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INDEX:

FIRST CHAPTER: OBLIGATIONS

1) Defective Contracts in Philippine Law, by Rubén Belane
2) Inefficacy of contracts: Different categories, by Yolanda Bergel Sainz-Baranda.

SECOND CHAPTER: PROPERTY LAW

3) Indigenous Peoples and Their Right to Ancestral Domain, by Sedfrey M. Candelaria
4) An introduction to English and Spanish property law from a comparative perspective, by Juan Pablo Murga Fernández
5) Acquisition from a *non domino* in Spanish civil law, by José Manuel de Torres Perea

THIRD CHAPTER: CIVIL LIABILITY

6) The Philippine Civil Code Chapter on Human Relations and Contemporary Challenges, by Dean Perry Pe
7) Pre-contractual liability, by Teresa Rodríguez de las Heras Ballell
8) Torts in the family sphere, by José Manuel de Torres Perea

FOURTH CHAPTER: FAMILY LAW

9) Philippine Law on Paternity and Filiation, by Danilo Concepción
10) Inter Country Adoption, by Maria Gabriela Roldan
11) Private law of the Philippines and Spain scientific congress. Child protection system in Spain, by Julieta Moreno-Torres Sánchez

FITTH CHAPTER COMMERCE LAW:

12) Roots of modernity grounded on tradition: Select Civil Law concepts ingrained in Commercial Law, by Nilo Divina
13) Relations between the Spanish and Philippine Commercial Codes, by Eugenio Olmedo Peralta
14) Mortgage foreclosure and unfair terms in banking contracts, by Yolanda de Lucchi López Tapia,
15) Bankruptcy, an arrangement with creditors, by Nieves Jiménez López
16) How to secure the enforcement of penalties in international commercial contracts, by Ignacio Marín García

DEFECTIVE CONTRACTS IN PHILIPPINE CIVIL LAW

Prof. Rubén F. Balane

Abstract:

In the Spanish Civil Code, contracts can be rescinded in certain cases and certain contracts are considered defective for want of any of the three essential requisites—consent, subject-matter, and cause. The Philippine Civil Code, enacted in 1949, sought to refine this by providing a more finely tuned classification of these defective contracts. Thus, in the Philippine Civil Code, defective contracts are enumerated in a more or less meticulously graduated order of irregularity: (1) the rescissible, (2) the voidable, (3) the unenforceable, and (4) the void or inexistent.

In this paper, the author discusses the four kinds of defective contracts in the Philippine legal system. Along with discussing the requisites for the applicability of each defective contract, the author outlines the important Philippine jurisprudential guidelines that evolved since the Philippine Civil Code's enactment about six-and-a-half decades ago.

Keywords:

Philippines, Philippine Civil Code, Defective Contracts, Rescissible Contracts, Voidable Contracts, Unenforceable Contracts, Void Contracts, Inexistent Contracts.

Introduction

The word "contract" literally means a drawing together (*cum*-*trahere*). In the Philippine Civil Code a contract is defined as "a meeting of minds between two persons whereby one binds himself, with respect to the other, to give something or to render some service." (Article 1305, Civil Code).

In Philippine civil law it is elementary that all contracts have three common requisites: consent, subject-matter, and cause. (**Spouses Lequin v. Spouses Vizconde**, 603 SCRA 407 [2009]).

Art. 1318 accordingly provides:

> "**Art. 1318.** There is no contract unless the following requisites concur:
>
> (1) Consent of the contracting parties;
> (2) Object certain which is the subject matter of the contract;
> (3) Cause of the obligation which is established."

A lack or vitiation of any of these three results in some kind of defect in the contract. In addition, there is a special group of contracts which, though possessed of all the essential requisites, cause a particular kind of economic damage and are, for that reason, treated by law as defective. In the civil law tradition, the concept of defective contracts goes back very far. It was already known in the ancient Roman law. Contracts in the Roman law could be set aside for total want of capacity (as in the case of children below seven), or if entered into through force or fear (*vis* or *metus*) or fraud (*dolus*), or mistake (*error*), or for an illegal object or purpose, and so forth.

The Civil Code of Spain—which was also our law until 1950—likewise already regulated defective contracts. Thus, contracts could be rescinded in certain cases (Art. 1291, Spanish Code), and certain contracts defective for want of any of the three essential requisites were invalid. There was some ambiguity in the old code, however, between *contratos* that were referred to as *nulos* and those referred to as *anulables*.

When, in 1947 (just a year after the birth of the Philippine Republic, following more than three centuries of Spanish rule and half-a-century of American sovereignty), a Code Commission was created to draft a Civil Code for the infant Republic, one of the features proposed by the codifiers was a clearer distinction of the defective contracts. The result was the categorization of such contracts into four: (1) the rescissible, (2) the voidable, (3) the unenforceable, and (4) the void.

The defective contracts

These defective contracts are arranged, presented, and regulated (Articles 1380 to 1422) in ascending order of defectiveness.

The classification has been done with a not inconsiderable amount of effort and an attempt at thoroughness. Thus, each of these defective contracts has its own requisites and consequences. Ideally, one would suppose, the distinctions should serve as water-tight compartments. For the most part — but not always — they have functioned well in the jurisprudence that has been laid down in the six-and-a-half decades since the effectivity of the Code.

A **rescissible** contract is one, which, though possessing all the essential requisites of contracts, has caused a particular economic damage either to one of the contracting parties or to a third person.

A **voidable** contract is one in which the consent of one party is defective, either because of want of capacity, or because consent is vitiated.

An **unenforceable** contract is one that, for lack of authority or of the required writing, or for incompetence of both parties, cannot be given effect unless properly ratified.

A **void** contract is one which suffers from absence of object or cause and is therefore an absolute nullity and produces no effect.

I. Rescissible Contracts

A rescissible contract has all the requisites required by law for valid contracts (Art. 1380). What makes it rescissible is economic damage, not just any economic damage, but those kinds of economic damage enumerated under Arts. 1381 and 1382.

For a contract to be rescissible, four requisites are required:

1. it must fall under either Art. 1381 or 1382 (**Causapin v. CA**, 233 SCRA 615 [1994]);
2. the party seeking rescission must have no other legal means to obtain reparation for damages suffered by him (Art. 1383);
3. the party seeking rescission must be able to return whatever he may have obtained by reason of the contract (Art. 1385, par. 1); and
4. the things object of the contract must not have passed legally to a third person in good faith (Art. 1385, pars. 2 and 3).

Let us now take the requisites one by one.

A. The contract must be one of those enumerated under Art. 1381 or 1382.

"**Art. 1381.** The following contracts are rescissible:

(1) Those which are entered into by guardians whenever the wards whom they represent suffer lesion by more than one-fourth of the value of the things which are the object thereof;

(2) Those agreed upon in representation of absentees, if the latter suffer the lesion stated in the preceding number;

(3) Those undertaken in fraud of creditors when the latter cannot in any other manner collect the claims due them;

(4) Those which refer to things under litigation if they have been entered into by the defendant without the knowledge and approval of the litigants or of competent judicial authority;

(5) All other contracts specially declared by law to be subject to rescission."

"**Art. 1382.** Payments made in a state of insolvency for obligations to whose fulfillment the debtor could not be compelled at the time they were effected, are also rescissible."

a) The first two contracts enumerated in Art. 1381 are entered into by representatives (guardians on behalf of wards, and administrators representing absentees) where the ward or absentee suffers lesion exceeding 25% of the value of the property which he parts with.

Lesion has been defined as the "injury which one of the parties suffers by virtue of a contract which is disadvantageous to him" (IV ARTURO M. TOLENTINO, COMMENTARIES AND JURISPRUDENCE ON THE CIVIL CODE OF THE PHILIPPINES 574 (1987), citing 3 Camus 205-06). For the contract to be rescissible, the lesion must exceed 25% of the value of the thing owned by the ward or absentee.

The theory of lesion is simple enough but its application has been strongly criticized. Foremost among the critics is Justice JBL Reyes, perhaps the Philippines' greatest civilist, who, in his comments on the Civil Code, observed: "Modern doctrine does not regard favorably the rule of economic prejudice (lesion) being a ground of rescission, considering that goods do not have a fixed true value because value is always variable and fluctuating, being a function of supply and demand. The modern codes tend to view lesion of certain proportions (1/4, etc.) as merely raising a presumption of undue influence, that vitiates consent and renders the contract voidable…whenever the lesion is coupled with exploitation of one party by the other. (cf. German Civ. C., Art. 138; Mexico, Art. 17)." (JBL Reyes, *Observations on the New Civil Code, Fifth Installment,* LAWYERS J., JAN. 31, 1951; [*c.f.* RUBEN F. BALANE, JBL IPSE LOQUITUR 239 (2002)]).

This provision on lesion had been hotly debated by the framers of the French Code, the reason for its final inclusion being the personal intervention of Napoleon Bonaparte. Manresa criticizes its adoption in the Spanish Code in no uncertain terms. He calls lesion "*un absurdo económico evidente*" (a patent economic absurdity).

It must be noted that, as a rule, dispositions by guardians or administrators of real property of wards or absentees require court approval (Rules 95, 96, and 107, Rules of Court [1964]), and without such approval, the contract would be unenforceable (Art. 1403[1]), and not rescissible. On the other hand, if prior court approval is obtained, the contract would be valid, regardless of the presence of lesion (Art. 1386).

"**Art. 1386.** Rescission referred to in Nos. 1 and 2 of article 1381 shall not take place with respect to contracts approved by the courts."

The only instance, it seems, in which these paragraphs will apply is when no court approval is required for the contract, as in dispositions amounting to mere acts of administration (Rule 95, Sec. 1 and Rule 96, Sec. 2, Rules of Court).

b) The third paragraph (Art. 1381)—contracts in fraud of creditors—refers to the ancient remedy of *actio pauliana*. [Arts. 1177 and 1313 provide for the same thing.]

The requisites for *actio pauliana* are given in **Siguan v. Lim** (318 SCRA 725 [1999]):

1. the plaintiff asking for rescission has a credit prior to the alienation, although demandable later;
2. the debtor has made a subsequent contract conveying a patrimonial benefit to a third person;
3. the creditor has no other legal remedy to satisfy his claim;
4. the act being impugned is fraudulent; and
5. the third person who received the property conveyed, if it is by onerous title, has been an accomplice in the fraud.

c) The fourth paragraph has essentially the same purpose as the third, i.e. to prevent injury to a third person (in this case the party who has lodged a claim over the property).

d) Some specially declared rescissible contracts are found in the Title on Sales, viz: Arts. 1526, 1534, 1538, 1539, 1542, 1556, 1560, and 1567.

e) Re: rescissible contracts under Art. 1382, the insolvency there contemplated is factual insolvency, not necessarily involving an insolvency proceeding.

B. The party seeking rescission must have no other legal means to obtain reparation for damages suffered by him.

The remedy of rescission is subsidiary. This is clear from Art. 1383:

"**Art. 1383.** The action for rescission is subsidiary; it cannot be instituted except when the party suffering damage has no other legal means to obtain reparation for the same."

In this connection, a careful distinction must be made between rescission of a properly rescissible contract and rescission under Art. 1191.

> "**Art. 1191.** The power to rescind obligations is implied in reciprocal ones, in case one of the obligors should not comply with what is incumbent upon him."
>
> "The injured party may choose between the fulfillment and the rescission of the obligation, with the payment of damages, in either case. He may also seek rescission, even after he has chosen fulfillment, if the latter should become impossible."
>
> "The court shall decree the rescission claimed, unless there be just cause authorizing the fixing of a period."
>
> "This is understood to be without prejudice to the rights of third persons who have acquired the thing, in accordance with articles 1385 and 1388 and the Mortgage Law."

The rescission under Art. 1191, properly called resolution, is essentially different from rescission under Art. 1383. It is unfortunate that the distinction in terminology, so scrupulously observed in the Spanish Code [resolver (Art. 1124) versus rescindir (Art. 1290)] was so carelessly discarded in the Philippine Code, leading to confusion, even on the part of people who should know better.

Again, Justice JBL Reyes steps in to clear up the mess, in his concurring opinion in **UFC v. CA** (33 SCRA 1 [1970]). The relevant portion of that concurring opinion is:

> "'…the argument of petitioner, that the rescission demanded by the respondent-appellee….should be denied because under Article 1383 of the Civil Code of the Philippines rescission can not be demanded except when the party suffering damage has no other legal means to obtain reparation, is predicated on a failure to distinguish between a rescission for breach of contract under Article 1191 of the Civil Code and a rescission by reason of *lesión* or economic prejudice, Article 1381, *et. seq.* The rescission on account of breach of stipulation is not predicated on injury to the economic interests of the party plaintiff but on the breach of faith by the defendant, that violates the reciprocity between the parties. It is not a subsidiary action, and Article 1191 may be scanned without disclosing anywhere that the action for rescission thereunder is subordinated to anything other than the culpable breach of his

obligations by the defendant. This rescission is a principal action retaliatory in character, it being unjust that a party be held bound to fulfill his promises when the other violates his. As expressed in the old Latin aphorism: '*Non servanti fidem, non est fides servanda*.' Hence, the reparation of damages for the breach is purely secondary.'"

On the contrary, in the rescission by reason of *lesión* or economic prejudice, the cause of action is subordinated to the existence of that prejudice, because it is the *raison d'être* as well as the measure of the right to rescind. Hence, where the defendant makes good the damages caused, the action cannot be maintained or continued, as expressly provided in Articles 1383 and 1384. But the operation of these two articles is limited to the cases of rescission for *lesión* enumerated in Article 1381 of the Civil Code of the Philippines, and does not apply to cases under Article 1191.

"It is probable (JBL concludes) that the petitioner's confusion arose from the defective technique of the new Code that terms both instances as 'rescission' without distinctions between them; unlike the previous Spanish Civil Code of 1889 that differentiated 'resolution' for breach of stipulation from 'rescission' by reason of *lesión* or damage. But the terminological vagueness does not justify confusing one case with the other, considering the patent difference in causes and results of either action.'"[1]

"The last comment—parenthetically—is apropos, and codifiers will do well to avoid, as far as possible, the same identical terms for different concepts. Such terms as *rescission*, *fraud*, *collation*, *ratification*, etc.—all used in the Code in varying or equivocal senses—can only ensnare students, professors, practitioners, and courts." (Ruben F. Balane, *A Harvest of Eighteen Years: A Survey of Jose B.L. Reyes' Leading Supreme Court Decisions on Civil Law, Part II*, *in* CIVIL LAW *FLORILEGIUM*: ESSAYS ON THE PHILIPPINE VARIANT OF THE CIVIL CODE TRADITIONS 512 (2012)).

In a nutshell, the essential distinctions between rescission under Arts. 1380-1389 and rescission (resolution) under Art. 1191 are two:

1. Rescission is predicated on economic injury; resolution, on breach; and

[1] The distinctions drawn by Justice JBL Reyes in the *UFC* case—as to the nature, purpose, and requisites of rescission (resolution) under Art. 1191 and rescission under Arts. 1380-1389—have since been reiterated and confirmed in subsequent decisions: **Ong v. CA**, 310 SCRA 1 [1999]; **Velarde v. CA**, 361 SCRA 57 (2001); **Cannu v. Galang**, 459 SCRA 80 [2005]; **Raquel-Santos v. CA**, 592 SCRA 169 [2009]; and **Quirong v. DBP**, 606 SCRA 543 [2009].

2. Rescission is a subsidiary action; resolution, a principal one retaliatory in character.

This important differentiation was reiterated in **Ong v. CA** (310 SCRA 1 [1999]).

C. The party seeking rescission must be able to return whatever he may have obtained by reason of the contract.

This is required by Art. 1385, Par. 1.

> "**Art. 1385.** Rescission creates the obligation to return the things which were the object of the contract, together with their fruits, and the price with its interest; consequently, it can be carried out only when he who demands rescission can return whatever he may be obliged to restore."

Rescission cancels the contract; consequently, the parties must be returned to the *status quo ante*. Hence, the need for mutual restitution.

D. The things object of the contract must not have passed legally to a third person in good faith.

The basis for this requirement is found in Art. 1385, Paragraphs 2 and 3:

> "**Art. 1385.** x x x x x x x x x"
>
> "Neither shall rescission take place when the things which are the object of the contract are legally in the possession of third persons who did not act in bad faith."
>
> "In this case, indemnity for damages may be demanded from the person causing the loss."

II. **Voidable Contracts**

Voidable contracts are governed by Arts. 1390 to 1402. As noted earlier, consent is one of the three essential elements of contracts. If the consent of one of the parties is defective or vitiated, the contract is voidable. Defect or vitiation of consent is caused by either internal or external factors. These factors are laid down in Arts. 1327 to 1344.

Consent, as an element of contracts, must be intelligent and free. If either attribute is impeded or impaired, then consent is said to be vitiated, and the contract voidable.

A. The factors that impair intelligence are:

1. minority (Art. 1327, par. 1)

The age of emancipation, previously 21 under both the Civil Code and the Family Code, has been reduced by RA 6089 to 18.

Philippine law does not *ex professo* make any distinction among minors, as far as contracts entered into by them are concerned. No gradations of incapacity are recognized. On purely codal (statutory) criteria, consent of a minor of seventeen is just as defective as that of a minor of ten.

Some Philippine commentators have criticized this lack of gradation, proposing that a distinction should be drawn between a minor of tender age (an infant) and one who possesses some degree of discretion. The distinction drawn in Sections 104 to 106 of the German Code is proposed as the criterion: absolute incompetency [*Geschäftsunfähigkeit*] and relative or limited incompetency [*Beschränkte Geschäftsfähigkeit*]. In the second, there is a measure of consent, though imperfect; in the first, there is none.

In two cases, the Philippine Supreme Court did make a distinction between **absence** of consent and **defect** of consent. These cases—*Heirs of Sevilla v. Sevilla*, 402 SCRA 501 [2003] and *Gochan v. Heirs of Baba*, 409 SCRA 306 [2003]—ruled that where there is no consent whatsoever, there is no contract. However, the pronouncement was applied (erroneously, in this writer's opinion) to contracts entered into on behalf of a person by another who had absolutely no authority from the former. [Such a contract is clearly **unenforceable**, not **void**, under Philippine law]. Nevertheless, there exists the possibility that this distinction may be applied in some future case to contracts by and with minors.

2. insanity, deaf-mutism coupled with illiteracy, intoxication, and hypnotic spell (Arts. 1327, par. 2 and 1328)

3. mistake (Arts. 1331 and 1334)

To vitiate consent, the mistake or error must relate to:

a) the substance of the thing;
b) the principal conditions of the contract;

c) the identity or qualifications of one of the parties when such constituted the principal cause of the contract; or

d) the legal effect of the agreement, if the error is mutual and results in the frustration of the parties' purpose.

The mistake must be caused by facts of which the party demanding annulment did not know. As held in **Alcasid v. CA** (237 SCRA 419 [1994]):

> "To invalidate consent, the error must be real and not one that could have been avoided by the party alleging it. The error must arise from facts unknown to him. He cannot allege an error which refers to a fact known to him or which he should have known by ordinary diligent examination of the facts. An error so patent and obvious that nobody could have made it, or one which could have been avoided by ordinary prudence, cannot be invoked by the one who made it in order to annul his contract.

4. fraud (Art. 1338)

Fraud, as a vitiating factor of consent, is equivalent to and synonymous with deceit, and is not to be confused with fraud under Art. 1170, which consists in "the deliberate and intentional evasion of the normal fulfillment of an obligation" (**Legaspi Oil v. CA**, 224 SCRA 213 [1993]). That other fraud is synonymous with malice or bad faith. More, fraud as deceit is antecedent to or at least simultaneous with the birth of the contract and for that reason vitiates consent, which must exist when the contract is entered into. On the other hand, fraud as malice occurs subsequent to the constitution of the obligation and results, not in the annulment of the obligation, but in liability for damages (Art. 1170).

Fraud as deceit, in order to vitiate consent, must be serious (Art. 1344, par. 1), or as commentators call it, *dolo causante*, to be distinguished from *dolo incidente*, incidental fraud. *Dolo causante* vitiates consent; *dolo incidente* only gives rise to a liability for damages. (Art. 1344, par. 2).

In **Samson v. CA** (238 SCRA 397 [1994]), the Court explained:

> "In contracts, the kind of fraud that will vitiate consent is one where, through insidious words or machinations of one of the contracting parties, the other is induced to enter into a contract which, without them, he would not have agreed to. This is known as *dolo causante* or causal fraud which is basically a deception employed by one party prior to or simultaneous to the contract in order to secure the consent of the other."

Dolo causante has the following requisites:

1. it must be serious (Art. 1344);
2. it must have been employed by one party upon the other (Arts. 1342 and 1344);
3. it must have had the effect of inducing one of the parties to enter into the contract (Art. 1338); and
4. it must have resulted in damage or injury. (**Alcasid v. CA**, 237 SCRA 419 [1994])

B. The factors that impair freedom of consent are violence, intimidation, and undue influence (collectively called duress).

1. violence (Art. 1335, par. 1)

The elements of violence as a vitiating factor are:

a) it must be irresistible or serious; and
b) it must be causal, i.e. it must be the operative cause of the giving of consent.

2. intimidation (Art. 1335, par. 2)

The elements of intimidation are enumerated in **De Leon v. CA** (186 SCRA 345 [1990]):

> "In order that intimidation may vitiate consent and render the contract invalid, the following requisites must concur: (1) that the intimidation must be the determining cause of the contract, or must have caused the consent to be given; (2) that the threatened act be unjust or unlawful;[2] (3) that the threat be real and serious, there being an evident disproportion between the evil and the resistance which all men can offer, leading to the choice of the contract as the lesser evil; and (4) that it produces a reasonable and well-grounded fear from the fact that the person from whom it comes has the necessary means or ability to inflict the threatened injury."

3. Undue influence (Art. 1337)

According to **Alcasid v. CA** (237 SCRA 419 [1994]):

[2] A threat to carry out a lawful act, such as a prosecution for *estafa* (swindling) does not constitute the kind of intimidation that would vitiate consent (**Spouses Binua v. Ong**, 727 SCRA 59 [2014]). It may be observed, however, that the threat to carry out a lawful act may constitute intimidation if such threat amounts to an abuse of right, as when the threatened act has no relation to the contract sought to be executed.

"Undue influence, therefore, is any means employed upon a party which, under the circumstances, he could not well resist and which controlled his volition and induced him to give his consent to the contract, which otherwise he would not have entered into. It must in some measure destroy the free agency of a party and interfere with the exercise of that independent discretion which is necessary for determining the advantages or disadvantages of a proposed contract."

C. Characteristics of Voidable Contracts

A **voidable** contract is, as the term implies, susceptible to annulment; it is not *ipso facto* inoperative.

Some points to bear in mind regarding these contracts are:

1. they are binding unless and until set aside; (Art. 1390);
2. they may be assailed only by a proper action in court; (Art. 1390), brought within the specified prescriptive periods; (Arts. 1391);
3. they are capable of confirmation; (Arts. 1392-1396);

Confirmation (or, as somewhat inaccurately called by the Civil Code, ratification) can be done either expressly or tacitly, but, in either case, only by the party whose consent was vitiated, and only after he has acquired capacity or after the cessation of the vitiating cause.

4. the action for annulment can be maintained only by or on behalf of the incapacitated party, never by the other party; (Art. 1397); and
5. similarly to cases of rescission under Art. 1385, and resolution under Art. 1191, the general rule in annulment of voidable contracts is mutual restitution, i.e. the parties should be returned to their original situation.

III. **Unenforceable Contracts**

Third in the classification of defective contracts are the unenforceable, which are just a notch higher than the void. As such, they cannot be given effect, cannot be the basis of an action for specific performance. Their defect, however, is not irremediable; it can be cured in a process called ratification or acknowledgment.

A. The first of the unenforceable contracts is that referred to in Art. 1403, par. 1:

"(1) Those entered into in the name of another person by one who has been given no authority or legal representation, or who has acted beyond his powers."

To the same effect are the provisions of Art. 1317.

"**Art. 1317.** No one may contract in the name of another without being authorized by the latter, or unless he has by law a right to represent him."

"A contract entered into in the name of another by one who has no authority or legal representation, or who has acted beyond his powers, shall be unenforceable, unless it is ratified, expressly or impliedly, by the person on whose behalf it has been executed, before it is revoked by the other contracting party."

Thus also provides Art. 1910, par. 2.

"As for any obligation wherein the agent has exceeded his power, the principal is not bound except when he ratifies it expressly or tacitly."

The contract is unenforceable whether the authority is only exceeded or absolutely absent. The two cases mentioned *supra* (**Heirs of Sevilla** and **Gochan**) in which it was held that the contract is void if authority is totally wanting have no basis in statutory provision.

B. The second kind (although third in the enumeration of the Article) of unenforceable contracts is found in Art. 1403, par. 3:

"Those where both parties are incapable of giving consent to a contract."

The confirmation by one of the incapacitated parties does not convalidate the contract; it merely raises the contract one rung higher—to the level of a voidable contract.

C. The third—and best-known—kind of the unenforceable contracts includes those enumerated by Art. 1403, par. 2—the provision that is commonly known as the Statute of Frauds.

Rationale of Statute of Frauds

The rationale of the requirement in the Statute of Frauds that the contracts therein enumerated must be in writing is that the frailty of human memory, or, more frequently perhaps, the mischief of fraud, can impede the honest and accurate enforcement of a contract entered into merely orally. The Statute of Frauds is a cautious qualification to the general rule that contracts, no matter in what form they are entered into, are valid and enforceable. (Vide Arts. 1315 and 1356).

Thus **Art. 1403, par. 2** provides:

"**Art. 1403.** The following contracts are unenforceable, unless they are ratified:"

x x x x x x x x x

"(2) Those that do not comply with the Statute of Frauds as set forth in this number. In the following cases an agreement hereafter made shall be unenforceable by action, unless the same, or some note or memorandum thereof, be in writing, and subscribed by the party charged, or by his agent; evidence, therefore, of the agreement cannot be received without the writing, or a secondary evidence of its contents:

(a) An agreement that by its terms is not to be performed within a year from the making thereof;

(b) A special promise to answer for the debt, default, or miscarriage of another;

(c) An agreement made in consideration of marriage, other than a mutual promise to marry;

(d) An agreement for the sale of goods, chattels or things in action, at a price not less than five hundred pesos, unless the buyer accept and receive part of such goods and chattels, or the evidences, or some of them, of such things in action, or pay at the time some part of the purchase money; but when a sale is made by auction and entry is made by the auctioneer in his sales book, at the time of the sale, of the amount and kind of property sold, terms of sale, price, names of the purchasers and person on whose account the sale is made, it is a sufficient memorandum;

(e) An agreement for the leasing for a longer period than one year, or for the sale of real property or of an interest therein;

(f) A representation as to the credit of a third person."

Purpose of Statute of Frauds

Since the purpose of the Statute of Frauds is, quite obviously, to prevent, and not to promote fraud (**PNB v. Philippine Vegetable Oil Co.**, 49 Phil. 857 [1927]; **Shoemaker v. La Tondeña**, 68 Phil. 24 [1939]; **Carbonel v. Poncio**, 103 Phil. 655 [1958], **Mactan Cebu International Airport Authority v. CA**, 263 SCRA 736 [1996]), the application of the Statute has been limited to contracts which are wholly unperformed on both sides, i.e. to executory contracts, not to those executed in whole or in part on either side. Otherwise stated, if there has been so much as partial execution on either side, the contract is taken out of the scope of the Statute of Frauds and oral evidence is admissible to prove it. (Vide **Sps. Camara v. Sps. Malabao**, 455 Phil. 385 [2003]). The reason for this rule is clearly explained in an extended discussion in **Carbonel v. Poncio** (103 Phil. 655 [1958]), which deserves to be quoted at length:

> "x x x. It is well settled in this jurisdiction that the Statute of Frauds is applicable only to executory contracts (Facturan vs. Sabanal, 81 Phil., 512), not to contracts that are totally or *partially* performed (Almirol, et al., vs. Monserrat, 48 Phil., 67, 70; Robles vs. Lizarraga Hermanos, 50 Phil., 387; Diana vs. Macalibo, 74 Phil., 70)."
>
> > "'Subject to a rule to the contrary followed in a few jurisdictions, it is the accepted view that part performance of a parol contract for the sale of real estate has the effect, subject to certain conditions concerning the nature and extent of the acts constituting performance and the right to equitable relief generally, of taking such contract from the operation of the statute of frauds, so that chancery may decree its specific performance or grant other equitable relief. It is well settled in Great Britain and in this country, with the exception of a few states, that a sufficient part performance by the purchaser under a parol contract for the sale of real estate removes the contract from the operation of the statute of frauds. (49 Am. Jur., 722-723.)'"
>
> "In the words of former Chief Justice Morán: 'The reason is simple. In executory contracts there is a wide field for fraud because unless they be in writing there is no palpable evidence of the intention of the contracting parties. The statute has precisely been enacted to prevent fraud.' (Comments on the Rules of Court, by Morán, Vol. III [1957 ed.], p. 178.) However, if a contract has been totally or partially performed, *the exclusion of parol evidence would promote fraud or bad faith*, for it would enable the defendant to keep the

benefits already derived by him from the transaction in litigation, and, at the same time, evade the obligations, responsibilities or liabilities assumed or contracted by him thereby."

"For obvious reasons, it is not enough for a party to *allege* partial performance in order to *hold* that there has been such performance and to *render a decision* declaring that the Statute of Frauds is inapplicable. But neither is such party required to establish such partial performance by *documentary* proof *before* he could have the *opportunity* to introduce *oral* testimony on the transaction. Indeed, such oral testimony would usually be unnecessary if there were documents proving partial performance. Thus, the rejection of any and all testimonial evidence on partial performance, would nullify the rule that the Statute of Frauds is inapplicable to contracts which have been partly executed, and *lead to the very evils that the statute seeks to prevent*."

> "'The true basis of the doctrine of part performance according to the overwhelming weight of authority, is that it would be a fraud upon the plaintiff if the defendant were permitted to escape performance of his part of the oral agreement after he has permitted the plaintiff to perform in reliance upon the agreement. The oral contract is enforced in harmony with the principle that courts of equity will not allow the statute of frauds to be used as an instrument of fraud. In other words, *the doctrine of part performance was established for the same purpose for which the statute of frauds itself was enacted, namely, for the prevention of fraud*, and arose from the necessity of preventing the statute from becoming an agent of fraud for it could not have been the intention of the statute to enable any party to commit a fraud with impunity. (49 Am. Jur., 725-726; italics supplied.)'"

"When the party concerned has pleaded partial performance, such party is entitled to a reasonable chance to establish by parol evidence the truth of this allegation, as well as the contract itself. 'The recognition of the exceptional effect of part performance in taking an oral contract out of the statute of frauds involves the principle that oral evidence is admissible in such cases to prove both the contract and the part performance of the contract.' (49 Am. Jur., 927.)"

Contracts Falling Under the Statute of Frauds

Now, then, let us look at the contracts falling under the Statute of Frauds:

1. **Art. 1403** -

"(2) x x x x x x x x x

(a) An agreement that by its terms is not to be performed within a year from the making thereof;"

This paragraph has, in various cases, been interpreted to refer to contracts which, by their terms, cannot be fully performed within a year (Vide **Babao v. Perez**, 102 Phil. 756 [1957]; **PNB v. Philippine Vegetable Oil Co.**, 79 Phil. 857 [1927]; **Shoemaker v. La Tondeña**, 68 Phil. 24 [1939]). There are those, however, who doubt the correctness of this interpretation. They propose instead that the provision should be understood as referring to contracts whose performance cannot be commenced within one year. If interpreted thus, an inconsistency between this provision and the rule on partial performance will be avoided.

2. **Art. 1403(2)(b)** -

"(2) x x x x x x x x x

(b) A special promise to answer for the debt, default or miscarriage of another;"

This contract is a guaranty. (Vide **Art. 2047**). Thus, all guaranties, whether simple or solidary, must be in writing to be enforceable.

3. **Art. 1403(2)(c)** -

"(2) x x x x x x x x x

(c) An agreement made in consideration of marriage, other than a mutual promise to marry."

The law has very wisely, and very compassionately, excluded from the rule of writing a mutual promise to marry, because the universal experience of mankind attests that mutual promises to marry are made in circumstances where neither the promissor nor the promissee is in a position, or a mood, to write. Of course, we are all aware that a mutual promise to marry—whether oral or in writing—is not enforceable by specific performance, since that would be involuntary servitude in its cruellest form. Damages, however, may, in certain cases, be recoverable.

Nevertheless, agreements in consideration of marriage, other than a mutual promise to marry, may give rise to a cause of action, but to be enforceable, such must be in writing. (**Cabague v. Auxilio**, 92 Phil. 294 [1952])

4. **Art. 1403(2)(d)** -

> "(2) x x x x x x x x x
>
> (d) An agreement for the sale of goods, chattels or things in action, at a price not less than five hundred pesos, unless the buyer accept and receive part of such goods and chattels, or the evidences, or some of them, of such things in action, or pay at the time some part of the purchase money; but when a sale is made by auction and entry is made by the auctioneer in his sales book, at the time of the sale, of the amount and kind of property sold, terms of sale, price, names of the purchasers and person on whose account the sale is made, it is a sufficient memorandum;"

The minimum amount of five hundred pesos for the requirement of writing in sales of personalty is probably too small at present. In 1949, when the Code was drafted, that amount could probably purchase a good Rolex watch. Now, what can it buy—a keychain?

5. **Art. 1403(2)(e)** -

> "(2) x x x x x x x x x
>
> (e) An agreement for the leasing for a longer period than one year, or for the sale of real property or of an interest therein;"

The amount involved in the sale of the realty is immaterial for the transaction to fall under the Statute of Frauds.

