

CHANGE OF TERMS OR NOVATION : HOW TO RELEASE THE SURETYSHIP

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Novation is a legal process when one obligation replaces another, causing the extinction of the first and creating a new obligation¹. In the context of a suretyship, a surety who is bound by the first obligation will not automatically be bound by the second, since suretyship is not presumed².

But a simple change in payment terms, such as the conversion of a line of credit into a loan, does not constitute novation. The obligation remains the same. As a result, the suretyship generally remains valid and enforceable. Such conversion is said to be a mere change in the terms of payment and does not actually create a new obligation.

This article discusses the difference between novation by change of terms versus change of payment terms to release a surety.

NOVATION BY CHANGE OF TERMS

Novation requires not only changing the form of the obligation, but the complete disappearance of the original obligation and its replacement by another. The object may even be distinct from that of the original obligation.

In other words, it is not a mere modification of the original obligation but requires a profound change in it. Extinguishing the original obligation by creating a new obligation in its place is key and an essential feature of novation. The creation of a new obligation, without the original obligation being extinguished, will be insufficient to conclude that novation has occurred³.

Some actions may appear at first glance to be novation, but upon closer examination the courts have determined that they are not.

¹ Karim VINCENT, *Les obligations*, vol. 2, 5th ed. (Montreal: Wilson & Lafleur, 2020), p. 1293.

² *Civil Code of Québec*, CQLR c CCQ-1991, art. 2335.

³ *Supra*, note 1.

Justice Gonthier in the Supreme Court of Canada case of *Lalonde v. Sun Life of Canada*⁴ lists the five conditions required to establish novation:

- 1) there must be a prior obligation;
- 2) the creation of a new obligation;
- 3) the two obligations must be different from each other;
- 4) the parties have demonstrated their intention to novate;
- 5) they are capable of contracting.

Doctrine and case law specify the content of these conditions⁵. In Quebec doctrine, Jean-Louis Baudouin and Pierre-Gabriel Jobin⁶ maintain that novation by change of terms occurs when the parties make a fundamental change to the obligation. Changing terms of payment must not affect only the due date of the debt, but the nature of the obligation itself.

The new debt or contract must contain a genuinely new element in relation to the old debt. It cannot merely add an element to the old debt or be a mere change of form. The fundamental criterion for concluding that there is a genuine change is the incompatibility of the two obligations.

For example, a debt consolidation operates as novation⁷. Moreover, in certain specific situations, even the transformation of a variable credit loan agreement into a term loan agreement could constitute novation.

In *La Fontaine v. Archambault*⁸, the Court of Appeal held that when a declaration of dissolution of a partnership is registered, a former partner cannot be held liable to third parties who contract with the former partners, regardless of whether those third parties were already doing business with the partnership before its dissolution. The Court held that the conversion of the variable credit loan agreement into a term loan agreement novated the first loan and constituted a new loan agreement that could not be set up against the former partner who had duly registered the declaration of dissolution of the partnership.

CHANGE IN PAYMENT TERMS

Novation cannot be presumed; the intention to novate must be evident⁹. Although it may be tacit, it must be clearly proven since it is the loss of a right by extinction of an obligation. In case of doubt, Courts conclude that there is no novation¹⁰.

It is now recognized that the following do not constitute novation: (a) an extension of the term of a contract, (b) a change in the applicable interest rate or (c) a change in the terms of payment. These examples are considered mere accessories to the debt¹¹.

⁴ *Lalonde v. Sun Life du Canada, Cie d'assurance-vie*, [1992] 3 R.C.S. 261, 284.

⁵ *Clermont-Drolet v. Caisse populaire Desjardins de Sillery*, 2008 QCCA 1843, par. 30.

⁶ Jean-Louis BAUDOUILN and Pierre-Gabriel JOBIN, *Les obligations*, 6th ed, Cowansville, Éditions Yvon Blais, 2005, p. 1016-1018.

⁷ *Banque Toronto-Dominion v. Boulay*, 2007 QCCS 4505, par. 71; Jean-Louis BAUDOUILN, Pierre-Gabriel JOBIN et Nathalie VÉZINA, *Les obligations*, 7th ed., Cowansville, Éditions Yvon Blais, 2013, par. 998.

⁸ *La Fontaine v. Archambault*, 2000 CanLII 7769 (QC CA), par. 24 et 25.

⁹ *Supra*, note 2, s. 1661.

¹⁰ *Matériaux Audet inc. v. Giguère*, 2020 QCCS 1621, par. 33.

¹¹ Jean-Louis BAUDOUILN, Pierre-Gabriel JOBIN and Nathalie VÉZINA, *Les obligations*, 7th ed, Cowansville, Éditions Yvon Blais, 2013, para. 998; *Supra*, note 7, para. 35.

DISTINCTIONS

According to Professors Didier Lluelles and Benoît Moore, the facts are paramount in determining whether obligations are incompatible in their fundamental elements¹²:

It is more difficult to understand novation by change of terms. Indeed, the distinction between novation and modification of the obligation is particularly delicate here. The change of terms must relate to a fundamental aspect of the obligation, and the parties must intend to novate, that is, to extinguish the obligation and to create a new one, incompatible with the previous one. [...] Thus, the following cannot constitute novation by change of debt: a mere change in the term, the renewal of a loan, a change in the amount of the benefit, the loan or the line of credit, or the terms of payment or repayment.

[Our translation and underlining]

The conversion of a line of credit into a loan by a financial institution is a change in the payment terms. This transaction generally does not result in novation.

Novation is one of the means of extinction of an obligation explicitly recognized by the C.C.Q.¹³ It extinguishes the original debt and causes all the accessories to that debt to disappear. In principle, security offered by the debtor in respect of the original debt are extinguished¹⁴. As a result, by extinguishing the original debt, novation leads to the release of the sureties¹⁵.

CONCLUSION

Novation is a complex legal transaction with important consequences, particularly on suretyship.

Distinguishing novation by change of terms from a simple change of payment terms is a delicate but necessary operation.

A request to modify a contract could possibly cause the extinction of the original obligation and the release of all its accessories, including the suretyship.

If you have any questions, do not hesitate to contact a lawyer in our Litigation or Commercial Groups who will be pleased to advise you if you are faced with such a request that could result in novation.

¹² Didier LUELLES and Benoît MOORE, *Droit des obligations* (Montreal: Les Éditions Thémis, 2006), pp. 1856-1857; *Supra*, note 4, para. 31.

¹³ *Supra*, note 2, s. 1671.

¹⁴ 9053-4892 *Québec inc. v. Simard*, 2012 QCCS 4054, par. 77; *Supra*, note 6, par. 1008.

¹⁵ *Supra*, note 2, s. 1665; *Émond v. Banque Toronto-Dominion*, (C.A., 1978-11-15); *Beaudette v. Caisse populaire de East Angus*, 1996 CanLII 4429 (QC CS), par. 20 and 24 to 26; *Compagnie Trust Royal v. Entreprises B.M. St-Jean inc.*, 1997 CanLII 8959 (QC CS), p. 3 and 4.; *Placements Maurice Beaulieu inc. v. 2551-8259 Québec inc.*, 1998 CanLII 11892 (QC CS), par. 101 to 104 and 109.