

REDEMPTION OF DISPUTED DEBT: GOOD NEWS FINALLY, FOR PORTFOLIO HOLDERS

In its Judgment of 5 March 2020, the Spanish Supreme Court confirmed that the redemption of disputed debt established in the Civil Code does not apply to the sale and purchase of portfolios.

The Supreme Court thus ends the heated debate between those who defended the power to unilaterally cancel debts held by those debtors whose positions had been included in a portfolio and those who, by contrast, invoked the special characteristics of these types of transactions to defend that the redemption of disputed debt is not applicable.

This Judgment also confirms that disputes regarding certain clauses of loan agreements (such as floor clauses) cannot be used to convert a debt into a "disputed" debt in order to apply the redemption.

Key issues of the Supreme Court Judgment on the redemption of disputed debt:

- Confirms the exceptional nature of the redemption of disputed debt.
- Supports a restrictive interpretation of the term "disputed": proceedings on specific clauses do not convert debt into disputed debt.
- Confirms that the redemption does not apply to portfolio sales and purchases.

Brief review of the redemption of disputed debt under the Civil Code

The redemption of disputed debt (Articles 1535 and 1536 of the Spanish Civil Code (CC)) is an instrument that gives the debtor the power to cancel its debt, when this debt is transferred through the reimbursement of the price paid by the party acquiring it, plus court costs and interest. In order for it to apply, the debt must be the subject of a dispute between the originating creditor and the debtor. But, as will be explained below, not all disputes can convert a debt into a disputed debt.

This legal concept had long been forgotten until its use was reactivated during the financial crisis of 2008. Since then, the Supreme Court has pronounced on it on four occasions, in its judgments of: 31 October 2008, 1 April 2015, 13 September 2019 and now recently, 5 March 2020.¹

In its decisions, the Supreme Court confirms that redemption serves a dual purpose: to avoid speculation and to limit the origination of disputes, "*for reasons of humanity and benevolence*"². While in parallel admitting that it is "*a controversial concept*", "*whose application is not without problems*" and that "*little is said about it in case law opinions*".³

How should the term "debt" be interpreted?

¹ These are Supreme Court decisions taking the form of a judgment. The Supreme Court has also issued rulings rejecting appeals that have been lodged.

² Supreme Court Judgment dated 31 October 2008.

³ *Idem*.

Supreme Court case law has tended, in most of its decisions, towards a broad interpretation of the notion of "debt" (*crédito*) under Article 1535 CC. The most recent case law on this matter confirms that debt should be understood to refer to any rights and legal actions that are individually transferable, not just to monetary loans.⁴

How should the term "disputed" be interpreted, and how is it influenced by the Judgment of 5 March 2020?

It is important to clarify that not all litigation relating to a right or an action renders that right or action "disputed" for the purposes of Article 1535 CC.

Under Article 1535 CC, rights and actions become disputed when, "*with their holder having filed a claim requesting that the court declare them to exist and to be enforceable, the defendant contests or denies this and a final judgment is required to declare them to exist and to be enforceable*"⁵. The debt is then considered "disputed" as from the reply to the claim, although case law also admits the refusal to appear before court as tacit opposition⁶. Likewise, the debt ceases to be considered "disputed" when the dispute has been settled by a final judgment.⁷

The financial crisis brought with it an increase in litigation brought to request that certain ancillary clauses of facility agreements be declared null and void, with the aim of enabling the redemption of disputed debt. This occurred above all in consumer financing (floor clauses, default interest clauses, expense clauses, etc.).

The Supreme Court has limited this course of action by its Judgment of 5 March 2020, confirming that the interpretation of the term "disputed" must be restrictive. Consequently, only lawsuits relating to the existence and enforceability of the entire debt will trigger the possibility of redemption.

In the case in question, the borrower had brought a claim against the bank, requesting that the floor clauses be declared null and void. While the proceedings were underway, the portfolio was transferred. The borrower then filed a claim requesting the debt's redemption, invoking the fact that it was disputed (in order to settle the debt by paying the transfer price).

The Court of First Instance upheld the claim and admitted the redemption, a decision confirmed by the Court of Appeal. However, the Supreme Court reversed this decision, stating that a claim seeking the nullity of floor clauses in a corporate facility agreement was not sufficient to render the debt disputed. There is no claim regarding the existence or enforceability of the obligation in this case.

This doctrine can be extrapolated to other legal proceedings relating to unfair terms, if the nullity sought is not that of the debt as such, but rather that of certain ancillary clauses of the agreement.

The Supreme Court ends the debate: The disputed debt redemption regime does not apply to the sale and purchase of NPL portfolios

The most important part of the Judgment of 5 March 2020 is where reference is made to the disputed debt redemption regime not applying to positions forming part of the portfolios of Non-performing Loans ("NPLs").

We had already gotten a glimpse of the Supreme Court's opinion on this on two occasions, in pronouncements by its First Chamber:

- In its judgment of 1 April 2015, when it rejected the possibility of applying the redemption of disputed debt in cases involving the universal assignment of assets and liabilities as a result of structural modifications. The judgment confirmed that in those transactions, "*debts cannot be individualised, nor can there be a number of juristic acts*

⁴ Supreme Court Judgment of 13 October 2008.

⁵ Supreme Court Judgment of 16 December 1969, cited in the Supreme Court Judgment of 5 March 2020 to confirm the applicable principle.

⁶ Supreme Court Judgment of 31 October 2008, also cited in the Supreme Court Judgment of 5 March 2020.

⁷ Supreme Court Judgment of 13 September 2019.

involving the assignment of receivables" and that the specific transaction (the segregation of the banking business from a Caja (savings bank) to form part of a financial institution) "falls within the regulatory framework of an intensive process to restructure and strengthen the financial system's equity".

The arguments the Supreme Court gave on that occasion could be perfectly extrapolated to the sale and purchase of portfolios, although it did not directly refer to them.

- In its ruling (*auto*) of 13 September 2017, in which it refused to admit an appeal in cassation which raised the issue of whether this regime applied to positions forming part of NPL portfolios, due to the lack of grounds for cassation.

The Supreme Court rejected the appeal based on the issue already having been resolved in its judgment of 1 April 2015. Thus, it cited the opinion disallowing redemption in universal assignments of assets and liabilities.

In any event, a pronouncement by the Supreme Court was necessary –one that directly applied to the sale and purchase of portfolios–, to end debate on the matter for good. This Judgment of 5 March 2020 does just that, and bases its decision on three reasons:

- The general principle in Spanish law is that debt can freely be transferred. With that in mind, the redemption of disputed debts constitutes a restriction on the freedom to transfer that right. As with all exceptions, its scope must be interpreted restrictively.
- The first objective that justifies the existence of the disputed debt redemption (i.e. to limit speculation) does not apply to the sale and purchase of portfolios. These transactions are not performed for speculation, but rather to clean up banks' balance sheets, improve their ratios, reduce the rate of default and lower management costs and provisions.
- The second objective that justifies this concept's existence (i.e. to reduce the number of disputes) is not fulfilled either: if the redemption applied to each position in a portfolio, this would achieve just the opposite of what the legislator intended, that is, it would encourage the creation of disputes.

This Judgment will have a positive impact on Spanish NPL portfolios, since it reduces uncertainty on this issue. Indirectly, it should limit artificial disputes from arising (which was the aim here). And ultimately, it should help to contain management costs.

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