The writing that is required for the sale of the real property, so that the requirement of the Statute of Frauds is fulfilled, is, ordinarily, the written contract of sale itself. But the sense of the statute is broad enough to include some note or memorandum of the agreement. Thus, in **City of Cebu v. Heirs of Rubi** (306 SCRA 408[1999]), the requirement of writing was deemed met by the fact that, although no deed of sale was ever formalized, there was an exchange of correspondence between the parties in which the object and the price had been agreed upon.

Not all agreements affecting realty fall under the Statute of Frauds. The statute refers only to "sales of real property or of an interest therein." Thus, in **Hernandez v. CA** (160 SCRA 821 [1988]), the Court held:

> "x x x. Under the Statute of Frauds, Article 1403(2)(e) of the Civil Code, such formality is only required of contracts involving leases for longer than one year, or for the sale of real property or of an interest therein. Hernandez's testimony is thus admissible to establish his agreement with Fr. Garcia as to the boundary of their estates."

Similarly, the Statute of Frauds was held inapplicable to an agreement of partition among co-owners of parcels of land (**Espina v. Abaya**, 196 SCRA 312 [1991]) or to one creating an easement of right of way (**Western Mindanao Lumber v. Medalle**, 79 SCRA 703 [1977]). More recently, it has been held that a right of first refusal relating to the purchase of a house-and-lot need not be written to be enforceable (**Rosencor v. Inquing**, 354 SCRA 119 [2001]).

6. **Art. 1403(2)(f)** –

> "(2) x x x x x x x x x
> (f) A representation as to the credit of a third person."

This paragraph is misplaced here—the act referred to is not a contract. The representation, if made the basis of liability, is quasi-delictual in nature.

Instead of par. (f), Art. 1443 should have been included in the enumeration:

> "**Art. 1443.** No express trusts concerning an immovable or any interest therein may be proved by parol evidence."

IV. Void Contracts

Fourth in the enumeration of defective contracts are the void or inexistent contracts, the most seriously defective of all:

> "**Art. 1409.** The following contracts are inexistent and void from the beginning:
>
> (1) Those whose cause, object or purpose is a contrary to law, morals, good customs, public order or public policy;

(2) Those which are absolutely simulated or fictitious;

(3) Those whose cause or object did not exist at the time of the transaction;

(4) Those whose object is outside the commerce of men;

(5) Those which contemplate an impossible service;

(6) Those where the intention of the parties relative to the principal object of the contract cannot be ascertained;

(7) Those expressly prohibited or declared void by law.

These contracts cannot be ratified. Neither can the right to set up the defense of illegality be waived."

A. Characteristics of Void Contracts

The following rules regarding void contracts may be mentioned:

1. They produce no effect whatsoever either against or in favor of anyone (*Quod nullum est nullum producit effectum*).

2. No action for annulment is necessary. Their nullity exists *eo ipso* and therefore any judgment of nullity is merely declaratory.

3. They can neither be confirmed nor ratified. (Art. 1409)

4. If performance is made, restoration of what has been delivered is required, except when the *pari delicto* rule is applicable.

5. The right to set up the defense of nullity cannot be waived. (Art. 1409)

6. The action or defense of nullity does not prescribe. (Art. 1410)

7. The defense of nullity may be invoked by anyone against whom the effects of the contract are asserted. (Art. 1421; **Tongoy v. CA**, 123 SCRA 99 [1983])

B. The *Pari Delicto* Rule

A word on the *pari delicto* rule. The old maxim says: *In pari delicto non oritur actio*, or *Ex dolo malo, non oritur actio*, or *In pari delicto potior est condicio defendentis.* Basically the *pari delicto* rule mandates that in a void contract, if both parties are at fault, neither can maintain an action for performance nor recover what he has delivered. The law, in short, will leave the parties exactly where they are.

The rationale of the *pari delicto* rule has been expressed as follows

"The principle of *pari delicto* is grounded on two premises — first that courts should not lend their good offices to mediating disputes among wrongdoers; second, that denying relief to an admitted wrongdoer is an

effective means of deterring illegality. This principle of ancient vintage is not a principle of justice but one of policy as articulated in 1775 by Lord Mansfield…" (**Acabal v. Acabal**, 454 SCRA 555 [2005]).

Thus provide Arts. 1411, par. 1 and the first two paragraphs of 1412:

"**Art. 1411.** When the nullity proceeds from the illegality of the cause or object of the contract, and the act constitutes a criminal offense, both parties being in *pari delicto*, they shall have no action against each other, and both shall be prosecuted. Moreover, the provisions of the Penal Code relative to the disposal of effects or instruments of a crime shall be applicable to the things or the price of the contract."

"**Art 1412.** If the act in which the unlawful or forbidden cause consists does not constitute a criminal offense, the following rules shall be observed:

(1) When the fault is on the part of both contracting parties, neither may recover what he has given by virtue of the contract, or demand the performance of the other's undertaking;"

In **Yu Bun Guan v. Ong** (367 SCRA 559 [2001]), the Supreme Court reiterated the settled doctrine that the *pari delicto* rule applies to cases where the nullity of the contract arises from the illegality of the object or cause (Vide **Modina v. CA**, 317 SCRA 696 [1999]; **Castro v. Escutin**, 90 SCRA 349 [1979]). The statement in these cases that the *pari delicto* rule does not apply to void or inexistent contracts is, to put it kindly, less than accurate. There are some void contracts to which it applies and others to which it does not. The correct formulation of the rule is contained in **Vasquez v. Porta** (98 Phil. 490 [1956]):

"…the maxim applies only in case of existing contracts with illegal consideration, and is not applicable to simulated or fictitious contracts nor to those that are inexistent for lack of an essential requisite."

Importance of classification

Thus are defective contracts classified in our Code. We should be reminded that the categories are well-defined and mutually exclusive. It is necessary to bear this in mind because the nature, effects, and consequences of these defective contracts are essentially different and distinct. For example, a contract cannot be both voidable and void, since a voidable contract can be cured of its defect while a void contract is irremediable. Jurisprudence has often, but not always, been helpful. Some cases can be somewhat perplexing. The case of **Comelec v.**

Padilla (the Photokina case) (398 SCRA 353 [2002]) is well-known. The issue there was clearly stated by the Court: "May a successful bidder compel a government agency (i.e., the Commission on Elections [COMELEC]) to formalize a contract with it notwithstanding that its bid exceeds the amount appropriated by Congress for the project?"

Photokina's winning bid far exceeded the amount of funds appropriated for the purpose. COMELEC had issued a Resolution approving the Notice of Award to Photokina, which in turn accepted the same. As things turned out, the transaction did not carry through, owing to objections raised by the Chairman of the COMELEC. In refusing to grant Photokina's petition, the Decision variously characterizes the contract as "void" (p. 18, Decision), and as "unenforceable" (Ibid.). At the same time, the Decision in effect states that there was as yet no perfected contract ("We cannot accede to PHOTOKINA's contention that there is already a perfected contract." [p. 20, Decision]). Then the Decision reiterates that the contract is "inexistent and void *ab initio*." (p. 25, Decision). Then it goes back to the concept of unenforceable contracts ("otherwise stated, the proposed contract is unenforceable as to the Government." [p. 26, Decision]). To round things out, the Decision closes with the statement: "In fine, we rule that…the proposed contract is not binding upon the COMELEC and is considered void." (p. 26, Decision).

Conclusion

The foregoing paper, almost purely expository in nature, is meant to give a basic presentation of an aspect of Philippine contract law.

It may also provide a little window on how the private law of the Philippines has acquired the blended character that it possesses: predominantly civil (Roman) law, but marked by features of the common (Anglo-American) law tradition.

INEFFICACY OF CONTRACTS: DIFFERENT CATEGORIES

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Abstract: The rules in the Spanish Civil Code have had an obvious influence in the regulation of the inefficacy of contracts in the Civil Code of The Philippines. The regulation of nullity, voidability and rescission of contracts is strikingly similar as we can see in this study. However, the Civil Code of The Philippines has organized the categories of inefficacy in a more reasonable and structured manner. Furthermore, the Civil Code of The Philippines regulates a particular category of inefficacy that does not exist, as such, in the Spanish Civil Code; the unenforceable contracts.

Key words: Inefficacy of contracts. Categories. Nullity. Voidability. Rescission. Unenforceable contracts.

1. **Introduction**

This paper has been prepared for the international Congress held at the University of Málaga on April 16 and 17, 2015 regarding the Private Law of The Philippines and Spain. My intervention in the Congress related to the ineffectiveness of contracts and the different categories of inefficacy of contracts. My first intention was to give a comparative legal view about the different categories of inefficacy in The Philippines and Spain. But then the writer was stricken by the similarities between the provisions in articles 1.290 and following of the Spanish Civil Code (hereinafter also "SCC") and articles 1.380 and following of the Civil Code of The Philippines (hereinafter also "PCC"). Only the existence of the "unenforceable contracts" in the Civil Code of The Philippines seemed to make a difference between the two Codes. Therefore, it looked more interesting to explain the Spanish rules about inefficacy of contracts and point out those matters where differences can be found it the two regulations, and then analyze the category of "unenforceable contracts" in the Civil Code of The Philippines from a Spanish Civil Law perspective.

We shall see during this study that the Civil Code of The Philippines has learned from some of the mistakes made in the Spanish regulation and adapted its rules to avoid such mistakes. The most relevant proof of it is probably the use in the Civil Code of The Philippines of a correct terminology that clearly differentiates between "void" (arts. 1.409 to 1.422 PCC) and "voidable" (arts. 1.390 to 1.402 PCC) contracts, whereas the Spanish Civil Code refers to "the nullity of contracts" in articles 1.300 to 1.314 SCC. But that Chapter[1] mixes rules relating to the nullity of contracts with others relating to their voidability. However, most of the provisions in that Chapter regulate the category referred to as voidability, because such contracts can be invalidated but, in principle, they produce effects. For example, article 1.300 SCC provides that "contracts fulfilling the requirements specified in article 1.261 *might be annulled*[2], even if there is no injury for the contracting parties, whenever the contract has any of the vices which invalidate

[1] Chapter VI, Title II, Book IV.

[2] The fact that "they might" be annulled and are not null from the start implies that the article is thinking of voidability and not of nullity.

them according to the law", and article 1.301 SCC that "The action for the *nullity* of a contract must be brought within four years[3]". It has been for the Spanish scholars and courts to determine to what kind of ineffectiveness was each article in the Code referring to[4]. We shall use this terminology (nullity/voidability) in this study as it is nowadays generally accepted.

2. **Ineffectiveness of contracts under Spanish Law**

A contract is ineffective when it does not produce the effects wished for and which can be reasonably expected from that contract. This lack of effects results from the fact that there is a divergence between the contract as foreseen by the legal system and the contract which has been executed by the parties. The contract was not executed in accordance with the provisions of the legal system and therefore it does not produce effects, although depending on the type of inefficacy the contract might start to produce effects and stop having them afterwards.

There are three main[5] categories of ineffectiveness regulated in the Civil Code:

(i) Nullity: null contracts have such a far-reaching defect that it impedes that the contract produces any effect whatsoever. Nullity is the strictest sanction to a contract as the legal act is completely deprived of legal consequences. *Quod nullum est nullum effectum producit*.

(ii) Voidability: voidable contracts have a defect, but they are valid as long as they are not challenged due to the existence of such defect. In a voidable contract there is a cause of voidability that can be claimed by only one of the parties to destroy the effects of the contract which was effective up to that moment.

(iii) Rescission: rescission is the ineffectiveness stated by law for contracts which, although having all the essential elements and not having any defects therein, entail a prejudice for certain persons to whom the law provide with an action to stop the contract from being effective.

We have to point out that there are some scholars who split ineffective contracts in two groups: "invalid" contracts and "ineffective" contracts *strictu sensu*. Invalid would be those contracts which defects are of an intrinsic nature, affecting the essential elements thereof.

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[3] The existence of a term to bring the claim to court means that the provision is again referring to voidability and not to nullity, because there is no term established to bring to court an action to declare the nullity of a contract.

[4] However, articles 1.305 and 1.306 SCC refer to the nullity of contracts (see 1.411 and 1.412 PCC), whereas articles 1.303 (because even if the contract is null the parties have performed acts based on it), 1.307 and 1.308 SCC can be applied to both kinds of inefficacy.

[5] We consider in this study the main conceptual categories of inefficacy. However there are other categories and we see different kinds of inefficacy being applied to different cases. For example, very recently the Spanish Supreme Court has stated that when the legal system does not establish the kind of inefficacy of an act, the content and extent of such inefficacy has to be adapted to the nature and function of the act (STS October 28, 2014), adopting a very "flexible and dynamic" approach on this matter. The case in particular related to the efficacy of the acts performed by the person exercising parental authority without the necessary judicial authorisation required in art.166 SCC. The Supreme Court decided that the inefficacy of these acts did not adjust to any of the main categories, but constituted a "functional" or "relative" inefficacy, typical of incomplete contracts or of those of a progressive execution that generate a "provisional" efficacy.

Ineffective contracts *strictu sensu* are those contracts that have defects extrinsic to the contract which may lead to its lack of effects; such as an agreement between the parties to render it ineffective (*mutual dissent*); the termination of the contract for non-performance; a condition precedent not taking place, etc. Other scholars do not admit this distinction due to terminology reasons and because in the case of what these scholars refer to as ineffectiveness *strictu sensu* there is not properly such inefficacy but the extinction of a contractual relation.

2.1. Nullity

A null (or null and void) contract does not produce any legal effects, it is a contract without legal efficacy (*absolute nullity*). A null contract is so from the moment of execution (*ab initio)*. A null contract cannot be enforced. Therefore, it can never become effective through confirmation or due to the lapse of time[6]. Nullity is definitive.

The cases of nullity of contracts are[7]:

(i) Contracts contrary to the law are null and void, unless such law provides for a sanction different than nullity (art. 6.3 and 1.258 SCC) SCC). This refers to imperative Laws and not to dispositive Laws, the fulfilment of which is not compulsory. In this regard, see art. 1.409 (1) PCC that refers to contracts "whose cause, object or purpose is contrary to law, morals, good customs, public order or public policy".

(ii) Contracts lacking the essential elements thereof. Contracts lacking consent, object or cause shall be null and void (art. 1.261 SCC; see art. 1.318 PCC). Art. 1.409 (3) PCC refers to those "whose cause or object did not exist at the time of the transaction".

Some scholars (CASTÁN) and some court decisions (ex. STS December 18, 1981 or March 8, 1994) influenced by the French doctrine refer to this case of nullity as "inexistence" of the contract in order to differentiate these contracts from those contrary to Law which they refer to as "null" contracts. Today the category of inexistence is studied within the category of null contracts[8]. We point this out because Chapter 9 (Title II) of the Civil Code of The Philippines refers to "Void and Inexistent Contracts" probably having in mind that French idea of the difference between contracts contrary to Law (art. 1.409 (1) PCC) and contracts lacking the essential elements (art. 1.409 (3) PCC). Notwithstanding that, the Civil Code of The Philippines indistinctively speaks of void contracts or inexistent contracts in general (see arts. 1.409 and 1.410 PCC).

[6] See art. 1.409 *in fine* PCC.

[7] As we shall see the cases of nullity established in the Civil Code of The Philippines are very similar. They have the advantage of being all in the same provision (art. 1.409) whereas Spanish scholars have had to look for them in different provisions of the Code. There are some cases expressly provided by the Civil Code of The Philippines that we do not find as such in the Spanish Codes but whose type of inefficacy is the same in practice. For instance, "those which are absolutely simulated or fictitious" in article 1.409 (2) PCC shall be considered in Spanish Law radically null for lack of cause (arts. 1.275 and 1.276 SCC). Or "those which contemplate an impossible service" in article 1.409 (5) PCC shall be null for lack of object in Spain (art. 1.261 SCC).

[8] Basically because the difference has no practical relevance since the consequences of inexistent contracts and null contracts are the same [LACRUZ].

(iii) Contracts which object is not determined or is unlawful (arts. 1.271, 1.272, 1.273 and 1.305 SCC). This refers to contracts which object is completely undetermined[9] or is out of commerce (*extra commercio*). See art. 1.409 (4) and (6) PCC that refer to contracts "whose object is outside of the commerce of men" and those "where the intention of the parties relative to the principal object of the contract cannot be ascertained". This latter case seems to be more related to the impossibility to interpret the contract (see, art. 1.289 *in fine* SCC), but in the end it is a problem of non-determination of the object. See also art. 1.409 (1) PCC again for contracts whose object is contrary to Law.

(iv) Contracts with an unlawful cause (arts. 1.275, 1.305 and 1.306 SCC). The cause of a contract is unlawful when the contracting parties have a purpose that is contrary to the Law or moral and therefore it does not deserve the protection of the legal system. See arts. 1.409 (1) and 1.352 PCC.

(v) Formal contracts lacking the required form for their perfection. That is, contracts that do not comply with the form *ad solemnitatem* required for them by Law. This case is not expressly provided in art. 1.409 PCC but in art. 1.356 PCC which provides that when the law requires a contract to be in some form in order to be valid such requirement is absolute and indispensable.

As we can see, the cases of nullity of contracts are the most extreme and serious. This is why the strictest sanction is chosen for them. Nullity is said to protect public interest.

Nullity operates *ipso iure*, which means that there is no need for a judicial declaration thereof or a legal action to be started for the contract to be null and void. Of course, when there are discrepancies between the parties as to the existence of such nullity or when one or both of the parties have undertaken a performance deriving from the null contract (in which case everything has to go back to the situation previous to the contract because such contract would be considered as never executed) they might have to take the case to Court, but the decision of the Judge will only have a declarative nature.

The action to claim for the nullity of a contract at Court can be started at any time[10], there is not term for it. And it can be done by whoever is interested in the declaration of nullity. Anybody with a rightful interest can invoke the nullity, and it can also be declared *ex officio* by the judge. This derives from its public interest nature. The Supreme Court has decided that even the person responsible for the nullity is entitled to bring the case for the declaration of the nullity to Court[11].

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[9] A certain degree of indetermination is admitted as long as it can be determined without the need of a new agreement between the parties. However, nowadays, the courts adopt a flexible view of this requirement and are ready to find an object in a contract when it is "implicitly" agreed on it. A good example we find in services contracts in which is quite common that the performance of the provider of the service is determined throughout the life of the contract depending on the different necessities that arise during its performance.

[10] It is expressly provided in art. 1.410 PCC: "the action or defence for the declaration of the inexistence of a contract does not prescribe".

[11] In principle, and taking into account that anybody with a legitimate interest can start the action asking for the nullity of the contract to be declared, also the person responsible for having caused the nullity shall be able to do so. This is the position that the Spanish Supreme Court historically followed, giving primacy to the possibility to denounce nullity before the principle that nobody can go against his own acts. However, a Supreme Court decision of June 6, 1983 decided otherwise stating that the party that created the nullity cannot claim for its declaration in court as that would go against his own acts and would oppose other legal principles like the

Finally, it has to be said that nullity can be partial. It might be that only a part of the contract is void. Our Civil code does not contain a specific rule about this possibility[12] (the Civil Code of The Philippines does in art. 1.420 PCC). Therefore, if the nullity of a stipulation should entail the nullity of the whole contract or only that of such null stipulation while the rest of the contract remains in force shall be decided in a case by case basis. In principle, the Courts will tend to establish a partial nullity in favour of the conservation of the legal act (for example nullity of the unfair clause (but not of the whole contract) in a mortgage loan contract fixing an extremely high yearly default interest).

2.2. Voidability

A voidable contract is in principle effective, but it can be rendered void if the cause of voidability is asserted[13]. This because voidable contracts have all the essential elements required in article 1.261 SCC (consent, object, cause) and are not contrary to law, but have a defect that might lead to their invalidity. Voidability is also referred to as *relative nullity*. More than public interest (like nullity) voidability protects private interests; generally the interest of one of the parties to the agreement. If the cause of voidability is maintained by the party who is entitled to do it, the contract shall become ineffective with the same extent as if it was null and void[14].

The similarities between the Spanish and the Philippine regulation of voidability are, as we shall see, even greater than with regard to nullity.

The causes of voidability stated by the Spanish Civil Code relate to vices in the formation of the consent or defects in the necessary capacity to conclude the contract. The causes of voidability are the following:

(i) Vices of consent (art. 1.261 SCC): mistake, violence, intimidation or fraud. See art. 1.390 (2) and 1.330 PCC.

(ii) Lack of capacity to act. The contract is voidable if the contracting party does not have the necessary capacity to do so[15]. See art. 1.390 (1) and 1.327 PCC.

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prohibition of abusive exercise of rights, good faith, the impossibility to live the validity of the contract to the will of one of the contracting parties, etc. However, the most recent decisions of the Spanish Supreme Court follow the previous line of thinking and understand that any of the contracting parties can ask for the declaration of the nullity of the contract, even the party who provoked it (see, STS March 3, 2009 and December 21, 2009).

[12] It is provided, however, in other legal texts. For example, in article 83 of the Spanish Rehashed Consumers Law (recently modified in 2014) for the case of unfair terms in consumers contracts. Article 83 provides that unfair terms shall be null and void and that the Judge shall declare their nullity, but the contract might still oblige the parties if it can subsist without those terms.

[13] Art. 1.390 *in fine* PCC provides that “These contracts are binding, unless they are annulled by a proper action in court”.

[14] This is the traditional idea in Spain and the one adopted in art. 1.390 PCC. However, some scholars [LACRUZ] maintain the opposite; that a voidable contract is not effective *ab initio* but can become effective through confirmation or by the lapse of the four years term.

[15] However, the lack of capacity shall give rise to nullity (instead of voidability) when the person does not have the natural capacity to understand. In such a case, consent does not exist, and therefore the contract is null and void.

(iii) Lack of marital consent for the execution of onerous[16] acts when such consent is required (art. 1.322 SCC). Such consent is necessary, for example, to sell the family's dwelling, no matter if it only belongs to one of the spouses (arts. 1.320, 1.322 and 1.377 SCC). This case of voidability is not mentioned in art. 1.390 PCC but can be inferred from arts. 115, 166 and 173[17] PCC.

Voidability does not take place *ipso iure*, it is necessary that the corresponding action is started for it to be established by the judicial authority. The action is necessary because, if it is not exercised within the proper term, the contract is purified, that is, is becomes definitively valid. However, it might be that the contracting parties consider the contract voidable and therefore that they abandon it, without going to court (although these cases are few in practice because the parties generally seek for the return of the things exchanged and not for the mere declaration of the voidability).

The action for the declaration of voidability can only be brought to Court by the person whose interest is being protected[18]. It cannot be done so by the party who caused the voidability (art. 1.302 SCC; see art. 1.397 PCC). Furthermore, the action has a term of expiration of four years[19], which cannot be interrupted or suspended[20]. Article 1.301 SCC determines the *dies a quo* to start the action depending on the case of voidability concerned. Once the term of four years has elapsed without the action for voidability having been brought to court, the contract shall be considered to be valid and can no longer be challenged.

According to article 1.301 SCC the four years term starts to run: (i) in the cases of intimidation or violence, from the day on which they have ceased; (ii) in the cases of mistake or fraud from the consummation of the contract; (iii) in the case of contracts celebrated by minors or incapacitated persons from the moment they are released of guardianship (although their legal representatives or the curator could have started the action during the period of minority or incapacity); and (iv) in the case of contracts entered into by one of the spouses without the necessary consent of the other, from the date of dissolution of the marriage, unless the other spouse had had sufficient earlier knowledge of such contract. The wording of art.1.391 PCC is very similar to that of art. 1.301 SCC[21] with the exception of the starting point of the action for

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[16] When the act is by gratuitous title and the necessary consent of one of the spouses is missing, the appropriate sanction is the nullity of the act (except for the "liberalities of use" which are those made for social reasons, such as tips or wedding presents) [art. 1.378 SCC]. In this regard, see arts. 114 and 174 PCC.

[17] With a ten year term.

[18] In case of vices of consent only the person who suffered the vice. In case of lack of capacity, the legal representative or the curator or the incapable person when he acquires or recovers capacity. In case of lack of marital consent when required, it is the spouse whose consent was omitted the one who can start the action.

[19] However, the exception does not prescribe. There is always the possibility to oppose the voidability of a contract against a claim asking for the performance thereof.

[20] This is the general opinion and the most in accordance with the wording of art. 1.301 SCC: the action "shall only last" for four years. However, the courts are not weighty in favour of this solution. Some modern scholars understand that the term should be able to be interrupted.

[21] With the exception we have already commented of the case of lack of marital consent when necessary.

mistake or fraud, which in the Spanish Code starts with the *consummation*[22] of the contract whereas in the Code of The Philippines starts with the *discovery* of the mistake or fraud. The solution in the Philippine Code follows the one existing in France and Italy[23]. The fact that the term to bring the action to court starts to run from the moment of discovery instead of from the moment of consummation of the contract is very important because it can certainly extend the period of time during which the action for voidability can be exercised. The solution in the Spanish Civil Code was adopted for reasons of legal certainty because it was understood that fixing the *dies a quo* in the moment of discovery could lead to arbitrary solutions because such moment is an interior fact of the person difficult to demonstrate (DÍEZ PICAZO). Although this is true, it can also be said that the solution adopted by the Spanish Code entails that the action for voidability can be extinguished before the party knows of the mistake, banning such action for the affected party who should opt for a different action (for example, termination for non-performance), if possible, or be left without the possibility to claim[24].

Once the term of four years has elapsed without the action having been brought to court, the contract shall become valid and can no longer be attacked for such cause.

On the other hand, voidable contracts can be confirmed. Confirmation is the declaration of will of the party who could ask for the voidability of the contract making valid and effective the act[25] of the law which was affected by a cause of voidability. Confirmation purifies the contract affected by a cause of voidability and it does so, with retroactive effects, from the moment of perfection of the contract (art. 1.313 SCC; see art. 1.396 PCC). Of course, for the confirmation to be valid it is necessary that the cause of voidability is known to the party who could raise it and that it has stopped.

Confirmation can be express or tacit. Tacit confirmation exists when the person who could claim for the voidability behaves in such manner which is incompatible with the exercise of the action asking for voidability (art. 1.311 SCC; see art. 1.393 PCC).

2.3. Consequences of the nullity and voidability

As we have said, when the cause of voidability of a contract is asserted and the contract is avoided, it shall have the same consequences as if the contract was null and void.

The common outcome of the ineffectiveness of contracts due to their nullity or to the

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[22] For consummation the Spanish courts understand the moment in which all of the obligations deriving from the contract have been performed. (ex. STS March 27, 1989 or May 5, 1983).

[23] Arts. 1.304 French Civil Code and 1.442 Italian Civil Code. The Project of 1851 also provided in Spain that the *dies a quo* was the moment of discovery. This solution was abandoned in the definitive text of 1889.

In the initiatives for the harmonization of private Law in Europe it is also the moment in which the party discovers (or should have discovered) the mistake the one taken into account. See, arts. 4:113 PECL and II-7:210 DCFR.

[24] A very good example of this is the sale of works of art. In these kinds of sales it is very common that the party discovers the mistake after more than four years from the consummation of the agreement when the buyer intends to sell the work again, to insure it, restore it or give it on loan to a museum for its exhibition. In this regard, see, BERGEL, Y., p. 213-223.

[25] This is expressly provided in article 1.392 PCC: “ratification extinguishes the action to annul a voidable contract”.

maintenance of the voidability thereof is that the contract does not produce effects (nullity) or shall not produce them the contract that initially had effects (voidability).

Once the nullity or voidability of a contract is declared, the parties shall have to give back whatever goods or rights they had exchanged. Article 1.303 SCC[26] provides that, once the contract has been declared ineffective «the parties shall return to each other the things which have been the subject matter of the contract with their fruits, and the price paid with interests, without prejudice to the provisions contained in the following articles[27]». In principle, the solution preferred by the Code is the restitution *in natura*, that is, the return of the things actually exchanged by the parties (art. 1.303 SCC). If such return is no longer possible because the goods have been destroyed in the meantime, the obligation to return the goods is turned into a monetary obligation. In this regard, article 1.307 SCC[28] provides that if a party cannot return the thing because it has been lost, that party «must return the fruits collected and the value of the thing when lost, with interests from the same date». The solution in art. 1.307 SCC refers to the loss of specific things, but can be extended to all cases in which restitution *in natura* is not possible.

Furthermore, the declaration of nullity and the voidability of a contract affect subsequent transactions based on the initial ineffective transaction[29]. For example, in the case of an ineffective contract of sale the object might be claimed from subsequent buyers. Nevertheless, successive holders are not affected by the ineffectiveness if they are protected in their acquisition (e.g. because they have acquired through prescription or are protected by art. 34 of the Mortgage Law). If the third party is protected, the obligation to return is turned into an obligation to give compensation.

The obligation to return in art. 1.303 SCC is compatible with the compensation for damages in case the contracting party acted with negligence or fraud (because he knew or should have known of the defect in the contract that could render it ineffective) in front of the other party acting in good faith.

2.4. Rescission

The Civil Code provides for a few cases in which a valid act can be made ineffective because it produces a prejudice that the Code considers to be unfair. The SCC regulates

[26] In the same manner see art. 1.398 PCC.

[27] One of the exceptions mentioned in article 1.303 SCC *in fine* arises in the case of lack of capacity of one of the contracting parties. In such case, article 1.304 SCC provides that minors and incapables are not obliged to give back the goods or rights exchanged except to the extent that they enriched themselves by the thing or sum received (in the same manner, see art. 1.399 PCC). This exception to the general regime of restitution that might lead to the incapable only having to return a part or even nothing of what he received, is established to protect his interests. To that end, enrichment exists not only in the case of increase in the patrimony of the incapable but also when what he received has been useful to him. The proof of the enrichment of the incapable corresponds to the person who contracted with him and is now claiming restitution.

Other special cases are provided for in articles 1.305 and 1.306 SCC that apply to nullity.

[28] In the same manner, see art. 1.400 PCC.

[29] See, art. 1.422 PCC.

rescission in arts. 1.291 to 1.299 the wording of which is practically the same as that in arts. 1.380 to 1.389 PCC[30].

The main cases of rescission of contracts are stated in article 1.291 SCC. The causes of rescission are *numerus clausus*; no other case of rescission shall exist apart from the cases foreseen by the law (e.g. article 1.074 SCC rescission of the partition of the inheritance). Furthermore, rescission is a subsidiary remedy; it can only be used if no other legal resort can be used to remedy the prejudice (art. 1.294 SCC; see art. 1.393 PCC).

The contracts that can be subject to rescission are:

(i) Contracts celebrated by tutors without judicial authorisation or contracts celebrated in representation of absentees whenever the person represented suffers lesion of more than one-fourth of the value of the things traded (arts. 1.291.1 and 1.291.2 SCC; see art. 1.381 (1) and (2) PCC).

In Spanish Law the only cases of rescission for lesion are those in arts. 1.291.1 and 1.291.2 SCC[31].

(ii) Contracts undertaken in fraud of creditors (arts. 1.291.3; see art. 1.381 (3) PCC).

Article 1.297 SCC[32] provides that contracts by which the debtor has transferred goods gratuitously or onerous transfers of goods made by persons against whom a condemnatory judgement has been rendered or against whom a writ for the seizure of assets has been issued, shall be presumed to be made in fraud of creditors. When the debtor has performed acts to harm his creditor's interests (generally taking out of his patrimony goods that could be used by the creditors to execute their credit), the creditor is provided with the *actio pauliana*. Such *actio* confers to the creditor the power to challenge acts that the debtor has undertaken to prejudice his right of credit when the patrimony of the debtor is insufficient to pay such credit, and such patrimony is insufficient because he has fraudulently emptied it not to have to pay his creditors. The creditors have the power to go to Court to undo such fraudulent acts. The effect of such *action pauliana* is to rescind the fraudulent contract in as much as it is required to pay the credit.

(iii) Contracts celebrated to trade goods that are subject to litigation without the knowledge and approval of the parties in the litigation or of the judicial authority (art. 1291.4 SCC; see art. 1.381 (4) PCC); and

(iv) Payments made by an insolvent debtor on account of obligations whose fulfilment the debtor could not be compelled at the time they were effected (art. 1.292 SCC; see art. 1.382 PCC).

The effect of rescission is that it compels the parties to the contract to return the things traded with their fruits and the price paid with interests. Rescission shall not take place when the thing which is the object of the contract is legally and in good faith in the possession of third parties. In this case the obligation to return turns into an obligation from the person who caused

[30] With the only exception of arts. 1.293 SCC and 1.384 PCC.

[31] There are cases in Cataluña (arts. 321 to 325 of the Compilation of Civil Law of Cataluña; lesion of more than half of the price) and Navarra (Law 499; *laesio enormis*).

[32] See art. 1.387 PCC.

the damage to pay a compensation for damages (art. 1.295 SCC; see art. 1.385 PCC).

The action to ask for the rescission of a contract has a term of four years (art. 1.299 SCC; see art. 1.389 PCC); term that cannot be interrupted. In the case of lesion suffered by persons under guardianship or absentees, the term starts to count from the moment of termination of the incapacity or of knowledge of the domicile of the absentee. In the rest of the cases it is not specified in the Code but the Spanish courts currently understand that it begins to count when the creditor knows of the fraudulent act[33].

3. **Unenforceable contracts**

The Civil Code of the Philippines contains one more category of ineffectiveness of contracts which is not established in the Spanish Civil Code. Articles 1.403 to 1.408 regulate "unenforceable contracts". These kinds of contracts are valid contracts but, due to a lack of authority to conclude them, a lack of the form required therein or lack of capacity of both parties, they cannot be enforced in Court. That is, the contract is valid but the parties cannot ask a Court to enforce them. However, unenforceable contracts can be ratified (art. 1.403 PCC) and from the moment of ratification shall therefore be enforceable.

Art. 1.403 PCC establishes three kinds of unenforceable contracts.

