

The position of family sureties within the framework of protection for consumer debtors in European Union member states

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Abstract: Different approaches to the protection of sureties are currently taken in the European Union member states. A consideration of these different levels of protection requires an examination of social welfare law, contract law and bankruptcy law. This consideration is important because different approaches to surety protection represent potential barriers to the integration of the credit market, as envisaged under the draft Directive on consumer credit. The draft Directive may eliminate some of these barriers, but not others. In addition the Directive also has the potential to bring other, negative, consequences. If the Directive is successful it may have a significant impact on the level of over-indebtedness among consumers and, consequently, there will be a need to monitor the adequacy of consumer bankruptcy laws in the member states, in particular in light of any changes to the social welfare systems in operation.

Introduction

The protection of family sureties has been largely neglected in consumer legislation and literature in the European Union.¹ Persons who have entered into surety agreements are however afforded protection through various means under the laws of the member states, in particular in contract law, although the scope of protection varies. Sureties may benefit from forms of protection that are offered to consumer debtors generally, and from some other forms of protection specific to sureties. It is helpful to consider the position of sureties by reference to their position within a framework of five broad categories of general consumer protection:

1. General social welfare policy;
2. Procedural protection, consisting of information provision and lender regulation;
3. Provisions relating to the giving of consent to the contract;
4. Regulation of the content of the contract; and
5. Consumer bankruptcy.

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¹ For example it has been held that suretyship agreements are not to be regarded as credit agreements under the Consumer Credit Directive 87/102/EEC: ECJ 23 March 2000, Case C-208/98 *Berliner Kindl Brauerei AG v. Andreas Siepert* [2000] ECR I-1741. However there is some scope for such agreements to come under the Doorstep Selling Directive 85/577/EEC: ECJ 17 March 1998, Case C-45/96 *Bayerische Hypotheken- und Wechselbank AG v. Edgar Dietzinger* [1998] ECR I-1199.

The categories are presented in the chronological order in which they would normally take effect. Naturally these categories of protection affect sureties in a different manner from principal consumer debtors. The liability of a surety is triggered by the default of the principal debtor. Therefore any forms of consumer protection, such as some bankruptcy systems, that enable the principal debtor to escape his obligations may result in liability for the surety. In view of the difference in interests of the principal debtor and the surety there is a strong need for separate consideration of the place of the surety within the framework of protection.

Current approaches to surety protection will be examined in part one (I) of this paper. The interrelationship between the categories of protection and differences in emphasis among the laws of the member states will be considered. This consideration is particularly important in evaluating the potential impact of the draft Directive on consumer credit, for two main reasons.² First, the current draft of the Directive omits consideration of many features of consumer protection in the member states, specifically the forms of protection in Categories 1, 3 and 5 and, possibly Category 4, so the potential for the different approaches of the member states under these categories of protection to act as barriers to the integration of the credit market must be examined, an issue that will be briefly dealt with in the second part (II).³ Secondly, the impact of the Directive on the categories of protection must be examined. The draft Directive, in implementing a ‘maximum harmonisation’ approach, will inevitably be the product of compromise, and there is therefore a danger that it will not be as effective as the systems of consumer protection in operation in some member states. Certainly lenders will argue for a construction of the Directive that is least protective of sureties. There is also a danger that, in interpreting provisions of the Directive that facilitate surety protection, the courts in the member states will be influenced by their existing norms regarding surety protection, prolonging the differences in protection offered even in spite of harmonisation. A final point is that it will be particularly important to have a suitable scheme of protection in operation if the Directive succeeds in opening up the credit market. On previous occasions when credit markets have been democratised there has been a rise in over-indebtedness. It is therefore crucial that measures should be implemented to prevent aggressive and socially harmful lending from occurring in markets which have previously been largely resistant to it, and to eliminate it from markets where it already is present. Moreover member states will need to review the likely ability of their bankruptcy laws to cope with a rise in instances of over-indebtedness that may be predicted and to equip consumers with information to

² Commission of the European Communities, Proposal for a Directive of the European Parliament and of the Council on the Harmonisation of the Laws, Regulations and Administrative Provisions of the Member States Concerning Credit for Consumers, Art. 9.

³ Although they are merely one aspect of the fragmented nature of the credit market in Europe. See generally N. JENTZSCH, ‘The Implications of the New Consumer Credit Directive for EU Credit Market Integration’ Freie Universität Berlin, John F. Kennedy Institute Position Paper April 22, 2003. For a suggestion of an alternative way forward see K. LANNOO and A. DE LA MATA MUÑOZ, ‘Integration of the EU Consumer Credit Market, Proposal for a More Efficient Regulatory Model’ Centre for European Policy Studies Working Document No. 213/November 2004, <<http://www.ceps.be>>.

enable them to select the most appropriate form of credit to meet their needs. These issues will be considered in part three (III).

I. Differing approaches under the five categories of consumer protection

Each of the categories of protection will be explained and selected differences in the form or content of these laws within Europe will be highlighted. In addition the interrelationships of different categories of protection will be explained. It will be seen that the present approaches of member states to the issue of surety protection are so divergent that they present significant obstacles to the integration of the credit market, as proposed under the draft Directive.⁴

Category 1: General social welfare policy

Social welfare policy relates to the material security of citizens and dictates how consumers must finance their basic needs. This policy affects consumer finances in many ways, including the provision of housing; childcare resources; resources for caring for elderly relatives; a basic level of subsistence for those who are unemployed and even the provision of sufficient public transportation so that a car is not a necessity. It is particularly important where the family structure of the consumer does not enable support to be given, and where the consumer does not have sufficient wealth at his disposal to fund his requirements. For such consumers, if no social welfare support is provided, a need for credit may arise. The lender may require this credit to be backed by a surety.

In cases where limited social welfare support is available and the consumer has had to resort to credit that is subject to a suretyship agreement, events, such as the loss of a job or the birth of a child, can force the principal debtor to default, triggering liability for the surety. The degree of social welfare support provided therefore has an indirect but important effect on the position of sureties since it is linked with the likelihood of default by the principal debtor. The likelihood of default by the principal debtor will additionally be taken into account by lenders in agreeing the terms of the credit contract with the principal debtor in the first place. The greater the risk of default, the greater the likelihood that a family member will be asked to enter into a contract of suretyship. Changes in social welfare, leading to persons having to have more recourse to their own resources, and those of their families, may increase the chance that a contract of suretyship will be requested and that the principal debtor will default. Therefore, the impact of this category of protection on sureties should not be overlooked.

The impact of the system of social welfare on the fifth category of protection, bankruptcy, and to a lesser extent the fourth, substantive protection, needs to be considered. There is a natural link between social welfare and bankruptcy, since both relate to general standards of living, providing a safety net in difficult times. Comparative bankruptcy lawyers have consistently pointed out the manner in which

⁴ For discussion of differing approaches under the laws of the member states see also A. COLOMBI CIACCHI, 'Non-Legislative Harmonisation of Private Law Under the European Constitution: The Case of Unfair Suretyships', in this volume.

countries' bankruptcy systems are influenced by the social welfare system in that is in operation.⁵ They observe that the more generous the social welfare system, the more restrictive the bankruptcy system, and vice versa. In this regard the social welfare system can have a significant indirect influence on the position of sureties. Since this category of protection is so strongly linked with consumer bankruptcy, detailed consideration of the influence of social welfare on consumer protection will take place alongside the discussion of Category 5, consumer bankruptcy.

