

# How to protect suppliers from defaulting or insolvent payers

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## Introduction

In most trading relationships, suppliers enter into deferred payment agreements, such as instalment sales, with their retailers in order to allow retailers to stock their inventory and to manage cash flow between the delivery of goods and the resale to the customer. The possibility of default on payments or often the insolvency of a trade customer/retailer exposes the supplier to considerable risk without control of its goods and without payment. As an unsecured creditor, the supplier then stands in an unfortunate position and may never recover its goods or receive payment.

Nevertheless, in case a retailer becomes bankrupt or is placed under receivership, the *Bankruptcy and Insolvency Act*<sup>1</sup> (BIA) provides a **30-day** rule<sup>2</sup> for unpaid suppliers to reclaim goods which have been delivered within **30 days** of a customer's bankruptcy or receivership or receive payments for such goods. However, protections afforded by the BIA to suppliers are very limited and must satisfy many preconditions to be applicable.

There are many ways of mitigating these risks. In this article, we identify the principal areas of suppliers' risk and provide a guide to practical legal tools, which may help suppliers protect goods placed in their customer's possession prior to full payment.

More specifically, this article focuses on the reservation of ownership and security arrangements in Québec. While the other provinces of Canada adopted a *Personal Property Security Act* (PPSA), in Québec, the relevant provisions are found in the *Civil Code of Québec* (CCQ).

In this article, we discuss the pros and cons of possible arrangements, such as instalment sales agreements, master instalment sales agreements, hypothecs as well as master lease agreements. Additionally, for each proposed solution, we summarize:

- whether the goods are considered in or out of the creditor/supplier's "patrimony"<sup>3</sup> (and thus may or may not be protected from the buyers' other creditors);
- the administrative burden (depending on the number of documents required, registration requirements, follow-ups and advance entry requirements); and

- the suppliers' rights upon default on payments or in case of bankruptcy of a buyer (prior ranking, adverse entries).

## A. Instalment Sale

### 1. Definition

An instalment sale (IS) is an arrangement by which the seller/supplier reserves ownership of the property sold until full payment by the buyer (1745 CCQ). This regime transfers to the buyer the risks of loss of the property, except in the case of a consumer contract or where the parties have stipulated otherwise (1746 CCQ). A reservation of ownership is thus a particularly effective mechanism to protect the seller against the buyer's default, including in insolvency. However, in order to be set up against a third person, the reservation of ownership (and the transfer thereof) must be registered in the Register of Personal and Movable Real Rights (RPMRR) with respect to a road vehicle or other movable property determined by regulation, or with respect to any movable property acquired for the service or operation of an enterprise (1745(2) CCQ). Such reservations do not have effect against a third person who acquires any such property in the ordinary course of business of the seller's enterprise. Recent Québec cases have imposed greater diligence on sellers and lessors to protect their rights under this arrangement.<sup>4</sup>

### 2. Publication

The reservation of ownership must be published within **15 days** of the creation of the contract to be enforceable against third persons.<sup>5</sup> In order to ensure opposable title and thus first priority, we recommend that the supplier not deliver any goods before the contract is signed and published. This is because, according to 1749 CCQ and case law, if the property is delivered before the signing of the IS or in case of late registration, if the buyer is bankrupt, any prior creditor of the buyer who may have a hypothec (security interest) whose charged property is large enough to cover the goods sold during this period could be given priority over the goods. To be prudent, the seller/supplier may also seek to obtain a subordination<sup>6</sup> of priority non-interest letter or voluntary reduction (in respect of the goods being the object of the IS) from the buyer's prior secured creditors.

### 3. Late Publication

Also, if the reservation of ownership is filed late, the seller may take the property back only if it is in the hands of the immediate buyer (1749 CCQ), unless the reservation was published at the RPMRR before the sale of the property by that buyer, in which case the seller may take it back from the subsequent acquirer, subject only to such rights and charges with which the immediate buyer may have encumbered it at the time of filing of the reservation of ownership and which had already been filed.

### 4. Title Retention

Under Québec law the reservation of ownership is treated as a title retention device, which is neither a security interest nor a hypothec.<sup>7</sup> The reservation of ownership is treated as a security interest under section 2 of the BIA. Failure to register makes it

therefore unenforceable against the trustee in the bankruptcy when a buyer has petitioned, or is petitioned by a third party, into bankruptcy. When coupled with the fact that 1749 CCQ states that recourses similar to hypothecary recourses must be used to enforce an instalment sale (*i.e.*, *inter alia* the need for a prior notice of intention to exercise the reservation of ownership to be drafted, served on the buyer and registered at the RPMRR; and the need to wait **20 days** before enforcing one’s reservation of ownership), this means that the supplier’s road to repossess its goods could be longer and more complicated than it typically is for an owner to get its products back when it is unpaid for them.

