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CJEU rules insolvency courts must determine unfair contract terms claim in sub-prime lending case

Radlinger v Finway A.S. Case: C-777/14

Article by David Bowden

The Court of Justice of the European Union (CJEU) CJEU considered whether the legislation of an EU member state could prevent its courts during insolvency proceedings from investigating whether the Consumer Credit Directive 2008/48/EC **('CCD') and/or the Unfair Terms in Consumer Contracts Directive** 93/13/EEC **('UTCCD') had been complied with, and if so, what remedy should be provided to a consumer where a court found a breach. The case has been remitted back to the lower court in Prague so it can apply to CJEU ruling on both the CCD and the UTCCD in contested insolvency proceedings.**

Ernst Radlinger and Helene Radlingerová v Finway A.S.
Case C-777/14 21 April 2016
Court of Justice of the European Union, 3rd Chamber
Judges Ilešič *(President),* Toader, Biltgen, Jarašiūnas and Fernlund
Advocate General Eleanor Sharpston QC

What are the facts?
On 29 August 2011 Mr & Mrs Radlinger took out a loan with Smart Hypo for €43,205. This was loan was secured by way of second charge over their home. The loan was for 10 years with an APR of 28.9%. The loan was assigned to Finway AS shortly after completion. Under Czech law then applying, pure consumer credit was treated in the same way as mortgage credit. The loan was used solely to refinance existing indebtedness. The lender charged a fee of €1200 for arranging the loan which was deducted from the overall amount of the loan.

A month after completion the lender alleged that the borrowers had failed to tell it about the existence of an enforcement order for €158. The lender claimed this was the provision of false or grossly misleading information by the borrowers. The lender demanded immediate full repayment of the loan. The loan terms provided for penalty interest at 0.2% of the principal sum for every day the loan was in default. The borrowers continued paying the loan until December 2012.

What happened when the case came before the judge in Prague?
The borrowers applied for voluntary bankruptcy. In a court hearing to review the borrowers' proposals, they contested the amount due and said the loan agreement was "contrary to accepted principles of morality". The borrowers admitted the sum of just over €55k was due. The borrowers then made a formal application to the bankruptcy court seeking a declaration of enforceability about the loan agreement. Whatever was printed in the standard loan conditions, the lender submitted in these proceedings that it did not enforce some of them.

Who else was involved in this case?
Both the lender and borrowers were represented at the CJEU hearing held on 15 July 2015 and a further hearing before the Advocate General on 19 November 2015. In addition representations were also made by the Governments of the Czech Republic, German Republic and Republic of Poland. The European Commission engaged 3 counsel to make its submissions.

Are there any special provisions in Czech Law?
The Czech Republic had transposed both the CCD and UTCCD into its national law. However Czech insolvency law purported to prevent a Czech court in insolvency proceedings from considering whether there had been breaches of either of these two transposed Directives. The rights the borrowers had were relevant to their application for a declaration that the loan had been made unlawfully and/or was not in compliance with either or both of these Directives.

What were the terms of reference to the CJEU?
The Czech court referred these 6 questions to the Court of Justice of the European Union (CJEU) for a preliminary ruling:

1. Does Article 22(2) of the CCD and Article 7(1) of the UTCCD or other provisions of EU law on consumer protection preclude:
- the Czech Law on Insolvency (which enables the court to examine the authenticity, amount or ranking of claims only) on an application lodged in insolvency proceedings?
- provisions which restrict the right of the debtor to request a court review of creditor's claims solely on the basis that the claim has lapsed or is time-barred?

2. If Question 1 is answered affirmatively, is the court required to have regard by virtue of its role (even in the absence of an objection by a consumer) to the creditor's failure to comply with the information requirements under Article 10(2) of CCD? Is the court to apply Czech law which provides for invalidity of the credit agreement in these circumstances?

If Question 1 or 2 is answered in the affirmative:
3. Do the provisions of the CCD and/or UTCCD have direct effect? Is their direct application precluded by court action by virtue of its role because this encroaches on the horizontal relationship between creditor and debtor?

4. What amount is represented by "the total amount of credit" in Article 10(2)(d) of the CCD? What amounts are included as "the amounts of drawdown" when calculating the APR? How should a fee paid by the debtor when the loan is taken out be treated? Does the inclusion of a fee which in reality is not paid out affect the APR calculation?