On the first hand those entered into in the name of another person by one who has been given no authority or legal representation, or who has acted beyond his powers. Under Spanish Law the solution for these cases is different. In Spain, contracts concluded by a person in the name of another but without power to do so, the so called *falsus procurator*, are not unenforceable. The consequences of these acts shall be that the contract does not bind the person in the name of whom they were concluded. However, the person contracting with the third party without the power to do so shall be liable to that third party for the damages that he might have suffered. Article 1.259 SCC provides that "Nobody can contract in the name of another without being authorised by him or without having his legal representation according to Law. A contract concluded in the name of another by one who has neither authorisation nor legal representation shall be null, unless it is ratified by the person in whose name it was executed before being revoked by the other contracting party". The wording of article 1.259 SCC is practically the same as the wording of article 1.317 PCC except for the consequences and for the fact that article 1.317 PCC expressly provides for the possibility of tacit or implied ratification, something not provided in art. 1.259 SCC but that has been accepted by the Spanish Supreme Court (ex. STS July 10, 2002 or June 25, 2004). The ratification is a declaration of the will (express) of the "principal", or acts of the principal that show such a will (tacit), by virtue of which he knows and accepts the consequences of the acts of a person who contracted in his name but without authority.

Under Spanish Law if the person in whose name but with no authority the contract was concluded does not ratify it, the contract has not efficacy whatsoever as far as he is concerned. No matter if article 1.259 SCC speaks of "nullity", such contract is not really null[34], because the "principal" can ratify it and make the contract affect him. If the ratification does not take place the person who contracted without power shall be bound to the third party with whom he

[33] STS January 31, 2006 and May 27, 2002.

[34] It is not voidable either, because voidable contracts are valid and produce effects, unless the cause of voidability is raised and a Court declares it. Spanish scholars prefer to say that these contracts are "incomplete" due to the missing will of the principal [LACRUZ, I-3, p. 302] or "irrelevant" or have a "relative inefficacy" [DÍEZ PICAZO, *Sistema*, I, p. 573].

contracted (unless this latter knew of the inexistence of power) and shall have to compensate him for damages (ex. Art. 1.725 SCC).

On the second hand, art. 1.473.2 PCC establishes a category which is completely unknown to Spanish Law. Those contracts that do not comply with the Statute of Frauds established in said article shall be unenforceable unless they have a written form[35] and are subscribed by the party charged or his agent. The different cases in that Statute of Frauds are:

a) An agreement that by its terms is not to be performed within a year from the making thereof;
b) A special promise to answer for the debt, default, or miscarriage of another;
c) An agreement made in consideration of marriage, other than a mutual promise to marry;
d) An agreement for the sale of goods, chattels or things in action, at a price of no less than five hundred pesos, unless the buyer accept and receive part of such goods and chattels, or the evidences, or some of them, of such things in action or pay at the time some part of the purchase money. When the sale is at auction, the detailed entry of the auctioneer in the sales book shall be a sufficient memorandum for these purposes.
e) An agreement for the leasing for a longer period than one year, or for the sale of real property or of an interest therein;
f) A representation as to the credit of a third person.

As we have said there is not a parallel provision in the Spanish Civil Code to this one. Our impression is that these provision might have been influenced by the rules of form in the French Civil Code[36] (art. 1.341 FCC and the exceptions in arts. 1.347 and 1.348 FCC) and also by article 1.280 SCC. Article 1.341 FCC requires written proof for legal acts exceeding of a certain amount. It is true that the French Code requires that form *ad probationem* and not as a need for the enforceability of the legal act, but the practical outcome is the same. If they cannot be proved, they cannot be enforced. In Spain article 1.280 SCC requires certain acts to be executed in a public deed (among them, even in private document, contracts of more than 1.500 pesetas, although this is not applied today). But the requirement of form in art.1.280 SCC is not a requirement for the validity of the contracts but for other purposes (for example, access to the Registry, efficacy against third parties, etc). It is normally said that in this case the form has the character of form *ad probationem*, but this does not mean that contracts cannot be proved otherwise (in Spanish law freedom of proof rules). This expression is used in the sense that the form facilitates the proof of the contract and is not necessary for its validity[37]. The

[35] This requirement shall be complied with by a signed written statement that contains the essential terms of the contract (ex. signed letter constituting an adequate memorandum in the Supreme Court decision, Manila, March 13, 1968).

[36] TERRÉ, F., SIMLER, P. LEQUETTE, pp.127-154 ; CABRILLAC, R., p. 85; SANTOS MORÓN, M.J., pp. 28-36.

[37] Article 1.280 reads: «The following must be incorporated into a public instrument:

»1. Acts and contracts having as purpose the creation, transfer, amendment or extinction of real rights on real property. (See art. 1.358(1) PCC)

»2. Leases of real property for a term of six or more years, provided that they have to be effective against third parties.

»3. Marital agreements and amendments thereto.

»4. Assignments, repudiations and renunciations of inheritance rights or those arising from the marital property. (See art. 1.358(2) PCC)

»5. Powers of attorney to contract marriage; general powers of attorney to litigate and special powers which have to be produced in a legal action; the power of attorney to administer assets; and any other power of attorney having as purpose an act in a public deed or which has

consequence of not following the form required in article 1.280 SCC is not the inefficacy of the contract but the possibility for any of the parties to ask for that form to be adopted (art. 1.279 CC)[38].

There is however a rule in Spanish Law requiring marital agreements to be concluded in a public deed, but in this case it is a form required for validity and not for enforceability (art. 1.327 SCC). Notwithstanding that, no requirements of form are set in Spanish Law for suretyship contracts, lease contracts or sale of real property (safe for the necessary form to have access to the Property Registry, but not for validity or enforceability). Also, there are no formalities established in Spain depending on the moment of performance of a contract; the fact that performance of the contract is going to be delayed does not affect its validity or its enforceability under Spanish Law.

Finally, the last kind of unenforceable contracts established in article 1.473.3 are those where both parties are incapable of giving consent to a contract. Under Spanish Law these contracts would probably be understood to have the same grounds of invalidity as those in which one of the parties lacks sufficient capacity and shall therefore be deemed to be voidable.

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to be raised to a public deed or which has to be opposed to third parties. (See art. 1.358(3) PCC)

»6. The assignment of actions or rights arising from an act documented in a public deed. (See art. 1.358(4) PCC)

»All other contracts in which the amount of the performances of one or both parties exceed the sum of Pesetas 1,500 must also be in writing, even though it is only in a private document. (See art. 1.358 *in fine* PCC)»

[38] This, of course, unless it is a contract for which another rule requires the incorporation to a public document and if the requirement is not complied with nullity shall follow (e.g. donation, matrimonial agreements).

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INDIGENOUS PEOPLES AND THEIR RIGHT TO ANCESTRAL DOMAIN

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Abstract

The Indigenous Peoples' Rights Act of the Philippines is a piece of legislation which has been passed to correct historical injustice experienced by indigenous people since colonial times. It immediately became the subject of a constitutional challenge on account of the progressive legal concept of property rights of indigenous peoples. The need to reconcile, for instance, the concept of ancestral domain with the ownership by the state of natural resources underneath the domain remains a continuing challenge to decision-makers. But in the larger context of empowering indigenous peoples, the law has become an important instrument for advocacy to advance their rights in various fields of endeavor today. Given proper support and opportunity to decide in accordance with their traditional decision-making process, indigenous peoples will be able to track for themselves a culturally sensitive development strategy.

Keywords:

Philippines, Indigenous Peoples' Rights Act, Ancestral Domain, Indigenous Peoples' Right to Self-determination, Native Title, Customary Law, Spanish Colonial History in the Philippines

I. Introduction

In 1997, the Philippine Congress passed the Indigenous Peoples' Rights Act (R.A. 8371 or IPRA) which was perceived by the indigenous communities as a remedial legislation to correct a historical injustice. Conceptually, IPRA became immediately controversial on account of its apparent inconsistency with the Philippine Constitution, particularly the doctrine of *jura regalia*, i.e. that "all lands of the public domain belong to the State."

The legal characterization of ancestral domain rights as "private but communal" in nature has also been distinguished from the civil law concept of co-ownership over real property.

It took a 7-7 vote by the Supreme Court in the leading case of *Cruz v. Secretary of Environment and Natural Resources, et al.*,[1] to lay down the highly nuanced appreciation of different Justices of the Supreme Court over the concept of ancestral domain rights based on indigenous customary law.

This paper begins with the traditional conception of indigenous peoples in a legal and historical context using Philippine case law. The writer then proceeds to highlight the breakthrough in constitutional development when the framers of the 1987 Constitution crafted unprecedented constitutional rights of indigenous peoples to their ancestral domain. The significant provisions of IPRA are later discussed to emphasize the pervasive impact of the law in our legal system today.

The paper concludes by identifying the immediate tasks ahead of us in the application of IPRA, specifically the concept of ancestral domain, to current economic

[1] G.R. No. 135385, December 6, 2000.

development issues, like mining rights and utilization of natural resources, and the wider concern for self-determination of indigenous peoples in the Philippines.

II. Traditional Conception of Indigenous Peoples in a Legal and Historical Context

Spanish colonial setting in the Philippine Islands began with the discovery by Ferdinand Magellan in 1521. Historians identified three distinct groups of people inhabiting the archipelago at that time, namely: (a) the lowlanders of the islands of Luzon and Visayas; (b) the inhabitants of the mountains of northern Luzon; and (c) the Moro sultanates in the southern islands of the archipelago.

The early subjugation of the predominant lowlanders gave the Spaniards the much needed time and people to pursue the ultimate objective of *reduccion* or the process to convert pagan people to a civilized way of life exemplified by the life of the Hapsburg Empire. William Henry Scott explained the use of the term to clarify the prevailing Spanish policy at that time:

> "The verb *reducir* must sometimes be translated 'convert' but other times 'subjugate' or 'civilized.' Similarly, the term 'pacification' meant not merely the termination of armed resistance but the establishment of civil administration. The Spaniards were themselves sensitive to the implications of the term, and the Law of the Indies specifically prescribed the use of the words *conquista* in everything having been undertaken in total peace and charity."[2]

Two decisions of the Philippine Supreme Court during the American colonial period still carried over the Spanish policy of *reduccion* into the treatment of indigenous peoples at that time.

In *Rubi v. Provincial Board of Mindoro*,[3] some Mangyans were held in a reservation based on Provincial Board Res. No. 25. Mindoro justified the act as a form of protection and to introduce the Mangyans to civilized customs. The Court traced the *reduccion* during the conquest period. It also used the term "non-Christian" tribes to describe the geographical area and level of civilization of a people. The Government treated them as in a "state of pupilage" or as "wards" just like the way the United States related to the native Indians.

Twenty years later, in *People v. Cayat*,[4] a native of Baguio was sentenced to pay fine for having in his possession one bottle of A-1-1 gin other than a native wine. The Court reiterated the policy of *reduccion* to justify the exercise of police power. It rationalized the prohibition as a valid classification under the equal protection clause. Classification was not discriminatory because it was not based on accident of birth or parentage but on the degree of civilization and culture.

It was clear that the early colonial policies espoused an assimilationist approach toward the indigenous peoples in the Philippines. A more progressive perspective would later on be carried into the 1987 Constitution.

The policy of *reduccion* had the concomitant effect of converting indigenous lands into lands of the public domain following the adoption of the Spanish civil law system and the doctrine of *jura regalia* which declared all lands of the public domain as belonging to the King (or the State).

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2 William Henry Scott, The Discovery of Igorots 75 (1977).
3 39 Phil 660 (1919).
4 68 Phil 12 (1939).

III. The 1987 Constitution and Indigenous Peoples

The framers of the 1987 Constitution deemed it fit to articulate the rights of indigenous communities in a more elaborate set of provisions signalling an unprecedented recognition of indigenous rights to their ancestral domain.

Article II, Section 22 provides that the State recognizes and promotes the rights of indigenous cultural communities within the framework of national unity and development.

Moreover, Article XII, Section 5 states that the State, subject to the provisions of this Constitution and national development policies and programs, shall protect the rights of indigenous cultural communities to their ancestral lands to ensure their economic, social, and cultural well-being. In this regard, the same provision allows Congress to pass a law for the applicability of customary laws governing property rights or relations in determining the ownership and extent of ancestral domain.

According to Article XIII, Section 6 the State shall apply the principles of agrarian reform or stewardship, whenever applicable in accordance with law, in the disposition or utilization of other natural resources, including lands of the public domain under lease or concession suitable to agriculture, subject to prior rights, homestead rights of small settlers, and the rights of indigenous communities to their ancestral lands.

Article XIV, Section 17 provides that the State shall recognize, respect, and protect the rights of indigenous cultural communities to preserve and develop their cultures, traditions, and institutions. It shall consider these rights in the formulation of national plans and policies.

In addition to these provisions, Article X, Sections 15–21, recognized two compact groups of communities who have historically asserted their right to self-determination since the Spanish colonization. The Cordillera up north and the Muslims in Mindanao have been accorded autonomous regional status distinct from other local government units in the Philippines within the framework of the Constitution and the national sovereignty as well as territorial integrity of the Republic.

IV. R.A. 8371 of 1997

The Indigenous Peoples' Rights Act (IPRA) is a fusion of existing concepts on indigenous rights derived from domestic and international law instruments.[5]

An enumeration of selected provisions of the law is instructive of the expanse of indigenous peoples' rights in the Philippines today.

A. Who are the Indigenous Peoples (IPs)?

Section 3(h) states:

> "…a group of people or homogenous societies identified by self-ascription and ascription by others, who have continuously lived as organized community on communally bounded and defined territory, and who have, under claims of ownership, since time immemorial, occupied, possessed and utilized such territories, sharing common bonds of language, customs, traditions and other distinctive cultural traits, or who have, through resistance to political, social and cultural inroads of colonization, non-indigenous religions and cultures, become historically differentiated from the majority of Filipinos. ICCs/IPs shall likewise include peoples who are regarded as indigenous on account of their descent from the populations which inhabited the country at the

[5] Two principal sources of the text of IPRA are I.L.O. Convention No. 169 and the U.N. Declaration on the Rights of Indigenous Peoples.

time of conquest or colonization, or at the time of inroads of non-indigenous religions and cultures, or the establishment of present state boundaries, who retain some or all of their own social, economic, cultural and political institutions, but who may have been displaced from their traditional domains or who may have resettled outside their ancestral domains."

The definition of indigenous peoples may be summed up in three distinct characteristics, namely: (a) continuous display and expression of customary practices; (b) history of marginalization; and, (c) self-ascription as an indigenous group.

B. Ancestral Domains/Lands and the Constitutional Challenge

One of the more problematic areas in IPRA is the concept of ancestral domain, including ancestral land. As will be discussed, the scope of ancestral domain invited constitutional scrutiny on account of the vast legal implications particularly in the context of ownership and utilization of natural resources.

Ancestral domain as defined in Chapter II, Section 3(a) refers to:

"all areas generally belonging to ICCs/IPs comprising lands, inland waters, coastal areas, and natural resources therein, held under a claim of ownership, occupied or possessed by ICCs/IPs, by themselves or through their ancestors, communally or individually since time immemorial, continuously to the present except when interrupted by war, *force majeure* or displacement by force, deceit, stealth or as a consequence of government projects or any other voluntary dealings entered into by government and private individuals/corporations, and which are necessary to ensure their economic, social and cultural welfare… <u>including</u>: ancestral lands, forests, pasture, residential, agricultural, and other lands individually owned whether alienable and disposable or otherwise, hunting grounds, burial grounds, worship areas, bodies of water, mineral and other natural resources, and lands which may no longer be exclusively occupied by ICCs/IPs but from which they traditionally had access to for their subsistence and traditional activities, particularly the home ranges of ICCs/IPs who are still nomadic and/or shifting cultivators."

On the other hand, ancestral lands, is defined in Chapter II, Section 3(b), are those:

"occupied, possessed and utilized by individuals, families and clans who are members of the ICCs/IPs since time immemorial…including but not limited to, residential lots, rice terraces or paddies, private forests, swidden farms and tree lots."

In *Cruz v. Secretary of Environment and Natural Resources, et al.*,[6] a constitutional issue was raised premised on the doctrine of *jura regalia* under Article 12, Sections 2 and 3, respectively, of the Constitution which state:

"Sec. 2. Lands of the public domain, waters, minerals, coal, petroleum, and other mineral oils, all forces of potential energy, fisheries, forests or timber, wildlife, flora and fauna, and other natural resources are owned by the State…"

"Sec. 3. Lands of the public domain are classified into agricultural, forest or timber, mineral lands and national parks…"

[6] G.R. No. 135385, December 6, 2000.

Petitioner Cruz argued that the definition of ancestral domain runs contrary to the Constitution. The key to resolving the apparent conflict is the concept of native title. This was affirmed in the landmark case of *Cariño v. Insular Government.*[7] The Cariño ruling recognized the concept of private land title that existed irrespective of any royal grant from the State. Thus, in Chapter II, Section 3(1) of IPRA, native title has been defined as:

> "pre-conquest rights to lands and domains which, as far back as memory reaches, have been held under a claim of private ownership by ICCs/IPs, have never been public lands and are thus indisputably presumed to have been held that way since before the Spanish Conquest."

Judicial decisions in Australia[8] and Canada[9] confirm aboriginal titles in their respective jurisdictions.

Section 55 of IPRA states that areas within the ancestral domains are communally held but not in the concept of co-ownership under the New Civil Code.

The rule on vested rights respecting the existing property rights regimes is emphasized in Section 56.

A source of controversy is the rule on natural resources within the domains found in Section 57 granting ICCs/IPs "priority rights" in the harvesting, extraction, development or exploitation but allowing a non-IP to take part in the development and utilization for a period of not exceeding 25 years renewable for another 25 years provided a formal and written agreement is entered into with the IPs concerned or that the community, pursuant to its own decision making process has agreed to allow such operation.

The rule on sale or transfer of ancestral domain has been distinguished from that of ancestral land. Ancestral domains can never be sold as prescribed in Section 5. But, Section 8 clarifies that ancestral lands may be transferred only to or among members of same IPs. But these lands may be redeemed within 15 years if transferred to non-IPs due to vitiated consent or unconscionable price.

A Certificate of Ancestral Domain Title serves as a formal recognition of native title under Section 11 of IPRA. This is issued by the National Commission on Indigenous Peoples.

There is an option to register ancestral lands within 20 years from approval of the law under Commonwealth Act 141, as amended, or the Land Registration Act 496 as laid down in Section 12.

Under Section 60, ancestral domains, except those portions actually used for commercial purpose, large-scale agriculture, residence or upon titling by private person are exempt from real property tax, special levies and other similar exactions.

Section 7 outlines the rights related to ancestral domain:

a. To claim ownership;
b. To develop lands and natural resources (in relation to Section 57);
c. To stay in the territories;
d. To be resettled (in case of displacement);
e. To regulate entry of migrant settlers;

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7 53 L. ed. 594 (1909).
8 *Mabo v. Queensland*, 107 A.L.R. (1992).
9 Delgamuukw, <http://cstc.bc.ca/treaty/delgamKwsmKy.html> (August 30, 2000).

f. To have access to integrated systems for the management of their inland waters and their air space;
g. To claim parts of reservations (except: those for public welfare and service); and,
h. To resolve land conflicts using customary laws (before going to court).

C. Right to Self-governance and Empowerment

Sections 13–20 of IPRA provide that indigenous peoples not included in or outside Muslim Mindanao and Cordilleras may use the form and content of their ways of life as may be compatible with the fundamental rights defined in the Constitution. Their indigenous justice system may be used within their own communities but the system must be compatible with the national legal system and internationally recognized human rights.

Other rights worth noting are as follows:

a. Right to participate at all levels of decision-making and development of indigenous political structures, including mandatory representation in policy-making bodies and other local legislative councils, and the right to determine their own priorities for development; and,

b. Right to constitute tribal *barangays* provided they are living in contiguous areas where they are the predominant population but inside municipalities, provinces, or cities where they do not constitute the majority.

V. Beyond *Cruz v. Sec. of DENR*

A continuing concern among indigenous peoples' rights practitioners is the concept of codification of customary laws. Article 11 of the New Civil Code states that customs which are contrary to law, public order or public policy shall not be countenanced. Article 12 further requires that a custom must be proved as a fact, according to the rules of evidence. IPRA, on the other hand, allows the use of customary law in settlement of disputes among IPs and determination of property rights. It has been advanced by Supreme Court Justice Jose Vitug that Congress should first make customary laws part of the stream of laws. Due process demands that non-indigenous persons be properly informed of these customary laws in light of the expansive effect of these practices.

The demand for economic development in the Philippines has brought forth another immediate concern of indigenous peoples settled in areas subject of exploration, development and utilization of natural resources. IPRA has provided as a safeguard the "free, prior and informed consent" instrument for indigenous communities in order to ensure consultation before any major economic activity is undertaken within the ancestral domains and ancestral lands. However, the preparedness of indigenous leaders to deal with technical economic agreements attending natural resources development is gradually being tested in recent years. It will require empowerment of these communities to deal with these agreements involving the private sector and government agencies.

Finally, the assertion of self-determination as a people is becoming more evident in the context of socio-cultural development of indigenous communities. Politically, however, indigenous peoples are gradually making a dent through the sectoral representation in Congress. Considerable work is in progress to realize a more effective participation at the electoral level.

AN INTRODUCTION TO THE ENGLISH AND SPANISH PROPERTY LAW FROM A COMPARATIVE PERSPECTIVE

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Abstract. The present paper aims to give a general overview of English Property Law, giving an additional comparative point of view from the Spanish legal system. English property law will be presented following the structure and categories generally used by civil lawyers and in each of the points there will be a reference to the most similar legal figure belonging to the Spanish legal system.

Key words. English property law. Real property. Comparative law.

1. INTRODUCTORY REMARKS

The present paper aims to give a general overview of English Property Law, giving an additional comparative point of view from the Spanish legal system. English property law will be presented following the structure and categories generally used by civil lawyers and in each of the points which will be analysed there will be a reference to the most similar figures belonging to the Spanish legal system (giving the Spanish terminology in each case).

In other words, the main focus of the paper will be the description of the basis of English Property Law although the reference to the Spanish legal system will be continuous as to gain a complete understanding of the topic from the civil-Spanish lawyers perspective. Some of features which will be analysed do not have an exact equivalent in Spanish Law so it will be only the most similar Spanish legal institution which will be taken into account in those cases.

It is important to note that it will be the so-called “real property” the one in which the paper will mainly focus, that is the property rights dealing with immovables, due to its major importance from a dogmatic and economical point of view.

2. STARTING POINT: THE COMPLEXITY OF ENGLISH PROPERTY LAW

As Megarry & Wade affirm, English property law has tended to have an unenviable reputation for its complexity[1]. The main reason of this complexity is that English property law (namely, land law or real property) contains structures, concepts and language that date back to the middle ages. There has never been a codification of the law in England similar to the great civil codes on the Continent such as the Spanish civil code 1889. The nearest that English law has come to a codification of the land law is in the greats reforms of 1925, which in any case did not constitute a complete code, breaking with the past and laying down a new, self-contained set of legal rules and principles for land ownership and transactions relating to land. Instead, the 1925 legislation, which is still the basis of the current modern land law in England, reformed and developed the law as it then stood. And even the most recent reforms of land law, the Land Registration Act 2002, has not swept away the old law but can be fully understood only by reference to it[2].

The following points of this paper will analyse the concept of property law, the main types of rights which qualify as proprietary, the list of proprietary rights in respect of land, the ways in which they are created and transferred, and, finally, the ways in which they may come to an end. It must be noted that it is unusual in English law to treat these topics together and following this order, something which is proper of a civilian lawyer. This paper will not deal due to its introductory approach with the law of "trusts", nor will there be any reference to the protection of property rights, as in English law this is principally achieved through the law of "torts". As it was already announced the paper tends to give a general overview of English real property for the Spanish lawyer, therefore following the typical continental structures and naming out the Spanish figures which are most similar in each case[3].

3. WHAT IS THE LAW OF PROPERTY? MAIN TYPES OF PROPERTY RIGHTS

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[1] HARPUM, C., BRIDGE, S., DIXON, M., *Megarry & Wade The Law of Real Property*, 8th Edition, Sweet & Maxwell, London, 2012, p. 1.

[2] BURN, E. H., CARWRIGHT, J., *Chesire and Burn's Modern Law of Real Property*, 18th Edition, Oxford University Press, 2011, p. 1. With respect to the importance of history in the understanding of English land law DIXON, M., *Modern Land Law*, 9th Edition, Routledge, Abingdon, 2014, p. 2, affrims: "Land law is a subject steeped in history. It has its origin in the feudal reforms imposed on England by William the Conqueror after 1066, and many of the most fundamental concepts and principles of land law spring from the economic and social changes that began then".

[3] This paper is mainly inspired and follows the structure given by **William Swadling in his work: "The law of Property", in *Oxford Principles of English Law. English Private Law,* Edited by Andrew Burros, 3d Edition, Oxford University Press, Oxford, 2013, p. 173-306**. As well as his paper on *Introduction to English law of property* facilitated in the PhD seminar given in the University of Seville the 21st of November 2014.

The law of property, following Prof. Swadling can be defined as "that area of law concerned with certain types of rights between persons with respect to things, those things being either land or goods, and those rights being proprietary rather than personal"[4]. A definition that can be shared with the Spanish perspective of what property law is. And as in the Spanish legal system, the most basic distinction that can be made with respect to the "patrimonial" rights (with economic content) is that one that distinguishes between the property rights (known as *"derechos reales"* in Spain) and the personal rights (known as *"derechos personales o de crédito"* in the Spanish legal system)[5]. The sign of a property right is the ability to bind strangers to it. Rights in respect of things which do not bind third parties are personal rights[6]. As Lord Wilberforce said[7]:

"Before a right or an interest can be admitted into the category of property, or of a right affecting property, it must be definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability".

Taking into account this basic distinction the next thing that must be noted is that in English property law not all rights in respect of things have the consideration of property rights. There are rights in respect to things which are not binding to third parties and therefore are defined as personal rights with respect to things. This last distinction can bee seen in *Hill v Tupper* (1863) 2 H & C 121. This case demonstrates a right that over thing that was in fact personal. A company with a fee simple title (a property right –equivalent with what in Spain would be considered as *"derecho de propiedad"* as it will be seen with detail) to a canal and its banks granted a lease (another property right –we will see that there is not an exact equivalent to this proprietary right in Spanish law; although it could be defined as a *"suerte de arrendamiento de naturaleza real"*-) of premises on its banks to the claimant, a boat proprietor. The contract stated that the claimant enjoyed "the sole and exclusive right or liberty to put or use boats on the said canal, and let the same for hire for the purpose of pleasure only". The defendant, the landlord of an inn next to the canal, put his own boats on the canal and the claimant sued him for interfering with his "exclusive right". He failed. Pollock CB said that the grant operated merely as a licence or covenant on the part of the grantors, and was binding on

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[4] SWADLING, W., "The law of Property"…, *cit*., p. 173.

[5] BURN, E. H., CARWRIGHT, J., *Chesire and Burn's Modern Law of Real Property*…, *cit*., p. 4, affirm to this end: "Property rights are to be contrasted with personal rights. This contrast, in Enclish law, can be expressed in the same essential terms as were developed in Roman law: property rights are rights in rem; persona rights are rights in personam. Tos ay that one has a property right in relation tol and is tos ay that one has a right over, or in respecto of, the land itself. A personal right, however, is a right against a person, generated by the act of the persono r imposed on him by the law, but in every case the right is against… the particular individual concerned".

[6] BURN, E. H., CARWRIGHT, J., *Chesire and Burn's Modern Law of Real Property*…, *cit*., p. 4, affirm to this respect that "the significance of the distinction between personal rights and property rights, for our purposes, lies in the case where third parties become involved".

[7] *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175, 1247-8.

them as between themselves and the grantee, but that it gave the grantee no right to defend that right against anyone else[8].

In Spanish law all rights with respect to things are considered property rights, although of course personal rights can relate their content to a single thing *("derecho de crédito cuyo contenido opera sobre una determiada cosa*").

The question which immediately arises to this respect is how is it possible to tell the difference between a proprietary right and a personal right? The answer is that in English law, as in all developed legal systems, a *numerus clausus* of property rights. Looking to *Hill v Tupper* again, Pollock CB, stated in response to the argument for creating 'the exclusive right to put pleasure boats on a canal', said:

"The answer is, that the law will not allow it… A new species of incorporeal hereditament cannot be created at the will and pleasure of the owner of property; but he must be content to accept the estate and the right to dispose of it subject to the law as settled by decisions or controlled by Act of Parliament. A grantor may bind himself by covenant to allow any right he pleases over his property, but he cannot annex to it a new incident, so as to enable the grantee to sue in his own name for an infringement of such a limited right as is now claimed"[9].

In the Spanish legal system the *numerus clausus / numerus apertus* matter in the creation of property rights is greatly discussed. The majority of the Spanish authors consider that it is a *numerus apertus* the system which is followed in Spain, namely due to the essential principle of private autonomy which leads to the consideration that any one can impose whatever right they wish with respect to the thing which they own. However, there is not a definite position up to this extent[10].

English law, as well as Spanish law, also distinguishes between real property (what in Spanish law is know by *"propiedad inmobiliaria"*) and personal property (know as *"propiedad mobiliaria"* in Spanish law)[11]. Previously, the division was based on the rules of succession: traditionally on death, real property passed directly to the heir or legatee, but personal property passed to the executors of the will for distribution[12]. Today, the distinction is mostly historic,

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[8] SWADLING, W., "The law of Property"…, *cit*., p. 174.

[9] SWADLING, W., "The law of Property"…, *cit*., pp. 175-176.

[10] With respect to the *numerus clausus / numerus apertus* matter in the Spanish legal system see DÍEZ-PICAZO, L., "Autonomía privada y derechos reales", in *Revista Crítica de Derecho Inmobiliario*, Nº 513, 1976, pp. 273-305.

[11] DIXON, M., *Modern Land Law*..., cit., p. 3, affirms: "The law of real property (or land law) is, obviously, concerned with land, rights in or over land, and the processes whereby those rights and interests are created and transferred".

[12] BURN, E. H., CARWRIGHT, J., *Chesire and Burn's Modern Law of Real Property*…, *cit*., p. 5, with respect to the origin of the technical distinction between "real property" and other property ("personal property") affirm what follows: "The common law devised certain forms of action to enable rights to be enforced. … In the early law the actions by which property could be specifically recovered we known as

although it is still important due to the number of interests that can only exist under one type of real property, land.

The differences are explained by the different responses of the legal system to interferences with real and personal property rights. If real property rights are interfered with, the courts will order the return of the property. Conversely if a personal right is interfered with, the court can only order a dispossessor to make a money payment.

This does not mean that personal property rights are unimportant. The trademark of a property right is its sphere of enforceability, not the method by which it is enforced. For this reason, in English law the distinction between personal a real property has nothing to do with the differentiation between the continental category of rights *in rem* and rights *in personam*[13].

In the Spanish legal system the differentiation between real and personal property has only be given by the nature of the object of the proprietary right: chattels for personal property and land/immovables for the real property. Both kind of proprietary rights have always counted with "real actions", therefore the distinction has not had the same historical importance as it has in English law.

4. LIST OF PROPERTY RIGHTS IN RESPECT OF LAND

4.1. Introduction

English authors when referring to the different types of proprietary rights usually start by making two sorts of distinctions: the one that distinguishes between state and interests in land; and that other that the differentiates between legal and equitable rights.

In the first case, "estates" are considered as a right to use and control land, being tantamount to absolute ownership, but with the important difference that the estate will define the time for which their ownership lasts. Whereas "interests" are generally a right that one person enjoys over land belonging to someone else (a right in the estate of another person)[14]. It would be a similar differentiation as the one made in Spanish law between *"derecho real pleno"* (estate) and *"derecho real limitado"* ("interest").

Furthermore, it is also common the distinction between legal and equitable rights. A differentiation which responds to historical reasons, based on the type of court in which a

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the "real actions". But only land could be specifically recovered by such actions; a person who was dispossessed of a chattel could bring only an action for damages for the wrong committed by the dispossession, and could not recover the chattel itself. Land, the subject of the "real actions", therefore came to be known as real property".

[13] SWADLING, W., "The law of Property"…, *cit.*, p. 178.

[14] DIXON, M., *Modern Land Law…*, *cit.*, p. 23.

claimant might obtain a remedy against a defendant for the unlawful denial of the claimant's right over the defendant's land. The King's Court (or court of common law) would grant a remedy to a claimant who could establish a case at law, usually on proof of certain formalities and on pleading a specified form of action. These common law courts were, however, fairly inflexible in their approach to legal problems and would often deny a remedy to a deserving claimant simply because the proper formalities had not been observed. Consequently, the Chancellors Court (where Equity was created) began to mitigate the harshness of the common law by giving and "equitable remedy" to a deserving claimant, even in the absence of the proper formalities required for a remedy at law. Since the Judicature Act 1875, all courts have been empowered to apply rules of law and rules of equity, and clashes of jurisdiction no longer take place. However, for the present this historical diversity still echoes in the modern law[15]. The distinction up to 1926 (before the 1925 property legislation) was that this could determine the property rights effect on third parties[16], but today these principles have been mainly replaced to a very considerable extent by requirements of registration[17].

According to the basic approach to English property law which characterises this paper, the referred distinctions (estate/interest; legal/equitable rights) will be left aside. Therefore, we will give a general list of the main property rights which exist in English law in respect of land.

Nevertheless it must also be noted that one of main contributions of equity in the grounds of property law is the creation of "trusts" which will not be deeply analysed in this paper -inexistent legal figure in the Spanish legal system as it occurs in most civil law legal systems-. In English law and systems derived from it, as Dixon outlines, it is perfectly possible for a single piece of property to be owned by two or more people at the same time. This is not simply that two people may share ownership; it is, rather, that two or more people may have a different quality of ownership over the same property at the same time. In other words, one person may have the legal title to the property, and another may have the equitable title. So, for land, it is possible to have a legal owner and an equitable owner: one with legal rights of ownership; the other with equitable rights. Necessarily, these two owners must stand in a relationship to each other and this relationship is known as trust. This is what is meant when it is said that A holds land on trust for B: A is the legal owner (and trustee), and B is the equitable owner (and beneficiary). The trust that exists between A and B can take many forms, and different rights and duties can be imposed on A (the trustee) for the benefit of B (the beneficiary), depending on how the trust was established and any relevant statutory provisions[18]. However, as we say,

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[15] DIXON, M., *Modern Land Law…*, *cit*., pp. 10-11.