However one further way in which social welfare affects surety protection should briefly be mentioned. A certain level of social welfare is also provided under civil procedure rules, which may exempt certain assets from being seizable by creditors. The debtor is thereby guaranteed a minimal range of assets necessary for everyday living. This safeguard may be used by lenders to argue that the debtor should thereby not be relieved of liability in cases where the debtor seeks transaction avoidance, on the basis that the debt is excessive, under one of the grounds mentioned under Category 4 below, which consider the proportionality of the burden placed on the surety. However in evaluating such arguments it is necessary to consider the reasons why the surety entered into the agreement. It is arguable that there should be no impact on the availability of relief if the circumstances of the transaction are unfair, in particular if there was a defect in the surety's consent to the transaction, for example if it was entered into under a threat, or if the lender failed to observe a duty to advise the surety of the consequences of the agreement. The general standard of living guaranteed under the welfare system can only be relevant in assessing the ability of the surety to pay liabilities that have been fairly incurred in the first place.

Category 2. Procedural protection

The main form of procedural protection implemented by the member states under this category consists of requirements for the provision of information. Currently the member states place differing levels of requirements on contracting parties. Jurisdictions applying the duty of precontractual good faith have long required the provision of information as part of the process of contracting.⁶ A breach of the duty to inform can lead to the invalidity of a contract on the basis of mistake or fraud.⁷

⁵ See R. EFRAT, 'Global Trends in Personal Bankruptcy' (2002) 76 Am. Bankr. L.J. 81, p. 96-98 for an overview of the relationship; and U. REIFNER, 'Thou Shalt Pay Thy Debts' Personal Bankruptcy Law and Inclusive Contract Law' in J. Niemi-Kiesiläinen, I. Ramsay and W.C. Whitford (eds), *Consumer Bankruptcy in Global Perspective*, Hart Publishing, Oxford, 2003, p. 144.

⁶ See further S. VAN ERP, 'The Pre Contractual Stage' in A. Hartkamp, M. Hesselink, E. Hondius, C. Joustra and E. du Perron (eds), *Towards a European Civil Code* Kluwer Law International, Nijmegen, 2nd edn, 1997; and M. W. HESSELINK, 'The Concept of Good Faith' in M. W. HESSELINK, *The New European Private Law*, Kluwer Law International, The Hague, 2002, p. 203, citing sources including Cass. Com., 8 November 1983, *Bull. Civ. IV*, no. 298, p. 260 (France); and HR, 30 November 1973, *NJ* 1974, 97.

⁷ M. W. HESSELINK, above n. 6 at 204.

The existing consumer credit Directive includes some Category 2 requirements.⁸ For example it requires advertisements offering credit, or credit arranging services, to include, in addition to the rate of interest or the cost of credit, a statement of the annual percentage rate.⁹ In addition it requires the credit agreement to be in writing and to include information on matters including the cash price, any deposit provided, and the effect of early repayment.¹⁰ Further protection in this category relates to the licensing, inspection and monitoring of credit providers.¹¹ However these provisions lack specific reference to sureties. The draft Directive will extend the procedural protection that is offered to sureties, although, as will be discussed later, in quite limited fashion.¹²

The approach to the protection of sureties in England is heavily based around Category 2 protection, in keeping with the general approach under UK law where the courts do not normally tend to consider the fairness of the transaction from a substantive perspective,¹³ although under recent reform proposals, outlined below, it may become easier for sureties to attack agreements that are unfair in substance.¹⁴ The English case law however does appear to offer a lower threshold of avoidance than some Continental systems, and more flexible remedies.¹⁵ The bulk of surety protection cases in England have been considered under the law of undue influence. Although the approach under this law originally centred on defects of consent, the courts subsequently refined the applicable principles by establishing a set of procedural steps to be followed by lenders. The law has therefore arguably shifted

⁸ Council Directive 87/102/EEC of 22 December 1986 for the Approximation of the Laws, Regulations and Administrative Provisions of the Member States Concerning Consumer Credit, hereafter ‘Consumer Credit Directive’, Arts 3-7.

⁹ Consumer Credit Directive, above n. 8, Art. 3.

¹⁰ Consumer Credit Directive, above n. 8, Art. 4 and Annex.

¹¹ Consumer Credit Directive, above n. 8, Art. 12.

¹² See Part II, below. Commission of the European Communities, Proposal for a Directive of the European Parliament and of the Council on the Harmonisation of the Laws, Regulations and Administrative Provisions of the Member States Concerning Credit for Consumers, Art. 2 e-f, 10 and 23.

¹³ Although the case law approach is largely procedural there is a substantive element to banking practice. Under the Banking Code, a voluntary code of good banking practice, it is provided that banks should not accept an unlimited guarantee: British Bankers’ Association, The Building Societies Association and the Association for Payment Clearing Services (March 2003), para. 13.4. If, however, an unlimited guarantee is required, in spite of this, the bank is required to consider whether any solicitor with proper regard to the wife’s interests would advise her to sign such an agreement: *Royal Bank of Scotland plc v. Etridge (No 2)* [2001] 4 All ER 449, HL, at para. 112.

¹⁴ See note 31, and accompanying text, below.

¹⁵ See below under the heading ‘Remedies’. In Scotland the avoidance of suretyship agreements, which are termed ‘caution’ agreements, has been achieved in similar circumstances to the English jurisdiction under the requirement of fair dealing in good faith. *Smith v. Bank of Scotland, Mumford v. Bank of Scotland* 1997 SC (HL) 110.

from Category 3 to Category 2.¹⁶ The case law¹⁷ on undue influence provides that a bank should be put on notice in cases where the relationship between borrower and surety is ‘non commercial’ in nature. In such a case the bank should communicate with the surety informing him or her that the bank will require written confirmation from a solicitor that the nature of the suretyship and its effect has been explained. The bank should explain also that the purpose of this requirement is to prevent the surety from later being able to dispute that the suretyship agreement is binding on them and should request that the surety nominates a solicitor to provide advice. The bank should not proceed with the transaction unless it has received an appropriate response from the surety. Alternatively, if the bank does not provide the required explanation, it should provide the solicitor with information to enable proper advice to be given to the surety: the bank should obtain the permission of the borrower for the provision of this information and if this permission is not given this should put the bank on notice. If, however, there are further circumstances which lead the bank to believe that the prospective surety is not acting according to his or her free will they should share their concerns with the solicitor. Whichever approach is taken to advising the surety, written confirmation should be obtained from the solicitor that the documents and their nature have been explained. If these requirements of advice have not been observed the contract can be set aside.

At this stage it is helpful to consider how Category 2 protection may limit the need for laws under Categories 3, defects of consent, and 4, substantive protection. It could be argued that the more information that is provided to consumers, including sureties, before they enter into the contract the less need there is for protection under Category 3 and, in particular, Category 4. An approach based heavily on the provision of information might assume that freedom of contract should reign unchecked. The contracting parties have entered into a bargain; in doing so they were in full possession of information; therefore their decision to enter into the contract is rational and principled, and they should be held to their bargain. However the case law surrounding sureties provides ample evidence that the provision of information regarding the transaction may still be insufficient. Sureties will still enter into disadvantageous transactions through family loyalty or vulnerability. In cases where the surety has given defective consent, they may be able to invoke protection under Category 3. However, under a particularly altruistic approach, it might be argued that the law should contain Category 4 protection so that the substantive fairness of contracts can be regulated and that there should be some measures available to assist persons who make bad decisions even in spite of being in possession of full information and where the transaction cannot be attacked on defect of consent grounds. In practice, however, laws in the member states tend to be based on a combination of Category 3 and 4 protection, that is, they tend to require both for there to have been a defect in the surety’s consent and for the transaction to have been unfair to the surety in substance.

¹⁶ Although the surety may be able to rely on some other form of Category 2 protection, such as duress, in cases where the correct procedures have been followed and the protection of undue influence is unavailable.

