



May 2020

RECENT DEVELOPMENTS REGARDING UNFAIR TERMS IN MORTGAGE AGREEMENTS

Recent Irish Supreme Court and Court of Justice of the European Union (CJEU) decisions, provide further clarity on the interplay between Council Directive 93/13/EC on Unfair Contract Terms in Consumer Contracts (the **Directive**) (implemented in Ireland by the European Communities (Unfair Terms in Consumer Contracts) Regulations 1995 (S.I. 27/1995) (as amended) (the **Regulations**)) and claims of unfair terms in mortgage agreements.

▣ **Supreme Court Decision in *Pepper Finance Corporation (Ireland) DAC v Brian and Christina Cannon* (4 February 2020) (*Pepper Finance v Cannon*)**

Pepper Finance v Cannon involves an order for repossession of the home of the appellant borrowers, granted by the relevant county registrar, as the result of a default in the payments related to a mortgage agreement with the respondent mortgagee. The substantive issues included claims that (1) the county registrar failed to assess the fairness of the terms of the mortgage agreement between the parties as required under the Regulations; and (2) certain terms (namely the 'price variation' clause, "acceleration" clause, and "transfer of rights" clause) are unfair.

The Regulations

The intent of the Regulations is to protect consumers from the inherent asymmetry in bargaining power related to, and knowledge of, the non-negotiated (i.e., standard) terms in a contract between a consumer and a seller or supplier. The Regulations closely reflect the core principles of the Directive, including the indicative list of terms that may be regarded as

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“unfair”. To alleviate the imbalance between consumer and vendor, the Regulations provide that consumers will not be bound by any term in the contract that is “unfair”; that is “if . . . [the term] causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer” in the absence of the vendor’s “good faith”. Good faith can be satisfied if the vendor deals “fairly and equitably” with the consumer and takes the consumer’s “legitimate interests” into account. In *Pepper Finance v Cannon*, O’Malley J comments that the “good faith” assessment, in relation to a term, asks the court to determine “whether a seller or supplier could reasonably assume that the consumer would have agreed to such a term if the contract had been negotiated individually”.

Obligation of the national court: The analysis of “fairness” is to be conducted by the national court on its own motion. It is the responsibility of the national court to determine which terms of the contract are in scope and, if in scope, which are unfair. O’Malley J concurred and went on to state that when assessing a term for unfairness, the court should remember:

1. the primary consequence of finding a term unfair is that the term becomes unenforceable as against the borrower, although the contract will remain in force provided it can exist without the unenforceable term;
2. where an unfair term is not invoked against the borrower, it is examined only for the purpose of drawing such inferences as may be appropriate. According to the Court, such inferences must relate to whether the lender has dealt with the borrower in “good faith” as defined by the Regulations; and
3. the assessment of fairness should take into account, *inter alia*, any relevant EU provisions and any relevant remedies against unfairness available to the borrower under the consumer protection legislation related to mortgages, in order to meet the requirement to consider “all of the circumstances”.

With regard to the assessment of unfairness by a county registrar, however, O’Malley J stated that, because a county registrar is not a “judge” under the Constitution, there may be constitutional issues if asked to make such a determination on its own. Instead, according to the Court, a county registrar should consider the contract, by reference to the relevant EU jurisprudence, to determine whether there is a potential defence to a mortgagee’s claim, which should then be referred to the court.

Exclusion of mandatory terms: Mandatory terms required by statute or regulation, while not negotiated, are deemed to be “fair” and thus excluded from the application of the Regulations.

Exemptions for terms that are the “main subject matter of the contract”: Terms that are the “main subject matter of the contract” (i.e., the essential obligations of the contract) or relate to “the adequacy of the price and remuneration, on the one hand, as against the services or goods supplied in exchange, on the other” are exempt, although all such terms will still need to be expressed in “plain and intelligible” language. In *Pepper Finance v Cannon*, the main terms of a standard mortgage agreement were taken to be the borrower’s obligation to repay the loan, the borrower’s obligation to provide security for the loan, and the lender’s right to take possession of the secured property in the event of default.

