

Obligations

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Why Debts Pay When Compensation You May

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The recovery of a debt from a debtor, whether a borrower or any other co-contracting party may prove a challenge whenever the debtor is in default or in bankruptcy, or whenever judicial proceedings must be undertaken. When available, compensation is of great advantage to a creditor, especially when his claim is otherwise unsecured.

1) Definition

Compensation is defined as the simultaneous extinction of two debts reciprocally owing by one person to the other, up to the amount of the lesser debt.

Compensation occurs by operation of law whenever two persons are at the same time both a debtor and a creditor of each other, both debts being for a sum of money certain, or for a certain quantity of fungible property identical in kind, and both being liquid and exigible (due and payable).¹ When occurring by operation of law, compensation is called legal compensation.

Two other forms of compensation are also possible, judicial compensation decreed by a judge and conventional compensation resulting from the parties' agreement. For the purposes of this article, our attention will focus more particularly on legal compensation.

2) Conditions

In order to invoke legal compensation as a mode of payment or extinguishment of a debt, certain prior conditions must be satisfied. First, both debts to be set off must turn on the same kind of obligation, be of same nature, usually a sum of money. This first condition is very easy to ascertain and will seldom cause any problems.

Second, both debts must be liquidated. This requirement results from the fact that, for compensation to occur, both parties must be in a situation where they could actually make a real payment. A debt is liquid when the following two conditions are met: 1) its existence is not open to challenge, and 2) the amount must be determined precisely or at least be easy to determine. In other words, the existence of the debt must be undisputed and its amount determined or determinable with certainty.

Finally, both debts must be exigible (payable) in order to compensate. Indeed, compensation is impossible between a debt that is payable and one that is not because it was contracted under a suspensive term or condition. However, a period of grace granted to a debtor for the payment of one of the debts will not prevent compensation from taking place, since the debt itself remains due and payable, the period of grace only postponing the right to initiate legal proceedings.² For the purposes of compensation, a debt payable means a debt the payment of which can be demanded and not only those for which payment has already been requested.

3) Practical applications

In effect, whenever the above three conditions are satisfied, compensation is a mode of payment which can be used in many situations.

Often, compensation will enable a financial institution to obtain a protection similar to that offered, for instance, by a moveable hypothec with delivery on certificates of deposit. Since bank deposits are truly loans granted by the client to the financial institution, the latter may avail itself of the rules of compensation to draw sums from the client's account and apply them against the sums owing by the client.

Compensation also provides a much easier way of obtaining payment than a hypothec on a deposit. Indeed, a moveable hypothec with delivery requires that the formalities set out in the Civil Code for the exercise of hypothecary rights be followed. This involves the publication of a prior notice of the exercise of one of four hypothecary rights. This procedure may also lead to some rather strange situations as, for instance, one could possibly have to sell a sum of money under judicial authority.

For compensation to be a truly effective mode of protection, the contract between the parties should include provisions to the following effect: that the client may not draw from the sums on deposit until the debt has been repaid; that the financial institution may compensate the sums on deposit whenever the client is in default, even before the expiry of the term, if there is one; that the eventual bankruptcy of the client will not prevent compensation and that the right to compensate may be set up against any third party assignee of the deposit or a seizing creditor.

Compensation is also available in commercial credit operations. Two companies doing business together, each one being a client of the other, may compensate the sums of money which are mutually owing when they are liquid and exigible.

There is the rub, as it often occurs that the debts to be compensated are not exigible at the same time. In order to avoid this difficulty and avail themselves of compensation, the companies will find it advantageous to include in their contracts some provisions making all debts exigible at the same moment.

For instance, the parties may agree that should "A" fail to respect his obligations under the terms of the agreement, "B" may then consider that the debt is payable, even though a not-yet-expired term was granted for payment acceleration. Thus, if "B" also owes a sum of money to "A" which is exigible, both debts may be compensated since under the contract, the debt which was not exigible has become so, by application of the default provisions.

It is perhaps in the absence of any security for payment that compensation is most valuable since it occurs by sole operation of the law, without any formalities, and indeed, it gives true priority to a creditor's claim since he does not have to share in the sums to be compensated with any of his debtor's other creditors.

4) Bankruptcy and compensation

Under the rules of the *Bankruptcy and Insolvency Act*³ (the "BIA"), a bankrupt debtor may not make a preferential payment to one of his creditors. It is thus necessary to determine whether compensation is possible between a debt of the bankrupt and that of his creditor. In this respect, the BIA states the following, at Section 97(3):

The law of set-off applies to all claims made against the estate of the bankrupt and also to all actions instituted by the trustee for the recovery of debts due to the bankrupt in the same manner and to the same extent as if the bankrupt were plaintiff or defendant, as the case may be, except in so far as any claim for set-off is affected by the provisions of this Act respecting frauds or fraudulent preferences.

