents.

A third form of individualized pledge of an incorporeal arises in respect of claims, debts and other rights under a contract.[74a] Here the holder's possession cannot be perfected by mere delivery of the instrument since a specific contractual right is not encompassed in the document which evidences it. Articles 1570 and 1571 C.C. establish the formalities for constituting this type of pledge.[75] A fourth regime, which is, in effect, a subset of this third, relates to the pledge of life-insurance policies. Under article 2557 C.C. notice must be given directly to the insurer in order to crystallize the pledgee's rights.[76] Finally, a fifth regime (also a subset of that set out in articles 1570 and 1571 C.C.) is established in respect of privileged or hypothecary claims, for which an additional registration under article 2127 C.C. is required.[77] Despite this diversity of form, each of the above pledges has the following important features: first, each presupposes the pledge of an individually identified or identifiable incorporeal right;[78] and second, each is only applicable, as in the case of the pledge of corporeals, to property which is in existence.

To be contrasted with these individualized forms of incorporeal pledge is the special regime established under articles 1971d and

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73. See *Chamandy* v. *Leblanc*, [1977] C.S. 176.

74. See *Paquin* v. *Dunlop*, (1933) 71 C.S. 506; *Genest* v. *Castonguay*, [1975] C.S. 266. Cheques and promissory notes payable to order are examples of such instruments.

74a. For a comprehensive discussion of security over claims see LEGEAIS, *Les garanties conventionnelles sur créances*, (Thèse, Poitiers, 1984). See also CIOTOLA, "Les cessions de créances: modalités de réalisation et conflits de collocation", (1982-83) 17 *R.J.T.* 365.

75. *Banque Canadienne Nationale* v. *Paquet*, [1978] C.P. 251.

76. See also article 2558 C.C. which makes the date of notice to the insurer the key date for establishing third party effect. See LLUELLES, *Droit des assurances*, pp. 97-99.

77. *Lemcovitz* v. *Laurentide Acceptance Corp.*, [1966] B.R. 160.

78. The special regime of article 1571c C.C. does not depart from this presupposition since the contract must relate to a whole class of existing rents or debts sold *collectively*.

1966(3) C.C. which permits the pledge of a universality of book accounts. Because article 1966(3) C.C. provides that "a whole, a portion or a particular category of ... debts or book accounts, *present or future*" (emphasis added) may be pledged, this form of pledge of incorporeals must be understood as an imperfect pledge.[79] That is, the substitution of a general categorical description of future property for precise identification of the specific items comprising the pledge *corpus* significantly alters the structure of rights between the parties.[80]

From this discussion it follows that there is no functional unity to the rules relating to the pledge of incorporeals. Some incorporeal rights are pledgeable as if the document reflecting them (and not the value of the rights themselves) were the pledge *corpus*. Other incorporeals can only be pledged by means of a fictitious possession through completion and delivery of a deed evidencing the contract. Still other incorporeals may be pledged in a like manner even though at the time of the pledge they constituted future property. Of course, in the first hypothesis, special legislative rules relating to negotiability, opposability and risk of loss mean that the creditor's possession is, in effect, real; in the latter two, however, the pledgee's possession *vis-à-vis* his debtor is fictitious or notional.

### 3. **Documentary Pledges**

The most important species of non-standard possessory pledge transaction recognized at the time of codification was the documentary pledge. Both articles 1971(2) and 1979(2) C.C. contemplate the negotiation of documents of title by simple endorsement and transfer. As applied to contracts of pledge the endorsement produces the same effects as a simple putting into possession because by statute the document itself and not the underlying assets are deemed to be the juridical object of the pledge.[81] It follows that there is an analogy with each of the two primary regimes of the pledge of incorporeals: as with the pledge of negotiable instruments possession may pass by endor-

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79. See for an oblique suggestion to this effect, *In re Singer Ventilation and Air Conditioning Ltd.*, [1970] C.S. 476.

80. See *In re Immeubles Westgate*, [1976] C.S. 893; *In re Pomerleau Sand and Gravel*, [1979] C.S. 703; see also DEMERS, "Cession de créances et affacturage", (1980) 21 *C. de D.* 190.

81. But see CIOTOLA, *op. cit.*, note 16, 66 who sees the documentary pledge as an ordinary example of third party possession.

sement and delivery; as with the pledge of debts and rights of action, the document itself is merely representative of the material object of the pledge.

The standard form of documentary pledge will arise under the provincial *Bills of Lading Act*[82] or the federal *Bank Act*[83] as complemented by the federal *Bills of Lading Act.*[84] The most important feature of the documentary pledge is that the pledgee himself only takes actual possession of the document while the goods themselves remain in the physical custody of the issuer of the document (*i.e.* the shipper, warehouseman, *etc.*).[85] In other words, the pledge may be constituted, transferred, substituted and discharged without the need for multiple physical displacements of the pledged collateral.

But the disjunction of juridical and material possession implied by this reification of the interest represented by documents of title raises the question whether the "trust receipt" device is possible in Quebec.[86] In a trust receipt arrangement, the pledgor regains possession of the documents (in order to assert control over the underlying collateral) as against his written promise not to deal with that collateral contrary to the pledgee's interest. This highly practical device compels analysts to decide whether there is an exact congruence between creditor possession and debtor dispossession, or whether the pledge may be constituted as soon as the creditor is in a position to control the debtor's possession (even if the creditor himself has no direct possession of the goods). Its analysis also helps clarify the respects in which the pledge of negotiable documents of title differs from the pledge of non-negotiable documents of title, and from the ordinary case of third party possession.

### 4. Quasi-Pledges: Quasi-*Fiducia*

In each of the types of pledge previously considered, the Code does not depart from the structure of possessory rights as

82. L.R.Q. 1977., c. C-53.

83. S.C. 1980-81-82-83, c. 40, s. 2.

84. R.S.C. 1970, c. B-6.

85. See WOOD, "The Pledge of Documents of Title in Ontario", (1984) 9 *C.B.L.J.* 8 for a thorough historical analysis.

86. The early cases would suggest a negative response: see *Molson's Bank* v. *Rochette*, (1888) 14 Q.L.R. 261 (C.S.). However, the advent of the new transfer of property in stock legislation may change this position.

between pledgor and pledgee inherited from the Roman Law of *pignus*. There are, however, two relatively modern and quite unique security devices which have evolved from the technique of endorsing bills of lading and warehouse receipts as collateral security. Rather than requiring the debtor to dispossess himself to a warehouseman or carrier for the purpose of then endorsing the document remitted to him, these transactions effectively permit the self-warehousing of goods.[87]

Despite the reference in article 1979(2) C.C. to the regime of security available to chartered banks under the *Bank Act* it is now clear that this security is not a true pledge transaction, but rather an arrangement which has a resemblance to mortgage-type security, or a *fiducia*.[88] Under such an agreement the debtor does not surrender possession, nor does the creditor obtain a mere execution priority over the goods of the debtor. Rather section 178 security vests in the creditor rights which can mature into something akin to ownership, and which are traceable into proceeds generated by the ordinary course sale of the collateral.[89]

While for many years the security available under the *Bank Act* was the only mortgage-type transaction which could be taken in Quebec, in 1984 the Quebec legislature created a provincial analogue to section 178 by amending the *Bills of Lading Act*. Once again, despite language suggesting that the transfer of property-in-stock is a pledge mechanism, it is apparent that the rights of a transferee are not simply those of an ordinary pledge creditor, but rather encompass the power to limit disposition and trace into proceeds.[90]

Both federal and provincial statutory regimes bear strong resemblances to the Roman law *fiducia*; but it would be a mistake to press the analogy too strongly. The truest modern reflection of *fiducia* is the sale with a right of redemption under articles 1546-1560 C.C.[91] In

87. Both should be contrasted with sections 3 and 7 of the federal *Bills of Lading Act*, which have always permitted a *bona fide* warehouseman to issue receipts covering his own goods.

88. See MacDONALD, "Security Under Section 178 of the *Bank Act*: A Civil Law Analysis", (1983) 43 *R. du B.* 1007, 1016-1036.

89. It is no doubt in recognition of the proprietary nature of the Bank's rights that courts have frequently characterized this security interest as a right of ownership *sui generis*. See *B.C.N.* v. *Lefaivre*, [1951] B.R. 83.

90. See MacDONALD, *loc. cit.*, note 31, 164-167.

91. Somewhat less analogous are other title transactions such as the double sale and the sale-leaseback.

effect, these modern statutory regimes lie somewhere between *fiducia* and *hypotheca*. To the extent that they permit debtor possession and ownership as well as to the extent they may affect future property, they are more in the nature of hypothecations than mortgages; to the extent they give the creditor private realization rights and a claim over proceeds they seem to be closer to mortgages than hypothecations. From no perspective, however, can they be understood as true pledges.

### 5. Quasi-Pledges: Quasi-*Hypotheca*

In the general modernization of commercial law undertaken during the post-War period, the Civil Code was amended to provide for two other quasi-pledge transactions, although each of these is more in the nature of a hypothecation than a pledge or a mortgage.[92] Similarly, to meet the needs of an emergent manufacturing sector at the turn of the century, a special non-Codal regime of financing was established in 1916.[93] This regime also has the basic features of a hypothecation.

In articles 1979a - 1979k C.C. the Code elaborates the rules for two species of secured transaction — the agricultural and commercial pledge — which it assimilates to the ordinary pledge. Nevertheless, these devices are not a classical pledge because they create a security independently of the debtor's dispossession. On the other hand, because they permit private creditor realizations but give neither a right to stipulate foreclosure (*i.e.* the *pacte commissoire*) nor a right to trace into proceeds of ordinary course sales, they are not mortgages. In effect these newer devices create a type of hypothec upon moveables for certain classes of commercial or agricultural debtor.[94]

The rights obtained by creditors under a trust for bondholders reveal even greater subtlety. Like the case under the special pledges the debtor remains in possession, but unlike these devices the trust may cover future property. However, the basic reason for treating the trust for bondholders as a transaction in the nature of a *hypotheca* rather than in the nature of a *fiducia* is that the trust does not vest an ownership interest in the trustee. In effect, unless the trustee also takes an assignment of receivables under section 31 of the Act, he

92. See articles 1979a-1979k C.C.

93. See *The Special Corporate Powers Act*, L.R.Q. 1977, c. P-16, ss. 27-31.

94. See DESJARDINS, "Du nantissement commercial à l'hypothèque mobilière", (1968-69) 71 *R. du N.* 87.

obtains no rights in proceeds generated by the debtor's ordinary course disposition of the collateral. Moreover, it is now established that the terms "cede and transfer" in section 30 relate only to the power of the trustee to demand possession so as to realize upon and dispose of the collateral; they do not give the trustee an ownership right similar to that which arises upon a mortgage (*i.e.* a right of foreclosure).[95]

It follows that neither the special pledges nor trust deed security can be readily seen as a species of *pignus*. The continuing possession of the debtor and the institution of a regime of registration are incompatible with the pledge. On the other hand, they are not true hypothecs since they both permit private creditor realization and they both are ranked *vis-à-vis* other creditors not on a temporal basis, but according to the nature of the claim. They are, consequently, most readily analogized to the hypothec.

### 6. **Distinguishing the Pledge from the Quasi-Pledge**

From this brief review of the various forms of secured transaction over a debtor's moveable property currently available under Quebec law, one can deduce that many modern institutions which have been assimilated to the pledge are not really pledges, but rather are either disguised mortgages or hypothecs.[96] In view of their marked dissimilarities with the pledge — primarily the fact of debtor possession, but also the presence of registration, and in certain cases a right to trace into proceeds — they will not be considered further in this study. Only the possessory pledge, including the documentary pledge will be analysed in detail. Some treatment of the pledge of a universality of accounts receiveable, an imperfect possessory pledge insofar as it relates to future property, will also be undertaken.

On the other hand, many creditors have attempted to obtain rights in their debtors' collateral analogous to those available under the pledge without, at the same time, heeding the formal requirements for establishing a valid possessory pledge. In order to assess the use and legitimacy of these devices it is now necessary to analyze the

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95. RENAUD, "L'efficacité de l'acte de fiducie comme sûreté", [1979] *C.P. du N.* 199; see also *Trust Général du Canada* v. *Roland Chalifoux Ltée*, [1962] S.C.R. 456.

96. A similar conclusion has been arrived at in France as concerns various *warrants* and other dispossessory securities over moveables. See DAGOT, *op. cit.*, note 7, 23-26, 69-71, 104-110; and especially 228-267.

basic functional and formal mechanisms for constituting the ordinary pledge over moveables.

### C. Constituting the Pledge

Just as it is necessary to review the various forms of pledge and quasi-pledge in order to establish the effective limits of the *pignus*, it is also necessary to pause briefly upon the formal characteristics of the pledge in order to determine when a contract which is functionally a pledge should be set aside for a failure of form.[97] The most important formal requirement for constituting a pledge is that set out in article 1970 C.C.: the pledge subsists only while its *corpus* remains in the hands of the creditor or his delegate. There are, nevertheless, several other requirements which limit the availability of the pledge; these relate to the claim to be secured, the parties to the transaction and the property which may be pledged. Each will be considered with a view to developing a theory of the true possessory pledge.

#### 1. The Debt Which The Pledge Secures

Any claim or obligation not contrary to public order and good morals may be secured by a pledge. Functionally this means that the obligation may be an obligation to give, to do or not to do.[98] It may also be an obligation which is either natural or legal, commercial or civil, liquidated or not.[99] Where the principal obligation secured is affected with a condition, a term, or a penal clause, or where it is joint and several, is indivisible, or is alternative, the pledge itself subsists only subject to these same characteristics, unless the parties otherwise provide.[100] For example, even were a principal obligation to have a term of 10 years, the parties could agree that the pledge would secure the obligation only for the first five years. However, because the

97. For a brief summary of these problems see SAUNDERS, "Pledge, Commercial Pledge, Sale with a Right of Redemption and Similar Security Devices", [1967] *Meredith Memorial Lectures* 16; TANCELIN, "Simulation et crédit mobilier sans dépossession au Québec", (1974) 26 *R.I.D.C.* 317.

98. See *Hammond* v. *R.*, (1930) 50 B.R. 131. This may be contrasted with, for example, the commercial pledge, which may secure only a loan or line of credit. See *Dauphin* v. *Bertin*, [1972] C.S. 532. But compare *Les Pétroles Irving* v. *Machinerie B.D.M. Inc.*, [1984] C.S. 511.

99. See DAGOT, *op. cit.*, note 7, 111-112. If the pledge is given to secure a natural obligation, the principal obligation is automatically transformed into a legal obligation.

100. RIEG, *loc. cit.*, note 55, 6 *et seq.*

pledge is an accessory, they cannot stipulate that it survives the obligation it secures, that it be absolute if the obligation be conditional, or that it guarantees the performance of only one of several alternative obligations. Only article 1976 C.C., which provides that the pledge may be indivisible even if the principal obligation is divisible, is an exception to this rule.

Temporally, the Code requires that the obligation be pre-existing or contemporaneous with the pledge.[101] Within the limits of article 1975(2) C.C., the pledge may also secure a future or eventual obligation. In other words, the pledge presupposes the present existence of an obligation even if the particular performance which it secures (*i.e.* repayment) has no substantive content.[102] The debtor may oblige himself to repay all future advances under a one year line of credit and pledge various objects in security; even though no advances have been made, the pledge subsists as against third parties.[103]

## 2. Parties to the Contact of Pledge

### (a) The Pledgee

In principle, the creditor of the pledge may be any person, physical or moral, without limitation whatsoever. Nevertheless, where the creditor is so closely allied to the pledgor that possession of the pledge *corpus* as between the two is difficult to determine, the pledge may not be valid. This could arise, for example, in domestic situations or where a field-warehousing operation has been established.[104]

A further nuance may be necessary in the case where the creditor of the pledge is a person different from the creditor of the principal

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101. Of course, the special rules relating to section 178 security or transfers of property-in-stock do not form a part of the general law of pledge.

102. See *In re Belleau, Dohonue and Lefaivre*, (1928-29) 10 C.B.R. 273 (C.S.). Some authors hold that this is a future obligation. See WEILL, *op. cit.*, note 6, 77. In effect, however, the obligation to repay arises at the moment of the contract. Only the value of repayment may be eventual.

103. In the above discussion no account has been taken of limitations such as those of article 1979e C.C. respecting the term of the loan or its qualification (*i.e.* as a loan or balance of purchase price arrangement). See *In re 600 Belvedère Inc.*, [1975] C.A. 730.

104. On the latter point see *Merchant's Bank* v. *McGrail*, (1878) 1 L.N. 231 (C. Rév.) and see *infra*, Chapter Two, Section C(4).

obligation. While article 1966(2) C.C. explicitly permits the *caution réelle* insofar as debtors are concerned, no similar paragraph speaks to the status of creditors. An example will illustrate this problem. While it is possible for Jones to pledge his property to secure a loan made to Jones Ltd. by Smith, it is not clear whether Jones could pledge the property to Smith Ltd. for a loan which Smith made to Jones Ltd. Article 1970 C.C. suggests that the third party custodian would only be acting for the creditor and not as pledgee. Consequently, to avoid the possibility of a pledge being set aside on this basis, it should be given to the creditor of the principal obligation, who may then establish a mandate or otherwise assign the pledge.

