

EARLY TERMINATION CLAUSES IN CONSUMER MORTGAGE LOANS: THE SPANISH SUPREME COURT MOVES CLOSER TO THE APPROACH OF THE BANKING SECTOR AND FINDS IN FAVOUR OF ALLOWING FORECLOSURE PROCEEDINGS

On 11 September 2019, the Spanish Supreme Court has taken up the slack from the European Court of Justice to solve the problems arising around early termination clauses present in Spanish mortgage-secured loans with consumers.

The ruling issued by this highest court offers a solution for the thousands of foreclosure proceedings that are deadlocked in the Spanish Courts and for those to be initiated.

The reason for the direction of this ruling is the attempt by the Supreme Court to safeguard the legal certainty in the Spanish real estate market.

Quick recap on the problems arising around early termination clauses in consumer mortgage loans¹

In the recent years, the Spanish Supreme Court and the European Court of Justice (ECJ) have coincided in affirming that early termination clauses in consumer mortgage loans that foresee "any breach" as a termination event are unfair and, therefore, null and void.

The ruling of 11 September 2019 summarises the position of these two Courts: in order for a termination clause not to be considered unfair, "it should modulate the seriousness of the breach depending on the duration and

¹ For further information on the origin of the issue that has arisen concerning early termination clauses included in Spanish mortgage-secured loans, on the content of the ruling issued by the European Court of Justice on 26 March 2019 or on the contents of the recently published Real Estate Financing Act please refer to our client briefing "**Consumer loans: early termination clauses after the most recent developments**".

Key issues

- The Spanish Supreme Court gives the criteria to address the scenarios that had not been covered by the Real Estate Financing Act regarding ongoing foreclosure proceedings based on the early termination of mortgage-secured loans with consumers.
- Financial institutions and NPL acquirers will be able to file new foreclosure proceedings based on the acceleration of the loan, if certain criteria set out by the Supreme Court are complied with.
- The criteria settled in the Supreme Court ruling are only applicable to mortgage-secured loans entered into with consumers.

amount of the loan, and it should permit the consumer to avoid its application by diligent behaviour, restoring the situation".

The evolution of the legal rules on loan acceleration and foreclosure proceedings

Clauses with the aforementioned (unfair) wording were standard in all loan deeds formalised with consumers in Spain, up to 2013, when the existing templates began to be modified.

In 2013 a legal amendment of the Civil Procedure Act established that there must be a minimum of three (3) unpaid monthly repayments (or equivalent) due in order for the lender to be allowed to accelerate a mortgage-secured loan. However, the general Court feeling was that this threshold did not provide enough protection for consumers.

In February 2019 the Real Estate Financing Act (*Ley Reguladora de los Contratos de Crédito Inmobiliario*) was approved by the Spanish Parliament. It entered into force on 16 June 2019.

This Act offers a solution for mortgage-secured loans and loans for the acquisition of real estate (in both cases, when the collateral or the asset is a residential property) that have not been accelerated before its entry into force (even if they were formalised before).

For those cases, lenders will be able to fully accelerate the loans, if: (i) during the first half of the loan's term, there are twelve (12) defaults on monthly repayments due (or 3% of the total amount loaned); or (ii) during the second half of the loan's term, there are fifteen (15) defaults on monthly repayments due (or 7% of the total amount loaned).

As per the wording of the Act, these new criteria will apply unless (i) the lender has decided to accelerate the loan before the entry into force of the new Act; and (ii) the consumer alleges that the current wording is more beneficial.

Consequences of the nullity of the acceleration clauses

Although the unfairness of the old acceleration clauses and the standards to be complied with in future had become clear following the case law and the legal regulation set out above, neither the ECJ nor the Spanish Supreme Court had addressed the consequences of the declaration of nullity of the unfair clauses.

This resulted in an overall halt of foreclosure proceedings against consumers, with the consequent concern for financial institutions and NPL purchasers.

In February 2017, the Spanish Supreme Court asked the ECJ to issue a pronouncement clarifying whether the presence of this sort of unfair clause should impede the initiation or continuation of the foreclosure of the loan, if already underway.

On 26 March 2019, the ECJ rendered its decision. The ECJ judgment opened the door to applying legal rules to accelerate mortgage loan agreements if the declaration of unfairness entails an invalidity of the entire contract. On the contrary, (i.e. if the mortgage loan can survive without this clause) the ECJ instructs the Spanish Supreme Court not to supplement the contract, preventing access to the foreclosure proceeding (unless the consumer agrees to it).

