

## **Supreme Court (Civil Chamber 1) Judgment no 364/2016, 3 June**

In this judgment the Supreme Court determined the unfair nature of clauses that establish disproportionate default interest in mortgage loans, and set the maximum limit of default interest admissible for such loans at two percentage points above the payable interest allowed for such loans.

In this case, a natural person filed an ordinary lawsuit before the First Instance Court seeking the annulment of the default interest rate established in the mortgage loan agreement executed between the plaintiff and a financial institution, on the grounds that he considered the default interest clause in the agreement manifestly unfair, since it set a nominal default interest rate at 19% per annum.

The complaint was partially upheld and the First Instance Court cancelled the default interest clause, considering it unfair in keeping with the legal interest rate on the relevant dates, which was between 5% and 7%.

The financial institution appealed the ruling and the remedy of appeal was upheld by the Appeal Court, which declared such clause as valid, rejecting its annulment by not considering the default interest as unfair or disproportionate.

The Supreme Court then issued its judgment, with the understanding that the Provincial Court did not correctly apply the doctrine of the European Court of Justice (ECJ) in relation to the appropriate analysis for determining whether the default interest clause is unfair, and upholds the appeal filed by the natural person, specifying the limits of default interest as set forth along the following lines.

The Supreme Court referenced case law on the subject, both its own as well as that of the ECJ, in relation to the cases under debate in prior instances.

Firstly, it was disputed whether or not consumer protection legislation is applicable to the case. In other words, while the initial purpose of the loan was to serve as financing for the acquisition of the primary residence of the natural person, the loan was subsequently extended to another purpose characteristic of commercial trade or personal use of the natural person. The Court explained that the subsequent extension of the loan did not prevent the application of consumer protection legislation to determine the unfair nature of the controversial contractual clause, and recalled the judgment of the ECJ dated September 3, 2015, according to which, "the relevant aspect is the purpose of the transaction and not the subjective conditions of the contracting party."

The Court stated that in this case it could not be argued that the mortgage loan was allocated toward the business activity of the natural person and that the controversial clause was included in the initial mortgage loan agreement, about whose use there is no doubt and, consequently, it was affected by consumer legislation.

Secondly, the Court recalled the provisions of Council Directive 93/13/EEC: "a term shall always be regarded as not individually negotiated when it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term, particularly in the context of standard contracts." The Supreme Court indicated that an imposition of a contractual term existed, for its consideration as a general contracting condition, when the incorporation thereof in the contract is done exclusively by the professional or contractor, without the consumer's opposition to such clause being a necessary requirement. In order to exclude the unfair control of the clause, the contractor or professional must prove and justify the reasons leading to the individual negotiation thereof with that specific consumer.

Likewise, the Court referred to its own case law (STS 265/2012, 22 April) on personal loans, in which it determined that the default interest clause is subject to control of unfair content since what it regulates is the compensation to be paid by the borrower in the event of a delay in payments, not the primary purpose of the loan.

The Court focussed on the issue of the control of the content of the interest clause with respect to the one deemed as unfair for setting a default interest of 19%. It indicated that the aforementioned European Directive as well as applicable Spanish law, the General Consumer and User Protection Act, expressly envisage the unfair nature of this type of clause when a disproportion exists between the compensation for consumer breach and the financial damage actually caused to the professional. Furthermore, the Court explained that in accordance with the preceding case law, the default interest clause is deemed unfair when it is disproportionately high to the detriment of the debtor whereby, in determining if the clause is unfair, it is necessary to examine such proportionality between the breach of the consumer and the compensation associated with the breach.

The High Court explained that, in accordance with the provisions of a resolution of the ECJ, Article 114-3 of the Mortgage Act cannot be applied as the objective limit for mortgage loans or credits allocated toward the purchase of a primary dwelling, since while such precept establishes that default interest cannot be greater than three times the legal interest rate, that precept cannot be the sole reference for determining the limit of default interest and instead the national court, in deciding the limit in each case, should resort to other criteria such as, among others, i) the comparison of the rate stipulated with national regulations applicable in the absence of agreement, or ii) the consideration of whether the professional could reasonably suppose that the consumer would have accepted that clause in an individual negotiation.

Therefore, the Court indicated that the purpose of the aforementioned Article of the Mortgage Act that establishes the limit at three times the legal interest is not to serve as a guideline for the legal control of unfair clauses, but to establish criteria for a prior control of the contents of the clause, by notaries and registrars, so that a clause establishing default interest greater than three times the legal interest should not be registered.

Finally, the Court considered that the **increase of two percentage points** envisaged in Article 576 of the Spanish Civil Procedure Act for establishing procedural default interest was the ideal legal criteria for setting default interest in personal loans arranged with consumers, in that it has a general scope of application and is not limited to a specific area of substantive law and, in addition to making it possible to prevent default interest that may be less than payable interest, it enabled proportional compensation to the plaintiff for any damages caused by the debtor's delay in payment and likewise serves as a deterrent to encourage the debtor to comply with the judgment.

In conclusion, the Supreme Court considered that the default interest stipulated (19%), greater than the payable interest plus two points, was unfair and consequently the controversial clause should be eliminated in its entirety, without the possibility of a "*restraint or conservative reduction*" of the increased interest rate, which should instead accrue ordinary interest only.