¹⁷ *Royal Bank of Scotland plc v. Etridge (No 2)* [2001] 4 All ER 449, HL. For a discussion of the implications of this case see D. MORRIS, ‘Surety Wives in the House of Lords: Time for Solicitors to ‘Get Real’?’ 11 *FemLS (Feminist Legal Studies)* 2003, p 57.

Category 3. Defects of consent

The member states' legal systems contain laws to enable persons who have given defective consent to a contract to obtain relief.¹⁸ Such laws may be of assistance to sureties, depending on the circumstances. Similar basic categories of protection appear in the jurisdictions considered. However the form and content of such laws varies so that it cannot realistically be claimed that there is a common system in place. Relevant laws will briefly be discussed by reference to the laws of selected member states.

Firstly, a contract that has been entered into under duress or by influence of threats can commonly be avoided under the contract laws of the member states, although the formulations of these laws differ. Where a suretyship contract is entered into under duress, or the influence of threats, the circumstances mean that the surety either could not have appreciated the importance of the information that was provided in connection with the transaction, or that he entered into the contract regardless of the risk of liability. For example, for such a claim to be made out in England, the surety will need to establish that there was an application of illegitimate pressure by the other contracting party; and that the surety had no option but to comply with the demands of the party exerting pressure.¹⁹ Similarly in Germany,²⁰ the Netherlands,²¹ Italy²² and France²³ a person whose declaration of will has been illegitimately obtained by means of threats can obtain relief, although the criteria that must be met can differ, in particular in relation to the conduct that the lender must have engaged in and the extent of disadvantage that the surety must have suffered.²⁴

Further protection is commonly provided under the law of mistake or error.²⁵ Under the Netherlands law, for example, the amount of information that has been provided to the surety prior to the contract being concluded will be highly relevant to a claim of

¹⁸ For an overview of relevant laws in selected countries, and suggestions as to how such laws could be unified, see M. FABRE-MAGNAN, 'Defects of Consent in Contract Law' in A. Hartkamp et al (eds), above n. 6.

¹⁹ See for example *Atlas Express v. Kafco Ltd* [1989] 1 All ER 641; *Pao On v. Lau Yiu Long* [1980] AC 614, PC.

²⁰ BGB §123.

²¹ Netherlands Civil Code, 3:45.

²² Codice Civile, Art. 1434.

²³ Civil Code, Art. 1112.

²⁴ For a general discussion see H. KÖTZ, *European Contract Law*, Clarendon Press, Oxford, 1997, at p. 209 ff.

²⁵ For example in France Art. 1118 Code Civil, Cour d'appel Paris 18 January 1977, JPC G (La semaine juridique, édition générale), II, 19318, note P. SIMLER, appr. Cour de Cassation, Cass. 4 July 1979, D, (Receuil Dalloz Sirey) 1979, p. 538. Discussed in C. LEBON, 'Vorlagebeschluss of June 29, 1999 – The Protection of "Vulnerable Sureties" as to German, French, Belgian, Dutch, English and Scottish Law', 2&3 *ERPL (European Review of Private Law)* 2001, p 417, at 422-3, who also notes that the courts in France can be reluctant to annul contracts of suretyship on grounds of error. Netherlands Art. 6:228 CC; German BGB §§119 and 120; Italian Codice Civile, Arts 1428-1433.

mistake. Protection is also widely available where the transaction is fraudulent²⁶ or, in England, if there was a misrepresentation.²⁷

In addition vulnerable persons commonly enjoy protection.²⁸ The provision of information will not enable a vulnerable surety to make a rational decision because their characteristics make them incapable of doing so. The Netherlands Civil Code, for example, permits relief where there has been an abuse of circumstances. This law will assist a surety, although it is not confined to sureties, where the lender knows or should know that the surety is being induced to enter into an agreement on account of special circumstances, generally relating to vulnerability, and where they promote the conclusion of the agreement even though what they know, or ought to know, should prevent them from doing this. The circumstances of vulnerability include a state of necessity and dependency. It would include relationships where the emotional bond means that consent is not freely given.

Category 4: Regulation of the content of the contract

Provisions that enable the courts to interfere with the substance of the terms that the parties to a contract of suretyship have agreed have clear potential to undermine commercial certainty. Therefore such laws are used sparingly and, within the member states, the laws falling under this category vary in scope. Some protection applies where the suretyship agreement contains financial obligations that are disproportionate to the financial means at their disposal, to an extent that they have little hope of repaying the debt. A fair amount of overlap with Category 3 protection is observable, since many of the laws that the member states have developed that enable the regulation of the substance of surety agreements require also some element of a defect of consent.

In Scandinavia broad powers are granted to judges to police the substantive fairness of contracts.²⁹ The courts in that group of countries therefore have potentially greater powers to provide protection to sureties who have entered into unfair agreements than courts in the other member states. In contrast, it has been noted that UK contract law does not normally consider the substantive fairness of contracts but rather

²⁶ For example, in France Civil Code Art. 1116, *dol*; Germany BGB §123, *arglistige Täuschung*; Netherlands Civil Code 3:44, *bedrog*.

²⁷ Misrepresentation Act 1967. See D.K. ALLEN, *Misrepresentation*, Sweet and Maxwell, London, 1988.

²⁸ For example in the UK, Infants' Relief Act 1874; *Gallie v. Lee* [1971] AC 1004 (non est factum); in the Netherlands, Civil Code Art. 45 of Book 3, *misbruik van omstandigheden* (abuse of circumstances), including protection for persons of abnormal mental condition or inexperience; and German BGB §104.

²⁹ See J. PÖYHÖNEN, 'Procedural and Substantive Fairness in Finnish Contract Law' in R. Brownsword, G. Howells and T. Wilhelmsson (eds), *Welfarism in Contract Law*, Dartmouth, Aldershot, 1994, at pp. 199-206; T. WILHELMSSON 'Standard Form Conditions' in A. Hartkamp et al (eds), above n. 6, at p. 262, citing Nordic Contracts Acts, sec. 36; T. WILHELMSSON, *Critical Studies in Private Law. A Treatise on Need-Rational Principles in Modern Law*, Kluwer, Dordrecht, 1992, p. 180; and *Perspectives of Critical Contract Law*, Dartmouth, Aldershot, 1993, p. 23.

concentrates on the circumstances of the contracting process.³⁰ Under proposed reforms, however, the ability of the UK courts to provide relief against unfair suretyships is likely to increase.

These reforms would increase the scope of the substantive protection that may be obtained under the Consumer Credit Act 1974. This Act targets agreements which either³¹ require the debtor to make payments which are, or were, ‘grossly exorbitant; or which otherwise grossly contravene the ‘ordinary principles of fair dealing’. These terms set a high threshold for debtors seeking protection, and indeed very few debtors have been able to have agreements set aside under the 1974 Act. Reform proposals have however been announced and a draft Bill has been produced which will enable consumers to obtain protection where their relationship with the lender is ‘unfair’, potentially a significantly easier standard to satisfy. In addition the Bill contains measures that are designed to make it easier for debtors to bring their cases. Under the 1974 Act the surety, or the debtor, must take his case to court, entailing a potentially long and expensive process.³² It has been found that in many cases complaints are not made where there are legitimate grounds for the adjustment of transactions.³³ Under the Bill it will be possible for debtors and sureties to take their case to an independent ombudsman. A further major drawback of the 1974 Act is that it only relates to credit agreements of a value up to £25,000 and so it will not apply to most suretyship agreements.³⁴ However it is proposed that this financial restriction should be removed.³⁵

Usury laws provide a common means of protection for debtors by prohibiting agreements at an excessive rate of interest.³⁶ Such laws are relevant to the position of sureties if the suretyship contract includes provision for the payment of an excessive rate of interest on the amounts owing under the contract. In addition an excessive interest rate increases the likelihood of default by the principal debtor and thereby the likelihood that the surety will be called upon. In the assessment of interest rates a balance needs to be achieved between protecting the debtor, on the one hand, and facilitating credit on the other hand. Lenders with excessive interest rates will argue that the excessive interest rate is justified on account of the risk presented by the debtor.³⁷

Usury laws are particularly important for vulnerable debtors, who are liable to exploitation in imperfect markets. They are unable, in the same manner as more sophisticated debtors, to shop around for credit. The ability to charge interest in an unfettered manner creates an incentive for creditors to charge excessive rates. Interest

³⁰ See the text accompanying n. 13, above.