We recommend suppliers clearly identify their goods or implement systems such as placing barcodes on their inventory to facilitate repossession in case of payment defaults or buyer bankruptcy.

## IS PROS AND CONS

### PROS

1. IS follow the requirements of the CCQ (*i.e.* **15-day registration** rule to reserve ownership)
2. Specific collateral description
3. No need to get subordinations of priority non-interest letters or voluntary reductions from prior ranking filers, as long as registration of the IS is done properly before delivery

### CONS

1. Does not protect from sales to third parties in the ordinary course of business
2. Sec. 2 BIA (definition of security falls under security interest<sup>8</sup> and instalment sale vendor is included in “secured creditor” definition, as in the PPSA)
  1. Must wait out bankruptcy delays
3. Must register with each purchase or delivery
4. 1745 CCQ,<sup>9</sup> *i.e.* must register within **15 days** of sale
5. Does not cover proceeds of sale of goods unless they can be identified and have not been commingled

## IS EVALUATION\*

|  |                        |                          |
|--|------------------------|--------------------------|
| Goods are in the patrimony of:                     | Supplier <sup>10</sup> | Buyer                    |
| Administrative burden:                             | Low                    | High                     |
| Supplier’s rights upon buyer’s default/bankruptcy: | Protected              | Vulnerable <sup>11</sup> |

## B. Master Instalment Sale (2961.1 CCQ)

With a Master Instalment Sale (MIS), article 2961.1 CCQ allows for the *one time registration of the reservation of ownership of property* rights with regard to a *universality of movable property* “of the same kind” in the *ordinary course of business*

between persons who operate enterprises. This registration retains all the rights of the seller for **10 years** (which may be extended if the registration is renewed), over any item sold from time to time, though, the seller documents each sale (and its separate terms) in a separate schedule (which schedules thus do not have to be registered individually). **However, such reservations are not enforceable against a third party who acquires any such property in the ordinary course of the business of its seller.**

Certain distinctions exist between the registration of MIS contracts, covering the universality of movable property, and IS contracts. The **15 day** registration delay does not apply to the registration of MIS, as article 2961.1 CCQ does not use the same terms as in articles 1745, 1847 and 1852 CCQ. However, the reservation of ownership is not enforceable “retroactively” (*i.e.* to the date of the contract) against third parties – it is only enforceable once registered in the RPMRR.

## MIS PROS AND CONS

### PROS

1. 1852 and 2961.1 CCQ (allow for one-time ownership reservation)
2. MIS follow the requirements of the CCQ (properly drafted universality; register against generic description for 10 years; document acceptances and schedules registered before first delivery)
3. No **15-day rule** for registration
4. Good for 10 years, subject to renewal thereafter with no other registration needed
5. No need to get subordinations of priority non-interest letters or voluntary reductions from prior ranking filers, as long as registration of the MIS is done properly before delivery

### CONS

1. Does not protect from sales to third parties in the ordinary course of business
2. Sec. 2 BIA (definition of security falls under security interest and instalment sale vendor is included in “secured creditor” definition, as in the PPSA)
  1. Must wait out bankruptcy delays
3. If creditors choose to take back the property, they must do it by respecting the rules regarding the exercise of hypothecary rights (1749 CCQ<sup>12</sup>)
4. Does not cover proceeds of sale of goods unless they can be identified and have not been commingled

## MIS EVALUATION

|  |                  |                   |
|--|------------------|-------------------|
| Goods are in the patrimony of:                     | <b>Supplier</b>  | Buyer             |
| Administrative burden:                             | <b>Low</b>       | High              |
| Supplier’s rights upon buyer’s default/bankruptcy: | <b>Protected</b> | <b>Vulnerable</b> |

## C. Hypothec (2660 CCQ and ff.)

### 1. Generalities

A hypothec is a real right on a movable or immovable property securing the performance of an obligation. It confers on the creditor the right to follow the property into whose hands it may be, save if sold in the ordinary course to a buyer in good faith (2700 CCQ). A valid hypothec requires publication to render it effective against third parties (including a trustee in bankruptcy).

Hypothecs can charge a “universality” of property or specific personal (movable) property, corporeal (tangible) or incorporeal (intangible) and immovable (real) property. It must sufficiently describe the property or the nature of the universality of property (2697 CCQ) and takes its rank from the day it is registered at the RPMRR (2698 CCQ).

In the case of a sale in the ordinary course of business, the hypothec granted on a universality of property may subsist and extend to any property of the same nature replacing the property “alienated” in the ordinary course of business (i.e. sold inventory replaced by new inventory). Unlike an IS, a MIS, or leasing contracts, hypothecs may extend to commingled and non-traceable proceeds if a general mention that proceeds are charged exists, but enforcement against same is dependent on publication and rank.