[16] If the right were legal, it would always bind every transferee or owner of the land over which it existed. Whereas if the right were equitable, it would bind every considerable extent by requiremets of registration. DIXON, M., *Modern Land Law…*, *cit*., p. 25.

[17] DIXON, M., *Modern Land Law…*, *cit*., p. 25.

[18] DIXON, M., *Modern Land Law…*, *cit*., pp. 15-16. There are many different essential books which deal with the law of trusts; for an introductory study of this particular common law legal figure see GARDNER, S., *An introduction to the law of trusts*, 3d Edition, Oxford University Press, Oxford, 2011.

trusts are not going to be analysed in this paper as its complete study would override the limits of our basic approach: give an introductory overview of English property law.

4.2. List of real property rights

The main property rights in respect of land are the ones that follow.

a) Right to exclusive possession forever ('fee simple absolute in possession' or 'freehold')

The most comprehensive right known to English law in respect of land is a right to exclusive possession forever, known technically as the "fee simple absolute in possession" or a "freehold". In English law there is not such thing as "ownership" or simple "property" as there is in civil law legal systems and namely in Spanish law. However, the most similar figure to that is precisely the freehold which we here analyse.

As Prof. Swadling underlines, the word "fee" denotes an estate of inheritance, that the right will descend to the grantee's heirs; the word "simple" implies that these heirs are general rather than restricted to a special class; the word "absolute" remarks that the estate will not come to an end on the happening of some specified event; and the word "in possession" signifies that the grantee has a right to immediate possession of the land[19].

Therefore, the fee simple is freely transferable during the life of the estate owner (i. e. by gift or sale), or on his death (i. e. by will or under the rules of intestate succession when there is no will), and each new estate owner is the entitled to enjoy the land for the duration of his life and that of his heirs and successors. Consequently, although the fee simple is, at its legal root, a description of ownership for a limited duration (as are all estates) the way in which the duration of the estate is defined and its free alienability means that, in most respects, the fee simple is equivalent to permanent ownership of the land by the person who is currently estate owner[20].

As it has been already noted, the most similar figure to a "freehold" in Spanish law would be what is simply know as "property", been the most absolute property right with respect to land and goods as defined by Article 348 of the Spanish Civil Code. It is important to note that the absolute nature of this right must be mitigated by its the so-called "social function" defined in Article 33 of the Spanish Constitution[21]. Curiously, although in English law there is not such

[19] SWADLING, W., "The law of Property"…, *cit.*, p. 185.

[20] DIXON, M., *Modern Land Law…*, *cit.*, p. 7.

[21] About the constitutional configuration of property law see the essential work: LÓPEZ Y LÓPEZ, A. M., *La disciplina constitucional de la propiedad privada*, Tecnos, Madrid, 1988.

thing as “ownership”, freeholds have a wider content in terms of their limits then what in Spain is referred as “property”. An example of this can be seen in *Bocardo SA v Star Energy UK Onshore Ltd* [2010] UKSC 35, [2011] 1 AC 380, where it can be seen that in the English legal system the holder of a fee simple has the right to the space below the surface without any limits: all mines and minerals belong to him, except gold and silver, which belong to the Crown[22]. Ownership in Spanish law does not have such an extent with respect to the underground.

b) Leases of land

A lease of land is also a property right. This is a right to exclusive possession of land for a finite period. No limits are imposed for the maximum length for a lease. Therefore it is possible to have a lease for 3,000 or even 3,000,000 years. But there must be some limit, and that limit must be certain.

Leases can only be granted by persons who themselves have a right to the exclusive possession of land. That includes a person with both a fee simple estate, or a lease: in the first case the person granting the lease is referred to as the landlord, whereas if the lease is granted by a lease, it is known as a sub-lease. There is no limit on the number of sub-leases which may be created[23].

The substantive requirements of a lease were said by Lord Templeman in *Street v Mountford*[24]: “To constitute a tenancy the occupier must be granted exclusive possession for a fixed periodic term certain in consideration of a premium or periodical payments”.

Therefore, three are the basic requirements of any lease: exclusive possession, the certainty of term, and the existence of a premium or periodical payment. Any arrangement which does not confer a right to exclusive possession of land will not qualify as a lease. Additionally, the lease must have a fixed term: there is no limit on how long the term of a lease might be, but there must be some limit and that limit must be certain. Finally, as Lord Templeman outlined, the third substantive requirement of any lease is the payment of a premium or rent (there is not such thing as a free lease).

With respect to Spanish law, leases quite often are translated as *“arrendamientos”*, although being similar figures the equivalence is not precise. In the Spanish legal system *“arrendamientos”* are considered (although it is discussed) as personal rights and not property rights. The most similar figure on the grounds of property rights would be what is known as *“usufructo”*, that is, a limited property right which gives the right to possess and enjoy the property of a third party (“*nudo propietario*”). Although even in this case there is not an exact

[22] SWADLING, W., “The law of Property”…, *cit.*, pp. 185-186.

[23] SWADLING, W., “The law of Property”…, *cit.*, p. 185.

[24] (1985) 49 P & CR 324, 332, CA.

equivalence between the figures; a proof of this is the existence of another property right known in English law which will be later analysed and is also similar to the Spanish *"usufructo"* which would be the "profits à prendre".

c) Easements

An easement is a right one owner of a fee simple or lease of land has over the land belonging to someone else. Typical easements are rights of way, rights of drainage, rights of light, and so on. Prof. Swadling states the main requirements that a property right must fulfil as to be considered an easement are the ones that follow: First, there must be a dominant and servient tenement. Second, the easement must accommodate the dominant tenement. Third, the rights to possession of the dominant and servient tenements must be in different people. Fourth, the content of the right must be certain. Fifth, no positive obligations may be imposed on the possessor of the servient tenement. And sixth, though subject to limited exceptions, the right must not be negative but positive[25], entitling its holder to do something on the servient tenement[26].

The most similar figure to easements in Spanish law are certainly what are known as *"servidumbres"*, a limited property right in which the owner of a piece of land obtains a certain benefit from a different land belonging to another person (this is the classical definition given by Article 530 of the Spanish Civil Code with respect to the most important kind of *"servidumbre"*[27], that is, the *"servidumbre predial"*).

d) Profits à Prendre

A profit differs from an easement in that where an easement is a right to do something on land belonging to another, a profit à prendre, is a right to take something from the land of another. Examples are minerals or crops, or the wild animals existing on it. As Prof. Swadling

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[25] See *King v David Allen (Billposting) Ltd* [1916] AC 54. Thus, in *Haywood v Brunswick Permanent Building Society* (1881) 8 QBD 403, a vendor of a title to land promised his purchaser to keep certain buildings on it in repair. Both parties assigned their various rights, and the question arose whether an assignee from the vendor, who had bought with knowledge of the promise, was liable for failure to perform it. The Court of Appeal held that he was not, for such right could not amount to an easement, as it required positive action.

[26] SWADLING, W., "The law of Property"…, *cit*., p. 195.

[27] Article 530 of the Spanish Civil Code affirms: *"La servidumbre es un gravamen impuesto sobre un inmueble en beneficio de otro perteneciente a distinto dueño.*

El inmueble a cuyo favor está constituida la servidumbre se llama predio dominante; el que la sufre, predio sirviente".

affirms, profits are quite ancient rights, and their content reflects an agrarian rather than an industrial economy[28].

This property right also reminds to the Spanish *"usufructo"* in all those cases in which it confers a right to obtain crops or minerals from land. As it can be seen, it is really difficult when not impossible to find exact equivalent legal figures between two legal systems belonging to very different traditions such as civil and common law ones.

e) Restrictive covenants

These are promises by a fee simple holder to his neighbours not to do something on the land. The genesis of the restrictive covenant is the decision in is *Tulk v Moxhay* (1848) 2 Ph 774. In this case, one fee simple title holder promised not to build on his land. This promise was held binding on a successor in title to the promisor.

It is a creation of the courts of equity answering to the question of whether a party should be permitted to use the land in a manner inconsistent with the contract entered into by his vendor, with notice of which he purchased. Lord Chancellor in *Tulk v Moxhay* precisely said that the price that the original purchaser paid would have been reduced because of the covenant, and nothing could be more inequitable than that the original purchaser should be able to sell the property the next day for a greater price because a purchaser from him would not be bound. In this specific context is where restrictive covenants of the user of land were originated as proprietary rights[29].

Later cases have introduced four limits o requirements for the creation of restrictive covenants. Many of which have been borrowed from the law of easements. That is why restrictive covenants can be almost described as "negative easements"[30]. These requirements are substantially the ones that follow:

- The first limit is that the doctrine only applies to negative rather than positive covenants.
- The second restriction is that there must be both a dominant and servient tenement.
- The third requirement is that the covenant must "accommodate" the dominant tenement. Therefore, the covenant must confer a benefit on the covenantee in his capacity of holder of a title to land.
- Finally, it must be shown that it was the intention of the original parties that the burden of the covenant run with the land concerned. This intention can be discovered attending

[28] SWADLING, W., "The law of Property"…, *cit.*, p. 199.

[29] SWADLING, W., "The law of Property"…, *cit.*, p. 200.

[30] Although this is not purely accurate for, unlike easements, they cannot be acquired by prescription: SWADLING, W., "The law of Property"…, *cit.*, p. 201.

to the words of the conveyance, indicating that the covenant was meant to bind not only the covenantor but also persons deriving title trough him[31].

In Spanish law the most similar figure to a restrictive covenant would be a *"servidumbre predial negativa"*, contemplated in Article 533 of the Spanish Civil Code[32]. We have already seen that *"servidumbres"* are a similar figure to easements, although according to Spanish law *"servidumbres"* can be not just positive, but negative, in the sense of imposing the holder of the servient tenement a restriction or prohibition. Therefore, restrictive covenants are surely (with the cautions that must be made in these kind of analogies) *"servidumbres prediales negativas"*.

f) Contracts to Purchase Estates in Land

A contract to purchase an estate in land without anything else creates a property right for the purchaser in respect of that estate, so that a third party purchasing the estate in question may be bound by the contract of sale. In this situation, a court imposed trust arises. As Sir George Jessel MR said in *Lysaght v Edwards* (1876) 2 Ch D 499, 506:

"The moment you have a valid contract for sale the vendor becomes in equity a trustee for the purchaser of the estate sold, and the beneficial ownership passes to the purchaser …".

It is another addition that equity creates to the list of property rights in respect of land. As Prof. Swadling underlines, the key to understanding this area of law is to realize that equity and common law take different views of the effect of the contract. The common law sustains that a contract of sale of a title to land creates only personal rights and is not itself sufficient to pass any property rights from vendor to purchaser. From the common law perspective, a property right in land will only pass on the execution of a deed (for unregistered land) or alteration of the register (in cases of registered land). From this point of view if there is a valid contract for the sale of a proprietary right in land and the vendor refuses to perform breaching the contract, the purchaser's only right would be to sue for damages fro breach of contract (as he does not have any property right).

Equity takes a different view of the referred situation. From equity's perspective the contract of sale has the effect of transferring the promised title vendor to purchaser. If the title is still in the hands of the vendor, the court says that he holds it on trust for the purchaser. It is a trust created by the court, therefore named as "constructive trust". The reason for the creation of a trust in this situation is that that a contract of sale of land is one which equity will specifically

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[31] SWADLING, W., "The law of Property"…, *cit*., p. 201.

[32] Article 533 of the Spanish Civil Code affirms: *"Las servidumbres son además positivas o negativas.*

Se llama positiva a la servidumbre que impone al dueño del predio sirviente la obligación de dejar hacer alguna cosa o de hacerla por sí mismo, y negativa la que prohíbe al dueño del predio sirviente hacer algo que le sería lícito sin la servidumbre".

enforce. Specific performance constitutes an exceptional remedy for the breach of contract, although the *rationale* here is that titles to land are unique and damages therefore are an inadequate response to any breach of contract to convey. In equity's eyes the purchaser becomes the titleholder on exchange of contracts, even though the title itself cannot pass until conveyance[33].

In Spanish law, due to the inexistence of "trusts", there is no similar figure for the situation of contracts for purchase estates in land in which the conveyance has not being completed. In Spain due to our transfer system contained in Articles 609 and 1095 of the Spanish Civil Code[34], contracts only create personal rights. Only a sales contract plus delivery is able to create a proprietary right (the so-called *"teoría del título y modo"*). Therefore, a valid contract of sale which is not performed by the vendor only enables the purchaser to action the remedies for breach of contract. Nevertheless, specific performance is not an exceptional remedy, so it is an option that can be asked by the purchaser in those cases by virtue of Article 1124 of the Spanish Civil Code[35]. This legal provision enables the creditor to ask for two possible options: specific performance, or termination of contract; and in both cases followed by damages in the case of deliberate breach by the other party of the contract. In other words, due to the remedies existing in Spanish contract law the final result of these kind of situations might be similar to the one given in English law, although in Spanish law no proprietary right is born with just a contract (we only have legal rights and not equitable or beneficial proprietary rights as in English law).

g) Unpaid vendor's lien

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[33] SWADLING, W., "The law of Property"…, *cit*., p. 202.

[34] Article 609.2 of the Spanish Civil Code affirms: *"La propiedad y los demás derechos sobre los bienes se adquieren y transmiten por la ley, por donación, por sucesión testada e intestada, y por consecuencia de ciertos contratos mediante la tradición"*.

Article 1095 of the Spanish Civil Code affirms: "*El acreedor tiene derecho a los frutos de la cosa desde que nace la obligación de entregarla. Sin embargo, no adquirirá derecho real sobre ella hasta que le haya sido entregada"*.

[35] Article 1124 of the Spanish Civil Code affirms: *"La facultad de resolver las obligaciones se entiende implícita en las recíprocas, para el caso de que uno de los obligados no cumpliere lo que le incumbe.*

El perjudicado podrá escoger entre exigir el cumplimiento o la resolución de la obligación, con el resarcimiento de daños y abono de intereses en ambos casos. También podrá pedir la resolución, aun después de haber optado por el cumplimiento, cuando éste resultare imposible.

El Tribunal decretará la resolución que se reclame, a no haber causas justificadas que le autoricen para señalar plazo.

Esto se entiende sin perjuicio de los derechos de terceros adquirentes, con arreglo a los artículos 1.295 y 1.298 y a las disposiciones de la Ley Hipotecaria".

Where the vendor of a title to land has conveyed that title but has not received all of the purchase price, a lien arises. This enables the vendor to go to court to recuperate the rest of the purchase price by forcing the sale of the land to get the moneys owed[36].

It is another proprietary right created by equity.

In the Spanish legal system the unpaid vendor's lien would be something similar to an automatic *"embargo"* that would appear due to the non payment by the purchaser who already holds the title with respect to the land. This *"embargo"* would then lead to the judicial or forced sale to recuperate the moneys owed. These would be the Spanish figures which would serve to explain what the unpaid vendor's lien consists in; but there is no legal figure which is exactly equivalent to it in Spanish law. In Spain, if the purchaser does not pay, and the title has already passed to the purchaser (which would not be frequent in practice, as the conveyance is usually subject to the full payment of the price), the vendor must use a remedy for breach of contract and only if the purchase still does not attend to the judge order of payment, the execution of that order must then be asked. This execution leads to the charge of any title owned by the debtor (it could be the land initially sold or any other asset) and the ultimate forced sale done by the court.

h) Options to Purchase

An option to purchase has a proprietary affect in the eyes of equity. While being one stage away from the sales contract, it remains an enforceable right. The reason for its enforceability is in the uniqueness of land: it is impossible to find land exactly the same anywhere, and as such is specifically enforceable. Thus, as Sir George Jessel MR explained in *London and South Western Railway v Gomm*:

[The promisor's] estate or interest is taken away from him without his consent, and the right to take it away being vested in another, the covenant giving the option must give [the promise] an interest in the land: (1882) 20 Ch D 562, 581[37].

The equivalent figure in the Spanish legal system is the *"opción de compra"* which is also considered a proprietary right, belonging to the category of the so-called *"derechos de adquisición preferente"*.

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[36] HARPUM, C., BRIDGE, S., DIXON, M., *Megarry & Wade The Law of Real Property*…, *cit*., p. 1115: "A vendor of land has an equitable lien on it until the full purchase Price is paid, even if he has conveyed the land to the purchaser and put him into possession. This lien gives him no right to possession of the land, but enables him to apply to the court for a declaration of charge and for an order for sale of the land, under which he will be paid the money due. … An equitable lien is therefore a species of equitable charge arising by implication of law".

[37] SWADLING, W., "The law of Property"…, *cit.*, p. 203.

i) Mortgage and equities of redemption

A mortgage is a device used to assure the performance of an obligation (usually repayment of a debt) by the mortgagor. In its simplest form, a mortgage functions by transferring the borrower's fee simple or lease to the lender with a proviso for reconveyance by the lender when the obligation is performed. It is a transfer for security purposes. English law confers rights on the mortgagor to ensure that the mortgagee gets nothing more than a security right. So, whilst the fee simple or the lease is in the hands of the lender, the borrower acquires a right called the "equity of redemption", which is *prima facie* binding on third parties (another proprietary right created by equity). Unlike the other rights discussed so far, the equity of redemption is not unique to land. Indeed, it is not unique to property rights at all, applying to all rights, personal or proprietary, which are transferred as security for the performance of an obligation. So far as content is concerned, the mortgagor is given the right to redeem the mortgage at any time, even after the agreed repayment date has passed[38]. In addition, the courts have been very protective of such right, and in a series of cases, have outlawed attempts to cut this down by contract[39].

An English mortgage is seen in the Spanish legal system as a real *"fiducia cum creditore"*, as it confers the lender the transfer of the property for security purpose, with the particularity of giving a parallel proprietary right to recuperate the property once the debt is paid. What many times is translated as mortgage as equivalent to the Spanish *"hipoteca"* is imprecise, as the real equivalent to the latter is what is known as "charge", which we will now analyse.

j) Charges

Another way to use property as security is to "charge" property rights in land (and other rights, including personal rights such as shares and debts). The difference between a charge and a mortgage is that a charge does not require the conveyance of the property that is subject to the security. Like transfers for security purposes, they are also effective against third parties. They are another creation of equity introduced to the common law by statute[40].

As we have already affirmed, the equivalent legal figure to a charge in Spain is the *"hipoteca"*: a security proprietary right with which the property is not transferred to the lender

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[38] DIXON, M., *Modern Land Law…*, *cit.*, p. 425: "Fundamentally, a mortgage is not seen as an opportunity for the lender to acquire the mortgagor's property: it is security for a debt. For this reason, a court of equity will intervene to protect the mortgagor and their equity of redemption against encroachment by the mortgagee and will ensure that the mortgage ends when the debt is repaid".

[39] SWADLING, W., "The law of Property"…, *cit.*, p. 203.

[40] SWADLING, W., "The law of Property"…, *cit.*, pp. 203-204.

thus it gives him the possibility of forcing a sale of the secured property in case of not paying the secured debt.

5. CREATION OF PROPERTY RIGHTS

This section will deal with the main ways in which property rights in respect of land come to existence, whereas the following one will explain how these rights can be transferred once created. It is what in Spanish law would be known as *"modos originarios y derivativos"* for the acquisition of property rights.

5.1. Taking possession

In English law, the act of taking possession of a thing is enough to give the holder the right to exclusive possession forever. Whether that was wrongful or not is irrelevant, nor does it matter that others may have had property rights in respect of that object before.

In the case of *Asher v Whitock* (1865) LR 1 QB 1, 6, it is said the mere act of taking possession of a parcel of land gives the actor a right to exclusive possession of that land good against all save those with a superior right to possession[41].

In Spanish law taking of possession of land that does give automatically a proprietary right such as proper "ownership" ("*derecho de propiedad*"). This could be given together with the legal requirements for adverse possession (which require a minimum period of continuous pacific possession for ten or twenty years -depending if the parties implied are or not present in the same place-, together with good faith, possession in the concept of owner and "just title" – *"usucapión ordinaria" ex* Articles 1940, 1941 & 1957 of The Spanish Civil Code[42]). However it must be noted that the fact of simply taking possession of a thing is provided of a limited protection by the Spanish legal system: the protection given to "possession" (*ex* Article 446 of

[41] SWADLING, W., "The law of Property"…, *cit*., p. 276.

[42] Article 1940 of the Spanish Civil Code affirms: *"Para la prescripción ordinaria del dominio y demás derechos reales se necesita poseer las cosas con buena fe y justo título por el tiempo determinado en la ley"*.

Article 1941 of the Spanish Civil Code affirms: *"La posesión ha de ser en concepto de dueño, pública, pacífica y no interrumpida"*.

Article 1957 of the Spanish Civil Code affirms: *"El dominio y demás derechos reales sobre bienes inmuebles se prescriben por la posesión durante diez años entre presentes y veinte entre ausentes, con buena fe y justo título"*.

the Spanish Civil Code[43]), which is considered to be a proprietary right (although limited, as we say). The mere possessor of land (not being the owner of it) can protect his possession throughout the traditionally called *"interdictos"* (contemplated in Article 250 of the Spanish Civil Procedure Act – *"Ley de Enjuiciamiento Civil 1/2000, de 7 de enero"*- but with that traditional name).

5.2. Long user (prescription)

English law has no doctrine of acquisitive prescription, where rights can be gained by the long user, unlike civil law systems. The one exception to this is are easements and profits. In certain circumstances, where someone has been openly acting as if they already have that right for many years without anything being said by the title holder, it is possible to gain the profit or easement at common law. The original thinking behind this was that the long user raised a presumption that a grant had been validly made at some point in the past, in accordance with the maxim *omni praesumuntur rite et sollemniter esse acta* (all things are presumed to be correctly and solemnly done), though the notion that there had been a grant soon became a fiction. In general, it is enough nowadays to show a twenty-year user[44].

In Spanish law, in accordance to the civil law legal tradition, acquisitive prescription does exist as it has already been noted. There two main kinds of *usucapio* in respect of land: the "ordinary *usucapio*" and the "extraordinary" one. The ordinary *usucapio* requires a continuous pacific possession of ten or twenty years (depending on the parties implied being present or not in the same place), acting as an owner, with "just title" and good faith (Articles 1940, 1941 & 1957 of the Spanish Civil Code). Whereas "extraordinary *usucapio*" requires a continuous pacific possession of thirty years, acting as an owner (in this case there is no need for "just title" nor good faith -Article 1959 of the Spanish Civil Code-[45]).

6. TRANSFER OF PROPERTY RIGHTS

Transfer may happen for a number of reasons, for example: as a gift, pursuant to a contract of sale, as a transfer on trust, in exchange for other property rights (barter), as a loan

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[43] Article 446 of the Spanish Civil Code affirms: *"Todo poseedor tiene derecho a ser respetado en su posesión; y, si fuere inquietado en ella, deberá ser amparado o restituido en dicha posesión por los medios que las leyes de procedimiento establecen"*.

[44] SWADLING, W., "The law of Property"…, *cit.*, p. 282.

[45] Article 1959 of the Spanish Civil Code affirms: "*Se prescriben también el dominio y demás derechos reales sobre los bienes inmuebles por su posesión no interrumpida durante treinta años, sin necesidad de título ni de buena fe, y sin distinción entre presentes y ausentes, salvo la excepción determinada en el artículo 539"*.

for consumption, as part of a divorce settlement, or even as the subject-matter of a mistaken transfer. The type of right transferred is more important than the reason for the transfer. Additionally, the transfer will not be affected if there is defect in the reasons for transfer[46]. English law, therefore, subscribes to a principle of abstraction.

Originally, fee simple and leasehold titles to land were only conveyed between private individuals. For fees simple, this was first done by *"feoffment with livery of seisin"*, a ceremony taking place on the land in which the transferor placed a lump of earth into the hands of the transferee. In 1845 the deed was introduced as an alternative method by legislature. And since 1925, the only method of transfer is the deed (according to section 52 (1) of the Law of Property Act 1925). A deed is a document that describes itself as deed, is signed and attested (signed in the presence of witnesses) and the witnesses must also record that on the deed. Not only fee simples, but also leases conveyances must be always done by deeds.

However, today, titles to land can only be transferred via a state registrar of title. This is because of the introduction of a state-maintained land register of title in 1925, backed up by a system of state insurance. Since 1st December 1990 the whole of England is subject to compulsory registration. Nevertheless, that does not mean that all titles are now registered, as in the case of for example corporations (which never die) there may never even be a disposition of the unregistered land, so it will never become registered. Until recently, compulsory registration only applied in the case of sale, though it now covers most other dispositions as well[47].

The transfer of real property in England is hugely similar to the compulsory registration transfer system existing in Germany: the transfer of real property is subject to compulsory and constitutive registration, therefore there will be no real property transferred outside the register.

In the Spanish legal system the transfer of real property is not subject to compulsory registration. The rules for the transfer of land are the same as those for the transfer of goods: both the contract ("*título*") plus the delivery of the thing ("*modo* or *traditio"*) are needed for the transfer of the proprietary right. It is a singular transfer system typically Spanish which differs from the French "consensual" system where the contract is enough to create a proprietary right. As it has already been noted, this system is contained in Articles 609 and 1095 of the Spanish Civil Code[48].

7. EXTINCTION OF PROPERTY RIGHTS

[46] SWADLING, W., "The law of Property"…, *cit*., p. 282.

[47] SWADLING, W., "The law of Property"…, *cit*., pp. 282-285.

[48] A great analysis of the main transfer systems of proprietary rights can be seen in CUENA CASAS, M., *Función del poder de disposición en los sistemas de transmisión onerosa de los derechos reales*, José María Bosch Editor, Barcelona, 1996.

Although it is not a common topic in English law property books, following the continental structures that are usually followed in the study of property law, the final matter which will be analysed is that concerning the extinction of property rights (focusing, again, on real property).

7.1. Destruction of the Subject-Matter of the Right

The most basic cause of extinction of proprietary rights is the destruction of its subject matter. If proprietary rights are rights with respect to things, once the thing disappears, the right will also do so. This can happen in any number of ways, from actual damage, e.g. fire, flood, etc.[49].

This is also the most basic source of destruction of a proprietary right according to Spanish law.

7.2. Lapse of Time

English law has no doctrine of disuse, no notion that rights are lost if not exercised for long periods of time. However what does exist in English law, are rules which give time limits within which remedies for interferences with rights must be sought. While my right to physical integrity will not be lost simply because I fail to sue a someone who punches me on the nose within the relevant period of limitation, it is different with property rights. Failure to defend infringements in court will generally lead to a destruction of the right.

As to when I will lose the right to exclusive possession itself, section 15(1) of the Limitation Act 1980 says that actions to recover the possession of land may not be brought after twelve years from the date on which the right of action ensued and section 17 further provides that at the end of this period, the right of the dispossessed "shall be extinguished"[50].

In Spanish law the lapse of time will destroy the property right due to its disuse and the parallel use (with the *usucapio* legal requirements already seen) by someone else[51].

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[49] SWADLING, W., "The law of Property"…, *cit.*, pp. 288-290.

[50] SWADLING, W., "The law of Property"…, *cit.*, pp. 290-293.

[51] It must be noted that due to the basic approach which characterizes this paper we will not analyse other cases of extinction of property rights such as "inferior title sold to good faith purchaser for value", or encumbered title sold to good faith purchaser for value"; both extremely complex cases which would need to be deeply analysed to reach a comprehensive overview from a civil lawyers perspective.

ACQUISITION FROM A *NON DOMINO* IN SPANISH CIVIL LAW

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Abstract

The Spanish System to transmit the ownership and other real rights over assets is based on the theory of the title to the property and delivery of the transferred thing (*Teoría del título y del modo*). It is understood that the transferor should be the real owner or the thing. Spanish Law follows the Roman rule which establishes that nobody can transfer property that is not his own. This norm is applied with the only two exceptions stated by art. 34 LH related to acquisition of immovable property in good faith, and art. 464 SCC related to acquisition of movable property in good faith. However, a careful reading of articles 1124, 1295 and 1895 of the Spanish Civil Code (SCC) may lead to a review of these criteria. This paper aims to examine the nature of this issue in the Spanish Law. We have chosen this subject as a topic for a legal Spanish Philippine Congress as this article is based on some identical provisions of both Civil Codes: In fact, articles 609, 649, 650, 1124, 1295 and 1897 of the SCC are identical to articles of the 712, 766, 767, 1191, 1384 and 2160 of the Philippine Civil Code (PCC). Therefore, the debate and arguments followed by the Spanish scholars could easily be relocated to a Philippine context.

Keywords

Spanish law, Philippine law, property, transfer of property, protection of appearance, delivery of property, tradition, remote cause, third party.

1.- **Title to the property and delivery as requirements to acquire a real right**

In Spanish law, art. 609 SCC (identical to art. 712 PCC) governs the system of acquiring ownership and other rights over property. This provision includes ownership as acquired by occupancy and ownership and other real rights over property acquired and transmitted by law, by donation, by testate or intestate succession and in consequence of certain acts by tradition. Finally, this adds that they may also be acquired by means of prescription.

Therefore, the Spanish System to transmit the ownership and other real rights over property is based on the theory of the title to the property and delivery of the transferred thing (*Teoría del título y del modo*). On an obligational level delivery is a means of payment, a way to fulfill the obligation however on a real level delivery is made in order to transmit the possession and acquire an *ius in rem* right.

This theory is inherited from Roman law. In order to transfer the property, the ancient Roman law offered the method of formalism. On the one hand, *res mancipi* (rural or urban properties located in the Italian peninsula, slaves, pack animals…) provided that the transmission was

made by the mancipatio before the librepens through a precise legal formulation and it was made by the in iure cessio before the praetor through a precise legal formulation. On the other hand, in relation with *res nec mancipi* (all other things) conversely provided the transmission was made by the tradition (delivery). In times of Byzantine Law the spiritualisation of tradition took place; and the transmission was sometimes possible by the simple will of the parties. As a result of this evolution current Spanish law provides different forms spiritualized forms of tradition or delivery (symbolic, instrumental, brevi manu, constitutum possessorium...)[1]

The forms to make the tradition in the Spanish Law are regulated by arts. 1462 to 1464 SCC[2]. The basic form is by the real tradition, which implies the material delivery of the thing. The thing sold shall be understood as delivered, when it is placed in the control and possession of the vendee (1462.1 SCC).

The symbolic tradition implies the delivery of an ancillary or accessory thing that symbolises the main thing. With regard to movable property, its delivery may also be made by the delivery of the keys of the place or depository where it is stored or kept (art. 1463 SCC). By analogy, this tradition is also applied to immovable property. In this case the delivery of the key of the house symbolises the delivery of the whole house.

The delivery of the titles of ownership *("títulos de pertenencia") by* placing the titles of ownership in the possession of the vendee or the use by the vendee of his rights, with the vendor's consent, shall be understood as a delivery (art.1464 SCC)

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[1] A second theory is the consensual transmission of ownership. The origin of this theory is the spiritualisation of the tradition. Under this theory the will of the parties is thought to be enough to transmit the property or real right. (It is the system used in French Law).
A third theory is the translational abstract agreement theory ("*Doctrina del acuerdo abstracto traslativo*") (this is the system of the German BGB). The transmission is based on an abstract agreement, which is absolutely detached from the precedent contract. Therefore the nullity of the precedent contract does not affect the transmission if in the moment of the delivery or the registration there is an abstract agreement between the parties in order to give and receive the possession of the transferred thing. Immovable property requires a translational abstract agreement and registration whereas movable property requires also a translational abstract agreement, but instead the delivery is necessary.

[2] These articles are similar to the articles 1497 to 1501 PCC, which refer an interesting update to the doctrinal evolution when the Philippine Civil Code was adopted (1950), for example the following text: The delivery of movable property may likewise be made by the mere consent or agreement of the contracting parties, if the thing sold cannot be transferred to the possession of the vendee at the time of the sale, or if the latter already had it in his possession for any other reason. There may also be tradition constitutum possessorium.
GARCÍA CANTERO, Gabriel in "Hacia un subsistema comparado hispano-filipino dentro de la familia romano-germánica-canónica", paper presented in the *I Online International Congress on Latin-American and Philippine Civil Law: Concordances and Particularities* 1-15 December 2013, http://www.eumed.net/eve/civil-law.html, states that: The Spanish Civil Code was adopted in 1889 in Philippines and was in force until the Independence from the United States. During this time, a fluid relation between the Supreme Courts of Philippines and Spain was maintained. This means that the Philippine Supreme Court knew and applied the case law doctrine of the Spanish Supreme Court. Therefore this explains why the Philippine Civil Code of 1949 adopted by the Law 386 of 18 of June introduced this Spanish doctrine in many of its provisions.

Another form is by delivery by agreement between the parties. For movable property the delivery may likewise be made by the mere consent or agreement of the contracting parties, if the thing sold cannot be transferred to the possession of the vendee at the time of the sale, or if the latter already had it in his possession for any other reason (art.1463 SCC). When the vendee already has the thing in his possession the delivery is called Traditio brevi manu. If the vendor keeps possession of the thing after the transmission (e.g. in case the vendor keeps the sold dwelling as usufructuary) the tradition is called constitutum possessorium. Immovable property can be applied to both the Traditio brevi manu and the constitutum possessorium.

Delivery by the issuing of a public deed can be made when the sale is made through a public instrument. The execution or conclusion thereof shall be equivalent to the delivery of the thing that is the object of the contract, if from the deed does not appear or cannot clearly be inferred the contrary (art. 1462 SCC). This means of delivery is applied to both movable and immovable property. An exception to this is if it can be inferred from the deed that another purpose was desired[3].