If the situation for compensation existed prior to the bankruptcy and all the conditions were then fulfilled, compensation will be valid and may be set up against the trustee, subject to the parties' good faith. Where the debt of one of the parties towards the other is only payable under a suspensive term, the Civil Code provides that the insolvency of the debtor entails forfeiture of the term. As a result, the bankrupt's debt will generally be payable on the date of his bankruptcy. Compensation may then occur on the same date.

A more difficult question is the determination of whether compensation may occur after the date of bankruptcy, for instance when the bankrupt's debt only becomes liquid or the creditor's debt only becomes exigible after said date.

Article 1681 of the *Québec Civil Code* states that compensation may not occur or be waived to the prejudice of a third party's vested rights. One school of thought is to the effect that compensation must occur on or prior to the date of bankruptcy in order to be set up against the trustee since he is a third party within the meaning of this provision. Consequently, compensation could not be set up against him. Conversely, another school has rejected this solution on the basis of Section 97(3) of the BIA quoted above.

Indeed, the Courts have decided⁴ that the purpose of this provision is to allow legal compensation to occur, even after bankruptcy, between two debts which were extant on the date of bankruptcy. Thus, compensation rules will apply as if bankruptcy had not occurred and the fact that one of the debts may not have become exigible yet on the date of bankruptcy, will not prevent it from being subsequently declared exigible and compensated. The only bar to compensation in a bankruptcy situation appears to be the provisions of the BIA regarding frauds or fraudulent preferences.

5) Assignment or hypothec on claims and compensation

The impact on compensation of an assignment or a hypothec on claims is set out under Article 1680 of the *Québec Civil Code* which states the following:

A debtor who has acquiesced unconditionally in the assignment or hypothecating of claims by his creditor to a third person may not afterwards set up against the third person any compensation that he could have set up against the original creditor before he acquiesced.

An assignment or hypothec in which a debtor has not acquiesced, but which from a certain time may be set up against him, prevents compensation only for debts of the original creditor which come after that time.

The following example will show the application of this provision:

ABC Inc. owes \$5,000 to XYZ Inc., for goods sold and delivered. On the other hand, XYZ Inc. also owes \$10,000 to ABC Inc., as a balance for repairs on its building.

ABC Inc. assigns (or hypothecates) in favor of its banker the debt of \$10,000 owed by XYZ Inc. XYZ Inc. accepts by signing the said assignment (or hypothec) as debtor.

In the above example, XYZ Inc. may no longer set off the sum of \$5,000 owing by ABC Inc. for goods sold and delivered, against the assignee bank's claim of \$10,000 for repairs. In other words, XYZ Inc. may no longer argue as against the bank that it only owes a net amount of \$5,000. Quite the opposite, as the bank will be able to claim from XYZ Inc. the full \$10,000 which was assigned or hypothecated by ABC Inc., without XYZ Inc. being able to effect compensation.

However, in the same example, if XYZ Inc. does not accept the assignment (or hypothec) and is only notified afterwards, in the manner set out in the *Québec Civil Code*,⁵ it will then be entitled to set up against the bank the debt

of \$5,000 owed by ABC Inc. Indeed, this debt existed on the date when XYZ Inc. was notified of the assignment (or hypothec) of its debt of \$10,000 towards ABC Inc. in favour of the bank.

On the other hand, if, after the date of notification, ABC Inc. becomes indebted to XYZ Inc. for an additional \$5,000 for goods sold and delivered, XYZ Inc. will not be entitled to set it up against the debt of \$10,000 owing to the bank pursuant to the assignment (or hypothec). XYZ Inc. will only be able to set up against the bank those debts of ABC Inc. which existed prior to the date on which it was notified of the assignment (or hypothec).

6) Conclusion

When two reciprocally existing debts meet the conditions pertaining to their nature, liquidity and exigibility, compensation will prove to be an easy and practical means of payment in many situations and for several persons who are involved in credit operations. In certain cases, and most importantly for unsecured claims, compensation is a most advantageous mode of payment and extinction of debts.

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1) Art. 1673 Q.C.C.

2) Art. 1675 Q.C.C.

3) *Bankruptcy and Insolvency Act*; L.C. (1985), Ch. B-3

4) *Laviolette c. Mercure*, [1975] C.A. 599; *Hil-A-Don Ltd: Bank of Montreal c. Kwiat*, [1975] C.A. 157

5) Art. 1641, 1642, 2710 et 2743 Q.C.C