### (b) The Pledgor

Somewhat more restrictive conditions apply insofar as the pledgor is concerned.[105] Normally the pledge will be given by the person who is the principal debtor. But, the *caution réelle* is also permitted.[106] In these latter cases the person putting up the pledge will not be held to any personal obligation beyond that reflected by the pledge, unless he also binds himself by a contract of personal suretyship.[107]

The dominant doctrinal position would also require that the person giving the pledge have legal capacity to alienate, since the pledge is a contract under which a creditor may expropriate the pledgor's rights by means of a *pacte commissoire*.[108] However, there would seem to be no policy reason for this restriction in contracts where no *pacte commissoire* has been stipulated; in such cases the pledgee obtains only a possessory right, and must realize upon his security in the same manner as any other creditor (*i.e.* by way of seizure and judicial sale).[109] Nevertheless, Canadian courts, like those in France, have always assumed that a failure of capacity to alienate in the pledgor impresses the pledge with a relative nullity.

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105. But these are far less restrictive than for other pledges or quasi-pledges which limit the pledgor's status. See, *e.g. In re Thomassin: Gauthier* v. *Thomassin*, J.E. 81-143 (C.S.); *Letang* v. *Poirier*, J.E. 79-827 (C.S.)

106. Unlike the case with commercial pledge and security under the *Bank Act*. See *Simoneau* v. *Roy*, [1965] R.L. 193 (C.S.).

107. See articles 1948 and 1949 C.C. for the relationship between debtor and pledgor. See also WEILL, *op. cit.*, note 6, 79.

108. See MIGNAULT, *op. cit.*, note 53, 395; see also DAGOT, *op. cit.*, note 7, 116.

109. See DESLAURIERS and POUDRIER-LEBEL, *op. cit.*, note 16, 7; WEILL, *op. cit.*, note 6, 80-81.

A further limitation is that set out in article 1966(3) C.C. in respect of the pledge of a universality of accounts receivable. The Code seems to require that the pledgor be "a person, firm or corporation carrying on a commercial business". Nevertheless, on occasion courts have permitted professionals[110] and real estate brokers[111] to avail themselves of article 1966(3) C.C.

The most important limitation on the status of the pledgor is that, in principle, he must be the owner of the objects pledged.[112] Nevertheless, article 1966a C.C., which was added to the Code in 1888, modifies this rule by making articles 1488, 1489 and 2268 C.C. applicable to contracts of pledge.[113] Of course, as in the case of sale, few problems arise where the pledgor later becomes owner of the thing pledged, for here no conflict between the rights of the pledgee and third party owners is possible.

The more difficult cases are those where the pledge is validated because it arose as a commercial matter[114] or because a thing lost or stolen was pledged at a fair or by a trader dealing in similar articles.[115] A particular problem flows from differences in the wording between articles 1488 and 1489 C.C. which are not limited to corporeal moveables, and article 2268 C.C. which is so restricted.[116] In other words, the pledgee of incorporeals acquires no rights as against third parties. While modern jurisprudence assimilates bearer instruments to corporeal moveables,[117] the status as corporeal property of negotiable instruments made to order, or otherwise requiring

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110. *Côté* v. *Guardian Trust*, J.-E. 81-438 (C.P.).

111. *In re O.T.E.A.*, [1976] C.A. 539.

112. This flows clearly from articles 1966(1) and 1972 C.C. It is also possible to pledge an inferior real right such as a usufruct. Moreover, a bare owner may pledge his rights, subject to the usufruct.

113. Mignault suggests that the article was added in response to the decision in *The City Bank* v. *Barrow*, (1880) 5 A.C. 664 (P.C.). The courts have always held that article 1966a C.C. is also applicable to agricultural and commercial pledges. See *In re Bertrand*, [1967] C.S. 596. But this conclusion is not beyond doubt (in cases other than where the pledgor later becomes owner) if these special pledges are in fact quasi-hypothecs.

114. *Grondin* v. *Lefaivre*, [1931] S.C.R. 102.

115. *Leclerc* v. *Perrault*, [1970] C.A. 141; *Séguin* v. *B.C.N.*, [1971] C.S. 719.

116. See CARON, "La vente et le nantissement de la chose mobilière d'autrui", (1977) 23 *McGill L.J.* 1, 380.

117. *Leclerc* v. *Perrault*, [1970] C.A. 141; *Morgan, Ostiguy et Hudon Ltée* v. *Sun Life Assurance Co.*, [1975] C.A. 473.

endorsement and delivery, is more doubtful. At least one older case[118] implies that, even when endorsed to bearer, the instrument is not a corporeal within the meaning of article 2268 C.C. But another case, based on article 1573(2) C.C., held that endorsement and delivery of a stolen warehouse receipt could be validated under article 2268 C.C.[119] In view of the *Bills of Exchange Act*[120] the latter would seem to be the better position.[121] Nevertheless, article 2268 C.C. cannot apply to the pledge of all other incorporeals (*i.e.* the pledgee will not obtain rights opposable to third parties) even though as between pledgor and pledgee, articles 1488 and 1489 C.C. will validate certain *super non domino* pledges.[122]

### 3. Property Which May Be Pledged

Within the limits respecting the property of another just discussed, all forms of moveable property which are objects of commerce, alienable and sufficiently individualized may be pledged.[123] It follows that future property may not be pledged,[124] unless under special statutes such as the *Bank Act*, or a special regime such as the pledge of a universality of commercial accounts receivable.

Pledged property may be corporeal or incorporeal, fungible or not, consumeable or non-consumeable.[125] The pledge may cover only a fraction of an object,[126] may be of intellectual property or of insurance policies, and may even be of claims which have no contractual basis.[127] In all these cases, however, there must be a

118. *Young* v. *McNider*, (1895) 25 S.C.R. 272.

119. *Canadian Bank of Commerce* v. *Stevenson*, (1892) 1 B.R. 371.

120. R.S.C. 1970, c. B-5.

121. See also CARON, *loc. cit.*, note 116, 22-25.

122. For a discussion see *Frigidaire Corp.* v. *Malone*, [1934] S.C.R. 121. Of course, in all the above hypotheses it is assumed that the parties have perfected the pledge for all purposes through the appropriate formalities under articles 1570 *et seq.* C.C.

123. For an example where the court refused the pledge of an object not in commerce (a milk quota) see *Société de crédit agricole* v. *Lapointe*, J.E. 84-784 (C.S.).

124. RIEG, *loc. cit.*, note 55, 6; MAZEAUD, *op. cit.*, note 9, 73.

125. DAGOT, *op. cit.*, note 7, 112-113.

126. See CARBONNIER, *La mise en gage des parts d'intérêts*, Rev. soc. 1937, p. 173.

127. For an example, it would be possible to pledge one's rights to an income tax refund, a government subsidy or, subject to any statutory limitations, pension rights.

juridical means of ensuring a sufficient dispossession of the debtor and possession for the creditor.[128] But the courts have not yet decided, in the case of incorporeal property, whether the dispossession must be congruent with the possession. For example, they have held that shares may be pledged by simple possession even where company articles of incorporation require registration and notice of any transfers.[129]

Where the object of the pledge is a consumeable, the pledge, like the loan, makes the pledgor owner of the object subject to an obligation of returning the equivalent amount.[130] This rule is subject to an exception whenever otherwise consumeable property is pledged as an individualized object; for example, a bank note with a particular flaw, or a bottle of wine of a particular vintage; or a negotiable instrument with the signature of a famous person.

### 4. The Formality of Possession

In France there are several formalities which must be accomplished in order to constitute a pledge: possession; a writing; publicity.[131] By contrast under the Civil Code, there is only one such condition applicable to all ordinary pledges: the creditor or his representative must be put into possession of the pledge *corpus*.[132] The absence of other formalities such as a writing means that the requirement of possession is often understood in Quebec as a substantive condition.[133] Articles 1966 and 1970 C.C. clearly reflect the importance of this requirement.

Possession has two complementary purposes. As between debtor and creditor, the transfer of possession serves to protect the pledgee

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128. *B.C.N.* v. *Brouillette*, [1962] C.S. 696; *T.D. Bank* v. *Séguin*, [1976] C.S. 381.

129. See *Genest* v. *Castonguay et Reny*, [1975] C.S. 266.

130. MAZEAUD, *op. cit.*, note 9, 73. See *Place Versailles* v. *Montreal*, [1977] C.A. 176 as regards money.

131. DAGOT, *op. cit.*, note 7, 117-125.

132. *Thompson* v. *Lapierre*, (1934), 72 C.S. 460; *Bellavance* v. *C.A.C. Ltd.*, [1956] B.R. 407.

133. This, perhaps more than the rule of article 2022 C.C., explains the traditional hostility of courts to double sales, sales with a leaseback and like transactions. See MAZEAUD, *op. cit.*, note 9, 74. However, see *I.A.C.* v. *Marmette*, [1957] B.R. 861; *Traders Finance Corp.* v. *Landry*, [1958] B.R. 120; and *Canadian Dominion Leasing Co. Ltd.* v. *Laboratoire Choisy Ltée*, [1970] C.A. 1021 for a more modern tendency in Quebec.

from dissipation or misuse of his security by the pledgor. As between parties to the contract and third parties, the transfer of possession serves to publicize the creditor's security interest.[134] Nevertheless, possession is one of the most difficult concepts in the civil law, and many vexing problems arise from the application of the requirement of creditor possession to diverse forms of pledge. These problems can be grouped under three major headings: the identity and title of the possessor, mechanisms for transferring possession, and characteristics of the possession.[135]

### a) The Identity and Title of the Possessor

The Code contemplates in article 1966 that the creditor may achieve the possession required to constitute the pledge in one of two ways. Most commonly the pledgee will be put into actual possession himself. This may occur either through the delivery of the *corpus* to him by the pledgor,[136] or by converting or interverting his title to moveables of which he already has custody. In this latter case, the creditor's possession is real even if he is only fictitiously *put* into possession. Several examples of title interversion can be given. The creditor may have been put into possession originally as a repairman, improver, depository, borrower or carrier[137]; or the pledgee may have obtained possession as mandatary, broker or *negotiorum gestor* of the pledgor;[138] or indeed, he may have obtained possession as the buyer of the pledgor, prior to retransfer of title with a reservation of possession.

In addition to achieving possession by actually being himself the custodian of the pledge *corpus*, article 1970 C.C. provides that the creditor may also be put into possession by delivery of the property to his nominee.[139] Such a procedure would notably be followed when valuable objects are placed in a safety deposit box under the pledgee's name, or when the third party holding the property himself is

134. See WEILL, *op. cit.*, note 6, 81-83.

135. DAGOT, *op. cit.*, note 7, 121-125; CIOTOLA, *op. cit.*, note 16, 65-83.

136. But see *Marmette* v. *Villeneuve*, [1968] B.R. 841.

137. The facts in *Sawyer Tanning Co.* v. *The Leather Group*, [1977] C.S. 1150 are indicative of how improvers often attempt to convert rights of retention into pledge claims.

138. This is a particularly common occurrence in stock-brokerage contracts. See *Beatty* v. *Inns*, [1953] B.R. 349; *Smith* v. *Savard*, [1962] C.S. 625.

139. *Bouchard* v. *Couture*, (1933) 71 C.S. 536. See also WEILL, *op. cit.*, note 6, 84-85.

instructed to intervert his possession. For example, a banker may initially take possession of bonds as the depositary of the pledgor, and subsequently, upon direction from the depositor see his possession converted into that of a custodian of the pledge for the account of the creditor. One of the advantages of such a technique is that it permits multiple or successive pledges of the same collateral. The custodian holds for various creditors in the order and for the amounts agreed between them.[140] In all these cases, however, the possession of the custodian must be sufficiently ostensible to put third parties on notice of the pledgor's dispossession.[141]

Some authors see the documentary pledge as a further mechanism for achieving pledgee possession through a third party.[142] Nevertheless, the true documentary pledge adverted to by article 1979(2) C.C. is not really an example of third party possession. As LeDain notes, the distinguishing feature of these transactions is that the negotiable document of title, bill of lading or warehouse receipt is the representation of the property itself and is not merely the contract between the carrier or warehousemen and the party who consigned the goods.[143] Physical detention may be in the hands of the warehousemen but juridical possession is through the document negotiated to the creditor. The documentary pledge may also be adapted to successive or multiple pledges in that the warehouse receipt can be made out for a fraction of the value of the inventory, or for a subsidiary right.[144]

Where a non-negotiable document of title is issued by a depositary, a situation similar to that examined with bank vaults arises. The depositary's possession is interverted and he ceases to hold on behalf of the pledgor. In these cases the object of the pledge is the goods themselves and the depositary becomes the pledgee's nominee.[145] This situation is, therefore, no longer a case of a true documentary pledge.

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140. See MAZEAUD, *op. cit.*, note 9, 74-75. See article 2557 C.C. for a similar result in respect of the pledge of insurance policies.

141. *Payenneville* v. *Prévost*, (1916) 25 B.R. 246.

142. CIOTOLA, *op. cit.*, note 16, 66-67.

143. LeDAIN, *loc. cit.*, note 28, 95-103.

144. See WEILL, *op. cit.*, note 6, 105-109.

145. See WOOD, *loc. cit.*, note 85, 88-98 and 101-109.

### b) Mechanisms for Putting the Creditor Into Possession

Because of the fundamentally different juridical characteristics of the various types of moveable property which may be pledged, the Code elaborates a series of differing mechanisms for achieving creditor possession. In the case of ordinary corporeal moveables, possession is affected simply by giving physical custody of the *corpus* to the creditor or his nominee. Insofar as incorporeals are concerned, a distinction must be drawn, according to article 1573 C.C., between negotiable instruments and other titles and claims. The rules of articles 1570 and 1571 C.C., as made applicable to pledges by article 1578 C.C., will govern the transfer of possession of the latter.[146]

Insofar as commercial paper is concerned, notwithstanding article 1573 C.C. there is no reason to differentiate bearer instruments and those which are paid to order. Bearer instruments may be pledged simply through transfer to the pledgor. In this sense they may be assimilated to corporeal moveables.[147] By contrast, the transfer of possession of negotiable instruments made payable to order can only be made fully effective through endorsement and delivery to the pledgee. On the other hand, once the pledgor has surrendered custody of the document he is no longer able to benefit from it. For this reason, even absent endorsement to the pledgee the simple delivery of a negotiable instrument payable to the pledgor, or a negotiable warehouse receipt made out to him should be sufficient to constitute the pledge.[148]

Article 1571(d) C.C. provides a special means of signification and opposability where universalities of commercial claims and book debts are concerned: registration so as to ensure enforceability,[149] and newspaper notices so as to perfect possession as against account debtors.[150] Nevertheless, article 1966(3) C.C. permits the pledge to be constituted as between debtor and creditor by the simple delivery of the deed witnessing the pledge. Here, the pledgee's possession is perfected (even if his rights as regards third parties remain precarious)

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146. *B.C.N.* v. *Paquet*, [1978] C.P. 251.

147. *Chamandy* v. *Leblanc*, [1977] C.S. 176.

148. *Paquin* v. *Dunlop*, (1933) 71 C.S. 506; a similar regime governs documentary pledges. But see *The Toronto-Dominion Bank* v. *Geoffrion, Robert et Gélinas Ltée*, [1976] C.S. 381 for the special case of share certificates requiring registration.

149. *Comcap Factors* v. *Faucher*, [1979] C.S. 703.

150. *F. Vigneron Construction Générale*, [1976] C.A. 367.

without the need to comply with any of the formalities of article 1571d C.C.

Finally, the Code requires various other formalities in order to perfect enforceability of certain non-negotiable claims. The pledge of a privileged or hypothecary claim produces no third party effects unless registered under article 2127 C.C.,[151] and the enforceability of an assignment of insurance policies requires notice to the insurer under articles 2557 and 2558 C.C. In these latter two cases the additional formalities must be followed; without them, the debtor in no way surrenders control over the object of the pledge.

### c) Characteristics of the Creditor's Possession

French authors define the characteristics of the creditor's possession under three terms: it must be effective, apparent and permanent.[152] To say that the pledgor's dispossession must be effective, for many years was to say that any secured transaction where the debtor retained or regained possession of the collateral would be set aside as simulated. Thus, a sale-leaseback or double sale agreement under which physical control remained with the debtor could not be a pledge,[153] even though ostensibly it might be permitted as a *fiducia* or mortgage type arrangement.