For the delivery of incorporeal property, with respect to incorporeal property, the execution or conclusion of a public deed shall be equivalent to the delivery of the thing that is the object of the contract, if from the deed the contrary is not apparent or it cannot be clearly be inferred (1462.2 and 1464 SCC). In any other case, the placing of the titles of ownership in the possession of the vendee or the use by the vendee of his rights, with the vendor's consent, shall be understood as a delivery (art. 1464 SCC). What is really important is that the possession of the accipiens or of the transferee can be recognised by third parties.

2.- **The roman rule "nobody can transfer property that is not its own", and its application to the Spanish Law**

The theory of the title to the property and delivery of the transferred thing (*Teoría del título y del modo*) is provided for in the Base 20 of the Law of Bases of 1888, and developed, as it has been saild, by art.609 SCC (or art. 712 PCC). This theory may be an interpretation of the Roman "tradition" based on the cause. Following this theory, the transmission needs of two different elements: a precedent contract known as title, "*título*" or tradition or Delivery of possession providing a means of acquiring "*modo de adquirir*" [4].

[3] What happens if the tradens (former owner) retains the possession of the thing after concluding the public deed? He will be deemed as a mere possessor in a situation close to a squatter. What happens if the tradens is not the possessor of the thing when the sale deed is concluded? If he has only indirect possession (posesión mediata) such as in the case of a lease, then he transmits such an indirect possession. If tradens have no possession then the owner will not be considered as being the possessor and an action for the recovery of the ownership can be brought "acción reivindicatoria").

[4] Occasionally, it has been suggested that the situation of the purchaser after the conclusion of the contract deserves a special protection in order to acquire the property. It could be considered as a type of IUS AD REM, the

This means that two essential elements are required: a contract must exist (sale, barter agreement or exchange contract…) as well as tradition or delivery. In addition, other requirements are necessary: the pre-existence of ownership or possession in the concept of an owner and intention of the parties to transmit and acquire. However, the Spanish system has significant exceptions.

The general principle is *Nemo plus iura alium transferre potest quam ipse haberet:* nobody can transfer property that is not its own. The problem with this is that sometimes the person who transfers the property is not the real owner. This causes a legal certainty problem if anybody acquires the thing from the transferee. The legal solution is to protect the appearance created by the transmission in some occasions when the following requirements concur; transmission made by a *non dominus, a*cquisition made on a paying basis, for remuneration or consideration (*título oneroso*) and good faith.

In the case of the acquisition of immovable property from a *non domino,* art. 34 of the Mortgage Law or Ley Hipotecaria (ML/LH) states that a third party can transfer rights in good faith in exchange for consideration. If the registration allows for this transfer, the acquisition will be maintained once the right has been registered, despite further annulment of the title of the transferor by virtue of reasons that are not reflected in the Registry.

Therefore, the requirements to deserve legal protection are that the third party who acquires the transferred right is of good faith; the acquisition is for consideration or remuneration; the transferor is registered in the Property Registry as owner of the transferred right and; the transferee files his acquisition with the Property Registry.

In the case of acquisition of immovable property from a *non domino*, art. 464 SCC (its first part in art. 559 PCC) protects the acquirer in good faith, and states that the possession of movable property acquired in good faith is equivalent to a title. Scholars argue if it is a title of property or a title to acquire the property by usucaption or acquisitive prescription.

Nevertheless, an exception to this is when the one who has lost any movable or has been unlawfully deprived thereof may recover it from the person in possession of the same. If the possessor of movable property is lost or that the owner has been unlawfully deprived, so long as he has acquired it in good faith at a public sale, the owner cannot obtain its return without reimbursing the price paid. In addition, the owner of things pawned in Pawnshops should

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right of the creditor to the delivery of the thing. The historical background, fiefdoms *("feudos")* and ecclesiastical benefits to these rights derive from the Middle Ages. In the Middle Ages, the lord used to give the fiefdom to the vassal through a ceremony of investiture *(investidura).* From this moment the vassal had the right to claim the delivery of the fiefdom, but he would only acquire the real right when he had acquired the possession of the fiefdom. In such a case after the investitute ceremony the vassal had not a real right, but a right to claim the delivery of the fiefdom and therefore, to be entitled with an ius in rem right. Consequently, an ius ad rem is a special situation in which the person has not yet a real right, but is in a situation close to getting it. However nowadays, the *ius ad rem* are not accepted as real rights, and cannot be applied to the title to the property and delivery of the transferred thing (*Teoría del título y del modo*).

reimburse the amount of the pledge in order to recover his property. Finally, when a thing is acquired in a exchange, fair or market the commercial law is applied, resulting a special protection for the purchaser in good faith

In conclusion, the Roman rule that establishes that nobody can transfer property that is not its own is followed in Spanish law, with the only two exceptions established in art. 34 LH related to acquisition of immovable property in good faith, and in art. 464 SCC related to acquisition of movable property in good faith.

3- **Doctrinal debate about the consequences of the ineffectiveness of the precedent legal transaction**

However, when Spanish scholars tried to answer some interesting questions about the link between tradition and contract a new controversy has emerged: What happens when the precedent legal transaction becomes ineffective? Does it imply the ineffectiveness of the subsequent transfer of property? Does it lead to automatic nullity of the acquisition?

Professor DIEZ-PICAZO[5] proposes to come to some kind of conclusion after reading the articles 1124[6], 1295[7], 649 and 650[8] SCC which protect the rights of the transferee or acquirer when he is in good faith. He concludes that the fact that the precedent legal transaction becomes ineffective in a moment after the conclusion of the contract in case or rescission of bilateral contracts in case of breach ("resolución") rescission of fraudulent acts ("rescission") and the revocation of legal transactions not always implies the ineffectiveness of the subsequent transfer. He reaches the same conclusion in respect with the annulation of contracts (arts. 1303-1307 SCC) that creates a personal obligation of restitution. Finally, the referred author considers that in the case of absolute nullity of the contract the restitution or repayment obligation in case of subsequent transmission would be personal and not real. He believes that article 1897 SCC, (identical to art. 2160 PCC) could be applied. This provision rules a case of *Indebiti condictio* (in fact a *solution indebiti*), and states that he who in good faith

[5] DIEZ-PICAZO, Luis, *Fundamentos de Derecho Civil Patrimonial*, Volumen III, Civitas, Madrid, p. 797-798

[6] Art. 1124 SCC, identical to art.1191 PCC states the power to rescind obligations is implied in reciprocal ones. In case one of the obligors should not comply with what is incumbent upon him. This is understood to be without prejudice to the rights of third persons who have acquired the thing, in accordance with articles 1295 and 1298 SCC (arts 1384 and first part of 1388 PCC) and the Mortgage Law

[7] Art. 1295.2 SCC, identical to art. 1384.2 PCC, states that neither shall rescission ("rescisición por fraude o lesion") take place when the things which are the object of the contract are legally in the possession of third persons who did not act in bad faith

[8] Art.649 SCC, identical to art. 766 PCC: Although, the donation is revoked on account of ingratitude, nevertheless, the alienations and mortgages effected before the notation of the complaint for revocation in the Registry of Property shall subsist

Art. 650 SCC, identical to art. 767 PCC: In the case referred to in the first paragraph of the preceding article, the donor shall have a right to demand from the donee the value of property alienated which he cannot recover from third persons, or the sum for which the same has been mortgaged. The value of said property shall be fixed as of the time of the donation

accepts an undue payment of a thing certain and determinate shall only be responsible for the impairment or loss of the same or its accessories and accessions insofar as he has thereby been benefited. If he has alienated it, he shall return the price or assign the action to collect the sum. Therefore, when the *accipiens* or transferee keeps the thing, he must return it; but if not, he is only obliged to pay the pecuniary equivalent. Therefore the subsequent transmission is respected.

The conclusion that Professor DIEZ-PICAZO reaches is that in all these cases in which the precedent legal transaction loses its effectiveness at a later point in time, or originally, does not necessary take place the ineffectiveness of the subsequent transmission. This means that in spite of the fact of having as general criterion the prohibition of the acquisitions a *non domino*, the Spanish Law tends to protect the subsequent transmissions, not always being necessary to meet the requirements of articles 34 ML/LH or 464 SCC (Its first part in art. 559 PCC).

However, other scholars disagree. GULLÓN BALLESTEROS[9] maintains that the ineffectiveness of the precedent legal transaction affects the subsequent transfer of the property, and leads to the ineffectiveness of the acquisition. He believes that the restitution obligation action as the Roman *condictio indebiti* has a personal nature, but, this fact does not imply that the third parties who acquire from the *accipiens* or transferee by a subsequent transmission are invulnerable. This author believes that the Roman rule that states that *Nemo plus iura alium transferre potest quam ipse haberet*, should be applied with the only exceptions set forth by art. 34 ML/LH (in case of immovable property), and 464 SCC (in case of movable property)

DIEZ-PICAZO refuses this criterion and deduces from these different provisions that in our Civil Code the theory of the title to the property and delivery of the transferred thing (*Teoría del título y del modo*) has to be interpreted as a mechanism in which there is an immediate cause *("causa próxima*") which is a "*causa solvendi*", and a mediate or remote cause "cause remote", which is the original obligation that impose the payment or "*solutio*". Therefore, he believes that the existence of the immediate cause, the will to pay and receive the payment, it is enough to validate the transmission in spite of the fact that the mediate or remote cause is an inexistent obligation. Moreover, when the Spanish Civil Code was written the authors followed the Argentinian Civil Code of VÉLEZ, and it is illuminating to see that being the article 1897 of the Spanish Civil Code (2160 PCC) influenced by the article 787 of the Argentinian Civil Code, the former attributes to the restitution action a personal nature, and the former a real one.

[9] GULLÓN BALLESTEROS, Antonio, *Sistema de Derecho Civil* II, Tecnos, Madrid, first edition, p. 85 (DIEZ-PICAZO in *ob.cit* p.798 refers to the opinion of GULLÓN BALLESTEROS written in this joint work).

4.- **Reflection of this controversy in the Spanish Case Law**

In order to illustrate this interesting doctrinal debate with a real case, we can refer to the Ruling of the Spanish Supreme Court of 29 of May of 2006[10]. In this case the company "Vallerhermoso SA" was owner of an apartment located in Madrid, which was sold to the company "Aserma SA". This contract was made in a private document on 21st of September of 1976, moment in which the possession was delivered to the purchaser. It is important to point out that the price was deferred and the contract was subjected to condition subsequent in case of non-payment.

The company "Aserma SA" later sold the referred apartment to the couple formed by Humberto and Guadalupe. This contract, made in private document, was concluded on 15th of February of 1977, moment in which the purchasers acquired the possession of this immovable property. The buyers paid the total price of the sale.

The company "Aserma SA" never paid the agreed price to "Vallehermoso SA". Therefore, the latter took legal actions against the former in order to declare the contract rescinded as a result of the breach of the duties of the buyer. The Judge issued a judgment and when the latter tried to execute the ruling, he realized that Humberto and Guadalupe were living in the apartment. Therefore, he exercised an action for recovering the ownership of this property against the referred couple. The Judge of First Instance n.42 of Madrid granted the claimant's claim. However, the Provincial Court of Madrid reversed this judgment and the Spanish Supreme Court upheld the decision of the Appeals Court.

This decision was founded in the fact that the subsequent condition was not filed with the Land Registry, that neither the first nor the second contract were registered, and that the defendants deserved legal protection as they had acted in good faith (bona fides). In fact the Supreme Court applied the last paragraph or article 1124 SCC (1191 PCC), and considered that the effects of the rescission would be mitigated by this final part of the provision: "This is understood to be without prejudice to the rights of third persons who have acquired the thing", article connected with article 1295 SCC (1384 PCC) that estates that the rescission does not take place when "the things which are the object of the contract are legally in the possession of third persons who did not act in bad faith".

[10] Ruling of the Spanish Supreme Court of 29 of May of 2006. Reporting Judge: Xavier O'Callaghan Muñoz, (RJ 2006\3344)
See, SALAS CARCELLER, Antonio, "La protección de tercero no hipotecario en la adquisición de bienes inmuebles. Comentario a la sentencia del Tribunal Supremo de 29 de mayo de 2006". *Repertorio de Jurisprudencia Aranzadi*, 2007, Vol. VII, Tomo LXXIII. Pp.247-249

5.- **Conclusion**

In conclusion, we note that this is a debatable issue. The consequences of the ineffectiveness of a contract on a subsequent sale depend on the way in which the link between the tradition or delivery and the precedent contract is observed. There are arguments to defend the admission of the Roman rule “nemo plus iura alium transferre potest quam ipse haberet” as a mandatory principle that impedes the protection of any acquisition from a vendor who is not the real owner of the thing, and there are arguments to protect these acquisitions. Nevertheless, the Civil Code establishes different mechanisms to protect the acquisitions made by third parties and it considers the restitution action as personal. Therefore, the thesis of DIEZ-PICAZO is useful in order to understand how the system works. In fact, the consideration of the cause as immediate and not remote offers a reasonable solution to a historical controversy; thesis now confirmed by the referred decision of the Supreme Court supported by Prof. O’CALLAGHAM.

As mentioned above, we have chosen this subject as a topic for a legal Spanish Philippine Congress as this article is based on some identical provisions of both Civil Codes. Therefore, the debate and arguments followed by the Spanish scholars could easily be relocated to a Philippine context. I would like to offer this work as an invitation to my Philippine colleagues in order to start an interesting exchange of ideas and opinions about how this matter is considered in our both legal bodies, only one first step to start rebuilding a necessary and useful bridge.

THE PHILIPPINE CIVIL CODE CHAPTER ON HUMAN RELATIONS AND CONTEMPORARY CHALLENGES

Perry L. Pe[1]

The Philippine New Civil Code took effect on August 30, 1950. In this revision, the Code Commission added a new chapter on Human Relations. The chapter on Human Relations governs several aspects of private affairs not otherwise covered by the old Civil Code.

The chapter of the Philippine Civil Code on Human Relations starts with Articles 19, 20, and 21. These articles provide the legal bedrock for the award of damages to a party who suffers damage. These articles apply either when *first*, one commits an act in violation of some legal provision, or *second,* and more relevantly, one commits an act that does not violate any positive law but nevertheless violates rudimentary rights of the party aggrieved. These are so-called catch-all provisions because they provide the bases for actions for damages in the absence of any express provision.[2]

Under Article 19 of the Civil Code, "every person must, in the exercise of his rights and in the performance of his duties, act with justice, give everyone his due, and observe honesty and good faith". This provision codifies the concepts of justice and fair play. This prevents a person from abusing the rights that he may otherwise have, against another.[3] The law, therefore, recognizes the primordial limitation on all rights; that in their exercise, the norms of human conduct set forth in Article 19 must be observed. A right, although legal because recognized or granted by law, may nevertheless become a source of some illegality. When a right is exercised in a manner which does not conform with the norms enshrined in Article 19 and results in damage to another, a legal wrong is thereby committed for which the wrongdoer must be held responsible.[4]

Article 19 abandoned the old theory that no person can be held liable for damages against another while in the exercise of his or her right. And adopted instead the modern thinking, which is to grant indemnity for damages in cases where there is an abuse of right, even when the act is legal.[5] "Law cannot be given an anti-social effect. If mere fault or negligence in one's acts can make him liable for injury caused thereby (which can be a tortious act), with more reason, should abuse or bad faith make him liable."[6]

The next one, Article 20 of the Civil Code provides that "every person who, contrary to law, willfully or negligently causes damage to another shall indemnify the latter for the same". Article 20 was enacted to fill in any gaps in the law. It is a general sanction for all other provisions of law which do not especially provide their own sanction.[7] It makes it now almost impossible to have a situation whereby a person who suffers damage would be left without relief.[8]

The third provision, Article 21, provides that "any person who willfully causes loss or injury to another in a manner that is contrary to morals, good customs or public policy shall compensate the latter for the damage". This provision was enacted because of the countless gaps in the statutes, which leave so many victims of moral wrongs helpless, even though they have actually

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2. TIMOTEO B. AQUINO, REVIEWER ON CIVIL LAW 16 (1st ed., 2014).

3. MELENCIO S. STA. MARIA, JR., PERSONS AND FAMILY RELATIONS LAW 31 (5th ed., 2010).

4. Albenson Enterprises v. Court of Appeals, G.R. No. 88694, Jan. 11, 1993.

[5] Arturo M. Tolentino, Civil Code of the Philippines: Commentaries and Jurisprudence Vol.1, 60-61 (1987 ed.)

[6] Tolentino, *supra* at 61

[7] *Albensen Enterprises,* ibid.

8. REPORT OF THE CODE COMMISSION ON THE PROPOSED CIVIL CODE OF THE PHILIPPINES 39 (1948).

suffered material and moral injury.[9] It provides for adequate legal remedy for that untold number of moral wrongs, which it is impossible for human foresight to capture in the statutes.[10]

Because of this, Article 21 does not refer to any violation of any statute or positive law, but to a transgression of "morals, good customs, or public policy." This principle is taken from the German Civil Code. It is based on the idea that inasmuch as the Legislative cannot foresee all wrongs that cause damage to another person, there should be an all-embracing clause that will provide remedy in all such unforeseen situations.[11] When therefore combined with Articles 19 and 20, Article 21 broadens our law on civil wrongs; making it more difficult to conceive of any malevolent exercise of a right which could not be sanctioned; and, thus making it more adaptable than the Anglo-American law on torts.[12]

One usual example when Article 21 applies is for a breach of promise to marry as long as one party has paid for preparations when the marriage was called off. The damages due are to recompense a party for such preparations, and not the breach of the promise to marry itself.

With these foundational principles of Human Relations in mind, we now raise a question: What is the boundary between morality and law? Every good law draws its breath of life from morals, from those principles, which are written with words of fire in the conscience of man. The rule is a bastion of justice in the face of the impossibility of enumerating, one by one, all wrongs which cause damage. This helps maintain the social order, by preventing a person from causing damage to his fellow men with impunity, just he does not break any law of the state, though he may be defying the most sacred postulates of morality.[13]

Article 21 may also be justified by the words of Eugen Huber, author of the Swiss Civil Code of 1907:

> "Moral law has in law such a penetrating and valuable significance that we cannot speak of positive law without referring to moral law. The moral law and the law of the State have the same object and purpose, and together they govern human aims and conduct, which constitute human society itself. Human community is the field in which morality and law act as immanent ideas in our rational conscience. It is equally possible to consider law as included in morality."[14]

Question now: Will the person, for example, who fails to render assistance to a drowning man, or to a victim of a hit-and-run vehicular accident, when he has the means to help, make him liable under these three articles? Do these three articles require a person to be altruistic, or to perform charity, or sacrifice if he has the means to do so? Will this act of omission constitute a charge of quasi-delict or culpa aquiliana under Article 2176[15] of the Philippine Civil Code (which is the equivalent of the Anglo-American concept of torts)?

The Supreme Court of the Philippines in *Gashem Shookat Baksh v. Court of Appeals*[16] discusses the distinction, and how the provisions on human relations fill in the gaps otherwise not captured by the traditional concept of quasi-delicts:

> "Quasi-delict, known in Spanish legal treatises as culpa aquiliana, is a civil law concept while torts is an Anglo-American or common law concept. Torts is much broader than culpa aquiliana because it includes not only

9. *Id.*
10. *Id.* at 40.
11. Jorge C. Bocobo, *Dr. Jorge Bocobo's Commentaries*, *in* CIVIL CODE READER 470 (Carmelo V. Sison, 2005 ed.).
12. Tolentino, *supra* at 70.
13. REPORT OF THE CODE COMMISSION, *supra* note 4, at 40.
14. Bocobo, *supra* note 7, at 514.
15. Civil Code of the Philippines, Article 2176 provides, "Whoever by act or omission causes damage to another, there being fault or negligence, is obliged to pay for the damage done. xxx."
16. G.R. No. 97336, 19 February 1993.

> negligence, but intentional criminal acts as well such as assault and battery, false imprisonment and deceit. In the general scheme of the Philippine legal system envisioned by the Commission responsible for drafting the New Civil Code, intentional and malicious acts, with certain exceptions, are to be governed by the Revised Penal Code while negligent acts or omissions are to be covered by Article 2176 of the Civil Code. In between these opposite spectrums are injurious acts which, in the absence of Article 21, would have been beyond redress. Thus, Article 21 fills that vacuum. It is even postulated that together with Articles 19 and 20 of the Civil Code, Article 21 has greatly broadened the scope of the law on civil wrongs; it has become much more supple and adaptable than the Anglo-American law on torts."

The foregoing provisions of law are based upon justice, and were made suitable to Philippine conditions. The Civil Code incorporated into the positive law of the Philippines very many claims that had remained only within the sphere of natural law. It was intended by the Code Commission that the many grievances not redressed and the many injustices committed in the relations among men be righted and given some adequate legal remedy.[17] It was opined by the Code Commission that the guides for human conduct contained in these articles should run as golden threads through society, to the end that law may approach its supreme ideal, which is the sway and dominance of justice.[18]

Let me present a few examples of recent decisions of the Supreme Court of the Philippines, which interpreted and applied these provisions on Human Relations.

In *Joyce Ardiente v. Spouses Javier*,[19] a seller sold a housing unit to the buyer. Under the terms of their agreement, the buyer would be responsible for all the utilities. However, the seller's rights over the utilities were never formalized with the water supplier. Hence, the seller was able to cut off the water supply of the buyer. The Court held that such conduct amounted to a violation of Article 19 because even if the seller still had the right to tell the water supplier to cut off the buyer's water supply, such right was exercised in bad faith to the prejudice of the buyer.

In *California Clothing, Inc. v. Shirley Quiñones*,[20] a woman bought a pair of jeans at a store. Upon leaving the store, the woman was chased by the store employees, claiming that she failed to pay for the item. The woman showed the employees the receipt, but they were not convinced, so they accompanied her to her office where her belongings were searched, her employer was informed of the supposed theft, and she was humiliated in front of clients. The Court held that while the employees had the right to ensure the item was paid for, that did not justify the excessive means employed by the employees against the woman.

There are several other provisions on Human Relations that the Philippine Civil Code covers. The chapter on Human Relations likewise contains provisions against unjust enrichment, violation of privacy, and unfair competition.

But one more interesting provision is Article 32[21]. Article 32 allows a person to file an independent civil action for damages arising from a violation of any constitutional right, whether

17. REPORT OF THE CODE COMMISSION, *supra* note 4, at 5-6.
18. *Id.* at 39.
19. Joyce Ardiente v. Spouses Javier, G.R. No. 161921, July 17, 2013.
20. California Clothing, Inc. v. Shirley Quiñones, G.R. No. 175822, Oct. 23, 2013.
21. Civil Code of the Philippines, Article 32 provides:

"Art. 32. Any public officer or employee, or any private individual, who directly or indirectly obstructs, defeats, violates or in any manner impedes or impairs any of the following rights and liberties of another person shall be liable to the latter for damages:

> (1) Freedom of religion; (2) Freedom of speech; (3) Freedom to write for the press or to maintain a periodical publication; (4) Freedom from arbitrary or illegal detention; (5) Freedom of suffrage; (6) The right against deprivation of property without due process of law; (7) The right to a just compensation when private property is taken for public use; (8) The right to the

by a public officer or a private individual. This transcends the usual understanding that the constitutional rights provided under the chapter on the Bill of Rights usually just regulate the actions of the Government and its officers and agents. Article 32 expands this by allowing a person to claim damages against a private person who violates his constitutional rights, such as the right to privacy and free exercise of religion.

The underlying purpose of Article 32 is to allow the citizen to enforce his rights in a private action brought by him, regardless of the action of the State attorney. It is not conducive to civic spirit and to individual self-reliance and initiative to habituate the citizens to depend upon the government for the vindication of their own private rights.[22] Article 32 also recognizes that the civil liberties guaranteed by the Constitution need further implementation. The present laws are inadequate for the protection of individual rights as intended by the fundamental law.[23]

Taken alone, the creation of an absolutely separate and independent civil action for the violation of civil liberties is essential to the effective maintenance of democracy. In most cases, the threat to freedom originates from abuses of power by government officials and peace officers. Usually, the citizen has had to depend upon the prosecuting attorney for the institution of criminal proceedings, so that the wrongful act might be punished under the Penal Code and the civil liability exacted. But not infrequently, because prosecutors are burdened with too many cases or because they believe that evidence is insufficient, or worse, he is disinclined to prosecute a fellow public official (usually of a high rank), no criminal action would be filed. The aggrieved citizen is thus left without redress. And at times, even when the prosecuting attorney filed a criminal action, the requirement of proof beyond reasonable doubt often prevented the appropriate punishment. On the other hand, an independent civil action would afford the proper remedy by a mere preponderance of evidence.[24]

Direct and open violations of the Penal Code trampling upon the freedoms named are not so frequent as those subtle, clever, and indirect ways, which do not come within the pale of the penal law. It is in these cunning devices of suppressing or curtailing freedom, which are not criminally punishable where the greatest danger to democracy lies. Thus, the injured citizen will always have, under the Civil Code, adequate civil remedies before the courts because of the

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> equal protection of the laws; (9) The right to be secure in one's person, house, papers, and effects against unreasonable searches and seizures; (10) The liberty of abode and of changing the same; (11) The privacy of communication and correspondence; (12) The right to become a member of associations or societies for purposes not contrary to law; (13) The right to take part in a peaceable assembly to petition the government for redress of grievances; (14) The right to be free from involuntary servitude in any form; (15) The right of the accused against excessive bail; (16) The right of the accused to be heard by himself and counsel, to be informed of the nature and cause of the accusation against him, to have a speedy and public trial, to meet the witnesses face to face, and to have compulsory process to secure the attendance of witness in his behalf; (17) Freedom from being compelled to be a witness against one's self, or from being forced to confess guilt, or from being induced by a promise of immunity or reward to make such confession, except when the person confessing becomes a State witness; (18) Freedom from excessive fines, or cruel and unusual punishment, unless the same is imposed or inflicted in accordance with a statute which has not been judicially declared unconstitutional; and (19) Freedom of access to the courts.

In any of the cases referred to in this article, whether or not the defendant's act or omission constitutes a criminal offense, the aggrieved party has a right to commence an entirely separate and distinct civil action for damages, and for other relief. Such civil action shall proceed independently of any criminal prosecution (if the latter be instituted), and mat be proved by a preponderance of evidence.

The indemnity shall include moral damages. Exemplary damages may also be adjudicated.

The responsibility herein set forth is not demandable from a judge unless his act or omission constitutes a violation of the Penal Code or other penal statute."

22. REPORT OF THE CODE COMMISSION, *supra* note 4, at 46.
23. *Id.* at 28-29.
24. Id.

independent civil action, even in those instances where the act or omission complained of does not constitute a criminal offense.[25] Malice or bad faith is not necessary under this article because to make it such a requisite would defeat the main purpose of this article, which is the effective protection of individual rights.[26]

Note that the philosophy of individualism that characterizes these new provisions of the Civil Code is not based on Roman law, but on the individualism of American common law. The Code Commission believed that democracy draws its breath of life from the spirit of rugged individualism, and should not derive its effectiveness from the action of public officials. The philosophy of the Anglo-American torts is that private wrongs should be redressed in a private civil action. When this principle shall have seeped into the general consciousness of our people, there will arise and develop a spirit of individual independence on which, when all is said and done, popular government rests.[27] This new reform places in the hands of the people themselves the power to seek remedy in the courts without having to depend on the fiscal or public prosecutor who, for some reason or another, is unwilling to start prosecution. The intention of the new Civil Code is to foster this rugged individualism, which is the very life of democracy.[28]

Article 32 is patterned after the Anglo-American concept of tort.[29] The Philippine Supreme Court explained that as to tort, "[there] are cases in which it has been stated that civil liability in tort is determined by the conduct and not by the mental state of the tortfeasor, and there are circumstances under which the motive of the defendant has been rendered immaterial."[30] As such, the innovation in the Philippine Civil Code is to "create a distinct cause of action in the nature of tort for violation of constitutional rights, irrespective of the motive or intent of the defendant."[31]

Thus, the purpose of Article 32 is to cultivate in our citizens an undaunted determination to guard their liberties guaranteed by the Constitution, without depending on public prosecutors. Our citizens should learn to make use of this right of action not only to obtain indemnity, but also to help build a general respect for individual liberties.[32]

It is the belief therefore that taken in their entirety, the combination of Articles 19, 20, 21 and 32, together with the establishment of the courts of justice, simply enhance the time-honored principle that no person hence can take the law in his own hands. Any person who is entitled to enforce a right must resort to the courts, or any other competent authority, to enforce such right.[33]

Interestingly, recent events have shed light on a few potential challenges in the implementation of these provisions.

In 2010, Carlos Celdran, a Filipino tour guide and an advocate of reproductive health rights, disrupted an ongoing mass in order to express his disdain with the Catholic Church. At the time, the Philippine Catholic Church opposed the Philippine reproductive health bill, which, among others, mandated increased availability of artificial contraceptives. In response, Celdran entered the Manila Cathedral and staged a protest during a mass. He dressed himself in garb mimicking Philippine National Hero José Rizal and he held up a sign saying "*Damaso*" – a reference to a corrupt friar who was a central character in Rizal's *Noli Me Tangere*, a book that sparked the Philippine revolution against Spain.

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25. *Id.* at 30-31.
26. Totlentino, *supra* at 129-130.
27. Pacifico A. Agabin, *Philosophy of the Civil Code*, *in* CIVIL CODE READER, *supra* note 7, at 245.
28. Bocobo, *supra* note 7, at 472.
29. *Vinzons-Chato v. Fortune Tobacco,* G.R. No. 141309, 19 June 2007.
30. *Ibid.*
31. *Ibid.*
32. *Id.* at 522.
33. Tolentino, *supra* at 68.

Celdran was arrested and is currently being tried for offending religious feelings, a seldom-used provision under the Philippine Revised Penal Code. But beyond this, and with regard to civil liabilities, public reception for Celdran's acts is divided: certain sectors of society lauded his acts as a manifestation of an individual's freedom of expression, while some disagreed, seeing his acts as overtly disrespectful of religious liberties.

From a civil law perspective, thus, the question remains: could there be a concurrent application of the abuse of rights doctrine and the provisions on independent civil actions for violation of a constitutional right? Can, for example, the right to free speech be abused as to be a source of damages, and can such claim for damages be a form of suppression which in turn can be made subject to a claim for damages? As of now, this is a lacuna or a gap in this chapter of the Philippine Civil Code that has yet to find any cogent solution.

I wish to end with a quote from Dr. Eugen Huber, author of the Swiss Civil Code, on "Right and Its Realization." He stated that:

> "Juristic conscience, enlightened by culture and experience in life, in the case of the judge as well as in that of the jurist or of the right-thinking citizen, and above all, of the law-maker, has to seek and formulate that solution which every time responds to the highest exigency, bearing in mind the transcendent purpose of realizing whatsoever is just."[34]

PRE-CONTRACTUAL LIABILITY

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Abstract

Pre-contractual stage has been long ignored by traditional Codes whose classical contract rules were mainly focused on defining and regulating offer and acceptance and their perfect matching as expression of the agreement. Commercial practice does contrarily offer an image that greatly differs from such simple, single-issue and adversarial offer-acceptance model. Pre-contractual statements, preliminary agreements, negotiations and other bargaining behaviours preceding the conclusion of the contract are not only frequent in commercial trade but do also play critical roles in relation to the contract that should not be disregarded: assisting in interpreting parties' real intent, supplementing the contract and signalling eventual vices of consent caused by the breach of pre-contractual duties. In contrast to currently in force Code provisions that still remain silent, in some uniform texts, express rules on pre-contractual liability have been adopted. At the domestic level, two revealing, albeit partial, movements lead the long awaited legislative evolution. On the one hand, specific pre-contractual duties are being provided for in special laws (consumer law, rules on electronic commerce, insurance law, financial regulations). On the other hand, attempts to formulate general rules on pre-contractual liability have been made within the framework of two reform initiatives, still pending, aimed to modernize, respectively, Spanish Civil Code and Spanish Commercial Code.

Key Words

Contract formation, pre-contractual, liability, preliminary agreements, duty to inform, MoU (Memorandum of Understanding), freedom to deal

I.- Contract Formation: Context and Process

In commercial trade, a contract is essentially the outcome of a process along which negotiating parties aim to reach an agreement within a specific transactional context. Therefore, gaining a full insight into a contract requires taking into consideration such two factors: the process leading to the agreement and the context within parties' positions have approached. Far from a simplistic understanding of the contract as a perfect fitting of two converging parts – offer and acceptance -, contract formation is indeed a continuum along which negotiations and will formation stages pass. From a dynamic perspective, real negotiations visibly depart from the simple image envisioned by the classic rules of offer and acceptance that captures "single-issue, adversarial, zero-sum bargaining as opposed to multi-issue, problem-solving, gain-maximizing negotiation"[1].

Even if many cases in modern trade parties enter into an agreement instantaneously (daily transactions), in general terms, a contract is the result of a multi-phased and considerably complex process: the contract formation process.

According to the mainstream thesis on contract life, three stages might well be worth being distinguished. Firstly, pre-contractual stage that comprises all acts and conducts intending to

[1] As brilliantly described by Allan FARNSWORTH, "Precontractual Liability and Preliminary Agreements: Fair Dealings and Fair Negotiations", 87 *Colum. L. Rev.* 217 1987.

reach an agreement between the parties. Secondly, ("gradual or progressive") conclusion of the contract that describes the moment or the phase where the agreement arises as a result of the offer and the acceptance. Thirdly, performance of the contract in order to satisfy parties' interests – *Supreme Court,* judgments of 24 June 1991 (RJ 1991, 4578); of 28 February 1996 (RJ 1996, 1268); of 30 September 1988 (RJ 1988, 6939); of 3 October 1966 (RJ 1966, 4481); of 31 October 1951 (RL 1951, 2364); of 10 January 1922 (CL January 1922, num. 13); of 12 June 1900 (CL June 1900, num. 15).