Regardless of the answer to the preceding questions:
5. In assessing whether agreed compensation is "disproportionate" under point 1(e) of the Annex to the UTCCD, is it necessary to evaluate the **cumulative** effect of all the penalty clauses regardless of whether a creditor actually insists they be satisfied in full? Does a court only consider the total amount of the penalties actually demanded?

6. If these contractual penalties are found to be abusive, does a court disapply all those partial penalties which (only when considered together) lead the court to conclude that the amount of compensation was disproportionate? Or does the court disapply only some of them and if so, what criteria should it use?

What answers did the CJEU give to these referred questions?
The CJEU expressly agreed with the opinion of the Advocate General on the 1st, 2nd, 5th and 6th questions referred and came to the same result as her on the 4th question. The CJEU said it was unnecessary to answer the 3rd referred question on direct effect of the CCD and UTCCD.

What did the CJEU rule on unfair contract terms?
The CJEU said the phrase "effective means" under Article 7(1) of the UTCCD must include provisions in national law enabling consumers to be guaranteed effective judicial protection by:

- making it possible for them to bring legal proceedings in relation to the disputed loan agreement in insolvency proceedings,
- under reasonable procedural conditions,
- not subject to particular time limits or costs which make it excessively difficult or impossible for consumers to exercise their UTCCD rights: *Erste Bank Hungary zrt v* Sugar (Case **C-32/14**) applied.

It said article 7(1) of the UTCCD has to be interpreted as precluding national legislation which does not permit an insolvency court hearing a case to examine for itself any allegation made by a debtor relating to the unfairness of contractual terms on which the underlying claim is based. A national law which allows an insolvency court to examine only whether debts are either time-barred or have been paid is not compatible with the UTCCD where a debtor alleges that the underlying contract is unfair.

The UTCCD must be interpreted as meaning that in order to assess whether the amount of compensation required to be paid by a consumer who does not fulfil his obligations is "disproportionately high" (point 1(e) of the annex) it is necessary to evaluate the **cumulative** effect of all the penalty clauses in the disputed contract. This is so regardless of whether a creditor actually insists on enforcing them.

The CJEU noted that the UTCCD aims to:

- eradicate the practice of including unfair terms in consumer contracts,
- ensure that consumers are protected from abuse by suppliers who have a stronger bargaining position, and
- discourage creditors from including penalty clauses in credit agreements.

The CJEU found that if necessary national courts must under article 6(1) of the UTCCD establish **all** the consequences of a finding that certain terms are unfair and then **exclude** all terms found to be unfair (rather than merely some of them) in order to ensure that the consumer is not bound by them.

What did the CJEU rule on consumer credit?
The Advocate General noted that it is the credit agreement itself that falls within the CCD's scope rather than any resulting debts or creditor's claims. National courts must apply the provisions of the CCD and UTCCD by virtue of their office (even where a consumer does not raise issues under them) because a consumer is in a weak position as regards his bargaining power and level of knowledge: *Rampion and Godard v Franfinance SA* **[2008] 1 CMLR 28, [2008] CCLR 4, [2008] Bus LR 715** applied. Where a national court finds breaches of the CCD it must impose penalties prescribed by national law for non-compliance.

Article 10(2) of the CCD has to be interpreted as meaning that it requires a national court hearing a dispute relating to a credit agreement to examine whether the obligation to provide information prescribed by the CCD has been complied with. This obligation contributes to achieving the CCD's objectives namely:

- full and mandatory harmonisation,
- ensuring that all European consumers enjoy a high and equivalent level of protection of their interests, and
- facilitating the emergence of a well-functioning internal consumer credit market: *CA Consumer Finance v Bakkaus* **[2015] CMLR 28, [2015] CCLR 7, [2015] Bus LR 81** applied.

A national court must establish the consequences under national law of infringing CCD obligations but any penalties imposed must satisfy the requirements of CCD Article 23.

What about the calculations of drawdown, total amount of credit and APR?
As "drawdown" is not defined in the CCD, the Advocate General said the Oxford English Dictionary definition should be used. This defines drawdown as "an act of raising money through loans; borrowing". Recitals 31 and 43 to the CCD which stipulate that creditors provide consumers with an APR is of critical importance because:

- it contributes to the openness of the market,
- it enables consumers to compare offers of credit, and
- it enables consumers to assess the extent of his commitment: *Cofinoga Mérignac SA v Sachithanathan* **[2004] 2 CMLR 14, [2004] CCLR 6, [2004] ECR-I 2157** applied.