³¹ Consumer Credit Act 1974, sec. 138(1).

³² Consumer Credit Act 1974, sec. 139(1).

³³ See L. BENTLY and G. HOWELLS, *Loansharks and Extortionate Credit Bargains 2 Conv. (Conveyancer and Property Lawyer)* 1989, p 234, at 235.

³⁴ Consumer Credit Act 1974, sec. 8(2).

³⁵ Consumer Credit Bill, sec. 2(1)(b).

³⁶ For example the Consumer Credit Act 1974, sec. 138(1); §138(2) BGB (Germany).

³⁷ For example in the UK it was decided that an interest rate ceiling should not be introduced, on the basis that such a law could represent a barrier to low income borrowers and could encourage them to seek credit from illegal lenders.

rate caps are a feature of the majority of legal systems in the member states, although the UK government, in outlining its reforms to consumer protection laws, concluded that a similar law should not be introduced in the UK, preferring for usurious contracts to be attacked under the general standard of unfairness, rather than by reference to a fixed ceiling interest rate.³⁸ However the fact that interest rate caps have been successfully applied in most member states is evidence that an appropriate balance can be found. The argument of the UK government that such caps are inappropriate in the UK market, which has a wider variety of forms of credit than in continental Europe, moreover fails to take account of the operation of such caps in the United States.

In France a measure of substantive protection for sureties is provided under statute. This law provides relief where there is a manifest disproportion between the goods and income of the surety and the amount of liability.³⁹ Prior to this protection coming into force that jurisdiction also developed important protection, of a partly procedural nature, in the context of tort law where a bank acted contrary to good faith in failing to enquire whether the surety was able to carry the burden of the contract of suretyship. The principle stemmed from a case in which a company director provided security in respect of the debts of the company, limited to 20.000.000 francs.⁴⁰ The bank was held to have not acted in good faith since it knew or ought to have known that the director's obligation was manifestly disproportionate to his income but that this knowledge did not restrain the bank from concluding the agreement.

Germany offers substantive protection but with a high threshold. A rich vein of case law has concerned sureties who have incurred lifelong debts as a result of their surety agreements. Such agreements have on occasion been held to be invalid on the basis they contravene good morals (under the *sittenwidrigkeit* provision of §138 BGB). This provision has enabled sureties to avoid agreements that glaringly overburden them and where the surety's decision making has been inhibited by undue influence, a lack of business experience, or psychological distress. It is notable that not only does

³⁸ DTI White Paper, *Fair, Clear and Competitive, The Consumer Credit Market in the 21st Century* Cm 6040, para. 3.49 ff. A number of reasons were given for this decision, including that there would be practical difficulties in implementing such a law in view of the sophisticated and diverse credit market in the UK and that excessive credit rates would be better targeted in other ways. This view has been criticised by consumer credit workers and other experts in countries with existing interest rate caps. For detailed criticism of this finding, and the methodology by which it was reached, see U. REIFNER, 'Comments on the DTI Study: "The Effect of Interest Rate Controls in Other Countries" (Germany, France and US) Preliminary Remarks from a German Perspective' available at <www.kickback.org.uk/html/files/UsuryCeilingDTI_CommentUR.pdf>, 19 November 2004; and 'DTI Decision on Rate Caps Slammed by International Expert' <www.debt-on-our-doorstep.com>, 29 October, 2004.

³⁹ Loi no. 93-949 du 26 juillet 1993 relative au Code de la Consommation (Partie Législative), J.O. (*Journal Officiel*) no. 171, 27 July 1993, Art. L 313-10.

⁴⁰ Cass. Com. 17 June 1997, *Cts. Macron c/Banque internationale pour l'Afrique occidentale*. For a discussion of the case see C. LEBON, 'Vorlagebeschluss of June 29, 1999 – The Protection of "Vulnerable Sureties" as to German, French, Belgian, Dutch, English and Scottish Law' 2&3 *ERPL* 2001, p 417 at 425-427.

the law look at the substance of the contract, but that it also has regard to whether the surety was subject to a defect of consent. This law therefore contains requirements under both Categories 3 and 4. Contracts of suretyship are avoided on the basis that they interfere with the surety's right to the development of personality and to human dignity,⁴¹ in that they leave the surety with no economic options other than to continue paying the amount for which they are liable, and that, further, they offend against the welfare state principle.⁴²

The high threshold for avoidance in Germany is apparent if regard is had to the nature of the litigation. In contrast to the English case law, under the law of undue influence, the concern has been to relieve sureties who are faced with a life-long liability, rather than to protect the surety's home ownership.⁴³ A contract of suretyship that resulted in a loss of the family home would be tolerated under German law, since this loss would not be sufficient in itself to indicate that the debt glaringly overburdens the surety. What instead is required is a gross disparity between the amount that the surety is liable for and their ability to pay the amount. For example one typical German case concerned a 21 year old woman who guaranteed a 100,000DM loan in spite of having no prospect of ever paying that amount, since she had no job and no professional education.⁴⁴ A more guarded approach to contractual avoidance is therefore apparent in Germany, perhaps reflecting a sense that the debtor should observe his or her obligations.

Therefore there are a number of different approaches to the protection of sureties in the member states surveyed. Differences are observable in the scope of the applicable laws, most notably in the level of substantive unfairness that is required, and, in addition, whether or not a defect of consent is also required. However, as will be discussed below, the impact of these differences may potentially be lessened if the responsible lending provision of the draft Directive is implemented.⁴⁵

Category 5. Consumer bankruptcy

Bankruptcy can provide an opportunity for the relief of the surety, should none of the other categories of protection be applicable. However the bankruptcy of the principal debtor will trigger the liability of the surety so the availability of these laws may be both a blessing and a curse. Very different models of consumer bankruptcy are observable within Europe. As noted above, these models correlate quite strongly to the system of social welfare that is in operation. It has been observed that the more generous the social welfare system is, the less likely it is that the debtor will be granted a fresh start without having to adopt a scheme the repayment of debts over a

⁴¹ Arts 1 I and 2 I Grundgesetz.

⁴² Art. 20 I, 28 I Grundgesetz.

⁴³ M. SIEMS, 'No Risk, No Fun? Should Spouses be Advised before Committing to Guarantees? A Comparative Analysis' *ERPL* 2002, p 509 at p 520, although this article discusses *Barclay's Bank v. O'Brien* [1994] 1 AC 180, the leading case prior to the *Etridge* case, above, n. 17.

⁴⁴ BVerfGNJW 1994, 36.

⁴⁵ See the text accompanying n. 67 below.

number of years.⁴⁶ In addition, different levels of democratisation of credit are observable within the European Union, with the United Kingdom at one extreme and the southern European member states at the other and this has led to differences in levels of development of bankruptcy laws in those countries.

In systems linked with strong social welfare principles the emphasis is on prevention rather than treatment, with the consequential effect that, where prevention has failed, treatment is educative and largely unforgiving of debtors. The rationale here may be that, if the basic needs of the individual are catered for by the state, there is no need for the individual to rely on credit to provide for his needs and so borrowing should remain at a level that is manageable. Over-indebtedness should therefore only occur in cases of extravagance and, in such circumstances, it might be considered that the individual requires rehabilitation and assistance to repay over a longer period of time, and that he should not be able to escape his debts.⁴⁷ It is arguably right that welfare based systems should take this approach since the provision of welfare produces perverse incentives to take excessive credit risks⁴⁸ and a more generous bankruptcy system would exacerbate this by undermining the obligation to pay ones debts. However these arguments do not apply with the same force in relation to sureties who have only become indebted out of a sense of family loyalty.