Despite the more or less common perception of contracts in modern trade as instantaneous phenomena, process aiming to reach an agreement between the parties may be long, multi-phased and considerably complex, where negotiations, preliminary agreements and previous statement along the pre-contractual stage play a critical role. In sum, preliminary dealings are also building materials of the final agreement.

Wrongly, expressions as "previous, preparatory or preliminary acts" might encourage the conception that such behaviours, dealings, covenants or genuine agreements are unnecessary and unimportant to the extent that they do simply precede the conclusion of the agreement and acclimatize negotiations. Certainly, negotiations prior to the agreement are neither indispensable nor necessary in the effective perfection of a valid and enforceable contract. Nonetheless, when preceding the formation of the contract, the pre-contractual stage performs essential functions in the interpretation, the gap filling and the enforceability of the final contract. Not surprisingly, sophisticated business parties and their legal counsels engage time and resources in preliminary contacts and dealings conducting a complex negotiation process, fully aware of their critical role for the success of the transaction.

In long and complex transactions, the relevance of negotiations stands out naturally. But even in those transactions that appear to arise instantaneously and be concluded on a simultaneous basis, a decontextualized and static approach proves to be inadequate and partial. Mass trade's needs have triggered the use of standard terms and contracts of adhesion, even to conclude commercial transactions. Not even in standard term contracts, pre-contractual stage becomes inexistent or irrelevant. Contrarily and despite that the apogee of the pre-contractual phase is revealed in long, complex and multifactor negotiations, information duties and other typically pre-contractual obligations are appreciably comparable and still decisive in the formation of the agreement in "dealings without dealings/negotiations". A number of Court decisions in banking, insurance or electronic commerce cases confirm the relevance of the compliance of pre-contractual obligations in assessing the validity and the enforceability of the final agreement.

In contrast to its crucial value in practice and its relative legal controversial nature, pre-contractual stage has been long ignored by legislator. Spanish Codes, both Civil Code and Commercial ones, have historically disregarded pre-contractual issues. Currently, international uniform instruments and some modernizing projects and proposals for legal reform are correcting such a traditional oversight and filling the historical gap. For reform initiatives are not enacted yet, a systematic, comprehensive and all-embracing legal treatment for pre-contractual stage is still missing in Spanish domestic rules.

Considering that, the aim of this Paper is to critically analyse most recent modernizing proposals to regulate pre-contractual obligations and liability in Spanish legal system compared to most significant uniform rules governing the preparatory phase in contract formation. To that end, the Paper is structured as follows. After these introductory remarks, Part II delimits the pre-contractual phase, proposes a definition and expounds its main functions. In Part III, uniform rules and, currently in force as well as proposed, domestic ones are traced. All rules pursue a stable balance between the exercise of freedom to deal and the due protection of reasonable expectations. Hence, on the one hand, cases where freedom to deal/not to deal and reasonable

expectations conflict have to be identified and the resulting pre-contractual liability typified to the possible extent, and, on the other hand, available remedies, in such cases, have to be proposed. Under Part III, two main issues are discussed accordingly: duty to inform (non-disclosure obligations will not be dealt with) and pre-contractual liability. Part IV deals with preliminary agreements and how negotiating parties wish to "contractualize" their pre-contractual contacts and negotiations and to which extent they are entitled to depart from liability rules and to shape their pre-contractual obligations.

II.- Pre-Contractual Stage: Concept, Scope and Functions

Any attempt to approach pre-contractual stage and define it in legal terms clashes with an inherent complexity, heterogeneity of acts and variety of behaviours likely to concur in the formless, imprecise and vague period preceding the conclusion of the contract. Certainly, the pre-contractual stage may comprise a wide range of actions, behaviours, agreements and activities of varied nature – mere contacts, information exchange, negotiations, advertisement, commercial dealings, preliminary agreements -. Such complexity, disparity and heterogeneity hinder all efforts to formulate a legal definition. By nature, pre-contractual stage encompasses a broad spectrum of acts, is open and indeterminate in length. Therefore, a working legal definition of pre-contractual stage has to manage and internalize such natural features, instead of attempting to conceal them or ignore them.

Considering that, it is my contention that two factors succeed in satisfactorily demarcating the legal outline of the pre-contractual stage: a time factor and a teleological or final factor.

a). Under a time perspective, the pre-contractual stage can comprise solely those acts, behaviours, activities or agreements, no matter their nature and scope that precede the conclusion of the agreement. Then, logically, once the contract is concluded, the pre-contractual stage has definitively finished and any action, statement or behaviour should be labelled "contractual" or "post-contractual" (performance stage). Although the rationale of the proposed time factor is extremely obvious and might even appear too simple, it may show some legal complexity when attempting to pinpoint the beginning and the end of the pre-contractual stage. Not surprisingly, it might be questioned, on the one hand, when informal conversations, a first approach, expressions of interest, mere contacts and requests of information qualify for being deemed genuine "pre-contractual" acts likely to exert any impact on the future contract, if finally reached. Interestingly, on the other hand, despite it is clear the assertion that the pre-contractual stage ends when the contract is concluded, it might be well worth discussing when the pure contract formation stage starts. Should it argue that the first firm offer opens the contract formation/perfection phase – offer, counteroffers, acceptance -, any subsequent declaration will not be then pre-contractual anymore. Therefore, to ascertain when a statement made by one party amount to an offer becomes the priority task. Departing from the definition of offer, previous acts and subsequent statements likely to affect the contract conclusion can be identified.

Scholars' opinions differ. A rigorous approach would understand that preliminary dealings would end when an offer is proposed. Under that perspective, although the contract is not perfected yet, the exchange of offers, counteroffers and acceptance would form the "successive contract formation stage". Contrarily, from a broader and all-embracing approach, the pre-contractual stage would encompass all actions, dealings and negotiations until the perfection of the contract. Under such wide perspective, the pre-contractual stage may even start with an offer subsequently negotiated by parties until the reaching of the agreement.

Notwithstanding the different nature and the legal implications of simple negotiations compared to authentic offers or counteroffers, I tend to defend the broadest conception of pre-contractual stage.

B). The time perspective has to be necessarily completed with a final factor. Many imprecisions and uncertainties resulting from the sole application of the time factor are repaired by applying the final factor. The pre-contractual nature of an action is not only a question of time. Not all behaviours and statements preceding the conclusion of the contract are pre-contractual, unless they are aimed to reach an agreement. Hence, a final or teleological factor is needed to duly demarcate the scope of the pre-contractual stage. In sum, the pre-contractual stage comprises all acts, behaviours, negotiations, preliminary agreements or any other dealings that, preceding the conclusion of the contract, are addressed to reach an agreement between the negotiating parties.

The final factor enables to draw the distinction between preliminary agreements and the final agreement. Preliminary agreements - MoU (Memorandum of Understanding), Term Sheet, NDA (Non-Disclosure Agreements) - are not sought by the parties on an isolated basis; their value is instrumental, their conclusion is contributory to and oriented towards the reaching of the final contract.

To conclude, the pre-contractual stage demarcates a formless, broad and of imprecise limits set of acts, negotiations, dealings, expressions of interests, preliminary agreements and other commercial contacts that enable parties to approach their positions, evaluate their interests and reach an agreement. A time factor and a final one, as discussed above, amalgamate such a disparity of behaviours and statements under the pre-contractual label.

Broadly speaking, preliminary deals embrace a wide-ranging, elastic and multiform stage of the formation process comprising acts and statements whose common factor is precisely temporal: acts, conducts and statements made by on party aimed at reaching an agreement but prior to the arising of an offer (or under an extended understanding of formation stage, prior to the arising of a contract). Such deliberating period is not indispensable for the agreement to be concluded. That could probably explain the long disregard revealed by scholars and courts of the existence and the conditions of negotiating period rendering apparently unnecessary and inconvenient further legal analysis on preliminary deals from a contract law approach. Notwithstanding the foregoing limited perception of preliminary deals, if preceding the reaching of an agreement they are decisive to:

> i). construe parties' intent for interpretation[2] purposes. All preliminary dealings and previous statements are likely to operate as interpretative criteria to find out the real

[2] Interpretation of commercial contracts is governed by special rules aiming at better meeting trade needs and market demands. The key rule for interpreting commercial contracts is Article 57 Spanish *Commercial Code* where good faith requirements play a prominent role (even more prominent than in civil contracts) in the interpretation, the performance and the enforcement of commercial contracts. Unlike the subjective theory of civil interpretation, statements made by the parties in commercial agreements are to be interpreted according to the sense and the meaning having in the particular trade concerned (technical interpretation). Should foregoing rules fail to solve the uncertainties of the contracts, the rule *favour debitoris* (in favour of the debtor) shall be applied. When the contract at hand is qualified as an adhesion contract or one of the contracting parties is a consumer, rules *pro consumatore* and *contra proferentem* are applicable for the weakest party benefit. As far as adhesion contracts and standard contract terms are concerned, specific legislation (*Standard Contract Terms Act 1998*), besides importing the just described rules in favour of the weakest party (adherent) from the Spanish *Civil Code*, declares the prevalence of individually negotiated clauses over the standard contract terms (not individually

intent of contracting parties or to serve as reference points to assess the expected understanding of a reasonable person in similar circumstances. Even the inclusion in the contract of a *merger clause* (or *entire agreement clause*)[3] does not automatically prevent the resort to previous statements or preliminary agreements for interpretation purposes, unless expressly stated so by parties in the said clause.

ii). fill gaps or supplement the final agreement. According to Article 1258 Spanish *Civil Code,* parties are to abide by not only the expressly agreed terms but also the natural consequences of the agreement as far as they are in conformity with usages, law and good faith requirements. The foregoing wording is to be supplemented by Article 1287 that apart from stating interpretation rules establishes that usages normally observed in the country (or place of the conclusion of the contract) shall fill the gaps of contracts by including currently agreed clauses. Hence, usages generally observed in the specific trade concerned and in the place where the contract has been concluded shall play a supplementing role to fill the gaps of the agreement. In this regard, usages to be applied comprise practices regularly observed in the relevant place but they should not be mistaken for clauses, conducts or practices statistically frequent in trade when they do not amount to a country custom. In addition, the guiding principle of good faith, besides being a subjective model to interpret or qualify parties' intent, represents a legal standard of conduct embodying specific duties for the parties according to socially accepted behaviours.

As far as consumer transactions are concerned, the courts have formulated a consumer-biased doctrine whereby statements made by the professional supplier in advertisement before or when the contract is concluded is to be treated as giving rise to a contractual obligation as regards the quality or use of the supplied services or goods or other property. In accordance to the described doctrine, the courts held that the developer was bound to build and deliver the housing development with the three tennis courts as published in the advertisement brochure thereof – *Supreme Court,* judgment of 23 May 2003 -. The same theory is inspiring Article 6.101 EPCL, although the rule is not only devoted to consumer contracts. Moreover, the rule is qualified by the requisite of ignorance of the inaccuracy of the statement as embodying indeed good party by the trusting party:

> "(u)nless it is shown that the other party knew or could not have been unaware that the statement was incorrect".

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negotiated terms) in case of conflict thereof, unless the latter ones are more favourable for the adherent (Article 6).

[3] Entire agreement clauses are commonly included in commercial contracts as part of the boiler plate provisions.

> "This Agreement [...] constitutes the entire agreement [...] this Agreement shall supersede any prior promises, agreements, representation, undertakings or implications whether made orally or in writing between you and us relating to the subject matter of this Agreement [....]".

Such a clause aims to prevent the party relying upon it from being liable for statements or representations (including pre-contractual representations), except as expressly laid out in the contract.

In *AXA Sun Life Services PLC v Cambell Martin [2011] EWCA Civ 133*, the Court of Appeal held that the entire agreement clause on its true construction, the language was not intended to exclude liability but rather it sought to ensure that prior representations did not become terms of the contract. In sum, only the supplementing function of pre-contractual statements had been properly excluded by agreement. Certainly, parties may achieve that goal and exclude liability for pre-contractual misrepresentation, provided that provisions are clear and precise to that effect.

iii). signal vices of consent (i.e. mistaken consent due to lack of information provided by the counterpart during negotiations). Provided that one of the most paradigmatic pre-contractual duties is the duty to inform, misinformation, omissions or unreasonable reluctance to reveal relevant data likely to affect the proper decision-making process of the counterparty can be the cause of a subsequent mistake, error or vice in the manifested consent.

III.- Rules governing Pre-contractual stage: obligations and liability

In negotiating, parties are exercising their freedom to contract and, as a consequence, not to contract as well. Accordingly, the freedom to negotiate or to stop negotiations at a specific moment would be a natural expression of the general freedom to contract. Not surprisingly, parties are supposed to be free to leave or interrupt negotiations at any time or to renegotiate conditions at stake at their convenience. Freedom to deal and not to deal should be protected accordingly. Nonetheless, reasonable expectations of the counterparty and his/her confidence in the seriousness of the negotiation process should be also protected anyhow against harming acts in bad faith. A balance between protecting trust and honoring freedom to contract has to be carefully settled.

Three regulatory issues deserve special attention. Previously, a prior matter has to be briefly mentioned: whether current Philippines and Spain count on specific rules on pre-contractual stage. Against such a normative backdrop, three questions will be discussed. Firstly, whether in comparative law, and particularly, in Philippine and Spain, it is, either expressly or impliedly, provided for that good faith principle has to govern preliminary dealings. Secondly, which specific obligations negotiating parties are subject to and whether such pre-contractual duties are typified in statutes. Thirdly, which rules would govern pre-contractual liability: typical cases and remedies.

III.A. Rules on pre-contractual stage

The theoretical construction of *culpa in contrahendo* doctrine was masterly formulated by the German scholar Rudolf von Ihering in the second half of XIX century. His ideas were widely adopted later by scholars and subsequently enshrined in some national codes (BGB, Swiss codes). But general rules on pre-contractual liability are not actually enacted until the promulgation of later codes such as the Greek code and the Italian one. Subsequently, other European Code, as the Portuguese one, follows the same policy. Along with such a slow legislative acknowledgement, the theoretical framework and the practical scope of pre-contractual liability have been always illuminated and fuelled by active German courts. Likewise, Faggella's [4] works leaded the evolution of such legal construction in European scientific literature and case law.

In Spain and Philippines, in particular, codes have been traditionally silent in respect to pre-contractual stage and, accordingly, a systematic set of rules governing, on a comprehensive basis, parties' obligations and eventual liability in the negotiation period prior to the reaching of the agreement are lacking. On the one hand, basic duties were to infer from the general principle of good faith. Nonetheless, on the other hand, specific pre-contractual duties started to be typified in special legislation mainly tackling consumer transactions or transactional situations whose context or circumstantial conditions increase the need to protect one of the

[4] FAGGELLA, "Dei Periodi precontrattualli e Della loro vera ed escatta costruzione scientifica", in 4 *Studi giuridici in onore di Carlo fadda* 217 (1906). G., Faggella, "Fundamento giuridico Della responsabilità in tema di trattative contrattuali", *Arch. Giur.,* 128 (1909); "II periodi precontratuali e la responsabilità precontrattuale", *Arch. Giur*., 18 (1918).

prospective contracting party – information obligations in electronic contracting (Article 27 Law 34/2002) – or information asymmetries need to be repaired – traditional duty to disclose risks in insurance contracts (Article 10 Law 50/1980 on Insurance) -. The regime is then fragmented in scattered legal rules of diverse scope and aims and fuelled by a powerful, albeit indeterminate, principle of good faith. Philippine legislation does also lack a general legal framework governing pre-contractual stage. Articles 19 and 20 of Philippine Civil Code acknowledges that the exercise of any right and the performance of any duty have to be in accordance with justice and in observance of honesty and good faith[5]. Hence, the general principle of good faith would cast over the pre-contractual stage naturally.

In contrast with the absence of a general regulation in domestic legislation, several supranational texts of different nature and scope, are expressly including rules on pre-contractual duties: Article 2.1.15 UNIDROIT Principles[6], Article 2:301 Principles of European Contract Law[7] or Article I.-1:103 Draft Common Frame of Reference.

Likewise, other European jurisdictions do also have express provisions on pre-contractual liability: Articles 197 and 198 Greek Civil Code, Articles 1337 and 1338 Italian Civil Code or Articles 8, 23 and 24 Swiss Civil Code.

Very recently, the draft new Commercial Code, albeit not in force yet, has nevertheless included two legal provisions dealing with pre-contractual issues (confidentiality obligation and pre-contractual liability): Articles 412-1 and 412-2[8], respectively. Previously, in 2009, the Proposal

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[5] As Professor Balane clearly explains there are no explicit or specific provisions in Philippines Civil Code on pre-contractual liability (.i.e. in the negotiation stage) in case of bad faith or fault. However, there are general provisions that govern the matter and provide for liability in case of bad faith. On the one hand, Articles 19, 20, and 21 of the Code may be cited:

> Article 19.
> "Every person must, in the exercise of his rights and in the performance of his duties, act with justice, give everyone his due, and observe honesty and good faith."
> Article 20.
> "Every person who, contrary to law, willfully or negligently causes damage to another, shall indemnify the latter for the same".
> Article 21.
> "Any person who willfully causes loss or injury to another in a manner that is contrary to morals, good customs or public policy shall compensate the latter for the damage."

[6] Article 2.1.15 UNIDROIT Principles:

> "(1) A party is free to negotiate and is not liable for failure to reach an agreement.
> (2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party.
> (3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party."

[7] Article 2:301 EPCL

> "(1) A party is free to negotiate and is not liable for failure to reach an agreement.
> (2) However, a party who has negotiated or broken off negotiations contrary to good faith and fair dealing is liable for the losses caused to the other party.
> (3) It is contrary to good faith and fair dealing, in particular, for a party to enter into or continue negotiations with no real intention of reaching an agreement with the other party."

[8] Article 412-1. *Deber de confidencialidad.*

> *"Cada una de las partes deberá mantener confidencialidad sobre la información reservada que con este carácter reciba de la otra en el curso de las negociaciones.*
> *La parte que infrinja el deber de confidencialidad responderá de los daños y perjuicios que ocasione a la otra parte la infracción de ese deber".*

Article 412-2. *Responsabilidad por los daños causados en la fase preparatoria del contrato.*

> *1. En el caso de que se hubieran entablado negociaciones para la celebración de un contrato mercantil, ninguna de las partes incurrirá en responsabilidad por el solo hecho de que no se consiga un acuerdo definitivo.*

for the Modernization of the Law of Contracts and Obligations expressly addressed pre-contractual liability as well in Article 1245[9] Civil Code[10].

III.B. Good faith in negotiating

Preliminary deals are aimed at reaching an agreement but do not entail the existing of any contract between the negotiating parties. Therefore, in absence of contract, parties are not to abide by a set of rules agreed thereby. Good faith principle is the only guiding rule governing the negotiation period. Parties are expected to bargain in good faith.

Principle of good faith should permeate all acts and behaviors (Article 1:201 EPCL[11], Article 1.7 UNIDROIT Principles in similar terms), insofar as the exercise of rights and the compliance of duties should be in accordance to good faith requirements[12] and fair dealing[13]. The natural consequence of this prevailing principle is its extended application to all stages of contractual process: negotiations, contract formation and performance. Roman Law-rooted legal systems[14] extensively accept such general assertion. *Common Law* systems are not totally unfamiliar with good faith principle and *culpa in contrahendo,* although approaches are majorly diverging. On the one hand, whereas a duty of fair dealing is generally imposed on the parties to a contract[15], the good faith principle is not formulated so as to extend to pre-contractual negotiations conceived more as an adversarial process[16] than a cooperative one. On the other hand,

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2. La parte que hubiera negociado o interrumpido las negociaciones con mala fe será responsable por los daños causados a la otra parte. En todo caso se considera mala fe el hecho de entrar en negociaciones o de continuarlas sin intención de llegar a un acuerdo".

[9] Article 1245 as drafted in the Modernisation Proposal:

"1. Las partes son libres para entablar negociaciones dirigidas a la formación de un contrato, así como para abandonarlas o romperlas en cualquier momento.

2. En la negociación de los contratos, las partes deberán actuar de acuerdo con las exigencias de la buena fe.

3. Si durante las negociaciones, una de las partes hubiera facilitado a la otra una información con carácter confidencial, el que la hubiera recibido solo podrá revelarla o utilizarla en la medida que resulte del contenido del contrato que hubiera llegado a celebrarse.

La parte que hubiera procedido con mala fe al entablar o interrumpir las negociaciones será responsable de los daños causados a la otra.

En todo caso, se considera contrario a la buena fe entrar en negociaciones o continuarlas sin intención de llegar a un acuerdo.

5. La infracción de los deberes de que tratan los apartados anteriores dará lugar a la indemnización de daños y perjuicios. En el supuesto del apartado anterior, la indemnización consistirá en dejar a la otra parte en la situación que tendría si no hubiera iniciado las negociaciones."

[10] CUADRADO PÉREZ, C., "La responsabilidad precontractual en la reforma proyectada: ¿una ocasión perdida? (Parte I)", *Revista Crítica de Derecho Inmobiliario,* nº 744, 2014.

[11] Article 1:201 EPCL *Good Faith and Fair Dealing*

"(1) Each party must act in accordance with good faith and fair dealing.

(2) The parties may not exclude or limit this duty".

[12] Alfonso DE COSSÍO Y CORRAL, *El dolo en el Derecho civil,* Madrid: Revista de Derecho Privado, 1955, p. 247.

[13] Both the Uniform Commercial Code and the Restatement (Second) of Contracts couple "fair dealing" with "good faith." U.C.C. § 2-103 (1978); Restatement (Second) of Contracts § 205 (1981).

[14] Observance of good faith in contracting was already demanded in Roman Law. MENGONI, L. (1956), "Sulla natura della responsabilità precontrattuale (comentario a Cass. 5 maggio 1955, n. 1259 e alla decisione del Trib. Roma, 24 gennaio 1955)", II *Rivista di Diritto Commerciale*, pp. 362 and 365 a 367.

[15] U.C.C. § 1-203 (1978); Restatement (Second) of Contracts § 205.

[16] It is commonplace to refer to the frontal oposition of Lord Ackner inwalford v. Miles [1992] AC 128, 138:

"(…) However, the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations (…)"

nevertheless, with different legal machinery - “duty to disclose”, “estoppel”, “implied subsidiary promise” or “instinct with an obligation” doctrine – same philosophy of *culpa in contrahendo* and similar rationale underlying the expansion of good faith are supported. Along the same lines, case law in common law jurisdictions, specially in US, is showing in last decades an increasing openness to accept pre-contractual cases and impose liability. Possible and most feasible grounds are in those cases grouped under three main categories: unjust enrichment, misrepresentation during the negotiations, breach of specific promise.

Interestingly, considering such a diverging Common Law-Civil Law approach [17] on the observance of good faith in pre-contractual negotiations, it might be well worth discussing whether Filipino legal system reveals in that matter a more visible American perspective or, contrarily, perpetuates a civilian understanding. Far beyond codified rules, a proper characterization of a legal system need to take into consideration a range of historical, institutional, educational or social factors describing how law is made, applied, interpreted, taught and socially perceived - *In re Shoop,* Supreme Court of Philippines Islands decision, 1920 (41 Phil. 213) -.

The above-mentioned divergences appear not be irreconcilable but it cannot be confirmed either that the application of good faith, in particular, to pre-contractual stage, is commonplace. Revealingly, in uniform instruments an express reference to the duty to act in good faith is avoided. UNIDROIT Principles and EPCL are illustrative in that regard when eluding an express recognition of good faith in pre-contractual dealings by resorting to a negative formulation: “negotiations in bad faith” (UNIDROIT Principles) and, less revealing but still opting for banning acts contrary to good faith instead of requiring a general observance of that principle, “negotiations contrary to good faith” (EPCL).

Unlike Article 1245 Civil Code as proposed by the Modernisation Proposal that included an express declaration of good faith in negotiations[18], Draft new Commercial Code aligns with uniform texts and does only utilize the negative formula. So, Article 412-2 devises the pre-contractual liability scheme around the element of bad faith without a general declaration of the duty to act in good faith: “(l)a parte que hubiera negociado o interrumpido las negociaciones con mala fe será responsable por los daños causados a la otra parte”.

III.C. Pre-contractual duties

The general principle of good faith would distil in a varied set of specific pre-contractual duties considering transactional circumstances, condition of the parties and other concurring factors. An exhaustive list of pre-contractual obligations, drafted in general terms, is not provided for by existing laws. Some special laws have expressly formulated specific duties for the pre-contractual stage: consumer law, laws governing electronic commerce and Internet service provision, or financial markets law. Although these provisions serve to signal the main angles of outline of pre-contractual duties and help to better understand the principle of good faith in practice, their assistance in interpretation is limited. On the one hand, for their compliance and enforcement are confined to the scope and conditions set out by each legislation, and, aimed to meet specific goals. On the other hand, because a mere formalistic compliance does not

[17] FARNSWORTH, E.A., “Duties of Good Faith and Fair Dealing under UNIDROIT Principles: Relevant International Conventions and National Laws”, 3 Tul. J. Int'l & Comp. L. 47 1995.
[18] Article 1245.2 as drafted by the Modernisation Proposal:
“(…)
2. En la negociación de los contratos, las partes deberán actuar de acuerdo con las exigencias de la buena fe.
(…).”

necessarily exhaust all manifestations of good faith and, in reverse, the non-fulfillment of such provisions does not automatically entail consequences in the validity and the enforceability of the final agreement.

Recent practices in bank sector provide illustrative examples in that regard. Interestingly, a numerous case law in Spain has tackled the validity of controversial swaps contracts linked to mortgage loans as risk-coverage mechanisms. In most cases, bank clients have challenged the validity of the swap contract on the grounds of vitiated consent. Claims for nullity has been based on commonplace allegations: banks did not fulfill their statutory duties, basically, to clearly inform the client of the risks, implications and operation of such sophisticated financial transactions. As a consequence, clients could not gain a full insight into the nature and extent of the contractual obligations they were taking on. Court decisions[19] differ but most of them do deeply rely on pre-contractual stage to assess whether clients were sufficiently informed in reasonable terms. In other words, whether the mistake the client incurred in was essential and excusable. In assessing the occurrence of an error invalidating consent, courts mainly consider the due fulfillment by the bank of information duties and other pre-contractual obligations as provided for by applicable regulations. Three recent Spanish Supreme Court judgments refine such a line of reasoning and clarify the consequences of the non-compliance - Spanish Supreme Court judgments 840/2013, of 20th of January of 2014, 385/2014, of 7th of July of 2014, 384/2014, of 7th of July of 2014 and 387/2014, of 8th of July of 2014 -. The Supreme Court held that the non-compliance of pre-contractual obligations does not automatically imply the nullity of the contract on grounds of error in consent. As a matter of fact, non-fulfilment or a defective compliance of obligations provided for by regulations influence the appreciation of a mistaken consent, whether the client could effectively understand the risks and the consequences of signing the contract, considering the circumstances, contract was not vitiated.

III.D. Pre-contractual liability

Conceptualising pre-contractual liability (*culpa in contrahendo*) has encountered wide-ranging controversies. Trapped in the rigid binomial contractual liability and non-contractual liability, liability arising from damages caused in bargaining is hard to qualify. Spanish scholars uphold a major stance on non-contractual thesis, in particular, where pre-contractual liability arises as a result of the breaking-off of negotiations. Notwithstanding the major position, some scholars are inclined to defend a contractual qualification of pre-contractual liability insofar as it stems from a situation of nullity of the contract, along the lines of a part of case law. Case law is indeed incoherent and provides contradictory solutions. In my opinion, it should be noted that cases are different because they are addressing consequences of pre-contractual stage at different phases of the contract formation process. Although the source is the same (pre-contractual), the scenario where it effects determines a different starting point (pre-contractual or contractual, respectively).

Under Philippines Civil Code, provisions on quasi-delict reveal an approach that appear roughly equivalent to torts in American law. Articles 2176 to 2195 of the Code encompass rules on quasi-delict. Article 2176 vertebrates the legal regime with the following wording: "Whoever by act or omission causes damage to another, there being fault or negligence, is obliged to pay for

[19] Among many others: SAP Álava (1ª) de 9-9-11 (FD 2); Asturias-Gijón (7ª) de 29-10-10 (FD 5); Asturias-Oviedo (5ª) de 27-1-10 (FD 7); Ávila (1ª) de 12-1-12 (FD 4); Badajoz (2ª) de 17-5-11 (FD 2); Barcelona (11ª) de 16-12-10 (FD 2) y (19ª) de 9-5-11 (FD 2 y 4); Girona (1ª) de 18-2-11 (FD 5); Islas Baleares-Palma de Mallorca (5ª) de 20-6-11 (FD 4 y 5); Jaén (3ª) de 27-3-09 (FD 2); León (2ª) de 22-6-10 (FD 2); Navarra (1ª) de 11-7-11 (FD 4); Orense (1ª) de 3-1-12 (FD 8); Palencia (1ª) de 30-6-11 (FD 4); Pontevedra (1ª) de 7-4-10 (FD 8); Salamanca (1ª) de 31-1-11 (FD 3); Santa Cruz de Tenerife (3ª) de 2-5-11 (FD 4); Soria (1ª) de 10-10-11 (FD 4); Toledo (1ª) de 2-11-11 (FD 4); Valladolid (1ª) de 3-11-11 (FD 6); y Zaragoza (5ª) de 20-6-11 (FD 10).

the damage done. Such fault or negligence, if there is no pre-existing contractual relation between the parties, is called a quasi-delict and is governed by the provisions of this Chapter."

Against such a backdrop, a systematizing approach appears highly advisable in order to categorize cases, spot liability scenarios and consider available remedies.

In practice, pre-contractual liability may arise in three different scenarios:

A). Unjustified Breaking-Off Negotiations.

As a general rule, freedom to deal would entitle parties engaged in negotiations to decide not to continue, interrupt or renegotiate conditions. Freedom to deal would encompass freedom not to deal, to negotiate or not to negotiate. Nonetheless, the exercise of such freedom is not absolute but subject to certain limits, insofar as other rights or interests may deserve protection as well. Unexpected, unfair or unfounded interruption of negotiations before reaching an agreement is likely to frustrate other party's reasonable expectations on the seriousness of the dealings and the continuation of the negotiations. Majority opinion[20] affirms that in such cases *reliance damages* should be compensated, provided that several factors are met for pre-contractual liability to arise[21]: reasonable reliance deserving of protection, unfair breaking-off of negotiations and losses caused thereby.

Delimiting the scope of *reliance damages* and determining which costs and expenses compensation should cover are critical tasks requiring attention. As a starting point, it has to be asserted that expected compensation should aim to place the injured party at the before-negotiation position. That means that any expense, cost or investment that were reasonable made during negotiations and to that end might be compensated. Contrarily, the expected compensation should not be addressed to replicate the financial scenario of a hypothetical contract. As a matter of fact, such an expansive position would exert a serious deterrence effect in the market, for commercial market players would be highly discouraged to initiate negotiations unless strongly relying on a success. Such a compensation option should be discarded then.

In sum, all costs and expenses that were undertaken in the belief and for the purposes of the expected agreement would be compensable. Therefore, eligible costs have to meet two criteria: finality and reasonability. Only an objective and reasonable expectation in the reaching of the agreement justify compensation. Accordingly, unnecessary expenses, unjustified investments, or sumptuary payments would not be objectively compensable. Reasonability has to be determined in accordance to all circumstances surrounding the transaction (parties behaviour, exclusivity arrangements, complexity, stage of the negotiations).

Article 412-2 of the Draft new Spanish Commercial Code states that when a party initiate or interrupt negotiations in bad faith, damages caused to the other party shall be compensated. Such succinct declaration still leaves unsolved two controversial issues.

Firstly, whether acting in "bad faith" comprises solely intentional or reckless behaviours.

It is discussed whether acting in bad faith also covers negligent or fault behaviours. Article 412-2.2 specifies *in fine,* in line with UNIDROIT Principles and EPCL, that "it will be deemed bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach

[20] Supreme Court judgment 16 December 1999 (RJ 1999, 8978).
[21] Supreme Court judgment 14 June 1999 (RJ 1999, 4105)

an agreement with the other party". An intentional factor, which should not be a prerequisite[22], is however clear remarked. Nevertheless, from the perspective of the protection of reasonable expectations of the relying party, it is argued[23] that any behaviour, even without fault[24], able to generate that reliance might trigger liability. It has to be remembered first that only reasonable, legitimate and objective reliance deserves protection. Contrarily, the party who decides to leave negotiations is not liable for eventual damages suffered from the other party arising from a mistaken risk evaluation, an imprudent or unthinking investment or a hurried decision without any illegitimate pressure from the former. In particular, in commercial trade, it is frequently discussed whether the opportunity of a better deal is a sufficient reason to break off negotiations on a good faith basis. Apart from cases of negotiations on an exclusivity basis or where parties have included in preliminary agreements provisions banning parallel negotiations or providing other consequences for that, parties are free to engage in several negotiations and opt for the deal that it is perceived as the most convenient given the circumstances. In sum, more justifiable the reason for breaking off is, less likely is to appreciate bad faith.

Secondly, whether the loss of opportunities to negotiate with other parties can be compensated as well.

Along with costs, expenses and specific investments that due to the interruption of negotiations become compensable, the mere initiation of negotiations entail the dismissing of other competing business opportunities. When negotiations are then abruptly and unexpectedly broken off, it is asserted that the loss of those opportunities[25] should be compensated as well. Two main concerns make the answer more complicated. On the one hand, it may be alleged that the loss of opportunities embodies an inherent risk of business activity. Market players evaluate available business opportunities, assess probabilities, analysis costs and benefits and make an informed decision to start negotiations. Therefore, losing opportunities would be a natural market risk for businesses. On the other hand, it is warned how difficult is to prove the likeliness of the lost opportunity, to estimate the damages caused by the alleged loss and to demonstrate the very existence of those competing opportunities. Notwithstanding such difficulties, loss of opportunities can be compensated when duly proved and reasonably estimated in probability terms.