But the requirement that the pledgor's dispossession be effective does not imply that he must do everything necessary to make the pledge opposable to third parties. Thus, in the pledge of incorporeals, the debtor is dispossessed once the formalities of articles 1570 or 1966(3) C.C. have been met, even though the creditor may have no possession *vis-à-vis* others because articles 1571 or 1571d C.C. have not been adhered to. The same would be true of negotiable documents of title: even without endorsement the creditor may be put into possession by delivery, for such delivery thereafter prevents the debtor from redeeming the goods. A similar result would also follow in cases of simple delivery of registered share certificates.[154]

The requirement that the dispossession be apparent has been interpreted as prohibiting pledges in situations where possession is equivocal. For example, pledges between spouses, or as between joint

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151. *Lemcovitz* v. *Laurentide Acceptance Corp.*, [1966] B.R. 160.

152. MAZEAUD, *op. cit.*, note 9, 75-76; DAGOT, *op. cit.*, note 7, 122-123; WEILL, *op. cit.*, note 6, 81-83.

153. *Campbell Auto Finance* v. *Comtois*, [1946] C.S. 136.

154. See *Genest* v. *Castonguay et Reny*, [1975] C.S. 266.

lessees, or as between a corporation and its principal shareholder have been viewed suspiciously.[155] Again, the delivery of the keys to a building in which pledged goods are stored has been held, in France, not to be a sufficiently apparent transfer of possession.[156] A like result would follow in attempted field warehousing operations where the warehoused inventory could not easily be distinguished from the pledgor's property.[157] While the requirement that dispossession be effective can be seen as directed towards the relationship of pledgor and pledgee, the requirement that it be apparent primarily has third parties in view.

A final characteristic of the debtor's dispossession is that it must be permanent. In other words, to ensure the publicity required to prove the pledge courts have held that the pledgor must be permanently excluded from dealing with the goods.[158] Nevertheless, the courts have accepted a certain modulation of this rule. If the pledgor recovers the property as a result of theft or false representations (such as the passing of an N.S.F. cheque) the pledgee may revendicate and reestablish the pledge.[159] However, where a third party custodian mistakenly remits the pledge *corpus* to the pledgor in good faith the pledgee loses his pledge and has only a personal action against the depositary. The courts have also permitted the pledge to subsist where the pledgee temporarily remits the *corpus* to the pledgor,[160] but only where such remission would not mislead creditors. Factors to be taken into account would include length of time remitted, whether the goods were placed in an area accessible to the public, whether this

155. DAGOT, *op. cit.*, note 7, 122.

156. WEILL, *op. cit.*, note 6, 81. One might analogize this case to that of a *don manuel*. See *Payenneville* v. *Prévost*, (1916) 25 B.R. 246. On the other hand, the delivery of keys to the creditor accompanied by the affixing of a notice on the building advertising the pledge should be sufficient. A similar conclusion should be reached where a retailer deposits his cash and sales receivables monies in a safe located on his own premises, but belonging to an express company and clearly marked as such.

157. *La Banque Nationale* v. *Boyer*, (1911) 20 B.R. 341; see also SKILTON, "Field Warehousing as a Financing Device", [1961] *Wisc. L. Rev.* 221, 403. Thus, it is not sufficient merely to say, draw a chalk line on a showroom floor to indicate where the field warehouse begins.

158. See for analogous reasoning in retention claims, *Hamel* v. *Gravenor*, [1960] B.R. 1223.

159. *Standard Credit Corp.* v. *Nadeau*, [1956] R.L.n.s. 127 (C.S.); *Wilson* v. *Doyon*, [1964] C.S. 93.

160. *Grobstein* v. *Hollander*, [1963] B.R. 440.

remission was necessary for the material or juridical preservation of the thing and whether the goods always remained sufficiently individualized so as to avoid admixture with the pledgor's other property.[161]

A particular problem relating to the question of the debtor's dispossession can arise in various field warehousing operations. In brief, the question is whether a documentary pledgee can remit, for a limited time and purpose, the instrument pledged to the debtor as against the latter's covenant not to deal (*i.e.* a trust receipt), and yet still maintain his security in the negotiable document of title.[162] Earlier cases on the point are conflicting[163] although doctrinal writers almost unanimously take the position that the trust receipt device is in conflict with article 1970 C.C.[164] Nevertheless, in view of recent jurisprudence authorizing the temporary remission of corporeal property to the pledgor, and given article 1978 C.C., which provides "the rules contained in this chapter are subject in commercial matters to the laws and usages of commerce", this doctrinal position is probably overstated. When the document of title is remitted for the purpose of clearing customs, trans-shipment, or a non-ordinary course sale on behalf of the endorsee for the purpose of realization, the better view would seem to be — provided the requirements noted in the previous paragraph are fulfilled[165] — that the pledgee can retain his documentary security even should he remit the bill or receipt temporarily to his debtor.[166]

### D. The Scope of the True Pledge

This review of the legal regime of pledge lending in Quebec calls forth two concluding observations. In the first place, legislative

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161. See MAZEAUD, *op. cit.*, note 9, 75; see also the examples given by DAGOT, *op. cit.*, note 7, 123.

162. See LeDAIN, *loc. cit.*, note 28, 100-103.

163. In *Merchant's Bank* v. *McGrail and Lajoie*, (1878) 1 L.N. 231 (C. Rév.) a trust receipt transaction was upheld, whereas in *Molson's Bank* v. *Rochette*, (1888) 14 Q.L.R. 261 (C.S.) the court reversed itself.

164. MIGNAULT, *op. cit.*, note 53, 403; CIOTOLA, *op. cit.*, note 16, 83.

165. See text accompanying footnote 161.

166. It is an interesting question whether the pledgee could retain the document of title, but authorize the warehouseman to deliver the underlying *corpus* to the pledgor while still maintaining the pledge. The better position would seem to be that the handing over of the warehoused goods removes them from the creditor's control, and that therefore the pledge falls.

tampering with the pledge has led to a series of analogous security transactions which lie on the margins of this device (from a legal point of view) but which are at the centre of pledge lending (from a commercial point of view). Secondly, a relatively strict judicial adherence to the formal requirements of ordinary pledge contracts has generated a remarkable creativity among members of the Bar anxious to arrive at a workable security device which is the functional equivalent of the common law chattel mortgage. These two tendencies actually work at cross purposes: the less the legislature is willing to provide what the courts might perceive as commercially viable security devices over moveable property, the more courts seem prepared to display flexibility in the application of the basic rules of pledge; and the more the courts loosen up the strictures of the Code, the less the legislature is inclined to overhaul the security provisions of the Civil Code.

In one respect, this symbiosis is not to be regretted. Of course, one might well wish that the legislature had not engrafted the commercial, agricultural and forestry pledges onto Title Sixteenth of Book Three. Surely these are sufficiently autonomous legal institutions that it is unnecessary to maintain the fiction that they are pledges. A similar point can be made in respect of the trust deed under the *Special Corporate Powers Act*. Nevertheless, by approaching law reform on a piecemeal basis, the legislature has to a large degree preserved the economic wisdom of the 1866 Code. Despite the growing number of special non-vendor financing regimes, it remains the case over a large area of the law that secured credit can be advanced only where a debtor is willing to surrender use and possession of the pledge *corpus*, and where a creditor is willing to take responsibility for its preservation.

Because of the rule in article 2022 C.C. and the requirement of dispossession in article 1970 C.C. many non-vendor consumer financers have attempted to deploy other title-based legal devices to create a security interest. As much as the modern quasi-pledge transactions enacted by the legislature these commercial innovations serve to define the limits of the true pledge. They require, therefore, brief consideration at this time.[167] Modern civil law recognizes two distinct interests in property: a title right and a possession right. Much of the

167. See LeDAIN, *loc. cit.*, note 28; BRIÈRE, "La propriété mobilière et le commerce", (1958) 18 *R. du B.* 169; TANCELIN, "Simulation et crédit mobilier sans dépossession au Québec", (1974) 26 *R.I.D.C.* 317 and SAUNDERS, "Pledge, Commercial Pledge, Sale with a Right of Redemption and Similar Security Devices", [1967] *Meredith Memorial Lectures* 16.

difficulty in this field arises because, by contrast with the situation which prevails with immoveables, with intellectual property and with ships, there tends to be no register of titles or other mechanism for giving publicity to rights in corporeal moveables apart from the fact of possession. As a result, the distinction between the right of ownership or any other right in (*jus in re*) or upon (*jus ad rem*) moveables, and the fact of possession is blurred.

Article 2268(1) C.C. states: "Actual possession of a corporeal moveable by a person as proprietor, creates a presumption of lawful title." But the Code has always recognized the possibility of dissociating title and possession in sale (initially through articles 1025 and 1027 C.C.,[168] as well as through sales with a right of redemption,[169] then later through conditional sales[170]) and lease. Consequently, to the extent they can be made to apply to non-vendor transactions, these title-based devices are presumptively a creditor's best means for retaining a security interest in property remaining in his debtor's hands.[171]

After much hesitation, in which considerations of substantive policy prevailed over even the most scrupulous respect for legal forms,[172] Quebec courts began in the late 1950's to accept various title transactions as a means of securing a non-vendor's rights.[173] Now it would appear that conditional sales and leasing, having been recognized and regulated in some measure by the *Consumer Protection Act*[174] so as to protect the debtor from repossession, and thereby indirectly protect his other creditors, are being accepted as models for double transactions where goods originally were in possession of the

168. *Creed* v. *Haensel and William*, (1903) 24 C.S. 178.

169. See *Salvas* v. *Vassal*, (1896-97) 27 S.C.R. 68.

170. See, for example, *Tremblay* v. *Tremblay*, [1949] B.R. 539; but compare BERGERON, "Des ventes dites conditionnelles", (1962) 22 *R. du B.* 150.

171. BAXTER, *loc. cit.*, note 2.

172. Despite early Supreme Court cases recognizing these devices - *La Sauvegarde* v. *Ayers*, [1938] S.C.R. 164; *The Queen* v. *Montminy*, (1898-99) 29 S.C.R. 484 - Quebec courts remained generally hostile to title transactions whether these were vendor or lender initiated. See *Lahaie* v. *Cayouette*, (1931) 51 B.R. 459; *Thompson* v. *Lapierre*, (1934) 72 C.S. 460; *Campbell Auto Finance* v. *Comtois*, [1946] C.S. 136; *General Finance Corp.* v. *Fortin*, [1958] R.P. 428 (C.S.).

173. The cases signalling this shift as respects lender financing were *I.A.C.* v. *Marmette*, [1957] B.R. 861 and *Traders Finance Corp.* v. *Landry*, [1958] B.R. 120.

174. L.Q. 1980, c. 72.

debtor.[175] In order to sustain the validity of any given arrangement, the courts seem to require first, that there be a *bona fide* alienation by the debtor (*i.e.* that he have no obligation to enter into the second agreement, be it a lease or conditional re-sale),[176] and second, that the original transfer become absolute upon default (*i.e.* that the creditor renounce his right to sue for the unpaid balance).[177] In any event, despite the sale with a right of redemption model explicitly enacted by the Code these double transactions remain somewhat risky for creditors who do not take the necessary documentary precautions.[178]

In retrospect, it would seem that a preoccupation with articles 1970 C.C. and 2022 C.C. seems to have blinded courts to the fact that the civil law has always recognized, through sales with a right of redemption and through conditional sales, the use of title as a security device. If indeed article 1970 C.C. continues the basic possessory rule of *pignus* and article 2022 C.C. prohibits *hypotheca* of moveables, it is still true that no Codal text declares *fiducia* contrary to public order.[179] To the extent any additional support for this view is needed, one need only consult recent jurisprudence which expressly recognizes the possibility of a transfer of ownership as security in respect of incorporeals.[180]

One might bring this discussion of the legal regime of the pledge to a close by recalling two fundamental characteristics which distinguish it from other forms of security interest: as a real contract the pledge requires the pledgor's dispossession; as a unilateral contract, the pledge presupposes that the pledgor retains a property interest in the goods pledged.[181] The details of these two features are analysed in

175. See *Canadian Dominion Leasing* v. *Laboratoire Choisy*, [1970] C.A. 1021.

176. For an early discussion see LAFOND, "Un contrat similaire au gage", (1952-53) 3 *R.J.T.* 260. Even when the two contracts have been signed on the same day courts have recently declined to penetrate behind legal form.

177. See DESJARDINS, "Du nantissement commercial à l'hypothèque mobilière", (1968-69) 71 *R. du N.* 87. There seems, however, to be no good reason of legal policy for distinguishing between an ordinary conditional sale (where this second condition would not apply) and a conditional sale subsequent upon an original sale by the conditional buyer. Surely the policy concerns of the courts could best be met by a generous reading of the *Consumer Protection Act*. For a discussion see MacDONALD, *loc. cit.*, note 13.

178. See *Marmette* v. *Villeneuve*, [1968] B.R. 841 and *Traders Finance Corp.* v. *Charlesbourg Auto*, [1967] C.S. 468.

179. For an eloquent statement of this view, albeit in slightly different terms, see LeDAIN, *loc. cit.*, note 28, 89-95.

180. See *Place Québec Inc.* v. *Desmarais*, [1975] C.A. 910, 912-913.

181. The first, second and fifth attributes — pledge as security, pledge as a

classical French doctrine under the rubric "effects of the pledge".[182] In reality, however, they are legal rules which define the functional scope of the true pledge. It remains now to consider how these details make explicit the realm within which pledge lending may be exploited with profit.

## CHAPTER THREE: EVALUATING THE PLEDGE

The analysis undertaken in Chapter One of this study suggests that a creditor seeking to take a security interest in his debtor's assets typically will be pursuing three main objectives: these are (i) to obtain *satisfaction* of his debt; (ii) to be paid by *priority* over other competing claimants on his debtor's property; and (iii) to assert *control* over the manner in which his debtor deals with the collateral so as to maximize its realization value. The particular mix of these objectives which any creditor demands and the covenants he stipulates in a credit agreement can be described as his "risk aversion" coefficient.[183] Not surprisingly, for a highly risk averse creditor this coefficient will be conditioned in large measure by a variety of factors both internal and external to his loan which put a premium on his ability to control (or police) his debtor's activity.[184]

External factors are primarily those relating to the regime of legal regulation which governs secured transactions in general, and specific security devices in particular. For example, where the law does not always permit a creditor to contract freely for a priority position (as is currently the case in Quebec) the lender of money might well attempt to reduce his risks by demanding higher interest rates and by seeking greater control of the collateral. That is, the creditor will maximize the value of his security by limiting his debtor's opportunities to waste or dispose fraudulently of his secured assets. Similarly, where the law does not always provide for an

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conventional device, and pledge as an accessory — are not unique to the pledge. See MAZEAUD, *op. cit.*, note 9, 63-67.

182. See MAZEAUD, *op. cit.*, note 9, 83-91; WEILL, *op. cit.*, note 6, 89-102; DAGOT, *op. cit.*, note 7, 126-139.

183. The structure of the analysis in this section is derived primarily from SMITH and WARNER, "Bankruptcy, Secured Debt and Optimal Capital Structure", (1979) 34 *J. Fin.* 247; JACKSON and KRONMAN, "A Plea for the Financing Buyer", (1975) 85 *Yale L.J.* 1; the several articles by Schwartz, Jackson and Kronman, Baird and Jackson, *supra*, note 4; those by Jackson and McCoid, *supra*, note 11a and Levmore, *supra*, note 12.

184. For a development of this point see SCHWARTZ and SCOTT, *op. cit.*, note 10, chapter XIV, "Policing the Collateral Through Possession".

effective scheme of asset tracing (again as in Quebec) the lender will be more concerned to supervise how the debtor deals with the original collateral than if he could project his security interest into proceeds generated by the ordinary course sale of that collateral. Finally, should the law not permit a creditor to realize privately, and thereby enhance the realizable value of his security, he is more likely to be concerned with policing so as to be in a position to trigger default prior to excessive indebtedness. Each of these examples illustrates how a risk-averse creditor will adapt the external environment of his loan (the legal regime available to him) in order to minimize his exposure.

But it is not just external factors which will influence a creditor's risk aversion coefficient. Internal factors — including debtor trustworthiness, the debtor's existing credit exposure, the nature of the debtor's business, and the nature of the assets to be secured — will bear upon the type of security taken and the additional covenants demanded by a creditor. Several examples where a creditor is not able to adequately compensate his risk through interest alone may be mooted. In a business where competition is severe and markets are seasonal (*e.g.* the manufacture of hockey sticks), the most effective way to minimize risk is to stipulate for a right to take possession of and manage the borrower's enterprise whenever the creditor feels "insecure". Here, an effective right to police the collateral can protect an outstanding balance much more effectively than a high priority position in the proceeds of a judicial sale held in the summer. Again, where assets are of high value, but easily concealed and transported, control becomes a major creditor concern. Even a property right is of little use to a creditor who does not actually have physical or juridical custody of assets such as diamonds, gold, cash or bearer bonds. Further, whenever a debtor is already highly levered, a new creditor's optimal security lies in his power to prevent his debtor from undertaking risky transactions. Thus a right of veto over potential customers (exercisable through the right to closely supervise the collateral) can serve to maintain cash flow, reduce the amount of capital tied up in accounts receivable and minimize the debtor's write-off for bad debts - all of which enhances a creditor's likelihood of obtaining full repayment. These examples suggest that internal features of any debtor/creditor relationship will also play a large role in determining the objectives which a risk-averse creditor will be pursuing in order to minimize his insecurity.