Within the European Union the Scandinavian countries follow this model. Those countries employ ‘institutional social policy’⁴⁹ under which the state provides a comprehensive income security system and, in addition, a wide range of public services. In line with theories connecting the generosity of the social welfare system with the parsimoniousness of the bankruptcy system, these countries have what may be considered to be quite restrictive and, in some respects, judgmental bankruptcy systems. Debtors have to overcome a number of moral thresholds in order to be

⁴⁶ See R. EFRAT, ‘Global Trends in Personal Bankruptcy’ (2002) 76 *Am. Bankr. L.J.* (*American Bankruptcy Law Journal*), 2002, p 81 at 96-98 for an overview of the relationship; and U. REIFNER, ‘Thou Shalt Pay Thy Debts’ Personal Bankruptcy Law and Inclusive Contract Law’ in J. Niemi- Kiesiläinen, I. Ramsay and W.C. Whitford (eds), *Consumer Bankruptcy in Global Perspective*, Hart Publishing, Oxford, 2003, p. 144.

⁴⁷ See for example the system in Norway, described in H. P. GRAVER, ‘Consumer Bankruptcy: A Right or a Privilege? The Role of the Courts in Establishing Moral Standards of Economic Conduct’ (1997) 20 *J. Cons. Pol.* (*Journal of Consumer Policy*) 1997, p 161.

⁴⁸ E. A. POSNER, ‘Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract’ 24 *J. Legal Stud.* (*Journal of Legal Studies*), 1995, p 283.

⁴⁹ The social policy terminology in this section is from V.-L. RITAKALLIO, ‘Trends of Poverty and Income Inequality in Cross-National Comparison’ 4 *EJSS* (*European Journal of Social Security*) 2002, p 151 at 154-156, explaining the models of social policy presented by W. KORPI and J. PALME, ‘Socialpolitik, kris och reformer: Sverige i internationell belysning’ in *Nya villkor för ekonomi och politik. Ekonomikommisionens förslag, bilagdel 2. Statens offentliga utredningar 1993: 16*, Finansdepartement, Stockholm, 1993, pp. 135-170. See also G. ESPING-ANDERSEN, *The Three Worlds of Welfare Capitalism*, Princeton University Press, Princeton, 1990.

eligible for relief. These thresholds emphasise the requirement that debts should be paid. The eligible debtor is given assistance in meeting his debt burden but this assistance takes the form of debt rescheduling, rather than debt cancelling, as in some other jurisdictions, such as the UK. Indeed the bankruptcy system is to some extent regarded as part of the social welfare system since it provides an ‘opportunity for individuals to emerge from a hopeless situation of over-indebtedness without being physically and mentally crushed’ which is regarded as being ‘of vital importance to the development of the welfare society, and for the perception of safety and well-being by the public’.⁵⁰ Scandinavian debtors are therefore held to their bargains, although it should be remembered also that the courts have the power to police the substantive fairness of transactions under Category 4 and so sureties should not be forced into this long and restrictive bankruptcy process by an unfair agreement and should not be forced to continue to pay what is owed under the agreement while subject to the process.

Conversely in a society where there are fewer welfare benefits, and family members are unable to assist in providing finance, more citizens have to look to the credit market to satisfy their basic needs.⁵¹ Thus, credit facilitates ‘the mobilisation of future income’.⁵² However in such systems the over-indebted consumer lacks financial support in the event of a loss of employment or some other circumstance leading to a dramatic drop in income, or a dramatic rise in expenditure.⁵³ In such societies there is an increased risk of financial difficulties that cannot be solved by a scheme of organised repayments, and so there is a greater need for bankruptcy procedures providing a fresh start.⁵⁴ It is therefore, in theory, more likely that the lender will request that a surety be provided, if security against the assets of the debtor is unavailable, and a greater risk of default by the principal debtor arises. However there are also broader possibilities for the surety to make use of bankruptcy himself to escape his suretyship obligations.

In keeping with this model, the Anglo Saxon countries operate a more restrictive ‘means test’⁵⁵ social welfare policy, in which the state plays a limited role in income security and the provision of services. Individuals are more likely to be reliant on credit to meet their needs. Over-indebtedness is therefore more likely to occur and more likely to do so through reasons that are not the fault of the debtor (although this

⁵⁰ H. P. GRAVER, above n. 46 above, at p. 163-4, quoting the Report of the Norwegian Parliamentary Committee, 1991-92 at p. 3.

⁵¹ For a detailed discussion of the need for United States citizens to rely on credit for the provision of health care see M. JACOBY, ‘Generosity Versus Accessibility: Bankruptcy, Consumer Credit and Health Care Finance in the US’ in J. Niemi-Kiesiläinen, I. Ramsay and W.C. Whitford (eds), n. 5 above.

⁵² U. REIFNER, n. 46 above, p. 143.

⁵³ The United States of America provides the clearest evidence of the impact of a lack of welfare provision on the over-indebted consumer. See generally T. A. SULLIVAN, E. WARREN and J.L. WESTBROOK, *The Fragile Middle Class*, Yale University Press, New Haven and London, 2000; and E. WARREN and A. WARREN TYAGI, *The Two Income Trap*, Basic Books, New York, 2003.

⁵⁴ Jurisdictions in this category include the UK, Canada, Australia, New Zealand and the USA.

⁵⁵ V.-L. RITAKALLIO, n. 49 above.

is not to suggest in any way that debtors in Scandinavian debtors are more likely to be delinquent). In light of these reasons a debtor in the UK can obtain a fresh start after going through the bankruptcy procedure. Another notable factor is that the UK credit market is highly developed within Europe, representing approximately one quarter of the EU credit market in general and over half of the market in credit cards in the EU. This high rate of development has led to reforms introduced under the Enterprise Act 2002, under which a bankrupt debtor can obtain a fresh start after only one year. This system facilitates streamlined processing of bankruptcy cases and the re-entry of the debtor into the credit market. In following this system the UK has more in common with other countries with highly democratised credit, including the US, Australia, New Zealand and Canada than with other EU member states. Indeed the UK position is not only different from the position in Scandinavia. As discussed below, it contrasts very sharply with the position in the southern EU member states and the new member states in particular, which may make it difficult to identify a suitable model for maximum harmonisation.⁵⁶

Between these extremes countries are such as France, Germany and the Netherlands, which operate 'corporatist'⁵⁷ social welfare systems, under which social security is linked to employment and where services are provided by voluntary organisations, including the church. Credit has not gained such a strong foothold in these countries as in the UK, and the bankruptcy systems are not as generous as the British, since they contain strong rehabilitative features. The French system is similar to the Scandinavian models in that it enables debtors in good faith to reschedule the payment of their debts.⁵⁸ The average length of payment plans has been ten years, although in hopeless cases it is possible to obtain a discharge after three years.⁵⁹ Germany requires the repayment of debts during a six year period of good behaviour before the debtor can achieve a release from remaining debts. During this time the debtor must subsist at a basic level and must take any reasonable offer of work. The system in the Netherlands has encouraged rehabilitation in the form of out of court settlements of debts, facilitated by local authorities as an alternative to bankruptcy administered through the courts.⁶⁰

II. Draft Directive on consumer credit: potential for consumer protection under domestic law to impede the development of the market

The draft Directive on consumer credit does not attend to many of the areas of difference that were noted above, in spite of its proposed maximum harmonisation approach, which would suggest it may not be fully effective in opening up the credit market. A number of problems have been pointed out in existing literature, including

⁵⁶ See the text accompanying n. 85 below.

