

## **BANKING & INSOLVENCY BULLETIN**

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### **QUEBEC SUPERIOR COURT DECLARES HYPOTHEC ON QUEBEC TAX REFUNDS INEFFECTIVE**

A recent judgment of the Quebec Superior Court has put into doubt the effectiveness of hypothecs on Quebec tax refunds.

In the case *111295 Canada Inc. (Syndic de)*, the Quebec Superior Court was called upon to determine whether the hypothec in favour of a creditor charging all of the debtor's accounts receivable actually conferred rights upon the creditor with respect to the federal and Quebec tax refunds. This case is another example of the federal and Quebec legislators attempting to address the same issue for the same purpose in different ways giving rise to opposite results.

Following the bankruptcy of 111295 Canada Inc., the Royal Bank of Canada, a secured creditor holding a hypothec on accounts receivable of the bankrupt, withdrew the debtor's right to collect the accounts receivable and called upon the Trustee to remit all proceeds to it upon receipt, including the federal and Quebec tax refunds payable to the bankrupt.

The Trustee took the position that both federal and Quebec legislation allow solely for the "assignment" of tax refunds and that a hypothec does not constitute an assignment for the purposes of these laws. Accordingly, according to the Trustee, the tax refunds were unencumbered by the hypothec. The Superior Court allowed the Trustee's contention with respect to the Quebec tax refunds but dismissed it with regard to the federal tax refunds.

On the federal front, the general rules with respect to Crown claims are set out in the *Financial Administration Act*. Section 67 provides that, except as provided elsewhere in the *Financial Administration Act* or other Act of Parliament, a Crown debt is not assignable. Section 68 allows for an exception to this principle for Crown debts due under a contract, or any other Crown debt of prescribed class, provided that the assignment is absolute and does not purport to be by way of charge only. In the decision *Construction E.L.S. Maritime v. Sa Majesté la Reine du Chef du Canada* rendered in 2001 and dealing with an attempt to hypothecate a Crown debt due under a contract, the Quebec Superior Court adopted the view that a hypothec is not to be construed as an "assignment" for the purposes of Section 68 of the *Financial Administration Act* since a hypothec is an instrument made by way of charge only and is not akin to an absolute conveyance whereby there is a transfer of ownership. In the case under discussion, the Superior Court adopted that reasoning and concluded that the bank's hypothec was not an assignment and did not qualify for the limited exception to the prohibition provided in section 67 of the *Financial Administration Act*.

However, the *Income Tax Act* ("ITA") provides for yet another exception to the prohibition of assignment of Crown claims made after March 5, 1996. Section 220(6) allows for a corporation to assign an amount payable to it by the Crown under the ITA. Contrary to Section 68 of the *Financial Administration Act*, there is no provision in the ITA to the effect that the assignment must be absolute and not by way of charge only. The Superior Court was of the opinion that the bank's hypothec on federal tax refunds due under the ITA qualified as an assignment for the purposes of Section 220(6) of the ITA and was therefore valid and opposable to the Trustee.

On the provincial front, an analysis of Quebec's legislation caused the Superior Court to invalidate the bank's hypothec on the Quebec tax refunds. Section 33 of the *Act Respecting the Ministère du Revenu* ("*Quebec Revenue Act*")

provides that, in addition to being inalienable, every amount owing by the Crown in respect of a fiscal law is unseizable. Hence, even though Section 1055.2 of the *Quebec Taxation Act* (“*QTA*”) provides for an exception to the general rule of Section 33 of the *Quebec Revenue Act* for assignments made after March 9, 1999 and allows for the assignment of claims owing to a corporation by the Crown under the *QTA*, Section 1055.2 does not change the unseizable nature of the amounts payable by the Crown under the *QTA*. Since the *Civil Code of Quebec* provides that property exempt from seizure may not be hypothecated, the Superior Court decided that the bank’s hypothec does not charge the Quebec tax refunds.

It is interesting to note that the bank’s hypothec was entered into before the March 9, 1999 effective date after which the assignments under the *QTA* were permitted. The Court however did not directly address that issue and decided that without regard to its date, for the reasons referred to above, the hypothec was not valid on Quebec tax refunds.

In allowing an exception to the general principle that Crown claims are not assignable, it seems clear that the legislator’s intention was to allow corporations to obtain financing on the security of certain claims. In light of this recent decision, it seems that the Quebec legislator did not achieve his likely purpose.

It is our view that the whole area has become needlessly complicated. The basic principle behind restrictions on the assignment or hypothecation of Crown claims is to protect the Crown from being affected by, or having to deal with, them. There appears to be no public policy reason to prevent such assignments or security interests from having their full effect as between the beneficiaries thereof and parties other than the Crown, or for making distinctions between contractual claims, tax refunds claims, absolute assignments or security interests. Restrictive legislation and judicial interpretation have lead to a confused situation where, for no apparent valid reason, some assignments or security interests are valid as between the parties other than the Crown and some are not.

It would be a simple matter for the respective legislatures to state that assignments and security interests (including hypothecs) are not binding upon the Crown, but that their validity as between assignees or secured creditors, and parties other than the Crown, are subject to the same rules and principles as apply to assignments of, or security interests on, claims generally.

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*The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.*

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