If one postulates a market of perfect information the negotiation of contractual terms between borrower and lender would focus exclusively upon factors relating to the creditor's degree of risk

aversion and the debtor's efforts to parlay his own assets into the most advantageous loan agreement. This negotiation may be characterized as the creditor's bargain. Typically a debtor's prime lever will be interest. Yet sometimes a creditor will be less concerned with obtaining a high rent than with obtaining a guarantee of payment. By contrast, sometimes a debtor will trade-off secured credit against lower interest precisely because the rights assigned to his creditor do not infringe upon his ability to conduct his affairs.[185]

These last two observations suggest that, even in a legal regime which permits purely documentary (*i.e.* debtor-in-possession) security interests without limitation, and which protects these interests by a right to trace into proceeds and a right to obtain private realization, there may nevertheless be an important place for possessory security devices.[186] In determining this place, it is necessary to evaluate the pledge in terms of its usefulness to a risk-averse creditor; that is, to assess the degree of satisfaction, priority and control which is inherent in the pledge creditor's bargain, and to suggest, therefore, when pledge lending can be most advantageous.

### A. Satisfaction

In classical civil law literature questions relating to creditor satisfaction are treated under the rubric "effects of the pledge as a real right between the parties".[187] Because the pledgee is given a real right in the pledgor's property, he obtains distinct execution advantages. These advantages are three in number: a right of possession and retention (articles 1972, 1973, 1975 and 1976 C.C.); a limited right to use and enjoy the fruits generated by the pledged object (article 1974 C.C.); and a right to realize his security by bringing the object to judicial sale or by expropriating the pledgor's rights (articles 1971(1) and 1971(3) C.C.).

#### 1. The Rights of Possession and Retention

The pledgee's rights of possession and retention have long been the object of doctrinal and judicial controversy. Article 1975 C.C. provides that the creditor may resist any attempts by the debtor to regain possession of the object given in pledge until the debt is wholly

185. See BAIRD and JACKSON, *op. cit.*, note 10, 357-358; SCHWARTZ and SCOTT, *op. cit.*, note 10, 563-565.

186. See WHITE and SUMMERS, *op. cit.*, note 26, 933-937.

187. See MAZEAUD, *op. cit.*, note 9, 83-87.

paid in principal, interest and costs. In addition, article 1972 C.C. describes the pledgee's possession as that of a depositary and article 1973 C.C. obliges the pledgor to repay the pledgee's expenses of preservation. Some authors conclude that the pledgee thus may assert two distinct rights of retention: one as pledgee under article 1975 C.C. and one as depositary under article 1973 C.C.[188] The cases also seem to suggest that these are two separate pledgor obligations.[189]

For the sake of conceptual clarity, it is probably better to characterize the article 1975 C.C. right as the pledgor's right to possession and his 1973 C.C. right as a right of retention. The former right is enhanced by article 1975(2) C.C. which projects it onto subsequent debts, and article 1976 C.C. which impresses it with the stamp of indivisibility.[190] Of course, both these latter two features may be waived by the parties,[191] and concomitantly, the scope of the pledge agreement supporting the right to possession may be enlarged or diminished by agreement.

Several examples will illustrate these possibilities. If an insurance policy has been pledged the creditor may stipulate that, in default of the debtor keeping the policy in force, the creditor may do so and recover the cost of premiums paid from the pledgor as a cost of the pledge.[192] Again, a creditor may stipulate that the debtor insure the property pledged and assign insurance proceeds to him in the event of loss. Notwithstanding article 2586(1) C.C. the creditor may, as an accessory to his right to keep the object pledged under article 1971 C.C., insist upon a right to be attributed the entire value of the insurance policy. Article 2558(2) C.C. regulates the ordinary pledge of insurance, while article 2558(1) C.C. speaks to the case where a *pacte commissoire* has been stipulated. Because the creditor is a depositary under article 1972 C.C. he is required to care for the object pledged as a prudent administrator.[193] It follows that charges for safety deposit box rental, warehousing and like expenses can be considered as a cost of the pledge. What is more, notwithstanding article 1973(2) C.C. (which seems to limit the pledgor's liability to the reimbursement of necessary expenses), a debtor and creditor may

188. FRENETTE, *Le droit de rétention*, (1980).

189. *McCaffrey* v. *Ball*, (1889) 20 S.C.R. 319.

190. WEILL, *op. cit.*, note 6, 89-91.

191. *Desrosiers* v. *Western Assurance Co.*, (1905) 33 R.J. 92 (C.S.).

192. *St. Charles* v. *Duclos*, (1915) 49 C.S. 188.

193. Article 1973 (1) C.C.; *Bruneau* v. *Dansereau*, (1928) 66 C.S. 91.

agree that the pledgee undertake non-necessary precautions to protect the pledge. Payment of these expenses will also be protected by the pledgee's right to assert possession.

This ability to augment the conditions of the pledge contract so as to enlarge the right to possession suggests one very useful attribute of the pledge: it may be elided by agreement into an ordinary non-contractual right of retention such as that given to carriers (article 1679 C.C.), mandataries (1713 C.C.), factors (1753 C.C.) and improvers (article 441 C.C.). Imagine the case where an owner of denim sends it to a cutter for manufacture into jeans, or the case where an owner of leather sends it to a tanning company for processing. Not only could the cutter and the tanner retain the cloth or leather under article 441 C.C., but they could also stipulate that they were holding the goods as a pledge to secure the amount owed by the debtor for the cost of the work undertaken. In other words, an ordinary contract giving rise to a right of retention can be collaterally secured by a pledge.

The reverse is also true. The obligations of the pledgee under an agreement of pledge may also be transmuted by contract into a relationship from which an independent right of retention results. This latter eventuality is exactly the double transformation which can arise in brokerage agreements between stockbrokers or precious metals dealers and their clients.[194] In each of these cases the advantage of the pledgee's possession over the ordinary right of retention is the possibility of also stipulating for a *pacte commissoire*.[195]

A final attribute of the pledgee's right of possession which enhances his chances of obtaining satisfaction is the pressure it puts on the pledgor whenever the value of the collateral pledged exceeds the value of the outstanding balance. Unless the parties have agreed to renounce the indivisibility of the pledge, the pledgee may assert his rights over an entire warehouse full of inventory until such time as the debt is liquidated in full. Typically, however, as in brokerage contracts where the pledgee agrees to segregate into a special account only sufficient securities to cover indebtedness then owing, parties will renounce indivisibility. In such cases the pledgee or warehouseman will be holding some previously pledged assets on deposit

194. See *Beatty* v. *Inns*, [1953] B.R. 349; *Smith* v. *Savard*, [1962] C.S. 625.

195. It is an interesting question whether a cutter or tanner whose work greatly exceeds in value the price of the raw material given to him may plead article 435 C.C. in order to assert title in the manufactured property. If so, the great advantage of the *pacte commissoire* (the attribution of property) is already achieved.

for the account of the pledgor, and other assets for the pledgee. To say that the pledgee's possession may be set up against the debtor means also that should the pledgee be involuntarily or fraudulently dispossessed and should the property find its way back into his pledgor's hands, he may nevertheless reassert the pledge and revendicate the collateral.[196]

### 2. The Attribution of the Prerogatives of *usus*, *fructus* and *abusus*

The question whether the pledgee has a right to use, to enjoy the fruits of, or to dispose of the object given in pledge raises important theoretical conflicts. Certain authors, relying on articles 1972 and 1802 C.C., hold that the pledgee can neither use the object given in pledge, nor take the fruits which it generates.[197] Nevertheless, other writers assert that article 1972 C.C. is not a rule of public order and that parties may derogate from it by agreement.[198] This latter view is more consistent with the rule of article 1974 C.C. respecting the interest generated by pledged debts.[199]

As to the general case, (*i.e.* that not relating to the pledge of debts) several examples of contractual stipulations relating to the prerogatives of ownership come to mind. A debtor might well pledge a sophisticated computer or other hi-tech item to a trade creditor under the stipulation that the pledgee could use the object.[200] In such an agreement it might also be stipulated that the value of its rental (at some suitable discount) be imputed against the interest due on the loan or against the capital, although such a stipulation is not mandatory. Similarly, even though the debtor retains ownership of objects pledged, he may agree that his creditor appropriate the fruits generated by the object to the payment of the debt. This is precisely the rule applicable to contracts of antichrèse, in that under article 1967 C.C. the creditor in possession benefits from the fruits which may be produced.[201] Again, however, the parties may agree that the creditor shall simply keep the fruits. Finally, it is even possible for the

196. For an analogous case see *Wilson* v. *Doyon*, [1964] C.S. 93; see also WEILL, *op. cit.*, note 6, 92-93.

197. MIGNAULT, *op. cit.*, note 53, 405; DAGOT, *op. cit.*, note 7, 137-138.

198. MAZEAUD, *op. cit.*, note 9, 84.

199. WEILL, *op. cit.*, note 6, 98 and 101.

200. See PLANIOL and RIPERT, *Traité pratique de droit civil français*, 2nd ed., tome 12, p. 127.

201. See *Vassal* v. *Salvas*, (1897) 27 S.C.R. 68; *D'Eglauch* v. *Labadie*, (1900) 21 C.S. 481.

debtor to confer upon the creditor to whom he has pledged certain objects various rights tending towards the power of disposition. In other words, the obligation of the creditor to conserve the pledge as a depositary has two senses: that relating to use and deterioration, and that relating to disposition, both of which may be waived by the parties. Thus, if shares in a company have been given in pledge, the agreement could provide that the pledgor could vote the shares (*usus*), appropriate dividends payable upon the shares (*fructus*), and even exercise rights to convert shares of one class into shares of another (*abusus*). A like result could be achieved where the pledgor agrees that the pledgee may manufacture the objects given in a pledge, or otherwise improve them, or even consume them in the production of new product to be then held in pledge (*e.g.* the processing of wood-chips into aspenite).

While any prerogatives of the above nature would have to be explicitly stipulated in the pledge agreement,[202] article 1974 C.C. provides for an automatic imputation of fruits in the case of debts bearing simple interest.[203] Yet because of lacunae in the text of this article, difficult problems of interpretation can arise whenever principal and interest are blended in a single payment. First, article 1974(1) C.C. which provides that "if a debt bearing interest be given in pledge, the interest is imputed by the creditor in payment of the interest due to him", only governs the case where the debt pledged generates less interest than that due on the principal obligation which the pledge secures. Second, article 1974(2) C.C. relates uniquely to situations where the debt pledged secures a non-interest bearing obligation, including an obligation to do or not to do. As a result, in cases of blended payments it would seem to be necessary to stipulate a special clause permitting the pledgee to also appropriate the part of any repayment attributable to capital.[204] In all events the parties could agree that the creditor would simply expropriate the interest without imputing it to either capital or interest on the principal obligation.[205]

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202. The absence of such a stipulation would mean that any use by the creditor would amount to an abuse of the pledge by the creditor. In this case article 1975(1) C.C. then permits the pledgor to recover possession of the object. See *Pacaud* v. *La Banque du Peuple*, (1893) 3 C.S. 8.

203. See article 1159 C.C.; *Sirois* v. *Hovington*, [1969] B.R. 97.

204. *In re Investissements Habibec Inc.*; [1981] C.S. 188.

205. MAZEAUD, *op. cit.*, note 9, 84 does not see the ordinary case of article 1974 C.C. as being an exception to the rule refusing fruits to the pledgee, since the imputation in fact goes to reduce the pledgor's outstanding obligations.

Precisely these types of difficulty have generated confusion in the jurisprudence as to the legal nature of the pledge of debts.[206] What is more, debtors and creditors have themselves developed a number of variations on the Codal principles regulating this species of pledge. Two main types of arrangement are common. First, if a debt is simply pledged under articles 1966 C.C. and 1570 C.C. it would follow that the pledgor remains owner of the debt. Thus, until the pledged debt is paid, it is the pledgor who must assume primary responsibility for enforcing it and it is he who bears the risk of loss.[207] When the debt is due payment is made to the debtor, absent a stipulation to the contrary. In other words, the object of the pledge is the debt, not the value represented by the debt; extinction of the obligation represented by the debt extinguishes the pledge. For this reason it is rare that a creditor would be content with a simple pledge of debts without undertaking the formalities under articles 1971 and 1971d C.C. required to make the pledge enforceable against the account debtor, or without stipulating for additional collection rights in the agreement.

The most usual clauses in pledge contracts convert the pledge into an assignment by way of guarantee. The validity of these assignments has been confirmed in several cases.[208] The assignment deprives the "pledgor" of his rights of ownership in favour of the creditor, and as long as the principal obligation is outstanding, the assignor has no right to sue for recovery of his claim;[209] any recourse relating to payment must be effected, in the first instance, through the assignee.[210] Nevertheless, because the assignment is by way of guarantee, the assignor retains a residual, conditional right to payment once the principal obligation is extinguished, and may also take conservatory measures to preserve the claim.[211] In other words, unlike the ordinary pledge, wherever debtor and creditor agree to

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206. See especially, LEGEAIS, *op. cit.*, note 74a; for the position in Quebec see PAYETTE, "Cession de créance en garantie", (1968) 3 R.J.T. 281; SARNA, "Assignments of Book Accounts and Standing to Sue", (1978) 56 *Can. Bar Rev.* 626.

207. *B.C.N.* v. *Paquet*, [1978] C.P. 251; *Sirois* v. *Hovington*, [1969] B.R. 97; *Robillard* v. *Vincent*, (1941) 79 C.S. 204.

208. *Canadian Terrazo and Marble Co.* v. *Kaplan Construction*, [1966] C.S. 505; *Dessureault* v. *Bastien*, [1960] B.R. 1052.

209. *Lemaire* v. *Tourville*, [1952] C.S. 221.

210. See SARNA, *loc. cit.*, note 206; see also *Desrosiers et Frères* v. *Thibault*, [1979] C.P. 283.

211. *Place Québec Inc.* v. *Desmarais*, [1975] C.A. 910.

permit the latter to encroach upon the prerogatives of *usus*, *fructus* and *abusus*, the contract changes its juridical nature and becomes analogous to a sale with a right of redemption.[212]

This last point leads to a consideration of the third major satisfaction right accorded to the pledgee — the right either to expropriate the object pledged by way of *pacte commissoire*, or to bring it to judicial sale and assert rights in the proceeds.

### 3. The Right to Realize by Judicial Sale or *Pacte Commissoire*

The basic rule relating to a pledgee's right to realize upon his security is that set out in article 1971(1) C.C. Saving an explicit stipulation to the contrary, realization may only take place through the judicial seizure and sale of the object pledged.[213] Nevertheless, because the pledgee has possession of the object he is in the best position to evaluate the most opportune time for realization, and this prerogative enhances his chances for strategic recovery.[214] In order to exercise his right to a judicial sale, the pledgee will obtain judgment confirming the default, then simply seize the object in his own hands. At this point the ordinary rules for seizures, oppositions, sale and distribution of proceeds will apply.[215]

Few contemporary pledge contracts, however, do not contain contractual stipulations under article 1971(3) C.C. permitting the creditor to retain the thing upon default. By this paragraph the codifiers confirmed the status of the *pacte commissoire* in the law of Quebec[216] and provided creditors with the right to impose obligatory giving-in-payment clauses upon pledgors.[217] In addition, because the pledge is an accessory and not an alternative obligation, the mere fact that a creditor exercises a *pacte commissoire* does not necessarily extinguish the principal obligation. Thus the creditor may stipulate

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212. See LEGEAIS, *op. cit.*, note 74a; but see the laconic judgment in *C.I.B.C.* v. *Zwaig*, [1976] C.A. 685 where the court seems to characterize such assignments as pledges. See also MacDONALD and SIMMONDS, *loc. cit.*, note 30, 270.

213. This of course is by contrast to the position in France. See DAGOT, *op. cit.* note 7, 131-135.

214. *Paquin* v. *Dunlop et Royal Bank*, (1933) 71 C.S. 506.

215. See MacDONALD, *loc. cit.*, note 13.

216. See *Sixth Codifiers Report*, p. 50. But note articles 1979d and 1979k C.C. which prohibit the *pacte commissoire* in special pledges. See *Crédit Nova* v. *Laliberté*, [1980] C.S. 10.