Should negotiations be interrupted in bad faith, insofar as the party breaking off dealings entered into or continued negotiations without intending to reach an agreement (as typified by legal rules), it will be easier to prove that the obstructive behaviour of the counterparty blocked other competing options and provoked loss of opportunities with unsuccessful negotiations.

In all previous cases, it might be well worth reminding that compensation will cover only the estimated loss of an opportunity not the eventual advantages that the uncertain conclusion of a contract, in case that such lost opportunity were feasible and successful, would have entailed.

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[22] PANTALEÓN, F., "Responsabilidad precontractual: propuestas para un futuro Código Latinoamericano de contratos", *Anuario de Derecho Civil,* LXIV, 2011, fasc. III, p. 911.

[23] GARCÍA RUBIO, M.P; OTERO CRESPO, M., "La responsabilidad precontractual en el Derecho contractual europeo", *InDret,* 2/2010, pp. 41-42; MEDINA ALCOZ, M., "La ruptura injustificada de los tratos preliminares: notas sobre la responsabilidad precontractual", *Revista de Derecho Privado,* May-June/2005, p. 104.

[24] Unlike scholars quoted in the previous footnote, ASÚA GONZÁLEZ, C., *La culpa in contrahendo,* Servicio Editorial de la Universidad del País Vasco, Leioa, 1989, pp. 161-162 sustains that fault or negligence is needed.

[25] MEDINA ALCOZ, L., *La teoría de la pérdida de oportunidad. Estudio doctrinal y jurisprudencial de Derecho de daños público y privado,* Thomson-Aranzadi, Cizur Menor, 2007.

B). Conclusion of an agreement that happens to be null and void due to the violation of pre-contractual duties (duty to inform).

Recent cases on swap contracts linked to bank loan agreements for risk coverage purposes offer a revealing example. Spanish Courts and Arbitration tribunals have settled in last years an abundant number of disputes in bank transactions on grounds of contract nullity caused by the violation of pre-contractual obligations. As previously explained, financial services contracts (swaps) have been declared null and void on grounds of invalidating error caused by the infringement or defective compliance by the bank of pre-contractual obligations to inform and to assess client's risk profile.

In all these cases, the contract is concluded but it is to any extent affected by the performance of the pre-contractual stage. At least two issues on remedies arise at a first sight.

Firstly, whether a claim to declare nullity of the contract on grounds of error[26] would be compatible to a claim of compensation for violation of pre-contractual obligations[27]. Secondly, whether remedies for breach of contract would be actionable in those cases as well. The factual scenario might be as follows. One of the contracting parties provides during negotiations false or inaccurate information about the product, its quality, authenticity or characteristics. The other party agrees to conclude the contract relying on such information that becomes part of the contract. Accordingly, the performance will not be in conformity with contract terms. The injured party would be entitled to enforce contract terms and exercise remedies for breach of contract.

At the uniform level, Article 40 UN Convention on International Sales of Goods, 1980 (CISG) provides for a very particular solution. Despite that it is commonplace that CISG did not intend to expressly regulate pre-contractual liability in international trade, a thorough analysis[28] of the uniform text reveals a few points to anchor the pre-contractual discourse. Article 40[29] deprives the seller of relying on Articles 38 and 39 CISG when the "lack of conformity relates to facts of which he knew or could not have been unaware and which he did not disclose to the buyer". Since the uniform provision does not subject to any time limit the awareness of the facts and the non-disclosure by the seller, it may be extended to cover the pre-contractual stage as well. Interestingly, Article 40 neither provides for nor acknowledges remedies in favour of the buyer against the infringement of the seller. Simply, it might be said that the seller is to any extent penalized for the defective information, the omission or the failure to disclose insofar as he/she is prevented from invoking Articles 38 and 39. These provisions set out those conditions under which the buyer can rely on the lack of conformity (duty to examine within a short period, give notice to the seller within a reasonable time). Under Article 40, the seller is not entitled to allege that the buyer did not comply with his/her duties in relation to the lack of conformity as laid down in Articles 38 and 39.

C). Conclusion of an agreement that is valid despite of the fact that the injured party would have entered into the agreement under different conditions if the other party were disclosed all relevant information in negotiations.

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[26] MORALES MORENO, A.M., *El error en los contrato,* Ceura, Madrid, 1988.

[27] Affirmatively, PANTALEÓN, F., "Responsabilidad precontractual…", *op.cit.,* p. 921.

[28] As brilliantly suggested by ILLESCAS ORTIZ, R., "Chapter 3 - Precontractual Liability: Civil Law", manuscrit provided by the autor.

[29] Article 40 CISG:

> "The seller is not entitled to rely on the provisions of articles 38 and 39 if the lack of conformity relates to facts of which he knew or could not have been unaware and which he did not disclose to the buyer".

The group of cases categorized under this category differ from the previous one in the fact that the violation of pre-contractual duties has not led to the invalidity of the contract. Notwithstanding, the contract, albeit validly concluded, has been agreed in different conditions, presumably unfavourable to the party who was not aware of all relevant information. For the contract is valid, the injured party is not entitled to claim for avoidance or termination. Nevertheless, it may be sustained that the injured party should be compensated for the damages caused by the unfavourable conditions. Two main options seem available.

On the one hand, the injured party might claim for compensation to cover the difference of between the value of the expected performance according to the pre-contractual representations and the value of the effective performance under the contract. On the other hand, following an *in favor negotii* approach, it may be contemplated the option of renegotiating contractual terms in order to adapt the agreed conditions to the expected value. Arguably, *rebus sic stantibus* or hardship seem to have been originally envisioned to manage extraordinary change of circumstances of absolute unpredictability with exorbitant effects on the equilibrium of the contract[30]. Such requirements might be too stringent for cases where the violation of pre-contractual duties simply frustrates the expected value of the contract or destabilizes the balance of parties' positions in the contract. It is indeed a highly controversial issue in modern contract law both at the international level and at a domestic one.

IV.- Preliminary agreements in pre-contractual stage

As previously expounded, the pre-contractual stage comprises a variety of statements, representations, acts, negotiations or behaviours of varied nature including as well agreements[31] (letters of intent, memorandum of understanding, term sheet, agreements to negotiate, non-disclosure agreements). Such preliminary agreements are aimed to regulate negotiations and its effects. As a consequence, parties determine their duties, set out principles and rules governing their dealings and agree (limiting or excluding) eventual compensation – disclaimers, limitation of liability, liquidated damages clauses, penalty clauses -. Overall, preliminary agreements have the ability to "transform" eventual pre-contractual liability from extracontractual to contractual. As a matter of fact, parties intend to "contractualize" the pre-contractual stage in order to rationalize costs, manage risks and enhance predictability.

Synthetically, preliminary agreements, in absence of express regulation, arouse an array of issues deserving further attention.

Firstly, it might be well worth raising the question whether good faith can be disclaimed by parties in a preliminary agreements and to which extent, and for the purposes of those legal systems reluctant to recognise the observance of that principle in negotiations, whether the agreement to observe good faith in pre-contractual stage is enforceable (and should be enforced by courts) and which are the available remedies.

Secondly, it might be discussed whether parties are totally free to aggravate by agreement the consequences of any infringement of pre-contractual duties, for instance, including a generous liquidated damages clause or broadly extending compensable damages. The underlying concern is that parties could be *de facto* encroaching upon the freedom to deal. As a matter of fact, should breaking off negotiation trigger exorbitant and unusual consequences, parties would be in practice prisoner in negotiations and forced to contract to avoid unaffordable sanctions.

[30] Spanish Supreme Court judgment num. 129/2001, of 20th of February of 2001.
[31] SCHWARTZ, A. & SCOTT. R., "Precontractual Liability and Preliminary Agreements", 120 *Harv. L. Rev.* 661, 2006-2007.

Thirdly, it is widely questioned whether preliminary agreements are binding. In practice, parties frequently include clauses aiming to diminish their binding character. But, on the other hand, the intrinsic value of such agreements is precisely their ability to establish a contractual framework for pre-contractual stage. Even more, should preliminary agreements be deemed binding, is specific performance an available (and feasible) remedy?

V.- Final remarks

1). Commercial practices reveal that business dealings are far from the image of simple, single-issue, instantaneous transactions. Parties' statements, representations or behaviours preceding the conclusion of the contract, even in contract of adhesion and/or standard term contracts, play critical roles in relation to the contract: for the purposes of interpretation, supplementing contract terms and identifying vices of consent.

2). Notwithstanding its practical relevance and extended use, pre-contractual stage is still ignored or barely regulated in codes and legislation. Nonetheless, more and more attention is being paid recently by scholars, special legislation and supranational regulating authorities. Pre-contractual liability is still a topical issue, is still open to debate and reveals a significant relevant in the market.

3). Both Philippines and Spanish legal systems rely on the expansive force of the general principle of good faith to deal with pre-contractual issues. Uniform solutions (UNIDROIT Principles, EPCL, Draft) encourage a more elaborated and comprehensive regulation of the pre-contractual stage. Two recent modernisation projects, still pending, in Spain, have purported to address pre-contractual duties and liability under a general approach. The topic is not concluded yet.

TORTS IN THE FAMILY SPHERE

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Abstract

Traditionally in tort law, the family sphere was excluded, with the only exception to the general criterion of this rule being when damage was caused as a result of an offence. It has been said that immunity protects family peace and on the contrary admitting claims between family members decreases family harmony. Nonetheless, scholars question whether is it appropriate to establish a paternalistic criterion in order to rule family relationships. Today a family interest cannot prevail over the individual interest of the members of the family when a fundamental right is affected. Within this new context the autonomy of will is being empowered and therefore, the traditional inhibition of the liability of family members is undermined. In this paper is analysed the evolution of the recent Spanish case law on this matter. Finally, I would like to put forward some questions which deserve to be debated.

Key words: torts, family law, claims between family members, infidelity, moral damages, Spanish Law, paternity, biological father, legal father, parental alienation

1.- **Introduction**

Traditionally in tort law, the family sphere was excluded , in fact the Spanish Civil Code (SCC) does not expressly regulate claims of damage between family members. Notwithstanding this statement, the SCC contemplates some absolutely exceptional cases. One such example is the pension in divorce or separation**,** which operates under art.97 SCC and occurs as a result of economic imbalance caused by marital breakdown. It is the civil responsibility of the parents in question to compensate for the loss or damage of a child´s asset under their administration, due to either fraud or gross negligence under art.168 SCC. In addition to this, the court can remove parental authority in cases of breach of duty which had been imposed by parental authority under art.170 CC. Such a decision would allow a child to disinherit their parents under arts.854.1 and 855.2 SCC[1].

Traditionally in tort law, the family sphere was excluded, with the only exception to the general criterion of this rule being when damage was caused as a result of an offence. In 1999, Sr. D.

[1] RODRIGUEZ GUITIÁN, Alma, *Responsabilidad civil en el Derecho de familia: Especial referencia al ámbito de las relaciones paterno-filiales*, Navarra, 2009, pp.19-21.
Most notable legal doctrine in this matter: RODRIGUEZ GUITIÁN. Alma *Responsabilidad*…. NOVALES ALQUÉZAR, *Las obligaciones personales del matrimonio en el Derecho comparado*, Madrid, 2009. ROMERO COLOMA, Aurelia María, *Reclamaciones e indemnizaciones entre familiares en el marco de la responsabilidad civil*. Barcelona. 2009. MARTÍN-CASALS, Miquel y RIBOT, Jordi "Daños en el Derecho de familia: un paso adelante, dos atrás", *ADC*, tomo LXIV, 2011, fasc. II, pp.504-561.

Alfonso Barcala y Trillo-Figueroa of the Spanish Supreme Court passed two judgments on this matter, which are the decisions of the 22nd and 30th of July 1999[2]. The judgments in question dealt with a breach of conjugal duties, in which the plaintiffs claimed compensation from their spouses after the breakdown of their marriage, claiming moral (non-material) and material damages on the grounds that the children of their wives were not their biological children. In this case, it was a relevant circumstance that both fathers had been paying maintenance before and after the divorce. Consequently, the court decided on both occasions that the breach of conjugal duties did not allow claims for compensation to succeed, on the basis that "any disturbance of matrimonial life would give rise to liability for damages" (July 30th 1999). The latter ruling states that: "the breach of the marital obligations contained in arts. 67 and 69 of the Spanish Civil Code deserves an ethical and social reproach", which leads us to think that the Supreme Court excluded the possibility of a legal reproach. There is another argument in support of the view of these decisions; the preservation of family peace. In this sense, it has been said that immunity protects family peace and on the contrary admitting claims between family members decreases family harmony.

In this regard, RODRIGUEZ GUITIÁN[3] said that the principle of family harmony cannot exclude the possibility of any action or claim related to damages caused within the family. Guiián believes that certain conducts of family members deserve a legal sanction, and that it is not appropriate to establish a paternalistic criterion in order to rule family relationships. Why should the members of a family not legally protect their relations? However, this author affirms that the principle of family harmony is useful in order to limit the cases which could deserve compensation in this context.

Fifteen years ago Professor ROCA i TRIAS wrote that these decisions maintained the traditional vision that excluded compensation for damages between family members, but she underlined that such a legal structure may soon collapse[4]. The effect of these two rulings on the Spanish doctrine is worth noting. It could be said that they were the detonators of a renewed interest in the study of this type of claim[5].

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[2] Spanish Supreme Court (STS-SSC) Judgment of 22nd July 1999. Reporting judge: Sr. D. Alfonso Barcala y Trillo-Figueroa RJ 1999\5721
Spanish Supreme Court (STS-SSC) Judgment of 30th July 1999. Reporting judge: Sr. D. Alfonso Barcala y Trillo-Figueroa RJ 1999\5726

[3] RODRIGUEZ GUITIÁN, Alma, *Responsabilidad civil*… p.87-88.

[4] ROCA i TRIAS, Encarna, "La responsabilidad civil en el Derecho de familia. Venturas y desventuras de cónyuges, padres e hijos en el mundo de la responsabilidad civil", *Perfiles de la responsabilidad civil en el nuevo milenio.* MORENO MARTINEZ, Juan Antonio, Madrid, 200, page 533.

[5] FERRER i RIBA, Josep "Relaciones familiares y límites del derecho de daños", *InDret,* 04/2001, October 2001, p.14 (pp.1-21). The complete text is available on http://www.indret.com/es/?ed=20, and ROCA I TRÍAS, "La responsabilidad…", 2000 537-554

2.- **Why was the family traditionally excluded from tort law?**

The family sphere was originally excluded from tort law due to the standard of morality that prevents a lawsuit from being filed between family members[6]. Also, in the family sphere, several ties of solidarity exist which imposes a duty of altruism, tolerance and forbearance between family members. These ties prevent them from litigating each other to claim for compensation of damages. The exceptions to this occur when damages are covered by insurance, in cases of matrimonial crisis and when the damage is caused by an offence.

Another reason the family sphere is excluded is due to the patriarchal family model[7]. The "pater familias" was a legislator (a judge) and was responsible for damages that the family members could cause to third parties. It is also worth noting the reasons why the Spanish Supreme Court has followed the traditional immunity from damages between family members. It is a principle implicitly established by the Spanish Civil Code and it requires exclusive application of family law norms to solve conflicts between families. Furthermore, they follow the traditional immunity because of the danger of the proliferation (explosion) of trivial complaints and the increase in family conflicts[8].

One notable exception, however, is in the field of private insurance, where these types of claims are normal when damages are covered by an insurance policy. Equally, in the case of criminal offences this exception also applies[9].

Nevertheless the process of the emancipation of the person and the growing individualism in Western society have determined that this immunity is to be increasingly questioned[10]. Today a family interest cannot prevail over the individual interest of the members of the family when a fundamental right is affected[11]. In fact the law protects the family because this institution is considered as a suitable and natural channel to develop the rights of the individuals[12]. Within

[6] The same argument that has been suggested in Italy by SALVATORE PATTI*, Famiglia e responsabilità civile,* Dott. A. Giuffrè Editore, Milano, 1984, p.67.

[7] See in this respect, DIEZ-PICAZO, Luis, *Familia y Derecho,* Cívitas, Madrid, 1984, p.74-75; and the prologue of the book of ROCA I TRIAS, Encarna, *Familia y Cambio Social* (De la "casa" a la persona", Cuadernos Cívitas, 1999, p.22.

[8] RODRIGUEZ GUITIÁN, Alma, "Responsabilidad…" pp.33-116

[9] FERRER i RIBA, Josep "Relaciones…" p.3.

[10] REGAN Jr. Milton C*. Alone together (Law and the meanings of marriage).* Oxford. University Press, 1999, 15-22

[11] ROCA i TRIAS, Encarna, has wroten in *Familia y cambio*… p.75-76, that today every member of a a family has to be considered in first place as a person. This means that he cannot be constrained to sacrifice his fundamental rights to the interest of the family or the other members of the family. RODRIGUEZ GUITÁN, Alma, in *Responsabilidad civil.*p.69, adds that the Spanish Consittution does not put the family in a prevailing situation.

[12] TORRES PEREA, José Manuel de, *El interés del menor y derecho de familia. Una perspectiva multidisciplinar*. Iustel, Madrid, 2009. P.31-41.

this new context the autonomy of will is being empowered and therefore, the traditional inhibition of the liability of family members is undermined[13].

3.- **Provincial courts decisions**

In accordance with this new insight into family relations, and after said judgments on the 22nd and 30th July 1999 by the Spanish Supreme Court, some provincial courts have set aside the traditional criterion and have assumed the new role given to the family relations by this modern way to understand the family[14].

For instance, the *judgments on the 2nd November 2004[15] and 5th September 2007[16] (the Provincial Court of Valencia)* and those dated on the *16th January 2007[17] (the Provincial Court of Barcelona)* and the *2nd January 2007[18] (the Provincial Court of León)*, show that the Courts are willing to award damages for non-material loss (moral damages). In the decisions of the Courts of Valencia and León, it was held that the wives in question had knowingly withheld information from their husbands and did not inform them that they were not the biological parents of the children. The Courts held that infidelity does not produce legal consequences, and that the liability stems from hiding information. In addition, it should be noted that the decision of the Provincial Court of Valencia (2nd November 2004) declared the mother and biological father *jointly and severally liable*, due to the fact he was the accomplice of the wife. The judgment ordered compensation to be paid for moral damages, but not for the material ones[19]. In contrast, a German case established that these kind of duties are the spouses' sole

[1313] Likewise, the Common Law has evolved considerably over the past century. From a defined original position based on the interspousal immunity as a consequence of the so called "marital unity" what it was considered an exception to the general rules of torts in order to protect the "domestic relations", has been reached the current position which does not admit this class of immunity, especially after the Law reform Husband and Wife Act of 1962 . However, now has the judge a great deal of discretion in order to admit these types of claims to avoid trivial complaints. LOWE, Nigel; DOUGLAS, Gillian. *Bromley's Family Law*. 9ª ed. Butterworths. London/Edinburgh/Dublin 1998, 63-64.

[14] It should be pointed out the delayed start of doctrinal debate regarding this issue in Spain. In Italy, the possibility of claims between family members has been discussed and debated since the 1950's. It should be remembered the famous ruling of the Court of Piacenza of 31st July 1950, which declared the right of a son to receive compensation from his father for the transmission of syphilis in the moment of his conception (FI, 1951, I, p.987-991).

[15] Judgment of the Appeals Court of Valencia (Sentencia de la Audiencia Provincial de Valencia) 11 November 2004. Reporting judge: Sra. María del Carmen Escrig Orenga (AC/2004/1994)

[16] Judgment of the Appeals Court of Valencia (Sentencia de la Audiencia Provincial de Valencia) 5 September 2007. Reporting Judge: Sra. Pilar Cerdán Villalba. (JUR 2007/340366)

[17] Judgment of the Appeals Court of Barcelona (Sentencia de la Audiencia Provincial de Barcelona) 16 January 2007. Reporting Judge: Sra. María Dolores Viñas Maestre. (JUR/2007/323682)

[18] Sentencia de la Audiencia Provincial de León de 2 de enero de 2007. Reporting Judge: D Alberto Francisco Alvarez Rodríguez (JUR 2007/59972)

[19] MARÍN GARCÍA DE LEONARDO, María Teresa, "Separación y divorcio sin causa. Situación de los daños personales", *RDPat.* N.16, 2006, p.157, affirms that in these cases there are two types of different liabilities. One, the moral and material damages which suffer the husband; the other, damages caused to the son who ignores his biological information and believes that the husband of his mother is his father.

responsibility, and it is not possible to demand any liability for damages to third parties (*Ehestörer).*

With regard to the decision of 5th September 2007 of the Provincial Court of Valencia, Professor DIEZ-PICAZO[20] affirms that in these cases the reason for the claim is not certain. It could be infidelity, the hiding of the truth or the fact that the husband had to discover the truth at a later date. He admits that this situation could cause the husband to suffer with severe depression, but he believes that such damage is unlikely to be compensated, because from his point of view is not possible to apply the rules of torts to the marital relations. In his opinion the only applicable regulation is the one which rules the marriage.

There are other judgments held on the previous doctrine. For example the decision of the Provincial Court of Cádiz (3rd April 2008[21]) ordered the ex-wife, who had hidden the true paternity, to compensate her ex-husband for damages. Another example is the decision of the Provincial Court of Murcia (18th November 2009[22]) in which the court ordered the ex-wife to compensate for moral and material damages. In this case, the ruling was that the *starting date for counting the one-year period to exercise the action* for non-contractual damages, was not the day in which the ex-husband discovered he was not the biological father, but *the date in which the judgment that had recognised the paternal denial action as being final and definitive.* On the other hand, the decision of the Province Court of Barcelona (31st October 2008[23]) dismissed the action brought about by the ex-husband. The grounds for the ruling was that it could not be proved that the ex-wife had acted with intent or deception, it was considered that she had only known the facts following the biological test.

FARNÓS AMORÓS considers that these judgments, especially the ruling of the Provincial Court of Valencia 2nd November 2004, were made to compensate partly as a result of the existence of previous infidelity, which may be incorrect. On the other hand, she adds that the option to compensate moral damages could cover an alibi to avoid justifying the amount of the compensation. Finally, she maintains that the rule of law requires that in these types of claims, based on the fact that the wife had hidden the real paternity of her child, the compensation and the scope of such claims should only reach the repayment of the alimony. Moreover she affirms that compensation could be admitted as a consequence of an unjust enrichment applying the rules of the law of torts[24].

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[20] DIEZ-PICAZO, Luis, *El escándalo del daño moral*, Thomson Civitas, 2008, p.46.

[21] Judgment of the Appeals Court of Cádiz. (Sentencia de la Audiencia Provincial de Cádiz) 3 April 2008. Reporting judge: Sr. D Antonio Marín Fernández. (JUR/2008/234675)

[22] Judgment of the Appeals Court of Murcia (Sentencia de la Audiencia Provincial de Murcia) 18 November 2009. Reporting Judge: D José Manuel Nicolás Manzanares (AC 2010/60)

[23]Judgment of the Appeals Court of Barcelona (Sentencia de la Audiencia Provincial de Barcelona) 31 October 2008. Reporting Judge: D Francisco Javier Pereda Gámez. (AC 2009/93)

[24] FARNÓS AMORÓS, Esther, "El precio de ocultar la paternidad", *InDret,* 2/2005, 279, May 2005, p.11. It can be viewed online at http://www.indret.com/pdf/279_es.pdf

4.- **Judgments of the Spanish supreme court (SCC) on this matter in recent years**

One could also look at the judgments of the Spanish Supreme Court (SSC) on this matter in recent years. SSC Judgment of (30th June 2009[25]) ordered damages, however the SSC Judgment (14th July 2010[26]) and SSC Judgment of (18th June 2012[27]) did not go to the heart of the matter because it maintained that the legal action regarding this matter had been time-barred.

4.1 Judgment of the Spanish Supreme Court of 30th June 2009:

A massive SSC judgment on this matter occurred on the 30th June 2009. The facts are as follows: Don Paulino and Doña Remedios were partners living together. They had a son in 1982, with Paulino being recognised as his legal father. In *1991* the mother became a member of the Church of Scientology, and on *23rd August* of that year she moved with her 9-year son from Spain to Florida. Soon after, custody was awarded to the father by Spanish Court. He then moved to Florida in order to implement the Spanish ruling there. After two years of judicial disputes, and having spent all his available economic resources, he returned to Spain without any real progress. When the son turned 18, he declared that he did not want to see Paulino and that he did not recognise him as his father. Paulino alleged that his son had suffered *"parental alienation"* and sued Remedios and the Church of Scientology, requesting compensation for all moral damage caused by the loss of his son. Paulino brought proceedings in tort claiming for *210.354 euros*.

The lower Spanish Court (First Instance Court) dismissed the action brought by Paulino on the grounds that the legal action regarding this matter had been time-barred. He filed an appeal to the Provincial Court of Madrid, which affirmed the ruling of the lower court. Then, Paulino appealed to the Spanish Supreme Court, who upheld the appeal and held the plaintiff had the right to claim. The SSC ordered Remedios to pay *60.000 euros* compensation for moral damages, but acquitted the co-defendant, the Church of Scientology. The principle established here was that the non-contractual action had not been time-barred because it was a case of ongoing damage. The *starting date for counting the one-year period to exercise the action* for non-contractual damages was they day in which the son turned 18. This was because until that date the mother had continued preventing the father from seeing his son[28].

[25] Spanish Supreme Court Judgment (STS-SCC) 30 June 2009. Reporting Judge: Sra. Encarnación Roca Trías. (RJ 2009/5490)

[26] Spanish Supreme Court Judgment (STS-SCC) 14 July 2010. Reporting Judge: Sr. Francisco Marín Castán. (RJ 2010/5152)

[27] Spanish Supreme Court Judgment (STS-SCC) 18 June 2012. Reporting Judge: Sr. José Antonio Seijas Quintana (RJ 2012/6849)

[28] Additionally, it could be of interest to refer to the growing number of cases in which the Spanish Courts decide to compensate the biological parents for the loss of their child. I mean the cases in which the parent has been awarded parental responsibility and custody of the child by a court decision, it is impossible to execute such a ruling. I refer to the cases when the State separates the child as dependent and gives him to a foster family and afterwards a judge revokes the said decision. However having lived

Nevertheless, most Spanish scholars believe that in relation to the judgment of the Spanish Supreme Court of the 30th June 2009 it could be possible to claim for criminal liability. Therefore, a case of civil liability could derive from the offence[29]. They added that in other rulings the Spanish Supreme Court does not admit to this kind of liability because the evolution of family law is against this type of sanction. In fact, the amendment of the Spanish Civil Code in 2005 means that today, either spouse is free to break the marriage link and claim for divorce[30]. It is indeed, no longer necessary to base a party's request on a concrete cause or reason. Consequently, the interest to continue the marriage or to fulfill the rules of marriage has been affected by the new family model. Therefore, if the new family law does not penalise the spouse for such marital breaches (infidelity is no longer a cause to ask for divorce), is it logic to penalise this conduct through tort law?

If fact, outstanding scholars like SALVADOR and RUIZ hold that as marriage is currently understood as a link founded and maintained on a voluntary basis, the spousal duties are therefore not enforceable. This idea can be considered as the most prominent legal principle governing marital relationships[31] .

MARTIN-CASALS and RIBOT[32] affirmed that the above-mentioned decisions of the Appeal Courts are wrong when they distinguish between wives acting in good faith and wives acting in bad faith. It is said, that when the spouse decides to hide the real biological paternity, the "legal father" can sue for compensation, but when she does not know the biological reality, he should not be entitled to do so. In fact, this argument is considered to be artificial. In any case, the claim for damages would be based on the infidelity of the spouse, and as it has been said, the modern family law does not permit compensating for infidelity. In this respect, in a year as early as 2001 FERRER wrote: "the admission of compensation for damages on account of adultery or breach of other duties that spouses owe each other… distorts that legal principle, which has earned a high level of consensus among judges and scholars, and reintroduces, through the

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with the foster family for a substantial period of time the judge may rule that it is in the best interest of the child to keep him with this second family. To cite but one example I refer to the order of the Province Court of Seville of 30th December 2005 (Sixth Chamber) Reporting Judge: Ruperto Molina Vázquez. I highly recommend you read this article: "Indemnización por la privación indebida de la compañía de los hijos", by ROIG DAVISON, Miguel Ángel, *InDret* 2/2006, 333, pp.1-12. It is available at http://www.indret.com/pdf/333_es.pdf

[29] GONZÁLEZ BEILFUSS, Cristina and NAVARRO MICHEL, Mónica, "Sustración internacional de menores y responsabilidad civil" *RJC* 109, 2010, pp.805-831, (footnote 62) 821 and following.

[30] Art. 86 of the Spanish Civil Code establishes that divorce will be finalised when the requisites required in article 81 are met. The circumstances occur upon the petition of just one of the spouses, once three months have lapsed from the celebration of the marriage. The Spanish law does not establish any other requirements.

[31] SALVADOR CODERCH, Pablo; RUIZ GARCÍA, Juan A. (2000b). "Comentari a l'art. 1 del Codi de família", en: EGEA FERNÁNDEZ, J.; FERRER RIBA, J. (dir.), *Comentaris al Codi de família, a la Llei d'unions estables de parella i a la Llei de situacions convivencials d'ajuda mútua*. Tecnos. Madrid. 43-66. P.63.

[32] MARTIN CASALS, Miquel and RIBOT IGUALADA, Jordi, "Daños en Derecho de familia: una paso adelante, dos atrás", *ADC*, LXIV, 2011, fasc.II (p. 503-561). p.557-558.

back door, a fault-based system of separation or divorce, increasing the strain in marriage crises"[33]. It is not coherent to reintroduce into the matrimonial proceeding the proof and analysis of trivial facts that time ago, were sidelined.

4.2 The decisions of the Spanish Supreme Court of 14th July 2010 and 18th June 2012:
These two rulings do not go to the heart of the matter, because it was maintained that the legal action regarding this matter had been time-barred.

A second important judgment occurred on the 14th July 2010. On the 29th June 1973, the plaintiff and the defendant got married and they had a daughter, Beatriz, in 1984. They separated in 2001. In 2003 the ex-wife brought a paternity denial action, and *the Court declared that Beatriz was not the daughter of the plaintiff.* Soon after the husband filed for divorce against his wife, he also filed for custody of his other son and demanding the withdrawal of Beatriz's pension and maintenance. In 2004, the ex-husband demanded the withdrawal of his wife's economic imbalance pension, who had began a relationship with another partner. In 2005 the ex-husband sued his ex-wife claiming non-contractual damages for different reasons. The first of these reasons was moral damage, due to the loss of the daughter. The second was moral damage due to psychological scars caused by the divorce and to the prejudice to his reputation and honor due to the infidelity. The third claim was for material damage and the claim of unjustified enrichment, due to the fact he had fed a person he thought was his daughter.

The First Instance Court dismissed the action brought by the plaintiff on the grounds that the one-year non-contractual action had been time-barred (*art. 1902 Spanish Civil Code*). The plaintiff filed an appeal alleging that it was a case of on-going damage, that it had began in 2001 (moment of the separation) and would have continued until 2005. In addition it was said the time in which the plaintiff gained knowledge he suffered long-term medical effects and consequences of the damage suffered by the ex-husband, as a medical certificate of 2005 proved. Also, in 2006, the Provincial Court of Cáceres affirmed that in spite of the fact that it was a case of on-going damage the action had been time-barred. The Plaintiff appealed, and the Supreme Court dismissed the action that he had brought. Contrary to the former SSC judgment, this time the Supreme Court upheld that it was not a case of on-going damage (daño continuado), but a case of lasting harm (daño duradero o permanente), which had been produced at a particular time and had ended in the moment of the marital separation. The SSC said that in this case the starting date of the one-year period to exercise the non-contractual action was the moment in which the Plaintiff should reasonably have become aware of the damage and could calculate and foresee its consequences. Therefore, it was decided that the action had been time-barred.

[33] FERRER RIBA, Josep, "Relaciones familiares y límites del derecho de familia*", InDret,* octubre 2011, 4/2011, p.1-21. p.14. This article is available at: http://www.indret.com/pdf/065_es.pdf

Scholar Rodriguez Guitián[34] considers that this lawsuit was wrongly argued. Her reasoning is that the Plaintiff had claimed compensation for moral damages due to the psychological scars caused by the divorce and to the prejudice to his reputation and honor due to the infidelity. She also argues that the lawsuit ought to have been based on compensation for damage caused by the discovery of the real paternity of the child. The date of notification of judgment declaring the real paternity was 27th March 2003, and the Plaintiff filed the lawsuit in 2005. Consequently the one-year period action had been time-barred.

In conclusion, it appears that the SSC Judgment does not go to the heart of the matter, because it maintains that the legal action regarding this matter had been time-barred. Therefore, this decision does not refer to what the necessary requirements are to admit liability in the familiar sphere.

Finally, the SSC Judgment of 18th June 2012 concluded that a case of infidelity and hiding of the real paternity of a child did not go to the heart of the matter, because it was maintained that the legal action regarding this matter had been time-barred. In this case, the plaintiff did not claim compensation of damages for infidelity, but for damage caused by the discovery of the real paternity of the two daughters of his ex-wife, that he thought were his biological daughters. However, the SSC considered that the starting date for counting the one-year period to exercise the non-contractual liability action to claim compensation for moral damages was not the date of notification of judgment declaring the real paternity. The Court upheld that in order to establish the "dies a quo", it was necessary to take into account the moment in which the ex-wife sued for divorce against her husband and (as a result of the deception and infidelity) moved with the girls into the apartment of the biological father. This is what caused the severe depression. Consequently the SSC affirmed that the date for counting the one-year period was the date of the medical certificate, which informed people of the severe depression suffered by the ex-husband. This date was the *16th October 2006*, and the date in which the Plaintiff filed the lawsuit was *18th December 2007*. Therefore, the SSC upheld that the legal action had been time-barred.