⁵⁷ V.-L. RITAKALLIO, n. 49 above.

⁵⁸ Loi 89-1010 relative à la prévention et au règlement des difficultés liées au surendettement particuliers et des familles, incorporated into the Consumer Protection Act as Arts L.331-1 to L333-8.

⁵⁹ Loi n. 98-657 (29 July 1998).

⁶⁰ See N. HULS, N. JUNGMANN and B. NIEMEIJER, 'Can Voluntary Settlement and Consumer Bankruptcy Coexist? The Development of Dutch Insolvency Law' in J. Niemi- Kiesiläinen, I. Ramsay and W.C. Whitford (eds), n. 5 above

not only the obvious language differences.⁶¹ The place of consumer protection as a potential barrier to integration of the credit market must also be evaluated. The availability of protection represents a risk that creditors must take into account in setting the terms of their credit contracts since it provides an opportunity for the debtor and the surety to default or to otherwise escape their contractual obligations.

Category 1 protection is likely to be of limited relevance to this consideration, however it does in part determine the need of consumers for credit, and it affects their potential to default. In addition, social policy affects bankruptcy, which does represent a significant obstacle to integration. Social welfare also indirectly affects enforcement through the civil procedure rules for the protection of the assets of debtors.

The draft Directive pays most attention to Category 2 protection, perhaps because the regulation of Categories 3 and 4 would stray into the realm of contract law in general. It is therefore in this area that barriers to the expansion of the market are least likely to occur, although questions may be asked regarding the effectiveness of the procedural protection that is provided to sureties, when contrasted with protection that is currently provided in some member states.⁶²

Although Category 3 methods of protection, such as duress, appear in similar form in the jurisdictions considered, it should not be thought that the laws are so similar that they can be regarded as the same. For example differences relate to whether or not substantive unfairness is required in addition to a defect in consent. There is therefore potential for these laws to act as barriers to market expansion. However it is arguable that, provided that lenders take care to ensure that the surety is provided with information, and that the surety both understands what they are getting into and that they are comfortable with it, these laws are not such that most honest lenders should be concerned.

The differences in approach in the member states to the issue of surety protection could create potential difficulties for lenders in assessing the likelihood of their arrangements being set aside. For example, the UK has strong Category 2 protection and the bulk of the case law has occurred under this Category through its undue influence law. In contrast in Germany the Category 2 protection has tended to be more limited and the main form of surety protection occurs under Category 4 with the *sittenwidrigkeit* principle. However, as will be seen, the role of these laws could change significantly in light of the 'responsible lending' provision of the draft, which supplements these laws by regulating procedural, and to some extent substantive, elements of the suretyship agreement.

Bankruptcy represents a significant potential barrier to the opening up of the credit market. Recent opportunities to bring greater uniformity to these laws have not been taken. Insolvency laws have long been on the reform agenda for the European Union,

⁶¹ See N. JENTZSCH, above n.3, K. LANNOO and A. DE LA MATA MUÑOZ above n.3.

⁶² For example the UK approach, noted above. See also P. ROTT, 'Consumer Guarantees in the Future Consumer Credit Directive: Mandatory Ban on Consumer Protection?', in this volume.

as part of the creation of a single market. Although harmonisation efforts have been restricted to conflict of laws provisions the open method of coordination has been adopted in relation to substantive insolvency laws, as part of the enterprise strategy. The focus under this process has been on corporate rescue procedures. However in official reports under the benchmarking exercise associated with the open method of coordination some thought was given to the position of bankrupt *entrepreneurs*, and to the desirability of providing a fresh start to enable them to try again. The issue of consumer bankruptcy was largely neglected in the review process, perhaps because the link with enterprise is less clear and the issues are more complex. This omission may be a blessing, since consumer bankruptcies are multifaceted. The issue is best considered alongside methods of resolving over-indebtedness of consumers via social exclusion policies and remedies available under contract law and consumer protection law. It is arguably only when such mechanisms are inadequate that recourse to bankruptcy procedures is required by consumers. Therefore the issue of consumer bankruptcies requires revisiting in light of the proposed reforms under the consumer protection Directive, as part of the European Council policy to tackle over-indebtedness and as part of the social exclusion agenda,⁶³ assuming that the powers which have been granted in this area are to bear fruit.⁶⁴

As things stand, however, the bankruptcy systems that are in operation in the European Union vary enormously in duration and effects. The likelihood of default is a factor that lenders must take account of in setting the terms of the contract of credit. The comparative easiness of a debtor obtaining a fresh start in the UK represents a far higher risk for a lender than for example the debtor in Germany who has to observe a 6 year payment plan before obtaining discharge, or debtors in Scandinavia who have to overcome a number of conditions if they are worthy of debt rescheduling in bankruptcy.⁶⁵ However it is submitted that the stigma of bankruptcy will prevent it being used by sureties as an easy way out and the number of bankruptcies is unlikely to rise to an extent where this procedure becomes destigmatised. Moreover, the responsible lending provision could potentially mean that sureties do not become so overburdened that bankruptcy should be considered as a serious solution. Nonetheless, suitable bankruptcy provisions should be provided so that consumers have an option in cases where the responsible lending provision does not assist.

III. Draft Directive on consumer credit: potential impact on existing categories of consumer protection

Having considered the categories of protection, and the extent to which they represent unharmonised obstacles to the development of the credit market, it is now necessary to consider how the draft Directive, as it currently stands, will affect the scope of

⁶³ EC Treaty, Art. 136.

⁶⁴ For a criticisms of the approach to social exclusion see P. SCHOUKENS, 'How the European Union Keeps the Social Welfare Debate on Track: A Lawyer's View of the EU Instruments Aimed at Combating Social Exclusion' 4 *EJSS* 2002, p 117 at 118.

⁶⁵ See J. NIEMI- KIESILÄINEN, 'Consumer Bankruptcy in Comparison: Do We Cure a Market Failure or a Social Problem?' 37 *Osgoode Hall LJ* 1999, p 473 at 488 - 497. See also H.P. GRAVER, above n. 47, describing Norway's system.

protection for European Union sureties, and other consumers.⁶⁶ Selected key issues will be discussed.

Responsible lending

As noted above the protection for sureties could potentially be bolstered in future if the provision on responsible lending contained in the draft Directive on consumer credit is implemented.⁶⁷ This protection, depending on how it is interpreted, has the potential to eliminate some of the current differences in protection due to member states emphasising particular categories of protection for sureties. As it presently stands⁶⁸ this provision includes obligations to sureties, since it is intended to apply to all consumers. It requires the lender and any intermediary to adhere to the requirement of pre contractual information, for the creditor to assess the consumer's creditworthiness by consulting a database, and, in good time before the consumer is bound by the credit agreement, to provide the consumer, on paper, with necessary and essential information regarding the transaction, including any sureties that are required. This provision, in requiring an assessment of the creditworthiness of both the borrower, and the surety, has the potential to supplement the protection noted above, for example under the English law of undue influence which takes a procedural approach, confined mainly to the provision of advice. The responsible lending provision might potentially go further, as it could also entail a need for the courts to assess the reasonableness of what the surety has agreed to. In addition the new law could bolster the laws of other jurisdictions, such as Germany, where lenders have been able to impose disproportionate liabilities except where sureties can demonstrate that this is contrary to good morals and where, in consequence, the scope for avoidance has been quite narrow. These effects will of course depend on the provision, firstly, making it into the final Directive in a form which places significant requirements on the lender and, secondly, on the provision being interpreted in a consistently generous fashion by judges in the member states. A danger is that judges in the member states, in interpreting the new law, will be influenced by their existing norms. It has been observed by Fehlberg, commenting on an Australian statute on surety protection, that legal change is made difficult when 'those implementing the law are trapped in a custom of interpretation which leads them to impose caveats on relief which do not exist in the statute itself'.⁶⁹ In addition, since this provision does not at present expressly indicate an ability to regulate the substance of transactions it

⁶⁶ See also P. ROTT, n. 62 above for detailed discussion of the potential impact of the Directive.