217. *Salvas* v. *Vassal*, (1896-97) 27 S.C.R. 68; *Beaudoin* v. *Trottier*, [1945] C.S. 63.

the forfeiture of the object pledged, say at its fair market value or its fair market value less 15%. Should this attribution of value fail to liquidate the outstanding balance, the creditor could then pursue the pledgor for the amount owing.[218]

Certain authors suggest that article 1971 C.C. exhaustively enumerates the pledgee's realization rights, and claim that the pledgee cannot stipulate for a right of private disposition.[219] Nevertheless, other authority holds that if the pledgee can completely expropriate the object pledged, he can then dispose of the object as he sees fit. *Qui peut le plus, peut le moins.* Express approval for such a procedure may be found in cases permitting stockbrokers to sell shares bought on margin.[220] In other words, pledgees may stipulate not only for a right to expropriate, but also a right to proceed to a private disposition of the property pledged by way of public auction or even private sale.

There are, however, good reasons for proceeding to realize in all cases by invoking the *pacte commissoire* first. To begin with, expropriating all a pledgor's rights under article 1971(3) C.C. will obviate the need for the pledgee to return to the pledgor any surplus produced by the sale of the objects.[221] Another reason for invoking the *pacte commissoire* flows from the fact that the purchaser at any such private sale will not benefit from the protection afforded by article 2268(5) C.C. Since the pledgor remains owner of the objects given in pledge, his right to revendicate from the purchaser will not be extinguished by a private sale. Only if he renounces his rights of ownership, or if a *pacte commissoire* is exercised, would the pledgee be in a position to pass on good title by way of private sale.[222]

### 4. Satisfaction as a Property Right

By contrast to various non-possessory security devices over moveables under the Civil Law, the pledge affords the creditor extensive satisfaction rights which enhance his ability to realize upon his loan. These are tied to his right of possession, the prerogatives of

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218. For analogous results with respect to giving in payment clauses see *Normand* v. *Beauchamp*, [1976] C.A. 86. But see MIGNAULT, *op. cit.*, note 53, tome 8, 415.

219. MIGNAULT, *op. cit.*, note 53, 414, citing *Campbell* v. *Beyer*, (1906) 30 C.S. 86.

220. *Beatty* v. *Inns*, [1953] B.R. 349.

221. See *Royal Trust* v. *Atlantic & Lake Supply Railway*, (1908) 13 Ex. C.R. 42.

222. See *Campbell* v. *Beyer*, (1906) 30 C.S. 86, 89.

*usus* and *fructus*, and his ability to expropriate the pledgor's interest. In effect, taken together these rights permit the pledgee to deprive the pledgor of the greater part of the attributes attaching to his ostensible right of ownership. It is now appropriate to consider how these satisfaction rights can be translated into enforceable claims against third parties. This is the second element of the creditor's bargain: priority.

### B. Priority

Doctrinal writers typically deal with the priority question under the title "effects of the pledge as a real right as against third parties."[223] Yet despite the apparent transparence of this rubric, the pledge presents a very confusing priority picture for loan creditors. This confusion flows from the fact that courts have often attributed a very different status to each of the pledgee's rights.

Certain attributes of the pledge have been held to vest in the pledgee a preference opposable to all competing creditors. Such a view has been taken in respect of the *pacte commissoire* and, to a lesser degree, the rights of possession and retention. In particular, there is authority that the pledgee may assert any one of an action in revendication, an opposition to withdraw, an opposition to annul or a contestation of a garnishment against seizures by any third party.[224] By contrast, other prerogatives, such as the right to be paid by preference, give a slightly less valuable priority. For example, articles 1969, 1977, 1994 and 2001 C.C. establish a pledgee's execution rank between that of the unpaid vendor and the lessor.[225] Finally, some of a pledgee's prerogatives, simply cannot be effectively asserted against third parties. This occurs notably when an involuntarily dispossessed pledgee attempts to assert his right to follow against a good faith possessor claiming the protection of article 2268 C.C.[226] Consequently, the priority position of the pledgee must be assessed independently for each of his various realization rights.

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223. See MAZEAUD, *op. cit.*, note 9, 87-90.

224. See CIOTOLA, *op. cit.*, note 16, 94; *Paquin* v. *Dunlop*, (1933) 71 C.S. 506.

225. See *Bell* v. *Wilson*, (1885) 5 L.C.R. 491; *Gosselin* v. *Ontario Bank*, (1905) 36 S.C.R. 406; *Belleau* v. *Donohue*, (1927) 10 C.B.R. 273 (C.S.).

226. See, for example, in the case of a disguised pledge, *Landry* v. *Nicole*, (1916) 51 C.S. 68 (C. Rev.).

### 1. The Rights of Possession and Retention

It is now settled that the pledgee's rights of possession under article 1975 C.C. and retention under article 1973 C.C. may be set up against not only the debtor, but third parties as well.[227] Nevertheless, there is considerable doubt as to the exact dimensions of this right. All agree that the pledgee may oppose his possession to any third party acquirer of the ownership or other principal real right in the pledge *corpus*.[228] Again, in view of article 1966a C.C. it would appear that the pledgee may oppose his possession to the true owner of an object pledged *super non domino* to him, subject to the rules of articles 1488, 1489 and 2268 C.C.[229]

Nevertheless, the impact of article 1977 C.C. upon the authority of the pledgee to assert his possession against other creditors has been a matter of great conflict. There are two reasons for this: first, it is necessary to determine if the pledgee's right of possession under article 1975 C.C. is a true right of retention like his right under article 1973 C.C.;[230] second, it is necessary to decide what remedies these various possessory rights give to the pledgee.[231] There are two main occasions when a pledgee's rights of possession and retention conflict with another creditor's rights: the most frequent is when a pledgee in possession attempts to resist a seizure by another creditor under article 597 C.P.; the other occasion is when a pledgee not in possession attempts to revendicate property in the possession of, or under the seizure of another creditor.

The majority of cases[232] and authors[233] take the position that an ordinary pledgee in possession may always resist a seizure by another creditor and may bring an opposition to withdraw from seizure any

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227. This would follow from the decision in *Elliot Krever & Associates* v. *Montreal Casting Repairs Ltd.*, [1969] C.S. 6.

228. See WEILL, *op. cit.*, note 6, 91-92.

229. See *Levasseur* v. *St. Onge*, [1979] C.A. 587. But article 1966a C.C. will not permit a pledgee to oust prior security interests, because of article 1977 C.C.

230. See FRENETTE, *op. cit.*, note 188.

231. See MacDONALD, *Proprietary Remedies for Wrongful Interference With Corporeal Moveables in Quebec* (forthcoming in volume 30 *McGill L.J.*) for an analysis.

232. See, for example, *B. Fabian Inc.* v. *Restaurant Le Carafon de Vin Ltée*, [1980] C.S. 768; *Doyle, Dane & Bernback Advertising Ltd.* v. *La Réserve*, [1980] C.S. 772.

233. See, for example, PAYETTE, *loc. cit.*, note 69; CIOTOLA, *op. cit.*, note 16. This also appears to be the position in France. See MAZEAUD, *op. cit.*, note 9, 87-88.

property over which he has such a right. Some even would afford this right to non-possessory pledgees not yet in possession.[234] By contrast, other authors[235] and cases[236] suggest that no possessory right of the pledgee can be set up against a seizure by any other creditor. Finally, at least one case has held, ostensibly following article 1977 C.C., that the opposability of the pledgee's right of possession depends on whether the seizing creditor has a higher or lower ranking privilege.[237] While this latter position may be incorrect when a judicial seizure is in issue, it may well be the appropriate response in certain cases as between a pledgee and a trustee for bondholders, as between two pledgees, or as between a pledgee and a bank claiming section 178 security.[238]

In view of the current provisions of the Civil Code and Code of Civil Procedure, the best position would be as follows. Article 597 C.P. should be understood as stating only a general rule under which third parties may protect their rights in property under seizure. That is, it sets out the requisite quality (*i.e.* the nature of the rights being asserted) which a third party must have in order to file an opposition to withdraw. It does not, however, set out the grounds upon which the opposition is to be founded. For such a listing one must turn to article 596 C.P. The reason for current confusion can be traced to differences in wording between the 1965 Code of Civil Procedure and its predecessor. It was certainly the case under the former Code that courts permitted a pledgee[239] to bring an opposition to withdraw the object of his possessory right from seizure.[240]

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234. *C.S.S.T.* v. *Monette*, C.S. Iberville, no. 755-05-000264-828, February 24, 1983; but see *Sous-ministre du revenu du Québec* v. *Restaurant Chez Gisèle Forget Ltée*, [1984] C.S. 488 and cases cited therein.

235. AUGER, *Cours de sûretés réelles*, (1981).

236. *Sous-ministre du revenu du Québec* v. *Fountainhead Fun Center*, C.S. Mtl., no. 500-05-002904-801, September 30, 1981; *Sous-ministre du revenu du Québec* v. *Total Rental*, [1979] C.S. 840.

237. *La Reine* v. *Bar et Restaurant La Seigneurie de Sept-Isles*, [1977] 2 F.C. 207 (T.D.). This difficulty with this position is that would oblige the court to distinguish between the creditor's right of possession under article 1975 C.C. (where the rank of a competing creditor is relevant) and the creditor's right of retention under article 1973 C.C. (where rank is irrelevant given that article 1977 C.C. does not speak the rights of retention *per se*.)

238. Notably where a subsequent pledgee in possession attempts to resist a non-judicial revendication by a bank or a prior non-possessory pledgee. See *Gagnon* v. *Banque Nationale*, (1919) 29 B.R. 166.

239. *Atlas Thrift Plan* v. *Lussier*, [1965] R.P. 181.

240. MIGNAULT, *op. cit.*, note 53, 408. There were cases asserting, correctly in my view, the contrary: *Fortier* v. *Hébert*, 15 R.L. 476; *Gauthier* v. *Fortin*, 1 R.P. 500.

The former article 646 C.P., upon which this jurisprudence was based, stated:

> The execution may also be opposed by any party who has a right of ownership or of pledge in the property seized.
>
> A lessor cannot, however, oppose the seizure and sale of the property subject to his privilege; he can exercise such privilege only upon the proceeds of the sale.

Since the promulgation of the new Code of Civil Procedure in 1965, however, this article has been divided into articles 597 and 604 C.P. The former, dealing with oppositions to withdraw from seizure, provides:

> The opposition may also be taken by a third party who has a right to revendicate any part of the property seized.

The latter, on oppositions for payment, states in part:

> The creditors of the debtor, for any reason, even for rental, cannot oppose the seizure or the sale; they can only exercise their privilege upon the proceeds of the sale, by opposition for payment ...

From these two articles one may deduce what was only implicit in article 646 C.P. The pledgee's right of possession cannot be converted *via* article 734(1) C.P. (which lists various persons who may seize before judgment because they have a right to revendicate) into a right of revendication sufficient on its own to sustain an opposition to withdraw. Even though the pledgee is given a right to revendicate, and a right to seize before judgment under article 734(1) C.P., he is not entitled to bring an opposition to withdraw property from a seizure practised by one of his own debtor's other creditors.

The pledgee's right to revendicate flows from his right to follow and is intended to protect his possession from interference by third parties claiming rights in the property for their own account. As a result, the expression "the creditors of the debtor" in article 604 C.P. controls the meaning of the phrase "right to revendicate" in article 597 C.P.[241] Only if the revendication (or opposition) is being taken to protect an interest in property which is not under seizure for the debtor's own debt (*i.e.* only if the seizing party is the creditor of a third party and has mistakenly seized the goods under article 569 C.P. and only if the creditor-opposing party is not a creditor of that seizure) may he oppose under article 597 C.P.

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241. Three other Codal articles support this view insofar as various "possessory-type" creditors are concerned: article 1977 C.C. for pledges; article 2000(1) C.C. as regards unpaid vendors; and article 2001 *in fine* C.C. as regards retention creditors.

On the other hand, the pledgee's right of possession may be opposed to certain creditors of the pledgor who are seeking to revendicate the pledge *corpus*. In these cases, where a creditor is revendicating in order to himself take possession (or to realize privately), article 1977 C.C. would permit the pledgee to assert his possession against all lower-ranking creditors. These would include subsequent non-possessory pledgees and the trustee for bondholders, but would not include vendors and prior non-possessory pledgees.[242] A final point to be noted is that should the pledgee be asserting a right of retention, or filing an opposition to withdraw not as pledgee, but as an owner (*i.e.* should he have stipulated a *pacte commissoire* which has become enforceable prior to the seizure)[243] then article 597 C.P. would be available in order to protect his rights. What is more, this right of ownership could be set up as against even prior privileged claims which do not give their titulary a right in (*jus in re*) the pledged assets.[244] In all events, this remains a highly uncertain area of the law, and the priority position of the pledgee's right of possession may well even be superior to that stated here.[245]

### 2. The Right to be Paid by Preference

Articles 1969, 1971, 1977, 1994 and 2001 C.C. establish the general ranking of the pledge creditor upon the proceeds of a judicial sale. Nevertheless, in view of the plethora of other statutes establishing execution priorities the pledgee's rank is not fourth, as article

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242. Regardless of the position one takes on the general point, it is clear that banks asserting section 178 security, transferees of property in stock and documentary pledgees who have prior rights to the pledgee may defeat any retention claim he might make. This flows from the language of section 179(1) of the *Bank Act* and sections 27 and 4 of the *Act respecting Bills of Lading, Warehouse Receipts and Transfers of Property in Stock* respectively.

243. This could occur if the service of a writ of seizure were made a default condition triggering the *pacte commissoire*.

244. The obvious case is the unpaid vendor under article 1999 C.C. Prior non-possessory pledgees, transferees of property-in-stock and banks would be protected by article 1977 C.C.

245. A further question is whether the pledgee's right of retention under article 1973 C.C., or any other right of retention for that matter, follows the same regime insofar as the right to resist a seizure is concerned. See PAYETTE, *loc. cit.*, note 206 for one view. A last issue is whether the right of possession may be projected into the proceeds of a private sale in realization. At least once the courts have said no; see *Banque fédérale de Développement* v. *D.D. Transport Ltée*, J.-E. 84-1022 (C.S.).

1994 C.C. would suggest, but rather at best a seventh-ranked right.[246] Moreover, despite the certainty which the sub-order of article 2001 C.C. seems to give pledgees seeking collocation of their claims, three features of the current law severely compromise the enforceability of this rank. First, legislative tinkering with the Code so as to create non-possessory pledges has opened up the possibility for multiple conflicting pledges.[247] Second, in combination with the nature of the claim priority scheme, the retroactive nature of oppositions for payment make a pledgee's realization rights more aleatory.[248] Third, in cases where the pledgee attempts to realize privately or assert a *pacte commissoire*, no Codal article speaks directly to the status of his rights.[249]

Prior to modern devices permitting registration to replace possession as a means of perfecting pledge and *quasi*-pledge claims, the occasions for conflicts between competing possessory creditors were limited. Of course, to take a first example, it would be possible for a pledgee to be faced with a retention claim from a third party depositary to whom he had given the object pledged for safe-keeping, or a shipper with whom it had been consigned. However, ever since article 2001 C.C. was amended so as to establish a sub-order of collocation for possessory claims, the respective rights of depositary, carrier and pledgee would be clearly settled. Moreover, by virtue of the maxim "a pledge of a pledge is void" it would be impossible for a retention creditor who also stipulates a pledge as security for his claim to come into conflict with the original pledgee: the moment the original pledgee delivers up possession to the pledgee-depositary he no longer has the possession required to assert his pledge against the original pledgor.[250]

A second example of cases where competing possessory pledge rights are possible may be seen in the creation of successive pledges through the use of third parties nominated to hold the pledged objects. In these situations, however, the respective rights of each pledgee would be ranked in advance by the agreement between them,

246. See MacDONALD, *loc. cit.*, note 13.

247. See articles 1966(3), 1979a, 1979e and 2557 C.C.

248. Under article 604 *in fine* C.P. creditors have up to ten days following a judicial sale to assert their claim.

249. But see article 1977 C.C. and *Pagé* v. *Montreal Trust*, [1981] C.S. 217.

250. Absent express authorization for the original pledgor, this would also constitute an abuse terminating the pledge under article 1975 C.C.

or between each pledgee and the custodian.[251] This result would follow even in the case of the successive pledge of incorporeal rights. In default of agreement between the pledgees, their rank would follow the date of the pledge agreement if corporeal,[252] or if incorporeal, the date of signification[253] or signification and registration[254] or the date of notice[255] as the case may be.

The competition of various dispossessory pledges measurably complicates the process of ranking. The basic rule for collocating claims of equal rank is that of article 1985 C.C., which provides for a pro-rata distribution. Despite this rule, however, an argument can be made that pledge claims ranked concurrently by article 2001 C.C. do not share pro-rata in the proceeds of a judicial sale.[256] Of course, in certain dispossessory pledge contracts requiring registration the Code explicitly establishes that priority of registration determines rank. This is true, for example, where a universality of receivables has been pledged under article 1571d C.C.[257] While a second ranking assignee who publishes newspaper notices first may initially enforce his rights against the account debtor, once the first-registered assignee perfects his rights, he will outrank the pledgee who registered second.[258]

The advent of the commercial pledge has, however, created several more acute ranking difficulties. The courts appear to favour a temporal ranking scheme where two or more agricultural pledges under article 1979a C.C. or two or more commercial pledges under article 1979e C.C. are in competition. The registration required to constitute the pledge is taken as perfecting a real right, which then becomes opposable to subsequent pledgees.[259] One rationale for adopting a temporal scheme as between special pledgees may be found in article 2130(2) C.C.[260] but this rationale cannot be invoked

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251. See MAZEAUD, *op. cit.*, note 9, 74-75.