The CJEU ruled that Articles 3(1) & 10(2) and point I of Annex I to the CCD must be interpreted as meaning that the "total amount of credit":

- is the sum actually paid by a lender to a consumer,
- is the sum placed at the consumer's disposal for him to use, and
- excludes any costs due to the creditor.

As to the expression "the total sums *made available* under a credit agreement" in Recital 18, Article 3(l) and Annex II paragraph 2 of the CCD the CJEU said this means the amount of loan exclusive of the lender's costs. The Advocate General said that the European Commission Staff Working Document "Guidelines on the application of Directive 2008/48/EC in relation to costs and the APR of charge" **SWD (2012) 128 final** should be used in calculating the total amount of credit.

Finally under Articles 3(1) and 10(2) of the CCD neither administrative costs nor interest nor commissions nor any other type of cost which a consumer is required to pay can be included in the total amount of credit.

What will happen next with this case?
The CJEU concluded by saying it was for a national court to determine whether any sums have been improperly included here in the total amount of credit. Accordingly the CJEU has sent the case back to the lower court in Prague. It will then have to apply the CJEU's ruling on the CCD/UTCD to the case, decide if the APR has been calculated properly or not, assess whether the terms in the loan agreed are unfair or not and then decide how much is lawfully due to the lender under the challenged loan agreement.

How are arrangement fees treated in the UK?
In relation to the arrangement fee and whether this should be included in the total amount of credit and hence the APR, this issue was resolved by the Supreme Court of the United Kingdom in *Southern Pacific Securities 05-2 PLC v. Walker* **[2011] CCLR 4.** Here Lord Clarke ruled that a broker administration fee was part of the charge for credit and was not therefore to be treated as part of the credit under CCA s9(4).

What about mortgages?
It is interesting that the rules in the Czech republic applied in the same way to pure consumer credit business as to mortgages. In relation to the points about unfair contract terms, then these will apply equally to mortgages where the lending is to consumers within the ambit of the UTCCD. The regime under the Mortgage Credit Directive is broadly the same as the CCD, and so it is likely when a case reaches the CJEU raising similar points on arrangement fees and whether they should be included in the APR that it will come to the same result.

Will this ruling have any impact on insolvency proceedings in the UK?
Here the debtors applied for voluntary bankruptcy. The more usual route for enforcing a secured loan would be by means of possession proceedings. This would then give debtors an opportunity to raise defences under the Consumer Rights Act 2015 or the regulations which implement the CCD in the UK. If debtors leave the raising of these issues until enforcement had gone beyond that point and a bankruptcy petition has been presented, no doubt a court would want to understand why the point had not been made before to satisfy itself that the issue was genuine and not merely a stalling tactic.

Under section 271(1) of the Insolvency Act 1986 a court can only make a bankruptcy order when it is satisfied that the debt "is owed to the creditor". It is this section that provides the gateway for *Radlinger*-type allegations. However with the lighter touch insolvency regime put in place by the Enterprise Act 2002, on the whole debtors who co-operate with the official receiver or trustee will be discharged from bankruptcy within a year. For this reason, there is less incentive for British debtors to adopt the same stance as Czech ones.

Could we see similar challenges elsewhere?
There may also be scope to make *Radlinger*-type allegations in proceedings other than insolvency ones such as:

- creditor proceedings to obtain a charging order (either at the interim or final stage),
- possession proceedings,
- applications for an order for sale under the Trusts of Land and Appointment of Trustees Act 1996, or
- ancillary relief proceedings in family law cases.

What about unfair contract terms challenges to standard form agreements?
It seems that it was just too convenient for a lender facing a challenge to its standard form contract terms to try and say that it didn't seek to enforce some of them. Fortunately both the CJEU and the Advocate General have seen through this and have come to their assessment based on the documentation the consumers actually signed.

Finally, it is very useful for the CJEU to say that a court assesses the cumulative effect of all disputed contract terms in assessing whether the contract as a whole is unfair. Turned on its head, this could be very useful for lenders and other firms regulated by the FCA when dealing with a regulatory investigation into whether standard form contracts comply with the Consumer Rights Act 2015 or not.

12th May 2016