Filings of movable hypothecs are made at the RPMRR and are valid for 10 years after the date of their registration, unless renewed. The document filed is called an application for registration, which may be done electronically or by mail. It identifies the debtor and the creditor, describes the property, indicates the date and place of the signature of the act constituting the hypothec, and the hypothec amount.

## 2. Recourses

There are only four ways for a creditor to exercise its hypothec – each with its own rules: (1) taking in payment; (2) possession for the purpose of administration; (3) sale by the creditor; and (4) judicial sale. In all cases, since the goods are in the patrimony of the grantor/debtor, the hypothecary creditors’ rights are subject to the rights and ranking of the debtor’s other creditors.

## HYPOTHEC PROS AND CONS

### PROS

- It is simple to put in place
- There are no schedules to make or update (however it must be registered to keep ranking)

### CONS

- Ranks from the date and time of registration
- Needs subordination from prior ranking filers
- The goods are in the patrimony of the debtor
- If creditors choose to take back the property, they must do it by respecting the rules regarding the exercise of hypothecary rights

## HYPOTHEC EVALUATION

Goods are in the patrimony of:      Hypothecary Creditor

Grantor/Debtor

|  |           |            |
|--|-----------|------------|
| Administrative burden:                             | Low       | High       |
| Supplier's rights upon buyer's default/bankruptcy: | Protected | Vulnerable |

## D. Vendor's Hypothec (2954 CCQ)

A vendor's hypothec (2954 CCQ) is similar to a regular hypothec, except:

1. It can only charge goods the vendor sells;
  1. **Remark:** not certain if traceable proceeds are ever covered
2. It only exists if entered into in the deed of sale;
  1. **Remark:** which increases the administrative burden
3. It does not apply for future sales;
  1. **Remark:** limited use
4. It provides a first rank to the vendor over the goods sold if registered at the RPMRR **within 15 days**;
5. The goods are in the patrimony of the buyer
  1. **Remark:** thus, the rights of the creditor are subject to the rank and rights of the buyer's other creditors

As a result of two and three above, it is not used in ongoing supplier relationships, but can be an excellent tool when:

1. There is a need to allow the buyer to be the owner of the good in a one-off sale
2. A sale of a business occurs and there is a balance of purchase price owing by the buyer to the seller

## VENDOR'S HYPOTHEC PROS AND CONS

### PROS

1. First ranking if registered **within 15 days** at the RPMRR
2. Good for 10 years, subject to renewal thereafter with no other registration needed
3. Specific collateral description

### CONS

1. **15-day rule** for registration
2. Hypothec must be created in each individual deed or sale
3. Each shipment must have its own registration
4. Does not protect from sales to third parties in the ordinary course of business
5. Does not cover commingled proceeds – and potentially does not cover any proceeds at all
6. The goods are in the patrimony of the debtor
7. Enforcement is limited to hypothecary recourses

## VENDOR'S HYPOTHEC EVALUATION

|                                |                      |                |
|--------------------------------|----------------------|----------------|
| Goods are in the patrimony of: | Hypothecary Creditor | Grantor/Debtor |
|--------------------------------|----------------------|----------------|

|  |           |            |
|--|-----------|------------|
| Administrative burden:                             | Low       | High       |
| Supplier's rights upon buyer's default/bankruptcy: | Protected | Vulnerable |

## E. Master Lease (1852 and 2961.1 CCQ)

In ongoing sales relationships, a safer approach to the above would be to register a Master Lease (ML) with an “early purchase option” and full payment upon the earlier of (i) resale by the lessee, or (ii) residual value payment at an agreed upon date (which can be net 30-60-90 days) under articles 1852 and 2961.1 CCQ.

As with MIS, the **15 day** window for registration is not applicable to a ML (2961.1 CCQ).

In a ML situation, as with MIS, the registration must be undertaken prior to the delivery of the goods. If the ML is appropriately registered, all delivered goods subject to the ML will be granted priority status. It should be noted that the registration, when undertaken, must clearly set out the universality of goods of the same kind that are going to be subject to the ML. A barcode system is best practice.

The enforcement is simpler than for MIS, as a lessor under an ML can seize or sue. As it is its property, the trustee in bankruptcy of the lessee can claim any rights to the goods, and must immediately return them to the lessor when a claim is made (NB – a lease is not deemed to be a security interest under section 2 of the BIA, as is an MIS).