252. See CIOTOLA, *op. cit.*, note 16, 94.

253. Article 1571 C.C.

254. Article 2127 C.C.

255. Article 2557(2) C.C.

256. See DESJARDINS, "Les garanties mobilières", (1972) 74 *R. du N.* 65, 74-76; and compare, as regards trust deeds, PAYETTE, "Priorité entre deux charges flottantes", (1982) 42 *R. du B.* 435.

257. *Le groupe Traders Ltée* v. *Commercial Credit*, [1974] C.A. 247.

258. See, for a similar result in an agricultural pledge, *Caisse populaire de Ste-Mélanie* v. *Coopérative de tabacs laurentien*, [1952] C.S. 211.

259. *In re Bertrand*, [1967] C.S. 596.

260. See PAYETTE, *loc. cit.*, note 256.

as between special pledgees and ordinary pledgees since the latter need not register his rights. Nevertheless, the rule of article 1977 C.C. would seem to provide sufficient reason for adopting a temporal rule. Such a result has already been reached in France as between competing ordinary pledgees.[261] The principle of article 1985 C.C. would, therefore, appear to be inapplicable to competing ordinary and commercial pledgees: *prior tempore, potior jure.*[262]

The second major priority problem for the pledge creditor arises because of the retroactive nature of oppositions for payment. The Code of Civil Procedure stipulates that a creditor who is not claiming ownership of goods under seizure, or who is not contesting the validity of the seizure may not bring an opposition to annul or suspend the process of execution. Rather, article 604 C.P. provides that the creditor must bring an opposition for payment, which permits him to register his claim against the proceeds of the seizure.[263] Unlike the opposition to annul, which must be taken prior to the judicial sale itself, the opposition for payment may be brought for a period of ten days after the sale, in the same manner as an ordinary opposition.[264] In view of the general terms of article 604 C.P. it would seem that not only the claim of chirographic creditors but also that of privileged creditors and that of owners too late to bring an opposition to withdraw may be raised thereunder.[265]

Where there are several seizing creditors, or where the opposition for payment has been taken prior to the date of the sale, the seizing creditor is in a position to know the approximate value which must be realized from the sale of property under seizure in order for him to be paid his claim. But, where an opposition for payment is filed after the sale has taken place (be this by a privileged creditor or by a third party owner), the collocation of the claim asserted by the opposing party may well diminish the amount of money available to pay the pledgee's judgment to the point where it is insufficient to cover his claim. In this case the pledgee has no alternative but to requisition

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261. See MAZEAUD, *op. cit.*, note 9, 89 and 200. See also *Nortown* v. *Feltus*, (1932) 52 B.R. 209, 223.

262. See CIOTOLA, *op. cit.*, note 16, 110. Support for this position may also be found in the recent case *Banque de Développement fédérale* v. *D.D. Transport Ltée*, J.-E. 84-1022 (C.S.).

263. *Aetna Factors* v. *Brouillard*, [1976] C.P. 405.

264. Article 604 *in fine* C.P. See *Les Industries Palmer Inc.* v. *Choquette*, [1981] R.P. 344 (C.P.).

265. See *Lester* v. *Turcotte*, (1913) 43 C.S. 385 (C. Rev.).

another writ of seizure and effect another seizure and sale, except that, in the distribution under any such seizure, he would rank as a chirographic creditor.[266] While there are few Codal privileges which undermine a pledgee's rights, the plethora of higher-ranking statutory and Crown privileges often means that the pledgee who seizes acquires no benefit from the judicial sale of the object of his security.[267]

The uncertainty attaching to the actual prospects for payment of a pledgee is one of the major reasons for the increased importance of the *pacte commissoire* and private realizations as a pledgee's recourse. As noted above, one of the principal advantages of the pledgee's right of possession is that it permits him some control over the time and manner of realization upon default. If he stipulates as a default condition the seizure by any other creditor, and exercises a *pacte commissoire*, he has effectively generated a super-priority by excluding all other privileges. That is, since the ordinary privilege lies solely on a debtor's own goods, it cannot attach to goods now the property of the pledgee. Only fully secured creditors, such as banks and transferees, who have rights in the property may disrupt the pledgee's ownership. If these other creditors have priority (either temporally or under article 1994 C.C.)[268] their rights may be asserted against the pledgee. Moreover, since the *pacte commissoire* cannot have retroactive effect, even if their rights are subsequent, the pledgee's ownership cannot expropriate them. Article 1977 C.C. means that the pledgee takes the property charged with these claims.[269]

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266. He could, of course, initially seize all the debtor's assets simply to guard against losing his privileged claim. The absence of a doctrine of "marshalling", or even the application of article 2049(2) C.C. to moveables exacerbates this problem. See MacDONALD, "Equity Among Secured Creditors: Article 2049(2) C.C. Re-examined", (1981-82) 27 *McGill L.J.* 721.

267. Paradoxically, it is precisely this feature of collocation schemes that critics of the commercial pledge advance on behalf of the trustee for bondholders. See HANNAN, "Trust Deed Security and Competing Creditors", [1976] *Meredith Memorial Lectures* 29.

268. As would be the case for example with the bank, transferee, tax payment, or unpaid vendor.

269. This result is parallel to that arising with respect to construction privileges in cases of voluntary giving-in-payment deeds. See GOULET, "Dation en paiement sans avis de 60 jours", (1965-66) 68 *R. du N.* 485; *S.C.H.L.* v. *La Caisse Populaire de St-Denis*, [1981] R.L. 1. Presumeably, the pledge under suspensive condition, in which case his ownership rights would be retroactive to the date of the agreement of "pledge".

As a consequence, it is sometimes in a pledgee's interest to attempt a private realization and disposition of the property. Two routes are open to him. He may assert the *pacte commissoire* if he is in the face of a seizure in order to profit from an opposition to withdraw. Then, obtaining the consent of higher ranking fully secured creditors to his own realization efforts, he may pass on clear title to the purchaser, distributing the proceeds first to satisfy the claims of these creditors. Or, where the fully secured creditor is of lower rank, he will obtain such consent in order to pass on clear title, undertaking to distribute the surplus after his claim is paid to these creditors. The second route which he may pursue, which is probably more efficient where no seizure is attempted, is to obtain from the pledgor and from fully-secured parties an authorization to dispose privately. In these cases, since the pledgor remains owner until the time of sale, all his other creditors may assert rights in the proceeds. Article 1977 C.C. would, therefore, make the pledgee subject to the ranking of article 1994 C.C., and would oblige him to pay any claims which are preferred to his own.[270]

### 3. The Pledgee's Right to Follow

The third major priority of the pledgee is his right to follow the object of his pledge. This right to follow has both a factual and a juridical element. At the purely factual level, since possession is the fundamental mechanism by which a pledgee may obtain satisfaction of his debt (and also the basis of his right to control his debtor's dealings with the assets), he is vested with an action in revendication to protect his interest.[271] Moreover, the Code of Civil Procedure provides in article 734(1) for a right to seize before judgment in any action in revendication brought by a pledgee who has been involuntarily dispossessed.[272] Because the pledgee has a real right, should he be involuntarily dispossessed he is able to assert his claim against any person who has come into possession of the pledged objects. This is the *vindicatio pignoris*,[273] which is, however, limited by the rules relating to prescription or protected sales under article 2268.[274]

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270. See *Sous-ministre du revenu du Québec* v. *Total Rental Equipment Inc.*, [1979] C.S. 840; *Pagé* v. *Montreal Trust*, [1981] C.S. 217; *Marois* v. *Alimentation B.M.R. Inc.*, (1981) 41 C.B.R.n.s. 45 (C.S.).

271. See Répertoire Dalloz, *Revendication*, no. 2-6.

272. See most recently *Pétroles Irving* v. *Machinerie B.D.M. Inc.*, [1984] C.S. 511.

273. WEILL, *op. cit.*, note 6, 92-93.

274. See *Chamandy* v. *LeBlanc*, [1977] C.S. 176. See also *Morgan, Ostiguy et*

The first aspect of the pledgee's right of revendication is especially important in cases where the object of the pledge has been placed in the hands of a third party. The main object of the pledgee's factual right to follow in modern pledge contracts is not, however, revendication in cases of involuntary dispossession. Rather it is the assertion of the pledge against those who may have acquired ownership from the pledgor. Thus, subject to the rules of article 2268 C.C., which are only implausibly applicable to cases of possessory pledge,[275] the pledgee's claim follows the object regardless of how the pledgor disposes of his ownership rights.[276] Nevertheless, the extent of this right to follow where a *pacte commissoire* has been stipulated remains unclear. This is because the *pacte commissoire* seems to function like a contractual giving-in-payment without retroactive effect.

Two examples will illustrate the nature of this problem. Should the pledgor sell corporeal property which has been pledged, it would appear that the *pacte commissoire* would not be opposable to the subsequent acquirer. One might analyse the ordinary *pacte commissoire* not as a sale under suspensive condition, but rather as a merely personal right under which the pledgor has indicated his intention to renounce his right to demand a judicial sale in the event of default. The second hypothesis arises where incorporeal rights have been pledged. The characterization of that species of pledge which is an assignment of book debts by way of security as a sale with a right of redemption seems to suggest the contrary.[277] Because the pledgor actually gives up ownership the pledgee achieves present rights in the objects pledged opposable to third parties, including subsequent assignees.[278] This difference of result illustrates neatly the impact of registration systems on the right to follow in secured transactions.

The third element of the pledgee's right to follow may be described as its juridical element. While it is certain that the pledgee may assert his rights upon the object given in pledge, it is less obvious

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*Hudon Ltée* v. *Sun Life*, [1975] C.A. 473; MAYRAND, "Le nantissement de la chose d'autrui", (1943) 3 *R. du B.* 313 and CARON, "La vente et le nantissement de la chose mobilière d'autrui", (1977) 23 *McGill L.J.* 380.

275. *Bouchard* v. *Couture et Jacob*, (1933) 71 C.S. 536; *Payenneville et Martineau* v. *Prévost*, (1916) 25 B.R. 246. This situation might arise in cases of third party custody where the rules of article 1730 C.C. would deem the depositary/mandatary to have acted with the pledgee's authority.

276. See WEILL, *op. cit.*, note 6, 91-92.

277. See LEGEAIS, *op. cit.*, note 74a and SARNA, *loc. cit.*, note 206.

278. *Place Québec Inc.* v. *Demarais*, [1975] C.A. 910.

that these rights can carry over into proceeds.[279] A few examples will illustrate the limits of the pledgee's juridical right to follow. If the object of the pledge is destroyed and an insurance indemnity is payable, article 2586(1) C.C. would preserve the pledgee's claim in the indemnity. On the other hand, if the object perishes from a latent defect (or is substantially diminished in value) the pledgee could not assert his preferred rights in any replacement property provided by the manufacturer, nor could he claim a pledge of any monies received as the consequence of a *quanti minoris* action. The object of the pledge itself is the creditor's guarantee, and absent any agreement with the pledgor about replacement property the pledge is exhausted on the original collateral.[280]

This last point suggests an important limitation on a creditor's juridical right to follow. The traditional rule in Quebec is that a privilege cannot be claimed against the proceeds of a private disposition of collateral subject to it.[281] However, there are at least two cases which have held privileged rights to be exercisable upon the proceeds of a private sale when these proceeds were generated by a sale in realization. The first concerned a payment by a trustee in bankruptcy in order to retain possession of goods[282] and the second concerned monies of a private sale deposited into court upon the allegation of a debtor's insolvency.[283] As a result, there is at least an arguable case that when a prior creditor (*e.g.* a bank or a transferee) revendicates property from a later pledgee, and proceeds to a private realization, the pledgee retains a privileged right in the proceeds. That is, in cases of forced dispossession in order to facilitate private realization by another creditor,[284] the pledgee's priority position

279. In general terms this may be described as the problem of *subrogation réelle*. See LeDAIN, *loc. cit.*, note 28, 81. See also *Comtois* v. *Lamarre and Boulé*, [1952] C.S. 252.

280. What is more, even if there were such an agreement, it could at best constitute a promise of pledge since the object (or the money) would not yet have been delivered to the creditor.

281. *Lanthier* v. *Avard Denis Ltée et Wilson*, (1920) 58 C.S. 463.

282. *Mechanic Supply* v. *Hudon*, (1933) 71 C.S. 400.

283. *Tremblay* v. *Villeneuve Coopérative de Colombier et Coulombe et Cie*, [1944] C.S. 281.

284. See *Holly M. Ward Lumber* v. *Ancam Woodcraft*, [1977] C.S. 237. A similar point could be made in respect of proceeds of private sales by carrier, hoteliers and jewellers, in the cases where a pledgee retains possession as against his pledgor but suffers a *bona fide* expropriation of his interest by the retention creditor.

should be the same as that applicable to a judicial seizure.[285]

A final series of situations in which the pledgee would wish to assert a right to real subrogation involves forced expropriation of his interest. For example, should the pledgee of a painting be forced to deliver up the painting to the state under the terms of a cultural property expropriation statute, it would not be inconceivable to attribute the indemnity, normally payable to the pledgor as owner, to the pledgee in satisfaction of his pledge. Notionally such a right could be founded on analogies with expropriations of immoveables. Where the pledgee suffers expropriation not at the hands of the state, but by operation of law, a like result should follow. Thus, should a pledgee consign the object to a depositary who inadvertently joins it to another object, or expends substantial labour on it, the rules of articles 430 and 435 C.C. could well expropriate the pledgor's interest subject to paying the price of the material. In this case also the pledgee should be able to claim a preference in the monies paid over to the expropriated pledgor-owner.

### 4. Priority as a Property Right

The pledge, therefore, can be a powerful device for promoting a creditor's priority rights in a wide variety of cases. Yet the devaluation of the right of retention, the uncertainty of realization resulting from the privilege attaching to the pledge, the fact that even the pledgee who has stipulated a *pacte commissoire* does not obtain rights which are opposable to third parties in all circumstances, and the possible juridical limitations on the pledgee's right to follow would cause a risk-averse creditor to be concerned with bargaining for additional rights to protect his security. Many creditors respond to this including in pledge agreements a variety of additional convenants. These covenants, which enhance a creditor's ability to control closely the day-to-day affairs of his debtor, are the third element of the creditor's bargain.

## C. Control

To this point it has been assumed that a creditor will be primarily interested in securing repayment of credit advanced to his

285. But compare section 42 of the *Act respecting Bills of Lading, Warehouse Receipts and Transfers of Property in Stock*, which seemingly requires the transferee who realizes to remit any realization surplus to the transferor and not to lower ranking secured creditors.

debtor by monopolizing certain rights which can be invoked upon his debtor's default. Frequently, however, a secured party's most effective rights are not those which arise after default; rather, they consist of rights of control over the debtor and his collateral which can be asserted prior to default, as well as the right to determine unilaterally when default under the loan has occurred. Commonly, these latter rights, which are stipulated in a series of convenants known as "insecurity clauses", are characterised in the treatises as "obligations arising from the contract of pledge."[286] On the analysis pursued here they are probably better understood not as contractual obligations between debtor and creditor, but as aspects of the pledgee's right to police the collateral.

### 1. Controlling Debtor Behaviour Prior to Default

If it is true that the ordinary pledge gives rise to certain personal obligations between pledgor and pledgee, it is also true that none of these, at least none of those which exist during the currency of the pledge, are of public order.[287] As for the pledgor, once he delivers possession to the pledgee in principle, he assumes no further obligations. Nevertheless, certain circumstances arising after possession may generate additional pledgor liability. He is obliged to pay the creditor his costs of preservation under article 1973(2) C.C. and he is responsible for paying any damages caused by latent defects in the object pledged, by analogy to article 1812 C.C.[288]

By contrast, the ordinary regime of the pledge imposes two continuing obligations upon the pledgee: the obligation to care for and preserve the pledge under article 1973 C.C., and the obligation not to use or derive fruits from, or dispose of the object given in pledge, according to articles 1972, 1803 and 1807 C.C.[289] The pledgee is responsible for loss caused by his neglect under 1973(1) C.C. as well

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286. See MAZEAUD, *op. cit.*, note 9, 90-91.