Thus, the ECJ deferred the final decision on the consequences of the nullity of the unfair clauses to the Spanish Courts.

The ruling of the Supreme Court dated 11 September 2019. A break for the banking sector

The Plenary Session of the Civil Chamber of the Supreme Court served its ruling on this subject on 11 September 2019. The pronouncement was agreed unanimously by all the judges of the Chamber.

The mortgage loans with consumers cannot survive without an early termination clause.

The Supreme Court has recognized that mortgage-secured loans with consumers cannot survive without an early termination clause that permits the acceleration of the loan in case of breach. This pronouncement opens up the possibility to supplement the contract in order to ensure lenders have access to the foreclosure proceeding under certain conditions.

The rationale of such statement is that mortgage loans are a complex legal figure with a dual legal cause: (i) the one for the consumer, which is the interest of obtaining the lowest price possible for accessing funds and; (ii) the one of the financial institution, which seeks to have effective security to cover any defaults.

On this basis, the Supreme Court affirms that the contract cannot subsist if the lender cannot enforce the mortgage effectively.

The solution for on-going foreclosure proceedings: acceleration before and after 2013

One of the main concerns for market agents (financial institutions, NPL purchasers and servicers) was the solution that the Supreme Court was going to give for on-going foreclosure proceedings, which were suspended since the beginning of 2017.

In its ruling, the Supreme Court gives minor courts the following guidelines for all on-going foreclosure proceedings that have not ended yet with the repossession of the asset, and in which the acceleration clause has been declared null and void:

- Proceedings where the loan has been accelerated before the entry into force of the amendment of the Civil Procedure Act of 2013 (i.e. the amendment that included the breach of three repayments as criteria to accelerate, hereinafter, the "**2013 Amendment**") should be dismissed. For said loans, there is no possible supplementation in the course of the on-going court action.
- Proceedings where the loan has been accelerated after the entry into force of the 2013 Amendment can continue if the requirements of seriousness and proportionality established by case-law are met. In this sense, the acceleration of the mortgage loan would have been valid if it was based on a breach of an essential obligation, and such breach is sufficiently serious considering the circumstances of the case.

Thus, the Supreme Court confirms the possibility to continue the foreclosure of the mortgage (under certain conditions) even if the early termination clause is unfair and, therefore, null and void.

The subsequent question is on what basis could the Courts consider a loan properly accelerated.

The decision of the Supreme Court distances itself on this point from the ruling of the ECJ dated 26 March 2019.

The ECJ pointed to article 693.2 of the Spanish Civil Procedure Act in its wording given by the 2013 Amendment (i.e. three months non-payment) as the potential legal rule to be used to supplement the contract if needed.

However, the Supreme Court has considered it more convenient to use the rule given by the new Real Estate Financing Act, which is more protective of consumers.

In fact, the wording of the ruling of the Supreme Court leaves room for interpretation by minor Courts, allowing other scenarios different to those envisaged in the above-mentioned Act, by saying that *"this should be an interpretation to be done on a case-by-case basis in which the number of monthly repayments unattended in connection with the entire life of the loan and the possibilities of reaction of the consumer should be considered. And in this interpretation [...] the criteria settled by the Real Estate Financing Act [...] could be a guideline [...]"*.

This wording opens the door for minor Courts to consider certain breaches that do not comply with the criteria set out in the Real Estate Financing Act, as valid for the purposes of allowing foreclosure proceedings to continue.

New foreclosure proceedings can be filed again even if a previous foreclosure based on such grounds was already dismissed.

The Supreme Court indicates that the dismissal of foreclosure proceedings based on either of the aforementioned arguments (i.e. if the acceleration was prior to the 2013 Amendment, or if it does not comply with the requirements of seriousness and proportionality) does not impede the lender from filing a new foreclosure claim based on the application of the new Real Estate Financing Act.

In this regard, it should be noted that the Real Estate Financing Act allows acceleration if the referred circumstances exist, no matter whether the parties had agreed to that. Therefore, instead of applying the (unfair) contractual clause the lender can accelerate pursuant to the law.

CONTACTS



Iñigo Villoria
Partner
T +34 91 590 94 03 E
inigo.villoria
@cliffordchance.com



Alexandra Borrallo
Senior Associate
T +34 91 590 94 06 E
alexandra.borrallo
@cliffordchance.com



Laura del Campo
Associate
T +34 91 590 9479 E
laura.delcampo
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, Paseo de la Castellana 110,
28046 Madrid, Spain

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