### ML PROS AND CONS

#### PROS

1. 1852 & 2961.1 CCQ (allow for one-time ownership reservation)
2. No **15-day rule** for registration
3. Good for 10 years, subject to renewal thereafter with no other registration needed
4. No need to get subordinations of priority non-interest letters or voluntary reductions from prior ranking filers, as long as registration of the ML is done properly before delivery
5. Seize or sue option available

#### CONS

1. Strange drafting requirements for allowing leased goods to be sold at any time on condition of payment to suppliers concurrently
2. Accounting issues may exist

### ML EVALUATION

|  |           |            |
|--|-----------|------------|
| Goods are in the patrimony of:                     | Lessor    | Lessee     |
| Administrative burden:                             | Low       | High       |
| Supplier's rights upon buyer's default/bankruptcy: | Protected | Vulnerable |

## Recommendations

Each form of contract listed above has its pros and cons, and thus, the legal and accounting goals of the supplier, as well as its appetite for administrative burden and risk will dictate the choice of structure made.

Our team at BLG would be glad to assist you in putting together your supplier programs and/or your inventory financing programs in light of the laws. As Canada's law firm, we have the expertise to do so both in Québec (per the above), as well as across the country.

\*Bolded words in the evaluation tables portray the selected items (*i.e.* here the goods are in the patrimony of the "supplier").

<sup>1</sup> *Bankruptcy and Insolvency Act* (R.S.C., 1985, c. B-3), sec. 2: BIA's definition of "secured creditor" is similar to a reservation of ownership in an instalment sale with a security interest. Sellers must register their reservation of ownership under the BIA to benefit from all the protections.

<sup>2</sup> The 30-Day Good right under s. 81.1 of the BIA is a super-priority claim, which allows an unpaid supplier to repossess goods that were delivered to a purchaser, who subsequently becomes bankrupt or is placed under receivership, within 30 days of the bankruptcy or receivership. In order to exercise this right, the supplier must present a written demand for repossession to the purchaser, trustee or receiver, in the prescribed form, containing the details of the transaction, within a period of 15 days after the day on which the purchaser became bankrupt or became a person who is subject to receivership.

<sup>3</sup> A "patrimony" can be simply defined as the basket which contains the assets and rights one owns.

<sup>4</sup> Benjamin Gross et al., "Lessors and Instalment Sellers: Beware!", *Lavery, De Billy*, June 2003, at p. 4.

<sup>5</sup> The date of the creation of the contract has been seen by case law as the date at which the parties have agreed to all essential elements of the contract (*i.e.* item sold, date, delivery details, payment mechanics, etc.) and not necessarily the date of signature of the contract – though the date of signature of the contract is the most evident display of the date of the contract used by the industry.

<sup>6</sup> "A subordination agreement is an arrangement whereby one creditor expressly and voluntarily agrees to subordinate its claim against the debtor to the claim of another creditor. That other creditor can, thus, have its obligations against the debtor satisfied first." (MacDougall, Bruce. "Subordination Agreements." *Osgoode Hall Law Journal* 32.2 (1994): 225-269.)

<sup>7</sup> *Massouris (Syndic de)*, J.E. 2002-726, *Mervis*, J.E. 2002-1650 and *Lefebvre and Services Financiers Daimler Chrysler (Rebis) Canada Inc. v. Lebel*, R.E.J.B. 2003-38975.

<sup>8</sup> *Security interest is defined in the PPSA as “an interest in personal property that secures payment or performance of an obligation...”*

<sup>9</sup> **1745.** An instalment sale is a sale with a term by which the seller reserves ownership of the property until full payment of the sale price.

A reservation of ownership with respect to a road vehicle or other movable property determined by regulation, or with respect to any movable property acquired for the service or operation of an enterprise, may be set up against third persons only if it has been published; the reservation may be set up against third persons from the date of the sale provided the reservation of ownership is published within 15 days. As well, the transfer of such a reservation may be set up against third persons only if it has been published.

<sup>10</sup> If registered ownership, goods will be protected from the buyers’ other creditors.

<sup>11</sup> Especially if goods are not easily identifiable.

<sup>12</sup> **1749.** A seller or transferee who, upon the default of the buyer, elects to take back the property sold is governed by the rules regarding the exercise of hypothecary rights set out in the Book on Prior Claims and Hypothecs; however, in the case of a consumer contract, only the rules contained in the *Consumer Protection Act* (chapter P-40.1) are applicable to the exercise by the seller or transferee of the right of repossession.

If the reservation of ownership required publication but was not published, the seller or transferee may take the property back only if it is in the hands of the immediate buyer; the seller or transferee takes the property back in its existing condition and subject to the rights and charges with which the buyer may have encumbered it.

If the reservation of ownership required publication but was published late, the seller or transferee may likewise take the property back only if it is in the hands of the immediate buyer, unless the reservation was published before the sale of the property by that buyer, in which case the seller or transferee may also take the property back if it is in the hands of a subsequent acquirer; in all cases, the seller or transferee takes the property back in its existing condition, but subject only to such rights and charges with which the immediate buyer may have encumbered it at the time of the publication of the reservation of ownership and which had already been published.

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