287. See DAGOT, *op. cit.*, note 7, 135.

288. See WEILL, *op. cit.*, note 6, 99-100. See *McCaffrey* v. *Ball*, (1889) 20 S.C.R. 319.

289. See DAGOT, *op. cit.*, note 7, 135-138. This obligation to conserve can even lead to the obligation to sell perishable property (eg. foodstuffs). (See MAZEAUD, *op. cit.*, note 9, 91.) But this obligation would not extend to the replacement of the property; it would only cover the value received. See *Labonté* v. *Banque d'Hochelaga*, (1921) 59 C.S. 588, a case of a pledgee letting an insurance policy expire. Further, it would not normally cover neglect such as failing to sell depreciating securities.

as for deterioration resulting from his abuse of the object.[290] According to article 1975(1) C.C., the sanction of these obligations is forfeiture of the pledge[291] and compensation of the principal obligation up to the amount of the loss.[292].

Notwithstanding articles 1972, 1973 and 1975 C.C., however, the contractual obligations of the parties respecting use and disposition of the collateral almost always depart (in commercial contexts) from this legal regime.[293] There are essentially two objectives which a pledgee will be pursuing in stipulating contractual modifications to the legal regime. To begin with, he will wish to protect himself against any unauthorized disposition of, or dealing with, the collateral which guarantees his claim. This also encompasses a desire to minimize the chances of his debtor wasting secured assets. Then, he will wish to be able to control in some measure the way in which the debtor carries on the undertaking which the secured loan facilitates. Of course, to the extent that the pledgee simply sits on pledged assets he may achieve, in large measure, these goals. But few risk-averse creditors are content to be mere passive observers of their debtor, or mere custodians of their collateral.[294] Reconciling a creditor's insecurity with his interest in the health of his debtor's affairs is the prime object of these contractual modifications.

Currently, the debtor who wishes to defraud his creditor may do so either by disposing of collateral without the creditor's permission or by prejudicing the creditor's rights in the collateral. Two basic civil law principles seem almost to encourage such fraud by debtors who rest in possession of secured assets. These two principles are first, that possession is the focus of all rights in moveables, and second, that real subrogation is an exceptional proprietary remedy. Thus, if a debtor in possession were to sell secured assets, not only would the creditor's security not be opposable to the acquirer,[295] but also he

290. See *Bruneau* v. *Dansereau*, (1928) 66 C.S. 91 for an exploration of the limits of this obligation.

291. *Gilman* v. *Campbell*, (1885) 9 L.N. 405; *Fornie* v. *Cité de Montréal*, (1902) 32 S.C.R. 335.

292. *Pacaud* v. *La Banque du Peuple*, (1893) 3 C.S. 8.

293. See the agreements set out in the Appendix.

294. This is precisely the point that critics of the dispossessory pledge are making in lamenting the restrictions the pledge imposes on the debtor's ability to carry on business.

295. *Denman* v. *Tousaw*, (1922) 66 D.L.R. 572 (C.S.); *Byers* v. *Craig*, (1929) 2 C.B.R. 528 (C.S.); *Descotes* v. *Collette*, (1919) 57 C.S. 420.

would have no preference in the proceeds of the sale.[296]

There are further ways in which debtor possession can be an inducement to fraud. The presumption of article 2268(1) C.C. combined with the short acquisitive prescription period for good faith acquirers of moveables often means that even the pledgee who is involuntarily dispossessed may see his rights expropriated. In addition, the limitations on revendication in various protected sale hypotheses (articles 1027, 1488-1490, 2268(3), (4), (5) C.C.) produce a similar result.[297] Again, the various rules relating to accessions to moveables set out in articles 429-441 C.C. can operate to extinguish the pledgee's claim. The same can be said where moveable property is immobilized by nature under articles 414-419 C.C.: neither the owner, nor even an involuntarily dispossessed pledgee can reclaim from the owner of the land. Finally, the courts have held that various creditors' rights to revendicate may be made subject to the possessory lien or retention claim of an improver, carrier or custodian.[298]

A further dimension of debtor control is directed not so much to his vesting of legal prerogatives in third parties, but to how the debtor physically deals with the collateral. The rules relating to hypothec provide a useful analogy for security over moveables. Articles 2054, 2055 and 1092 C.C. impose certain limitations on the holder's rights to deal with the property and these "deterioration rights" may be bootstrapped into default conditions. But it is usually much easier to waste moveable property than immoveables. Consequently, a risk averse creditor typically will want close control over collateral with a high unit value such as precious metals, electronic equipment and securities. Possession is the only civil law mechanism which assures this control. In other words, given the property rules of the Civil Code and the remedial structure of the Code of Civil Procedure, loan covenants relating to use of identifiable collateral are of little prophylactic value and are difficult and expensive to monitor.[299]

These features of the law induce creditors to structure loan agreements so as to maximize their control over the way the debtor generally conducts his affairs, and not just over the way he deals with the collateral. These loan covenants, including negative pledge

296. *Lanthier* v. *Avard Denis Ltée and Wilson*, (1920) 58 C.S. 463.

297. By virtue of article 1966a C.C. the same would be true of certain unauthorized pledges. See *Chamandy* v. *Leblanc*, [1977] C.S. 176.

298. See *Elliot Krever & Associates* v. *Montreal Casting Repairs*, [1969] C.S. 6.

299. For a recent example of the limited utility of such covenants see *In re Bourcier Super Marché Lefort Inc.*, J.E. 84-677 (C.S.).

agreements, default clauses, minimum receivable clauses, performance bonds, insurance clauses and so on, will be discussed in the next section. At this point, it is necessary only to review how the ordinary pledge, the documentary pledge and the pledge of book debts (as possessory security), coupled with clauses permitting the pledgee a large measure of the *usus*, *fructus* and *abusus* of secured assets, can give the risk-averse creditor an optimal mix of control and commercial viability.[300]

The ordinary pledge may have a very specific use in both financial and manufacturing contexts. Most frequently one encounters the pledge of stocks, bonds, debentures, negotiable documents of title, precious metals, diamonds, art and other rare treasures.[301] Nevertheless, in many such cases, while it is not necessary for the pledgor to have any access to the collateral, since the collateral has a significant use-value or may generate fruits it is common to vest those rights in the pledgee.[302] A further use of the pledge is as an accessory to another contract such as cutting or dying where the creditor is in possession of the collateral anyway. Here again it is necessary to derogate from the rules of the Code.[303] Finally, the pledgee can extract from the commercial pledgor the transfer of the collateral to a subsidiary manufacturer who then holds the assets for the account of the pledgee.

A second form of possessory control can be achieved through the documentary pledge. While it is common today to view this device as most useful in international sales agreements it also has an important role, via the mechanisms of field warehousing, and terminal warehousing, in domestic security.[304] Prior to the recent enactment of quasi-*fiducia* security under the "Transfer of property in stock" mechanism, field warehousing was clearly a better mechanism for a risk-averse creditor than any other security device, including the trust for bondholders.[305] Even after Bill 97, however, it has a role because, by dispossessing the debtor, it eliminates the risk of unauthorized dealing and minimizes the opportunity for asset wastage. Moreover, because field warehousing is usually undertaken

300. See SCHWARTZ and SCOTT, *op. cit.*, note 10, chapter XIV.

301. WEILL, *op. cit.*, note 6, 75-76.

302. See appendix.

303. See *Sawyer Tanning Co.* v. *The Leather Group*, [1977] C.S. 1150.

304. See WOOD, *loc. cit.*, note 85, 94-98; SCHWARTZ and SCOTT, *op. cit.*, note 10, 731-736.

305. MacDONALD and SIMMONDS, *loc. cit.*, note 30, 260-261.

by a professional warehousing company, which is insured for loss or dissipation of the collateral, the lender achieves excellent security.[306] Finally, because the goods are under the pledgee's control, he can release them to the debtor in accordance with a pre-arranged collateral-to-loan ratio, or with accounts receivable ratios.[307] When the right combination of creditor risk-aversion, debtor suspiciousness and asset volatility (value, portability, secondary market) exist together with a limited need for direct access (as in stockpiles of out of season goods) and/or relatively high per unit value, the field warehouse is an excellent monitoring mechanism.

To a certain extent, the field warehouse permits control over the ongoing financial solvency of the debtor. But the creditor may also be concerned about his debtor's business judgment as to potential customers. The remedy in such cases is to take possession of his credit and collection department under a factoring agreement.[308] This is the third major form of possessory pledge permitted under the civil law. A detailed treatment of this topic lies beyond the scope of the present study, but it is worth signalling (if only in broad outline) the benefits of accounts receivable financing for a risk averse creditor.

The ordinary pledge of a universality of receivables under articles 1966(3) and 1571d C.C. serves to put the pledgee in control of the collection of monies owing to the pledgor, and vests enforcement and policing prerogatives in him.[309] Nevertheless, unless the pledgor has warranted the account debtor's solvency under article 1577 C.C., in which case the pledgee has a personal recourse against the pledgor should the account debtor be insolvent at the time of the pledge, the security of collectability as established by article 1576 C.C. is of little value.[310] Hence, a risk-averse creditor will want to police to whom his own debtor extends credit.[311] In other words, by taking a general assignment of receivables, and supervising (for a fee) the credit-worthiness of a pledgor's customers, the pledgee can achieve a direct

306. WHITE and SUMMERS, *op. cit.*, note 26, section 20-5.

307. See "Inventory Financing Through Field Warehousing", (1960) 69 *Yale L.J.* 663, 699 for an analysis.

308. See BISCOE, *The Law and Practice of Credit Factoring*, (1975); see also LEGEAIS, *op. cit.*, note 74a.

309. SARNA, *loc. cit.*, note 206.

310. See DEMERS, *loc. cit.*, note 80.

311. But compare *Ajel Holdings Canada Ltd.* v. *Chrysler Credit Canada Ltd.*, J.-E. 84-916 (C.S.).

subrogation of his possessory rights under a field warehousing agreement into rights in the proceeds of disposition of warehoused collateral.[312] Once again, the pledgee's rights in the receivables will be buttressed by a variety of use and disposition provisions permitting him to compensate, settle, write down or restructure pledged debts.

Ordinary possession, documentary possession and possession of receivables are powerful monitoring tools for a secured creditor. When possession is tempered by contractual stipulations modifying the legal regime of the pledgee's possession, many of the usual disadvantages of pledge lending can be overcome without a loss of security for the risk-averse creditor, during the currency of the credit arrangement.

### 2. Controlling Default: Insecurity Clauses and Private Realization

While the creditor frequently is able to stipulate a variety of covenants to control the behaviour of his debtor, and while his right to possession under different types of pledge agreement is the most effective civil law mechanism for ensuring that any breach of these covenants does not seriously prejudice his security, the risk averse creditor also will be concerned to develop a lengthy inventory of default clauses under which he may unilaterally determine that the secured obligation has become due and that the security has become enforceable. Insecurity clauses raise two main issues for creditors: first, the creditor will want to anticipate the various circumstances when his agreement will become enforceable and second, he will want to realize upon his security without delay and without the need for judicial process.[313]

In the traditional literature in France, the use of insecurity clauses has not generated extensive comment.[314] This may be explained by

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312. See GILMORE, *op. cit.*, note 46, 146-195. It is also to be noted that while quasi-*fiducia* security permits the creditor to assert a claim in proceeds, as long as these remain simple receivables, the secured creditor cannot claim a priority over a good faith registered assignee of those receivables. See *Flintoft* v. *Royal Bank*, [1964] S.C.R. 631.

313. For an elaboration of these points under modern regimes such as the Ontario *Personal Property Security Act* see McLAREN, *Personal Property Security*, (1979), vol. I, pp. 8-1 through 8-19.

314. See DAGOT, *op. cit.*, note 7, 138-139 who sees this question as a minor issue relating to the rights of the creditor upon repayment of the principal obligation.

two features of French law: the absence of the *pacte commissoire*, which prevents pledgees from unilaterally appropriating the pledge; and the greater tendency of courts to supervise default by striking down all stipulations (*des voies parées*) which permit realization without judicial authorization.[315] In Quebec, by contrast, private enforcement is the rule, so that carefully drafted insecurity clauses can lead to expeditious realization. It has been common for creditors to make loans only on a "demand" basis and to stipulate that the security will become enforceable whenever they feel "insecure". Nevertheless, there is a developing trend in the jurisprudence towards imposing limitations on the creditor's ability to arbitrarily deem his loan insecure. This trend would also require secured creditors to give debtors reasonable notice of enforceability, including a delay to permit refinancing.[316] Consequently, prudent lenders are now stipulating relatively objective tests for insecurity which will protect them from delictual responsibility for intemperate realization.[317]

Some of the most usual of these "insecurity" clauses are (i) a failure to keep the collateral insured; (ii) a failure to generate minimum monthly sales totals; (iii) a failure to pay any supplier's invoice when due (*i.e.* usually within 30 days on net 30-day goods); (iv) the granting of prior or *pari passu* security to another creditor; (v) the failure to raise any seizure of goods within 48 hours; and (vi) any unauthorized disposition of the collateral. In each case the creditor is in a position to achieve immediate enforcement of the loan without judicial intervention. What is particularly useful in possessory pledge agreements is the fact that no formalities are required prior to realization. In other words, while these clauses are of great use to any creditor who wishes to call a loan, they suffer a major drawback at the level of enforcement of non-possessory security. They oblige a creditor to invest significant resources in monitoring his debtor without at the same time giving him immediate access to collateral once a default occurs.

The possessory pledge thus has two advantages over quasi-*hypotheca* and quasi-*fiducia* security. First, since the creditor is already in juridical and physical possession of the collateral, he can exercise his rights against a recalcitrant debtor even without legal

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315. See WEILL, *op. cit.*, note 6, 93-94. The pledgor may, however, waive this formality after default. Only the stipulation for private process in the contract itself is prohibited.

316. See PAYETTE, "Prise de possession: demande de paiement et délai raisonnable", [1981] *Meredith Memorial Lectures* 129.

317. See *Banque Provinciale* v. *Martel*, [1959] B.R. 278 for a classic example.

process. Second, because he may stipulate a *pacte commissoire* under article 1971(3) C.C. he can realize without the need for a seizure and judicial sale. In Quebec it is only the possessory pledge which vests in a secured creditor both these prerogatives.[318]

Of course, a seizure before judgment taken by a creditor out of possession may effectively sterilize the debtor's ability to waste assets, but it neither gives the creditor possession of the assets nor permits him to realize upon the property. What is more, if the seizure is taken under article 734(4) C.P. the creditor will have to prove that his claim is in jeopardy,[319] and if it is taken under article 734(1) C.P. he will still be required to prove his allegations in the affidavit supporting the writ.[320] In all events, the conditions which must be established to effect the seizure are restrictively interpreted,[321] and debtors are entitled, under article 738 C.P. to contest the seizure.[322] Even should the creditor succeed in obtaining possession by means of a mandatory provisional injunction, he would still require court authorization in order to realize upon the assets.[323] In other words, unless a debtor in possession is willing to surrender possession (or unless the creditor may convince him to do so with private bailiffs), expeditious realization will be impossible.[324]

For these reasons, even elaborate insecurity clauses which permit creditors unilaterally to determine default can be rendered nugatory by recalcitrant debtors in possession. On the other hand, many of these clauses are unnecessary as devices to structure the creditor's monitoring of his debtor's assets when the secured collateral is in his possession. These clauses do, however, facilitate the second stage in any realization process, namely, disposing of the collateral.

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318. For the position under the *Bank Act*, see MacDONALD, *loc. cit.*, note 88, and for the position under the commercial pledge, the transfer of property in stock and the trust for bondholders see AUGER, *loc. cit.*, note 3.

319. *Entreprises Lalonde* v. *Blanchette*, [1980] C.S. 509; *Signal Ford* v. *Cacciatore and Sons*, [1973] C.S. 168.

320. *Levasseur* v. *St-Onge*, [1979] C.A. 587.

321. *Gagné* v. *Avo Auto*, [1980] C.P. 106; *Sybertz* v. *Altas Window*, [1970] R.P. 64 (C.S.).

322. *Provincial Mobile* v. *Sellito*, [1972] R.P. 187; *Michalczyk* v. *Choynowski*, [1977] C.A. 203.

323. See CORDEAU, *loc. cit.*, note 54, 364-366.

324. There is also some doubt whether non-judicial forced possession is possible. See *Banque Nationale* v. *St-Louis Automobile*, (1981) 42 C.B.R.n.s. 275 (C.S.) and 281 (C.A.) and *Borkowski* v. *Traders Finance*, [1958] C.S. 457. But compare *Omer Barré Ltd.* v. *Gravel*, (1940) 78 C.S. 262.