⁶⁷ 2004 Draft of Commission of the European Communities, Proposal for a Directive of the European Parliament and of the Council on the Harmonisation of the Laws, Regulations and Administrative Provisions of the Member States concerning credit for consumers, Art. 5 (previous draft Art. 9).

⁶⁸ Taken from the Institute for Financial Services Hamburg, 'Consolidated Version and Comments on the Amendments to the Proposal for a Directive on the harmonisation of the laws, regulations and administrative provisions of the Member States concerning credit for consumers repealing Directive 87/102/EC and modifying Directive 93/13/EC of October 2004 (2002/0216 (COD))', Hamburg 5 November 2004.

⁶⁹ B. FEHLBERG, *Sexually Transmitted Debt*, Clarendon Press, Oxford, 1997, p. 280-1, citing Kirby P in *AGC v. West* [1986] NSWLR 610, at p. 616.

is likely that in any case law that is brought under the provision, lenders will lobby for a restriction of the scope of protection within the bright lines of Category 2.

Ample evidence of attempts by lenders to use law reforms to argue that the scope of surety protection should be limited can be seen in a recent case from Germany. In this case, the *sittenwidrigkeit* provision came under fire in light of the introduction of new bankruptcy laws on 1st January 1999, with critics arguing that, since a debtor can free himself from his debts by going through the process of six years of good behaviour,⁷⁰ it is not necessary for the courts to intervene on grounds that the contract is contrary to good morals.⁷¹ The *sittenwidrigkeit* jurisdiction was however upheld by the court, primarily in light of the different functions of these categories of debtor protection.⁷² One important factor was that, while the *sittenwidrigkeit* jurisdiction related to the time at which the contract was concluded, the debt release procedure in bankruptcy, being six years in duration, represented a pedantic and lengthy means of debt relief. Bankruptcy served a completely different function, structurally, from the *sittenwidrigkeit* jurisdiction.⁷³

This decision reflects a principled approach, based on an identification of the function of the different categories of surety protection. Arguably it could provide a suitable model for future cases in which the impact of the draft Directive on the scope of existing protection is at issue. Bankruptcy, in view of its consequences, should be viewed as the last resort for over-indebted consumers, including sureties. These procedures enable over-indebted persons to either manage their debts more favourably, or to achieve a fresh start through the cancelling of debts, so that they may regain control over their finances. In cases where the cause of over-indebtedness is a transaction that offends the principles on which the remedies under Categories 2, 3 and 4 are based, and this could include the responsible lending provision, bankruptcy should not be regarded as an alternative to contractual avoidance – each has a different aim and so should only be used where the circumstances are appropriate. If the suretyship transaction is flawed it should be capable of avoidance in spite of the fact that the surety can avail himself of bankruptcy proceedings to manage or shed the debt. Bankruptcy carries with it negative consequences, such as the duration of the procedure and significant stigma (even if unintended by the legislature) and so sureties should not be forced in that direction.

Socially harmful lending

Although the increased availability of different types of consumer credit can have positive aspects it is important in the interests of both principal debtors and sureties that it should not facilitate the expansion of the activities of the worst types of lenders, including loan sharks. Good usury laws can help in this regard. However it is also important for consumers who would normally be likely customers of such lenders to have alternative sources of finance, such as credit unions. It is important that these

⁷⁰ §§ 286 ff Insolvenzordnung.

⁷¹ See for example MEDICUS, JuS 1999, 833 [835]; RELLERMEYER, WuB I F 1 C 1.03; KRUEGER, MDR 2002, 856 m.w. Nachw.

⁷² OLG Frankfurt am Main, judgment of 24 March 2004 – 23 U 65/03.

⁷³ For criticism of this decision see D. UNGAR, EwiR §138 BGB 4/04, 691.

forms of credit should not be damaged by the extension of the credit market. Therefore aggressive marketing of credit should be controlled.

Remedies

Not only do the member states currently approach the protection of sureties in different ways but also the end results of surety protection cases are variable. One very striking difference is that in the UK the more common form of litigation relates to sureties who are seeking to *protect the family home* that is the subject of a mortgage or charge on behalf of the lender. In civil law jurisdictions, other than Scotland, this focus on the home is lacking and the case law concentrates on the general amount owing, in particular if the surety is facing a lifelong debt.⁷⁴ The level of protection is therefore, in this respect, broader in the UK, a surprising trend that is at odds with the ‘creditor friendly’ image of the country. However, since the UK law concentrates on whether the correct procedures have been followed by the lender, rather than on the substantive fairness of the transaction, there may in practice be no more chance of avoiding an unfair but procedurally well planned suretyship agreement than in civil law countries, although of course a surety in the UK can use the last resort of bankruptcy more easily than continental European debtors. A further difference is that while continental European protection generally provides that the offending provision is void, under UK law it is possible for the court to adjust the contract to remove the only the wrongful elements of the contract,⁷⁵ although it is also possible for the whole contract to be set aside.⁷⁶ Although this possibility would seem to allow the courts to offer less protection to the surety, the danger with a wholly void/valid approach is that it encourages conservatism among judges who wish to preserve the principle that contracts must be observed (*pacta sunt servanda*).

The issue of remedies is not dealt with under the present draft of the Directive, therefore, as the it currently stands, the remedies will be for the member states to determine. There will, therefore, be continued scope for divergence in the laws, until such time as a ruling of the ECJ on the matter. It would be desirable to deal with the matter expressly to minimise the need for clarifying case law.

Potential increase in over-indebtedness

A recent European Council document on social exclusion⁷⁷ identified the prevention and treatment of over-indebtedness as a major element in the fight against social exclusion and poverty. However the draft Directive has the potential to undermine this fight. A worst case scenario is that the elimination of barriers to consumer credit provision in Europe will lead to an increase in over-indebtedness with consequences for both principal debtors and sureties. The ‘democratisation’ of credit, as noted above, is a factor that, in other jurisdictions, including, within the EU, the United Kingdom, has led to a need for bankruptcy procedures to be relaxed. Greater

⁷⁴ For a comparison see generally M. SIEMS, above, n 43.

⁷⁵ *Barclay's Bank plc v. O'Brien* [1994] 1 AC 180, HL. Under German law there is some scope for partial nullity of offending contracts: BGB §139.

⁷⁶ *TSB v. Canfield* [1995] 1 All ER 551.

⁷⁷ Joint Report by the Commission and the Council on Social Exclusion, Brussels 5 March 2004, 7101/04.

competition in the credit market leads to more affordable credit, more accessible credit and more effective marketing of products. Consumers are therefore better able to borrow more capital and they are more likely to do so, in particular if lenders emphasise positive aspects of credit and downplay negative aspects. This behaviour may lead to over-indebtedness. Things that were no longer affordable become within the reach of consumers and consumers become more willing to take financial risks to attain what that they covet.