If such a term is not plain and intelligible, it will fall within the scope of the Regulations and, thus, “fairness” will need to be determined by the national court.

Exemption for Suppliers of Financial Services regarding Interest Rate Changes: When reviewing mortgage agreements, it is important to note that there is an exemption permitting a “supplier of financial services” to reserve the right to alter the interest rate without notice where there is a valid reason to do so, provided that the lender is required to inform the borrower at the earliest opportunity and that the borrower has a right to dissolve the contract immediately (the **Exemption for Suppliers of Financial Services**). However, as the Court notes, the option of the borrower to dissolve the contract has limited practical desirability since it will not extinguish the debt.

Findings of the Court re the claims of Unfair Terms

With regard to the substantive claims of unfair terms by the appellant borrowers, the Supreme Court could not find any grounds that an appeal on the grounds presented by the borrowers could succeed, holding as follows:

Price Variation Clause: The “price variation” clause is not unfair based on the following:

- On its face, the “price variation” clause comes within the Exemption for Suppliers of Financial Services.
- National legislation includes an obligation that a lender must provide a statement of the total cost of the credit being provided, a calculation of the effect of a 1% increase in the interest rate, and notice of any change in the applicable interest rate, thus giving further protections as to fairness.
- While the clause would likely be found to constitute an unenforceable penalty under Irish law if the rate is set at a level that is not fairly related to the costs of the lender, in this instance the interest rate payable by the borrowers was substantially decreased, and, accordingly, cannot be considered unfair.

Acceleration Clause: An “acceleration” clause may be found to be unfair if it permitted the lender to call in the entirety of the loan, and enforce the security, in the event of a single late or missed payment. However, the Court highlighted a number of protections from such unfair treatment under the Consumer Credit Act 1995, the Consumer Protection Code and the Code of Conduct on Mortgage Arrears and the European Union (Consumer Mortgage Credit Agreements) Regulations 2016.

Note that despite not being invoked against the appellant borrowers, the acceleration clause still required review for fairness.

Possession of the Property Clause: Given the facts of the case, the forbearance on the part of the mortgagee was sufficient to negate the possibility of arguing disproportionality as a defense to possession of the property in the event of a missed payment or other breach on the part of the borrower. The Court found on the evidence in this case that the mortgagee complied with the Code of Conduct on Mortgage Arrears. The mortgagee did not attempt to

take possession without a court order and did not issue proceedings until a period of almost 5 years elapsed since the date of default. The Court could find no indication of bad faith on the part of the lender. Thus the Court held that the issue of proportionality is closed off due to the forbearance on the part of the mortgagee.

Transfer of Rights Clause: The Court deferred to the decisions endorsing the views of Peart J in *Wellstead v Judge White & Fetherstonhaugh* that "transfer of rights" clauses are "neither unusual, mysterious nor unlawful". It was noted that no case has been cited showing that such a term has been found to adversely affect the rights or interests of the borrower and the appellants in this case have not indicated how the transfer of rights clause in the immediate mortgage agreement was unfair to them and the claim was dismissed by the Court.

▣ **CJEU Judgement in *Marc Gómez del Moral Guasch v Bankia SA* (03 March 2020) (*Gómez v Bankia*)**

Transparency of a variable interest clause: The CJEU has held that the variable interest rate term of a mortgage contract must not only be formally and grammatically intelligible, but must also enable an average consumer, who is "reasonably well-informed and reasonably observant and circumspect", to understand how that variable interest rate is calculated and be able to evaluate, based on clear, intelligible criteria, the consequences of such a term on her financial obligations with the supplier. The CJEU reasoned that since the Directive is "based on the idea that consumers are in a position of weakness vis-à-vis sellers or suppliers, in particular as regards their level of knowledge", for a term to be in plain, intelligible language, it must be transparent in a broad sense. The CJEU stipulates it is for the national court to make this assessment based upon all the relevant information, including the promotional material and information provided by the lender in the negotiation of a loan agreement and, when it considers all the circumstances surrounding the conclusion of the contract, to determine whether all the information likely related to the extent of a consumer's commitment has been communicated, enabling the consumer to estimate in particular the total cost of the loan.