Once again, there is in France an elaborate judicial mechanism, involving a public auction or expert evaluation of the collateral prior to its attribution to the creditor.[325] But in Quebec the possibility of the *pacte commissoire* permits the creditor in possession simply to advise the debtor that the security is enforceable and treat the property as his own.[326] From this moment onward the pledgee/owner may dispose of the property as he desires, for whatever price he can obtain[327] subject to any contractual agreement as to mode of disposition.[328]

### 3. Control as a Property Right

Because of the presumption of article 2268(1) C.C., a creditor's right to police assets subject to his security is limited in a number of ways. These limitations exist both prior to default, when his debtor's dealings with the collateral can be volatile, and upon default. In the latter case, the creditor out of possession does not have an effective procedural recourse for indicating the default, obtaining possession of the collateral and privately realizing. For this reason, the ordinary pledge, its field warehousing variant and the pledge of a universality of receivables offer a risk averse creditor distinct advantages which will permit him to minimize debtor misbehaviour. Moreover, the contracting out of Codal rules relating to risk of loss, the use of pledged assets, and disposition upon default enhance these advantages so as to give the possessory pledgee maximum control of the pledgor's property. Until the civil law develops more effective procedural mechanisms for creditor possession and private realization the possessory pledge will continue to play an important role precisely for its monitoring capabilities.[329]

## D. The Creditor's Bargain

If the law of secured transactions were hypostatized, it could be understood as a general meeting of a person's creditors in which each bargains with the debtor for rights in and upon the latter's assets, and with each other for a division of proprietary, priority and supervision rights over the debtor's operations. In other words, the creditor's bargain is not just with the debtor over terms of a security agreement,

325. See DAGOT, *op. cit.*, note 7, 131-135; WEILL, *op. cit.*, note 6, 93-96.

326. *Beaudoin* v. *Trottier*, [1945] C.S. 63.

327. *Charrier* v. *Boutin*, (1898) 13 C.S. 384.

328. *Campbell* v. *Beyer*, (1906) 30 C.S. 86; *Murray* v. *The Montreal and Sorel Railway*, (1886) 20 R.L. 435 (C.S.).

329. See MacDONALD and SIMMONDS, *loc. cit.*, note 30, 310-313.

but also with other creditors about the affectation of their debtor's patrimony.[330] As well as the most favourable interest rate (rent) on their loan, the best rights of satisfaction obtainable against their debtor, and the optimal priority position as against third parties, a creditor seeks to expropriate, in whole or in part, the influence which another creditor may have upon their joint debtor. In this sense, each creditor seeks to maximize his discretion to dispose of the debtor's patrimony or a part thereof.[331]

For the risk averse creditor this patrimonial expropriation will have the three main elements discussed in this part. It is apparent that even with the advent of the new regime of transfers of property in stock, which many see as the death-knell for traditional forms of security in Quebec,[332] the possessory pledge (in its various forms) remains a powerful and irreplaceable security device. While Bill 97 apparently gives a creditor a better *satisfaction* right, its usefulness is limited because the creditor obtains little control over ordinary course sales, and has no special expeditious recourse for obtaining possession. Of course, the new Act permits the creditor to trace his security into proceeds, but again it is only personal covenants which will guarantee the collection of receivables on the creditor's account and the deposit of moneys in his name. A Bill 97 security interest may well shift automatically into proceeds, but its priority position falls to be determined by provincial law; unless the transferee also takes a pledge of receivables under article 1966(3) C.C. his security is not enforceable against other accounts receivable financers.[333]

Again, as concerns *priority*, the transferee of property in stock is, in fact, in no better position than the pledgee. Of course, the transferee in possession would seem to be able to resist revendication or seizure by other creditors, and he also obtains rights which may be set up as against new owners (whether their title derives from the accession rules of articles 429-441 C.C. or from articles 1488, 1489 and 2268 C.C.).[334] But, the ordinary pledgee's possession accomplishes the same result. It simply prevents debtor dealing in a manner which

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330. See BAIRD and JACKSON, *op. cit.*, note 10, 1-3 and 361-366; JACKSON, *loc. cit.*, note 11a.

331. For a discussion of modern theoretical tendencies see CHARBONNEAU, "Les patrimoines d'affectation: vers un nouveau paradigme en droit québécois du patrimoine", (1983) 85 *R. du N.* 491.

332. See RENAUD, *loc. cit.*, note 3; PLEAU, "Commentaires sur la *Loi sur les cessions de biens en stock*", [1983] *C.P. du N.* 269.

333. See MacDONALD, *loc. cit.*, note 31, 176.

334. *Id.*, 178.

could bring any of these Codal articles into play. Furthermore, the stipulation of a *pacte commissoire* triggered by attempted seizures will prevent revendication by all but prior transferees and prior holders of section 178 security.

The third major item on the creditor's shopping list, *control*, is revealed as a domain in which the classical pledge provides the risk averse creditor with prerogatives far superior to those of the transferee. Even though the transferee may contract for various restrictions on the debtor's use and disposition for the collateral, since the transferor is characterized as the mandatary of the transferee and is empowered to dispose of the transferee's interest,[335] there is little day-to-day control over inventory or customers which the creditor may exercise. By contrast, under a documentary pledge arrangement the pledgee may control all dealings with the collateral and prevent unauthorized manufacture, sale or waste. Coupled with a pledge of receivables under article 1966(3) C.C. this permits the creditor to monitor closely not only the way in which the debtor deals with the collateral, but also the way in which he runs his credit department. Finally, because the pledgee is in possession he is in a much better position to enforce the security than the transferee, and may realize upon the collateral without judicial process.

Clearly the possessory pledge, and its two major variants, the pledge of negotiable documents of title and the pledge of a universality of book accounts, are not all-purpose security devices. While the pledge of receivables is a relatively streamlined mechanism, the documentary pledge can impose high transaction and execution costs on creditors, since it requires substantial paperwork to undertake. But with the appropriate mix of internal and external factors, the risk averse creditor will often find these drawbacks compensated for by the control the pledge permits over both the debtor's assets and his operations. In these contexts he will bargain explicitly for the pledge, notwithstanding that so-called modern and flexible security interests over commercial inventory may be available to him. That is, even where legal "modernization" of secured transactions has proceeded further than in Quebec,[336] possessory security continues to play an integral role in the law of debtor-creditor relations.[337]

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335. S.Q. 1982, c. 55, s. 16 and 17.

336. See ZIEGEL and CUMING, *loc. cit.*, note 3.

337. SCHWARTZ and SCOTT, *op. cit.*, note 10, chapter 14; especially at pages 716-718, 731-736 and 755-756.

## CONCLUSION: IN PRAISE OF THE PLEDGE

To conclude this study with the sub-title "In Praise of the Pledge" might strike the casual reader as an attempt at irony. Yet as the first three chapters suggest, there is much merit in the epithet. What is more, a defence of the pledge as a possessory security device also implies (although does not demand) a defence of traditional regimes of security on moveable property such as that in place in Quebec. In large measure, such a defence has been intimated. Now it is appropriate to set out briefly the general lines of the argument.[338]

Since one of the major rights which creditors taking security seek to monopolize is a priority advantage over third parties, it is naive to suggest, as some proponents of Article 9 type regimes do, that secured transactions should be viewed as a subset of the law of contractual obligations; while satisfaction and control prerogatives may indeed be viewed as a matter for private negotiation between debtor and creditor, once parties set out to create special rights opposable to third parties, the appropriate characterization of the law of security on property is as a subset of the law of debtor-creditor relations. From a micro-economic point of view it does not appear that secured financing in general can be justified on efficiency criteria; or if it can, the efficiency results from a morally unjustifiable expropriation of economic value from creditors who are either unaware of secured credit, or unable to adjust their credit conditions in consequence. Given these monopoly features of security, the choices of who should be entitled to take security, the scope and coverage of the security available, the underlying theory for establishing priorities, and the attribution of possessory and property rights as between debtor and creditor should be a matter of explicit legislative decision. In view of the variety of debtors, the variety of creditors, the variety of contexts in which security is sought, and the variety of collateral over which security might be taken, a pluralistic legal regime which contemplates a variety of possible secured transactions, each with its own prerogatives and limitations tailor-made to the industrial debtor/creditor relationship in view is not to be lightly dismissed.

A legislature seeking to assert some control over disruptions to *pari passu* distributions of the proceeds generated by the seizure and sale of a debtor's assets will consider first whether there is reason to provide for preferred rights beyond the mere identification and

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338. The point is further developed in MacDONALD, *loc. cit.*, note 37.

ranking of execution priorities. In other words, it is not self-evident that most of the public policy goals to be achieved through such disruption (most commonly the encouragement of certain kinds of credit advances for certain purposes) cannot adequately be met by execution priorities either upon proceeds of judicial sales or private realizations. To the extent other claimants have a cause for special treatment, the vast majority can be adequately protected by a scheme of possessory rights. In particular, in cases involving unpaid vendors, repairmen, carriers, warehousemen, hoteliers, borrowers, mandataries, factors, brokers, banks and other moneylenders, the presumption should be against the taking of any form of consensual security in their debtor's property. This presumption can best be worked out (in the case of moveables) by recurring to the two basic principles already a part of the civil law: first, that moveables are not susceptible of hypothecation; and second, that the execution priority flowing from the pledge exists only to the extent that the creditor takes possession of the collateral.

This is not to say that in certain circumstances, particular creditors should not be able to use title to property as a security device. The conditional sale, the lease and the financial lease are obvious devices for protecting some creditor interests. But, quite properly, such vendors, lessors and financers should run the risk of their interest being expropriated under articles 414-419, 429-441, 1488, 1489, 1966a and 2268 C.C. Similarly, the sale with a right of redemption, double sales, sale-leasebacks and like devices should be permitted to those creditors who are willing to assume seller's warranties and endure the potential of interest expropriation. The same could also be said in respect of the sale of present receivables.

Where the law is in serious need of recasting is in respect of the recent quasi-*hypotheca* and quasi-*fudicia* devices engrafted onto existing legal structures. While this is not the place to argue at length for a reassessment of high-priority debtor-in-possession security, including the pledge of a universality of book accounts, three points do merit notice. First, the current restrictions attaching to these devices (*i.e.* limitations on obligation secured, status of borrower, collateral subject to security) should be rigorously applied. Second, no equipment or inventory financer should be able to assert any priority in proceeds of ordinary course disposition of secured collateral without taking an assignment of receivables. Third, any general charge on property should have a last-ranking execution priority which is made explicitly subordinate to wage claims and other employment benefits.

Of course, much of the above four paragraphs is an apology for the main features of the regime now in place in Quebec. So be it. In my view, the ordinary pledge, requiring as it does, the debtor's dispossession, has a built-in control against excessive deployment or abuse. Similarly, its principal variant for use in respect of corporeal property - the documentary pledge - is not an all-purpose instrument. Its operation costs and cumbersome structure adequately define the class of debtor and creditor who are best in need of its benefits. Finally, the restriction of the pledge of receivables to either existing debts, or categories of future commercial debts provides satisfactory limits on its deployment. Only minor amendments to the current regime of pledge lending are necessary in order that the possessory pledge (and its variants) not only (i) is available uniquely in those cases where economically or socially justifiable, but also (ii) provides the risk averse creditor with the optimal mix of satisfaction, priority and control of collateral rights.

Four such amendments can easily be enacted. The first would be to repeal the second paragraph of article 1975 C.C. There is no reason to establish legislatively a presumption of continuing pledge; if parties wish to contract for a continuing pledge they may easily do so. The second amendment would be to transfer article 1974 C.C. to the title *Of Obligations*; at the same time the article could be redrafted so as to account for interest imputation where payments are blended. A third modification to existing Codal rules would be the clarification of article 597 C.P. in order to make explicit that the pledgee in possession cannot resist a seizure in execution of another creditor of his debtor, unless such seizure triggers default and the pledgee either immediately pursues a private realization upon the collateral, depositing the proceeds for legal distribution, or undertakes to consign to the sheriff the proceeds of any future private realization for distribution according to the collocation order drawn up by the prothonotary. The fourth amendment would be to article 1971(3) C.C. in order to prohibit the *pacte commissoire* except where a *bona fides* valuation of the collateral takes place, or where the creditor renounces his rights to a deficiency judgment, or where all prior ranking creditors consent. In all other cases the pledgee should be restricted to a judicial seizure and sale or a *bona fide* private sale in realization.

As a complement to these legislative amendments, certain inherited judicial interpretations should be cast off. Four areas which are ripe for jurisprudential development come to mind. Most importantly, courts should move towards a more generous view of the documentary pledge. In particular, they should permit certain forms

of trust receipt arrangement under the same types of condition that pledgees may remit pledged collateral to pledgors in ordinary pledge transactions. Another area for reform relates to the question of real subrogation into proceeds of private sales. Courts should permit secured creditors to exercise their priority rights against proceeds from any sale in realization (but not, of course, from ordinary course sales), be this by public or private sale. Third, courts should explicitly acknowledge that commercial and agricultural pledges are not real pledges, but are in fact quasi-hypothecs. Such recognition would not only facilitate adoption of a temporal priority rule as between competing creditors, but would permit them to refuse the application of article 1966a C.C. to all non-possessory pledges. Finally, courts should further develop their tendency towards permitting certain title transactions (*fiducia*) to create security interests. This would be especially helpful, given the controls of the *Consumer Protection Act*, in facilitating non-commercial credit in selected areas.

These minor changes to the Code and to judicial interpretation would serve a double purpose. To begin with, they would overcome some of the most obvious injustices in the current system of pledge lending — injustices which often lead to unnecessarily caustic evaluations of the Quebec law of security on moveable property. More importantly, however, they would confirm the circumstances under which a risk-averse creditor would bargain for possessory security. In this sense, they would serve to define clearly the optimal occasions for exploiting the pledge as a security device.

## APPENDIX: SAMPLE PLEDGE AGREEMENTS

Set out below are various clauses abstracted from different types of possessory pledge agreements currently in use in Quebec.

### A. Pledge of Money

The following are four paragraphs from an agreement where a sum of money is to be pledged as a collateral warranty in an assignment of a debt.

> En garantie additionnelle, le cédant dépose auprès du cessionnaire, la somme de "X" DOLLARS, laquelle somme sera conservée par le cessionnaire tant et aussi longtemps que la créance ci-haut transportée n'aura pas été remboursée en entier audit cessionnaire.
>
> Ladite somme en dépôt portera intérêt au taux de "X" POUR CENT l'an, que le cessionnaire s'engage à payer au cédant les premiers jours d'avril et octobre

de chaque année, le premier paiement devenant dû le ..., jusqu'à ce que ledit dépôt soit remboursé au cédant ou annulé tel que ci-après stipulé.

Ledit dépôt sera confisqué en faveur du cessionnaire, si ce dernier, pour protéger ses droits, doit intenter une action en recouvrement de la créance ci-haut transportée.

Il est entendu et convenu que le cessionnaire devra signifier au cédant son intention d'intenter une telle action, sans toutefois être tenu de mettre en cause le cédant dans toute action visant à protéger les droits qui lui sont accordés en vertu des présentes.

## B. Pledge of Securities

The following are seven paragraphs from an agreement respecting the pledge of "securities" (*i.e.* negotiable instruments, promissory notes and share certificates).

The pledgee may, in his sole discretion, collect any sum in principal, revenue, dividend or interest becoming due on the Securities. The pledgee may also exercise any option or right (including the right to vote) attached to the Securities.

The pledgee shall not be liable for any loss arising from its default to collect any sum or exercise any option or right or from its default to perform acts required to protect rights given by these securities.

Should the pledgor fail to fulfill any obligation to the pledgee, the pledgee may realize the Securities without notice to any party whomsoever.

It may, even before their maturity, request payment of the Securities and appropriate the proceeds thereof. It may also sell the Securities by private sale or otherwise.

Any sum collected by the pledgee on the Securities or the proceeds of their realization may be held in pledge or may be applied, at the discretion of the pledgee, to the payment of any of the debts or obligations of the undersigned or of the pledgor, whether matured or not.

The costs incurred in protecting and realizing the Securities shall be added to these debts and obligations.

The pledgee may grant discharge, settle by compromise, renounce to rights or grant extensions with respect to the Securities.

## C. Documentary Pledge

The following are six paragraphs from an agreement respecting the pledge of "documents of title" (*i.e.* bills of lading, warehouse receipts and terminal receipts).

All documents which may be delivered to the pledgee by or for the pledgor shall be held by the pledgee as security for the payment of any advance made to the pledgor and as security for all debts and obligations, present or future, direct or indirect, of the pledgor to the pledgee.

This security shall also apply to the proceeds of the sale of any property covered by the documents, including negotiable instruments, orders of payment or securities which might be given in respect of the said proceeds, as well as any receivables resulting from such sale.

The pledgor shall keep the property covered by the documents insured against all damages and risks of loss, for the full value of the property and by insurers accepted by the pledgee. The pledgee shall be the assignee and beneficiary of all policies relating to the property and the pledgor shall deliver these policies to it.

In the event that the pledgor fails to comply with the foregoing, the pledgee, without being so required, may insure the property for the amount which it considers suitable, and in such a case, premiums paid by the pledgee may be debited to the account of the pledgor.

Upon failure by the pledgor to fulfill any obligation to the pledgee, the pledgee is authorized to sell, in whole or in part, the documents or the property covered by same. The sale may be made in the manner and at the time and location which the pledgee shall choose, without notice to the pledgor, without formality and without the obligation of advertising or selling at public auction.

The pledgee may choose the manner in which the proceeds of such sale may be applied and it may deduct from these proceeds all costs incurred with respect to the documents, the property or their sale.