It is necessary to consider the wider financial context. Three types of over-indebtedness have been identified in the literature.⁷⁸ Active over-indebtedness occurs where the consumer has mismanaged his financial affairs, by overestimating his future income or overspending. It is this form of over-indebtedness that is facilitated by the democratisation of credit. Passive over-indebtedness describes the situation where the cause of over-indebtedness is a life event that occurs independently of the debtor's decisions. Potential over-indebtedness, is caused by a poor economic situation that is not going to change, such as low pension payments or where an adult aged 30 or more has yet to become economically active. These latter two types of over-indebtedness are affected by social welfare policies. Therefore, where this democratisation is accompanied by a shrinkage in welfare provision, as is happening in some member states of the European Union, rates of over-indebtedness are likely to rise further, with knock-on effects for sureties. There is therefore a need for bankruptcy procedures to be reviewed in light of both in light of the increased democratisation of credit but also with any changes in welfare provision in mind. The relationship is neatly encapsulated by Sullivan, Warren and Westbrook: 'The data suggest that the need for a more protective consumer bankruptcy law is directly proportional to the size of the social safety net and the availability of consumer credit. Like any good three-legged stool, change the length of one leg and the shift will be felt by the other two.'⁷⁹

In systems where significant democratisation of credit has already occurred the legislatures have responded by reviewing their bankruptcy laws so that the increased number of over-indebted consumers can be accommodated. Such reforms have already taken place in many European countries, following the deregulation of their credit markets in the 1980s.⁸⁰ This deregulation enabled previously unmet demand for credit to be satisfied and massive increases in consumer lending occurred, most notably in the UK, where, between the years 1986 to 1997, lending increased from £30,150 million to £77,548 million.⁸¹ It is estimated that the total volume of outstanding consumer credit doubled in many other member states.⁸² Problems occurred when the recession in the 1990s took its toll on the over-indebted through

⁷⁸ This terminology is from Adiconsum, *Il Sovraindebitamento della famiglie-Definizioni, profili e dimensioni di un fenomeno sommerso* M. Fiasco, Regione Basilicata/Campagna informative dell'Adiconsum/ UE DG XXIV (1999), quoted in G. BETTI et al, *Study of the Problem of Consumer Indebtedness: Statistical Aspects*, OCR Macro, London, 2001 and N. JENTZSCH, above n. 3 at p. 12.

⁷⁹ T. SULLIVAN et al, above n. 53 at. 259.

⁸⁰ See R. EFRAT, above n. 5, at p. 92-3, citing the examples of Finland, Norway, the Netherlands, the United Kingdom and France.

⁸¹ T. SULLIVAN et al, above n. 53, at 258.

⁸² J. NIEMI- KIESILÄINEN, above n.65, at p. 480.

factors such as redundancies, a drop in house prices, small business failures and the consequential liabilities of guarantors of business loans. Existing welfare provision was insufficient to cope with these shocks and so demand grew for a way of assisting consumers to cope. Therefore bankruptcy procedures were introduced in many member states to assist individuals in difficulty.⁸³ As noted above, in northern Continental Europe these procedures were regarded as being a part of the welfare provision: they enabled debtors to manage their burden through counselling.⁸⁴ In contrast the UK to some extent followed the United States model in allowing a fresh start after a period of bankruptcy, formerly three years but now as low as one year.

This pattern did not occur in the same way throughout the EU, however. In a number of jurisdictions, most notably those in the Mediterranean region, the process only happened later, largely on account of cultural factors. For example in Portugal the expansion of consumer credit occurred comparatively recently, although this expansion was dramatic, with family indebtedness increasing from 20% in 1990 to 95% in 2001. Consumer bankruptcy procedures were therefore not formerly required but a need for them has grown alongside the rise in indebtedness.⁸⁵ A similar situation is observable in many of the countries that acceded to the EU in 2004.⁸⁶

Although member states should keep their bankruptcy procedures under review if the draft Directive is implemented, it is unlikely that all systems will need to adapt to the British model, provided that currently strong features of consumer lending in particular member states can be preserved. For example the availability of overdrafts for German debtors has meant that credit cards, one of the most common forms of lending in countries with high levels of over-indebtedness, have gained less of a foothold in that country. If this situation continues, German debtors should be better placed to avoid over-indebtedness. Creditors in some other member states may be insulated, for other reasons, such as resistant attitudes of consumers to indebtedness.

A further form of protection which member states may have to review in light of the proposed Directive is consumer credit education, with the aim that consumers will thereby be able to make more informed choices in choosing credit. Two theories have

⁸³ See for example T. SULLIVAN et al, above n. 53, at p. 258-9; and R. MASON, 'Consumer Bankruptcies: An Australian Perspective' 37 *Osgoode Hall LJ* 1999, p 449 at 458.

⁸⁴ Therefore a contrast may be drawn with the United States system which enables a debtor who has failed to have a fresh start and re-enter the credit market: Bankruptcy Laws Commission, *Report of the Commission on the Bankruptcy Laws of the United States* H.R. Doc. No. 93-173 (1973). See further J. NIEMI- KIESILÄINEN, above n. 82, at 476-482 for a comparison of the approaches.

⁸⁵ M. M. LEITÃO MARQUES and C. FRADE, 'Searching for an Over-indebtedness Regulatory System for Portugal and the European Union' in J. Niemi- Kiesiläinen et al (eds), above n. 46 at p. 121.

⁸⁶ For example in Hungary there was previously no need for bankruptcy procedures since banks only lent money to consumers with adequate resources however this position has changed with the introduction of credit cards: A. CSÓKE, 'Problems Related to Collective Insolvency Proceedings Having Cross-Border Effects From the Perspective of Hungary' 13 *Int. Insol. Rev.* 2004, p 77 at 81.

been identified as underlying such schemes.⁸⁷ Firstly it is thought that consumers are empowered by the provision of financial skills and the ability to engage in financial planning to achieve their goals. Secondly it is considered that consumers are imbued with social control so that they are more likely to consider carefully the terms of the credit that they are being offered, and so they will be less likely to be swayed by manipulative sales techniques. Education can also be aimed at sureties to ensure that they realise the consequences of what suretyship entails. However in Europe extensive debtor education efforts tend to be aimed at persons who have become bankrupt, rather than consumers in general. Therefore the aim of such education is to prevent repeated over-indebtedness and bankruptcies, to achieve rehabilitation and a change in lifestyle and thereby to increase the amounts that the debtor is able to pay to his creditors.⁸⁸ If the market is expanded in the manner envisaged by the draft Directive it might be necessary to provide debtors with information about new forms of credit that they may encounter, in order to enable them to determine the advantages and disadvantages of what they are being offered and to compare them with other forms of credit that may be more appropriate to their needs.

Conclusion

The member states approach the task of surety protection in different ways, leading to laws which, although similar, are not identical. These differences potentially represent barriers to the integration of the consumer credit market. The draft Directive on consumer credit will introduce a greater level of uniformity, although it does not attend to all forms of surety protection. The responsible lending provision, depending on its final form, and how it is ultimately interpreted by the courts, can potentially overcome some of the existing barriers. If it is to achieve this task the scope of this proposed provision, and its available remedies, needs to be more clearly articulated. Further challenges also lie ahead in ensuring that the draft Directive does not lead to an expansion of socially harmful forms of credit and an increase in over-indebtedness. The reforms do not directly impact on social welfare policies and bankruptcy laws, which have important effects on the scope of consumer protection. However attention must be paid to those categories of protection if the credit market does expand.

⁸⁷ See J. BRAUCHER, 'Debtor Education in Bankruptcy: The Perspective of Interest Analysis' in J. Niemi- Kiesiläinen et al (eds), above n. 46, at p. 319.

⁸⁸ J. NIEMI- KIESILÄINEN, 'The Role of Consumer Counselling as Part of the Bankruptcy Process in Europe' 37 *Osgoode Hall LJ* 1999, p 409 at 413. The UK government initially intended to include debtor counselling in the reforms to bankruptcy law that were implemented under the Enterprise Act 2002 but dropped the idea when it failed to gain support in a consultation exercise on the proposals. One disadvantage of debtor counselling is the increase in the cost of proceedings that is entailed. It is therefore to some extent inconsistent with the streamlined UK system introduced under the 2002 Act.