According to the CJEU, for the purposes of the assessment to be carried out by the national court, information such as (i) whether information relating to the calculation of the rate is easily accessible to those intending to take out a mortgage loan (e.g., the publication of the method of calculation) and (ii) whether data relating to past performance of the underlying index/market measure on which the rate is calculated is accessible, would be particularly relevant.

Substitution of an unfair term: The CJEU held that, if a mortgage loan agreement cannot continue to exist in the absence of the unfair term and annulment of the agreement would expose the consumer to particularly unfavourable consequences thus penalising the consumer, the provisions of the Directive must be interpreted as not precluding the national court, where an unfair contractual term setting a reference index for calculating the variable interest of a loan is null and void, from replacing that index with a statutory index applicable in the absence of an agreement to the contrary between the parties to the contract. The rationale is that such substitution is consistent with the objectives of the Directive, since the intention is to "substitute for the formal balance established by the contract between the rights and obligations of the parties a real balance re-establishing equality between them" rather than to annul all contracts containing unfair terms.

It is important to note that the substitution idea is limited to the use of a supplementary provision of national law. The CJEU considers it a derogation to the general rule that the contract at issue can remain binding on the parties only if it can continue in existence without the unfair terms that it contains. The rationale is that supplementary provisions of national law are meant to “reflect the balance that the legislature intended to establish between all the rights and obligations of the parties to certain contracts in cases where the parties have not departed from a standard rule provided for by the national legislature in relation to the contracts concerned, or indeed have expressly opted for a rule introduced by the national legislature to that end to be applicable”. However, the CJEU goes on to conclude that the Directive must be interpreted as precluding resultant gaps in a contract from being “filled solely on the basis of national provisions of a general nature”. The CJEU when on to specifically qualify substitutions arising from the principle of equity or from established customs as “national provisions of a general nature”. Thus, unless national law provides for a specific substitute (the “supplementary provision”), the national court is not empowered to alter the terms of the contract even if the court deems the substitution as equitable or customary.

▣ **CJEU Judgement in *Györgyné Lintner v UniCredit Bank Hungary Zrt.* (11 March 2020) (*Lintner v UniCredit*)**

Limits to the extent of the review that a national court must perform in relation to unfair terms: The CJEU held that a national court, hearing an action brought by a consumer seeking to establish the unfair nature of certain terms in a contract, is only required to examine those terms which are connected to the subject matter of the dispute, as delimited by the parties. It is not required to examine all the other contractual terms, which were not challenged by that consumer. The rationale of the CJEU is that the subject matter of an action is delimited by the parties.

As previously held, however, a national court must investigate of its own motion whether a term in the contract which gave rise to the dispute comes within the scope of Directive and the national court must, if necessary on its own motion, obtain from the parties the clarifications or documents necessary in order to complete that case file. The CJEU states that it follows that the national court is required to take *ex officio* investigative measures, provided that the elements of law and fact already contained in that file raise serious doubts as to the unfair nature of certain terms which, despite not having been challenged by the consumer, are connected to the subject matter of the dispute.

Further, following the assessment, as a general rule the national court is required to inform the parties of any findings of unfair terms and invite the parties to submit their views on that matter, with the opportunity to challenge the views of the other party, in accordance with the national procedural rules.

Assessing the cumulative effect of all the terms of that contract: The CJEU held that, although there are limits to the terms which the national court is required to assess on its own motion, the national court must take account of all of the other terms of the contract, since the “examination of the contested term must take into account all the elements that may be relevant to understanding that term in its context”, to assess the cumulative effect of all the terms of the contract with respect to the unfairness of the term at issue. However, as discussed above, the CJEU does not require the national court to examine on its own motion all other terms autonomously for unfairness as part of the assessment it makes under the Directive.

▣ Conclusion

The above case law builds on numerous cases both at national and European level that examines the application of the Directive and the Regulations (as relevant) to loan agreements. Lenders when drafting and issuing loans to consumers need to ensure that the wording is fair, clear and intelligible to the average person and that the exercise by lenders of their rights are also conducted in a manner compatible with the Directive and the Regulations.

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May 2020

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