5.- **Conclusion**

In drawing conclusions regarding this topic of law, it seems apt to assume that the Spanish Supreme Court has affirmed that infidelity is not compensable. It also seems that what may be compensable is the moral damage caused by the loss of a child. This occurs especially in cases of parental alienation, due to the actions of the mother who has continued preventing the father from seeing his child. The SSC did not get to the heart of the matter in the other cases, because it maintained that the legal action regarding this matter had been time-barred (loss of a child when the husband discovered that he is not the real biological father). Furthermore, the Spanish Supreme Court upheld that these claims between family members are cases of non-

[34] RODRIGUEZ GUITIÁN, Alma Lecture at the UNIA Univesity (Málaga) on 27th of January 2014.

contractual liability and that the decisions in 2010 and 2012 take restrictive views with regards the calculation of the limitation period to bring the non-contractual action for damages.

Regarding Spanish Scholars, some part of Spanish legal doctrine sharply criticises the decision of the SSC from the 30th June 2009. Scholars consider that the compensation for damages on the grounds of breaching conjugal duties cannot mean the recuperation of the concept "divorce-sanction". Consequently, it would only be possible for compensation in the case of a breach of fundamental rights[35]. Certain lecturers justifies the award of compensation to the pain caused by the loss of a loved one (caused for instance by parental alienation or the finding that the plaintiff is not the real biological father). From this perspective, the infidelity could give rise to claims for damage in some special cases, depending on the reiteration, deception and consequences, especially when the real paternity is consciously hidden[36].

Therefore, most Spanish scholars agree that infidelity should not lead to compensation for damages[37].

What may be debated it is the consequences of an act of bad faith in this context. May the new conception of the social reality be impeding these types of claims between family members based on infidelity? In fact the State is evolving to a more neutral position in respect of families, so as to not to interfere in the marital life. Then what can be the effects when one of the spouses had acted purposely in bad faith[38]. It could be thought that in this case the reason to take legal actions is not the infidelity, but the fact to have deliberately hidden the real paternity of the child, and that immunity for tortious acts should not be admissible. Nevertheless, the rule

[35] LÓPEZ DE LA CRUZ, Laura, "El resarcimiento del daño moral ocasionado por el incumplimiento de los deberes conyugales", *InDret,* 4/2010, p.35. This text is available at http://www.indret.com/pdf/783_es.pdf

[36] ALVAREZ OLALLA, "Prescripción de la acción ejercitada por el marido contra su ex mujer por daños sufridos al determinarse judicialmente la filiación extramatrimonial de una hija, previamente inscrita como matrimonial", *Aranzadi Civil*, 9/2010, (BIB 2010\2878) p.5. ATIENZA NAVARRO, María Luisa, goes ever further in "La responsabilidad civil de los padres por las enfermedades o malformaciones con que nacen sus hijos en el ámbito de la procreación natural", en *La responsabilidad civil en el ámbito de las relaciones familiares*, VERDA BEAMONTE, José Ramón, Navarra, 2012, pages 47-74. Sometimes, it has been considered that the children would be entitled to sue their parents for compensation in case of lack of love, but most of the Spanish literature refuse such an option, for example: RODRIGUEZ GUITIÁN, Alma, op. cit. page 156. ROMERO COLOMA, in *Reclamaciones…* 2451, consider that only in case of strong moral pain could be possible to compensate the lack of affection
NOVALES ALQUEZAR, María Aránzazu, *Las obligaciones…*, p.211 try to objectify the marital liability and propone to adopt a scale of damages to be compensate (baremo de daños).

[37] MARTIN CASALS, Miquel and RIBOT IGUALADA, Jordi, "Daños en.." p.557-558.

[38] The opinion of RODRIGUEZ GUITIÁN, Alma, *Responsabilidad civil*… p.173. She believes that in order to be liable the mother has to act intentionally or gross negligently. This means that she deliberately lies about the real paternity of her son or daughter, or she is silent whilst withholding suspicion that her husband is not the biological father.

of law demands the approach to be very rigorous when admitting these complaints, which should be limited and treated as exceptional cases[39].

In conclusion, there it is true that is no longer a general immunity in this matter. Nevertheless this does not imply that each claim between family members will be successful. The modern concept of family and the respect to the right of each spouse to decide freely his divorce or separation determines that the possibilities to claim for compensation are rather limited. Moreover, I would argue that we are currently in a period of obsession with the biological nature of the parenthood. The affection for a father can be independent of the blood-bond, for example in the case of an adoptive parent. Therefore, the circumstances of each case should be very carefully inspected by the judge and what should not be appropriate is to identify these cases with the death of a son.

In this light, I would like to raise three key questions for the debate: First, we must ensure that justice is done for children whose rights are affected by the paternity denial action. Therefore the cornerstone of this matter will be to decide if the exercise of this action could benefit the child, if it is compatible with the best interest of the child. For example, in the case in which there is a correct relationship between legal father (husband of the biological mother) and the child, and exists a strong emotional bond between them, does make sense to exercise the paternity denial action by a third party? Is according with the "best interest of the child" that the biological father that had an affair with the mother years ago, and had never been interested in the child, and does have not had contact with him contests the paternity, in spite of the will of the husband which wants to continue being the "legal father"? The fact remains that the Spanish Constitutional Court admits this possibility

Secondly, could the spouse who contests the paternity to claim compensation for moral or non-material damages? It would be reasonable to think that the damage consists on the loss of the loved child, if he does not want to be his legal father, could he ask for compensation in such a case?

Thirdly, could the husband who has been enjoying of a close relation with the child, to claim the restitution of the cost of the maintenance of the child while he was acting as a "legal father"?

Finally, should the husband take legal actions against the biological father in order to recover the cost of the maintenance of the child? Could this legal action be based on an unjust enrichment?

[39] FARNÓS AMORÓS believes that it ought to be reduced the admissibility of such claims to the repayment of alimony. "El precio…" p.11.

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PHILIPPINE LAW ON PATERNITY AND FILIATION: THE SPANISH LEGACY

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Filiation under Philippine Law

The Philippine Civil Law has retained the old classification of children under the Old Spanish Civil Code, namely: natural and adoptive. It has also retained the two types of natural children, namely: legitimate and illegitimate. As in the Old Civil Code, the basis of the classification of children is the existence or absence of marriage between the mother and father of the child. When a child is conceived AND born outside a valid marriage, the child is illegitimate, while a child conceived OR born during a valid marriage is legitimate.

Gradation of Status and Rights of Children

There is a distinction between the rights of a father over his legitimate and illegitimate children. Under the Old Civil Code, an illegitimate father had neither rights nor obligations over his illegitimate children. In the same way, illegitimate children had no rights enforceable against the illegitimate father and his family. The illegitimate children, commonly called *bastards,* were total strangers to the family of the illegitimate father.

The New Civil Code enacted in 1950 introduced some reforms. On the one hand, the new code gave the illegitimate children the right of support from the illegitimate father and the right to inherit from him. The father, on the other hand, was given paternal authority over the bastard child jointly with the mother, provided he recognized the child in accordance with the formalities prescribed in the law. The illegitimate father was also given inheritance rights from the illegitimate child.

In a much recent law, the Family Code of 1988, the father of the illegitimate child was deprived of parental authority over the child. The reason was more practical than legal. Joint parental authority of two people who do not live together and who are usually at odds with each other, is simply unmanageable. Hence, parental authority was given solely to the mother.

Under the Old Code, an illegitimate child did not have any successional rights in the estate of his illegitimate father. This was true even though the father had publicly recognized him as his bastard. The New Civil Code of 1950 tempered this rule and allowed the illegitimate child an inheritance. However, the illegitimate child was not placed on equal footing with a legitimate child. For instance, the inheritance right of an illegitimate child is just half that of a legitimate child; a legitimate child excludes the grandparents from the inheritance of the legitimate parent while an illegitimate child does not; and an illegitimate child is barred from inheriting from the legitimate relatives of his illegitimate parent, and *vice versa*.

The Concept of *Legal Parent*

The Old Spanish Civil Code classified the children on the basis of presumption. This was understandable because at that time, paternity of a child was nothing but an act of faith on the part of the man who had to put absolute trust on the declaration of the child's mother. At that time, science did not yet have the capability to establish the paternity of the child with certainty. The Queen, in those days, had to be sequestered, quarantined, and guarded to ensure that only the King had access to her. That way, there would be no doubt that the King was the father of her offsprings. The Queen had to suffer, too, the duty of allowing a coterie of spectators when she was giving birth. This was done so that her child would be immediately *branded* to guard against the introduction of changelings to the throne.

The absence of the means to establish the filiation of a child left the law makers with no choice but to rely on presumptions. Legal presumption was the cornerstone of the paternity rules in the Old Civil Code, and it has remained the basis of the present law in the Philippines.

Under Philippine law, the husband is presumed to be the father of the child of his wife. This presumption holds even though they were no longer living together when the child was conceived and born, and even though the mother has admitted that her husband is not the father of her child, and even though she has disclosed who the biological father of the child is. Under our system of laws, the marriage of the husband to the biological mother of the child has made him the *legal father* of every child his wife will conceive and give birth to.

Such presumption may be defeated only by a court declaration that the child is not of the husband in an action timely instituted. In such action, the husband has the burden of proving that he is not the father of the child. The fact that it was impossible for him to be the father because of his physical separation from the wife is one of the evidence he may use to prove his case. He may also seek the aid of science, such as DNA matching, to prove that he was not the father of the child.

Unless the husband goes to court to reject siring the child, the presumption that the child is his legitimate child would subsist. The action to reject paternity of the child, however, is not open to the husband all the time. He has to do it within a prescribed period of time. If no action was instituted during the prescriptive period, the child becomes conclusively presumed as his legitimate child. In such a case, the husband and his relatives are not allowed to deny and question the filiation of the child and are obliged to honor his rights as a legitimate child.

Neither may the *biological father* successfully claim paternity of the child. This is true even though DNA tests have proven beyond doubt that the child is his biological child. The law has adopted this rule because at the time the law was adopted bastards were treated miserably by law and society. Hence, a legitimate status, even though a mere presumption, was preferred over a true but illegitimate filiation. The presumption of legitimacy was considered a measure of protection of the child who was better off with a legitimate status. Moreover, the law could not accept the proposition that a child has two natural fathers.

This system of presumption, however, poses many practical problems. For instance, may the child in our illustration marry another child of the *biological father* by another woman? In reality, the two are half-blood siblings who are not allowed to marry under ordinary circumstances due to close blood relation. The law, however, does not prohibit their marriage. And yet, the child in our illustration will not be allowed to marry another child of his *legal father* even though they are not at all related by blood.

With the advances in science, I firmly believe that it is now time for the Philippines to follow the step taken by Spain in revising its sytem of laws to keep up with the times.

Legal Parent vs. Biological Parent

To illustrate the difference between the concepts of *legal parent* and *biological parent*, let us take the case of a woman who was made pregnant by her boyfriend. The woman broke off with her boyfriend when he refused to marry her. While carrying her baby, she met another man, who despite knowing that she was pregnant by another man, married her. The child was born after the marriage.

What is the status of the child?

Under Philippine law, the child is presumed to be the legitimate child of the husband who shall exercise all the rights of a father. The husband is the *legal parent* of the child although the boyfriend was the *biological parent.* Under those circumstances, the *biological parent* has no rights with respect to the child and *vice versa.* The child cannot inherit from the boyfriend who was his true father, and the boyfriend cannot inherit from his biological child.

It would have been different if the woman got married after she has given birth. This is because the status of a child is fixed at the time of its birth. As a single mother, her child would be an illegitimate child at the time of its birth. In such case the mother shall, under the law, be the only *legal parent* of the child. The child would have no legal father until the biological father has formally recognized the child as his, or has been adopted by another. The subsequent marriage of the mother to another man will not change the status of the child which had already been fixed at the time of its birth. The husband and the mother, however, may adopt the child to level up its status. The adopted child is treated under the law as the legitimate child of the adopters. If, on the other hand, the biological father married the mother after giving birth to the child, the status of the child improves. From illegitimate, its status becomes *legitimated*.

For the same reason, while the sperm donor is the *biological father* in case of artificial insemination, he is not given any rights with respect to the resulting child if the woman who received his donation is a married woman. The husband of the woman shall be the *legal parent* of the child.

In modernizing our laws, I believe the identity of the sperm donor should be disclosed, to allow the resulting child of the donation, or the child's prospective spouse, to know if they are related by blood if such is important to them.

As regards a mother, our laws recognize the *birth mother* as the *legal parent* of the child regardless of the source of the egg or the embryo. If the mother is unmarried, the child will be illegitimate, but if she is married, the child is her and her husband's legitimate child.

Filiation of Illegitimate Children

As in the Old Civil Code, there is no presumption in the present law who the father of an illegitimate child is. To have a *legal father*, the illegitimate child has to be formally recognized by someone. Recognition may be voluntary or by court declaration. Voluntary recognition has to be in a public instrument or in a handwritten document signed by the recognizing *father.* A unilateral declaration by the mother is not enough. Hence, when the father has not signed the report of live birth, the child's record will indicate the father as *unknown*. Without such recognition, the illegitimate child acquires no rights enforceable against the illegitimate father.

In case the illegitimate father has denied paternity, the child may bring an action to seek judicial declaration of his filiation. He may present all admissible evidence to prove his claim. He may also ask the court to compel his alleged father to undergo DNA test. This action, however, may be brought by the bastard child only during the lifetime of the putative father. When the father dies, the child will never be able to get a judicial declaration.

As in the Old Civil Code, an illegitimate child may not be recognized by more than one *father.* Having two natural fathers was inconceivable under the Old Code. One of the two recognition has to be declared ineffective.

Under the Old Code, if recognition was at the initiative of the person claiming to be the illegitimate father, the consent of the illegitimate child was necessary for his recognition to take place. This requirement was suppressed in the Family Code. However, the Family Code allows any such recognition to be contested at any time by any interested party.

Filiation of Children Born After Termination of Marriage

When a widow, who remarries within 300 days after the death of her first husband, gives birth to a child after the celebration of the second marriage, who is the father of the child?

Under our present law, if the child was *conceived* before the death of the first husband, the child is legitimate of the first husband even though born after the celebration of the second marriage. If the child was *conceived* after the death of the husband, the child is considered

legitimate of the second husband. The problem is how do we know when the child was conceived?

Again, our paternity laws being founded on antiquity, relies on presumption in determining the paternity of such child. It is believed that a child is conceived during the first 120 days of the 300 days immediately preceding the birth of the child. Hence, a child born before 180 days after the celebration of the second marriage is presumed to be the child of the first husband provided it was born before 300 days after the death of the first husband. Otherwise, the child is presumed the child of the second husband. The same rule applies if the first marriage was dissolved not by death of the first husband but by the annulment or declaration of nullity of the first marriage. The presumption, however, is disputable. As discussed earlier, the child being presumed legitimate, such presumption may be defeated only by a court declaration.

Filiation of Adopted Children

Adopted children are considered legitimate children of their adoptive parents. The adoptive parents, therefore, are treated as the *legal parents* of the adopted child. But if the adopted child was a legitimate child of a married couple before his adoption, what becomes of the child's relationship with its *legal parents* after the adoption? Do the legal parents cease to be *legal parents*?

To bring home the point, an illustration may be helpful. Let us take the case discussed earlier. The case of the woman who married another man while pregnant by her boyfriend, and who gave birth after the marriage. In that case, the husband of the mother was the *legal parent* while the boyfriend was the *biological father*. If the child is to be adopted later on by another couple, it is the consent of the *legal parents* that is required to be given and not that of the *biological father.* By adoption, the adopting parents will have all the rights of legitimate parents, and the parental authority of the *legal parents* shall be terminated.

The adopted child shall be considered a legitimate child of the adopting parents. The adopting parents, therefore, become *legal parents* of the adopted child. And since the adopted child is considered a legitimate child of the adopters, he is prohibited from marrying the *legitimate* or another adopted child of the adopting parents. The prohibition is not because the adopting parents have become his *legal parents*, but due to public policy. It is viewed as not morally correct to allow two people who lived together and were treated and raised as siblings to marry each other. Take note, however, that the adopted child is allowed by law to marry an *illegitimate* child of the adopting parent because the illegitimate child is not expected to live with the illegitimate father.

In adoption, the *legal parents* do not cease to be *legal parents*. They simply lose their parental authority. The adopted child, therefore, has two sets of *legal parents* except that the first set lost their parental authority over him. Hence, the adopted child is a legal heir of both sets of *legal parents*, and both sets of *legal parents*, under the Family Code, are legal heirs of the adopted child. This was not the case under the New Civil Code, where the adopting parents were not legal heirs of the adopted child.

The adopted child remains a relative of the family of his *legal parents*. For this reason, the adopted child cannot marry his sibling and first cousins by his *legal parents*.

In our illustrative case, the *biological father* is still considered a stranger to the the adopted child. This is why the adopted child in our illustration is not prohibited from marrying his half-blood sibling by his *biological father*.

Conclusion

We recognize the need to update Philippine law on paternity and filiation to cope with the times. We believe that a review of the changes and reforms introduced by Spain to its laws is in order if only to find out if those changes are applicable or suitable to the Philippines. For this purpose, we will need an English translation of the Spanish law and other relevant

materials. We shall also need the translation of the pertinent jurisprudence on the subject. We are sure the Philippines will benefit from the wisdom and experience of Spain on this important aspect of family law.

INTERCOUNTRY ADOPTION:
BEST PRACTICES IN THE PHILIPPINE SETTING

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THE LEGAL FRAMEWORK AND GUIDING PRINCIPLES OF INTERCOUNTRY ADOPTION IN THE PHILIPPINES

Republic Act 8043, otherwise known as the Intercountry Adoption Act of 1995, is the basic law governing the intercountry adoption program of the Philippines and was largely crafted following the directives and policies spelled out in two (2) international instruments, namely: 1) the UN Convention on the Rights of the Child; and 2) the 1993 Hague Convention on the Protection of Children and Cooperation In Respect of Inter-Country Adoption (the "1993 Convention").

Under this Act, the Intercountry Adoption Board (or the ICAB) was created which is the Philippine Central Authority in matters relating to the intercountry adoption of Filipino children and the policy making body for purposes of carrying out the provisions of the aforementioned law.

Pursuant to the guidelines enumerated under the foregoing international instruments, the general policies advocated under the present system of intercountry adoption in the Philippines, include the following:

1. A child should primarily be in the care and custody of his/her biological/legal parents. In default of parents, relative adoption should be encouraged, before adoption by unrelated persons shall be considered.

2. If possible, prevent the unnecessary separation of the child from the birth parents. Ensure that no hurried decisions are made before relinquishing parental authority. For example:

    a) In the process of adoption, counseling is always provided to the birth parents, the prospective adoptive parents and the adoptee as well.

    b) A birth parent is not bound by an adoption plan before the birth of the child.

    c) Even after a DVC (or Deed of Voluntary Commitment) is signed- parents have 3 months to change their minds and reconsider the surrender of the child. After the 3-month period, however, the decision is irrevocable.

    d) Before adoption is possible, the Department of Social Welfare and Development (DSWD) must certify, after the necessary protocols and safeguards have been observed, that the child is indeed legally available for adoption. (

3. In every case, the principle of "exhaustion" must be applied, i.e., efforts must be exerted to place the child with an adoptive family within the Philippines.

4. Thereafter, the intercountry adoption of a child must eventually be considered to offer the advantage of a permanent family only when no suitable family can be found domestically and if it will serve and protect his/her fundamental rights.

5. Whether it be for domestic or intercountry adoption, there must be a judicious matching of the child with the Prospective Adoptive Parents (the PAPs.

6. In all cases, there must be minimum standards for child protection and to prevent the abduction, sale, or trafficking of children.

7. The automatic recognition of Convention Adoption in the receiving state must be ensured.

APPLICATION OF THE GUIDING PRINCIPLES OF EXHAUSTION AND SUBSIDIARITY IN THE INTERCOUNTRY ADOPTION PROCESS IN THE PHILIPPINES

The Philippines adheres to the "Subsidiarity Principle" as the same is highlighted and defined in the Preamble and in Article 4(b) of the 1993 Convention. "Subsidiarity" means that a child should be raised by his or her birth family or extended family, when possible. If that is not possible, other forms of permanent care in the Philippine should be considered. The Guide to Good Practice under the Hague Convention of 29 May 1993 confirms that: "Only after due consideration has been given to the national solutions should intercountry adoption be considered, and only if it is the child's best interests."

Note that the child's best interests are not necessarily served by keeping a child within the boundaries of his/her country of origin. As such, it is not technically correct either to say that inter-country adoption is a "last resort". In light of maintaining and protecting a child's best interests, the principle of subsidiarity may be interpreted in several ways as follows:

- maintaining a child in his/her family of origin is important, but not more important than keeping that child free from harm or abuse

- permanent care by an extended family member may be preferable, but not if carers are wrongly motivated or are unable to meet the needs (including medical needs) of the child

- national adoption is preferable, but in the absence of available domestic carers, placement abroad should be considered

- "national solutions" such as permanent institutionalization or having several temporary homes in the country of origin, are generally not in the best interests of a child.

In the Philippines, the principles of exhaustion and subsidiarity are ensured by the Department of Social Welfare and Development ("DSWD") which is the competent authority in the Philippines to determine the suitability and availability of a child for adoption.

A child legally available for adoption refers to a child in whose favor a certification was issued by the DSWD that he/she is legally available for adoption:

(1) after the fact of abandonment or neglect has been proved through the submission of pertinent documents, or:

(2) one who was voluntarily committed by his parent/s or legal guardian.

In ensuring that the "best interests principle" is maintained, the DSWD is tasked with the primary goal of ensuring that orphaned, abandoned, neglected and surrendered children are identified and "brought into the system" to find the appropriate local intervention and to guarantee the opportunity to find a permanent family in the soonest time possible. Failing a domestic solution, the DSWD determines and certifies that a child has undergone the process of exhaustion of local solutions - and thereafter shall certify a child as being available for international adoption.

The pursuit of a child's best interest has been strengthened by the requirement of the administrative issuance of a certificate of adoptability as mandated by Republic Act 9523, which provides that, with the exception of relatives within the 4th degree of consanguinity or affinity and in the case of step-parent adoptions, a Certificate Declaring a Child Legally Available for Adoption shall be necessary. The new procedure thereunder is now purely administrative in nature and grants the DSWD Secretary, the power and authority to verify the allegations of either neglect, abandonment and surrender of a child. This may be deemed a landmark piece of legislation, considering that previous to this amendatory law, the declaration that a child is available for adoption was a judicial process – an oftentimes unreasonably long and painful process in the Philippines. This may be deemed detrimental to a child's best interests, considering that an unduly prolonged delay in the permanent placement of children may be deemed a violation of the child's right to a family guaranteed under the United Nations Convention on the Rights of the Child. Note that while the degree of proof required in an administrative process is less stringent than those required by the courts, the law however requires the same evidentiary requirements required under the old judicial process including publication.

RA 9523, coupled with the DSWD's policy on de-institutionalization of children has so far ensured the movement of children from institutions. Ensuring a child's "adoptability" likewise prevents the possible abduction of, sale of and trafficking in children.

Thereafter, once a child has been declared as " legally free for adoption", the DSWD undertakes a local matching of a child against its roster of domestic prospective parents. No pre-identification of a non-related child is allowed. Under Philippine law, domestic matching is an essential, preliminary stage that must be undertaken before inter-country adoption may be considered.

If no local match is available, the child will then be issued a Clearance for Inter-Country Adoption and the child's dossier shall be forwarded to the Intercountry Adoption Board.

THE INTERCOUNTRY ADOPTION PROCESS

As a policy-making authority, the ICAB sets the guidelines for the manner of selection and matching of prospective adoptive parents and verifies that a child is qualified for adoption. The Board makes the final decisions on adoption applications and matching proposals. The Board's other other functions include the following:

1. Assessment of the Child

Once a child has been cleared for intercountry adoption, the ICAB assesses the completeness of the child's documents taking into consideration the different requirements of the receiving countries. When complete, the child is included in a roster of children available for matching.

One of the most important measures to protect the child's best interests and to combat trafficking in children in to ensure that a child is genuinely adoptable.

2. The Assessment of Prospective Adoptive Parents (PAPs)

A PAP files an application with the ICAB, either directly or through an intermediary, i.e., the Foreign Accredited Agency (FAA), and assesses the same prior to approval.

The burden to develop safeguards in adoption is a shared responsibility of the country of origin and the receiving state. While it is necessary to find a common standard, the particular needs and interests of the Filipino child is a responsibility of the ICAB who has developed, through experience, policies on the standards of assessing profiles of adoptive parents. Notwithstanding the issuance by a sending country of a document that the prospective adoptive parents' are eligible to adopt, it is necessary for the Inter-Country Adoption Board to

assess and ensure that the PAP will be able to address the particular social, cultural, spiritual and physical well being of the Filipino child.

Moreover, the ICAB's experience on "placement disruptions" has prompted it to require that all applicants for adoption undergo specific psychological testing to be submitted as part of the PAPs application. This requirement was initially met with complaints. Subsequently, however, despite the initial, albeit vehement protest, this additional requirement was eventually accepted and complied with.

Note that it is the responsibility of the ICAB, as the Philippine Central Authority, as well as all other countries of origin, to ensure the best interests of its children and not to otherwise succumb to the demands of international adoptions.

3. Matching

During the initial matching phase, the ICAB secretariat pre-selects five (5) to ten (10) families in its approved roster for selection and identification by the child's social worker who will select two (2) families and set a priority for the two. The families are presented by the Social Worker to the ICAB's Intercountry Placement Committee ("ICPC").

The child's social worker presents the Child Study Report and ranked PAPs for matching with the child. The participation of the social worker in the matching process is an important feature of the system as the ICAB recognizes that the child's social worker is the person most familiar with the child, his temperament and his/her needs and is therefor in the best position to assess the type of family that the child can readily bond with. The identification of second PAPs prevents a prolonged waiting period for the child if the first family chosen is unable to accept the referral.

The ICPC is a panel of professionals composed of the following: a medical doctor (a pediatrician), a social worker, a lawyer, non-governmental organization representative and a psychologist, who initially assesses the selection of families by the social worker and has the opportunity to query the social worker on the characteristics and personality of the child. The ICPC makes recommendations on the matching proposal of the child (i.e., approval, proposal for another match, deferment, etc) for the approval of the Board, stating the reasons for the recommendation.

If the Board approves the matching proposal or chooses another family for matching, a notice of matching is sent to the concerned FAA, who shall subsequently inform the PAPs, who shall then notify the FAA in turn of their decision on the matching proposal.

Upon receipt of the PAP's acceptance of the matching proposal, the Board shall issue the Placement Authority of the child. The child shall then be given pre-departure preparation and guidance to minimize the trauma of separation and to ensure that the child shall be physically and emotionally ready to travel and form new relationships with his/her new family.

The PAPs are then required to personally fetch the child from the Philippines.

4. Supervised Trial Custody and Adoption

The FAA shall be responsible for the pre-adoptive placement, care, and family counseling of the child for at least 6 months from arrival of the child in the PAPs residence. The ICAB requires the submission of Post Placement Reports which refer to three (3) reports submitted over a six (6) month assessment period. These reports relate to the relationship of the child with the PAPs, as well as their health, financial condition and capacity. Unlike most sending countries where the adoption is finalized before the child leaves the country, the ICAB issues the Placement Authority and requires the submission of the post placement reports to determine whether the issuance of an "Affidavit of Consent to Adoption" is appropriate. Only upon the families' receipt of the "Affidavit of Consent" to the adoption will the adoption of the

child be allowed to be finalized in the courts of the receiving country. Close monitoring of the adjustment of the child to the adoptive family for the first six (6) months of the placement is crucial to determine the success of the placement. The procedure is likewise helpful in cases of "disruptive placements" as these are flagged early in the placement. The process allows the ICAB to repatriate the child if necessary, and rematch the child with ease to another family or re-unite the child with kin in cases of relative adoptions.

5. Post Adoption Services

Given the increasing requests for Post Adoption Services such as a Motherland tour, search and reunion and request for information, the ICAB's capacity to deliver the services is being strengthened. As a policy, the request for search and reunion is only undertaken if the child is of legal age (as defined by the receiving country) and has reached the required emotional maturity to undertake the search. Intensive preparation of the adoptee by his or her foreign accredited agency and preparation of the birthparents by the ICAB is crucial for a positive result of the reunion. Exception to the stated policy is given where the need for the reunion is essential to the emotional well being of the child and only upon request of the minor's adoptive parents.

INTERCOUNTRY ADOPTION PARTNERS: FAAs AND CENTRAL AUTHORITIES

The ICAB authorizes the accreditation of foreign adoption agencies ("FAAs") in the receiving countries for the purpose of providing screening, training and preparation of PAP's to ensure the smooth transition of the child into the new family.

To ensure the quality of assessment of its foreign partners, the ICAB has set minimum requirements for the authorization of said partners. Primary among the requirements is that the organization must have a license to operate as an adoption agency from the proper competent authority together with the capacity/authority to carry out international adoptions. The applicant agency must show a positive five (5) year track record of successful placements without any record of violation of existing laws in their country or other countries they work with. The governing board and staff of the agency must be competent and responsible child welfare oriented leaders in the community. The financial status and management of the FAA is assessed based on submitted audited financial statements for the past three (3) years stating the sources of their funding including data on percentage of funds from adoption. Annual submissions of financial statements are thereafter required. Aside from desk accreditation, the ICAB undertakes actual visits to the applicant foreign agency to conduct a thorough assessment of the agency. The actual accreditation visits have resulted in the clarification of issues which cannot possibly be threshed through correspondence.

For the purpose of re-assessment and re-accreditation, the FAA must show diligence in complying with ICAB's requirements of the tempering of the number of applications sent to cater to the numbers of the Philippine adoption program and the quality of the applications; the timely submission of request for information and report; the number of case disruptions and compliance with post placement supervision.

There is also the challenge of meeting the changing profile of Filipino children available for international adoptions. There has been a growing percentage of the children with some special needs or may be categorized as children for special home finding. Special home finding may include children with disabilities, medical needs or those with a negative background (i.e., abused children, children of abused mothers, and older children (9 years to 18 years). The willingness or capacity of the agency to find permanent homes for these types of children may also be an important factor in the decision to accredit/authorize them.

To date, the ICAB has a total of 107 accredited foreign adoption agencies, broken-down into the following geographical areas:

Geographical Location	Number
Europe	48

USA		29
Asia Pacific		13
Canada	17	
Total		107

IV. PROTECTING THE CHILD: The Value of Cooperation

The end-in-view of every adoption is to provide every neglected, abandoned or surrendered child with a family that will love and care for the child, as well as provide him/her with opportunities for growth and development. While many ordinary citizens would simply imagine that the adoption of a child by PAPs, especially from the developed countries, should be encouraged and promoted as it would probably be in the child's best interest, the escalating incidents of abusive practices such as abduction, buying and trafficking of children requires the cooperation and vigilance of all the partners and stakeholders in the intercountry adoption process.

Under Philippine Law, specifically Rep Act 10364, in cases where the victim is a child, any of the following acts shall also be deemed as attempted trafficking in persons:

(a) Facilitating the travel of a child who travels alone to a foreign country or territory without valid reason therefor and without the required clearance or permit from the Department of Social Welfare and Development, or a written permit or justification from the child's parent or legal guardian;

(b) Executing, **for a consideration**, an affidavit of consent or a written consent for adoption;

(c) Recruiting a woman to bear a child for the purpose of selling the child;

(d) Simulating a birth for the purpose of selling the child; and

(e) Soliciting a child and acquiring the custody thereof through any means from among hospitals, clinics, nurseries, daycare centers, refugee or evacuation centers, and low-income families, for the purpose of selling the child.

There have already been many horrific incidents where children have been abducted, bought, sold and processed through the intercountry adoption system. For example, there is the infamous Jala-jala case in the Philippines where a Singapore based agency "sourced" babies in the sleepy town of Jala-jala from anywhere from P2000 to P7000 (between $40 to $160). Some babies were even bought and sold even while in the maternal womb. Some were separated from their mothers and brought to a safe house and issued bogus birth certificates and travel documents. They were vaccinated and fattened up for the trip to Singapore where they would be sold to PAPs for about $12000. Some were brought by their own mothers and personally surrendered to the foreign adoptive parents, while others were transported by women who pretended to be their mothers.

The only way by which these abusive practices, which eventually leave a child scarred for life, may be curtailed is for the sending and receiving countries to cooperate in order that safety mechanisms may be created, maintained and enforced. Central authorities , for example, should only course adoption applications through FAAs, prohibit private or independent adoptions and ban any form of contact between the PAPs and the child's guardian.

THE CHILD'S BEST INTEREST: ALWAYS THE PRIMORDIAL CONCERN

The ultimate objective of any adoption is the child's best interests: not merely to place a child with adoptive parents – but to make sure that the placement will benefit the child in the long term. There must be a change in mindset from thinking that a family is entitled to a child- but instead, that it is the child who is entitled to a family.

We note that in terms of intercountry adoption, Spain has always been a leading carer of our nation's children. The ICAB, in fact, has received the largest number of applications from Spain in all of Europe. In terms of geographical location, Europe, on the other hand, has the biggest percentage compared to North America, Canada, Asia and the Pacific, due to the number of Spanish applications. From only 1 child in the year 2004 there has been quite a noticeable increase in demand to 76 children in 2014 (with many peaks and valleys in between)- and it is probably for this reason that we need to increasingly make sure that these children are protected and cared for – by making sure that they will benefit and be happy and strengthened by this long journey from Manila to Espana.

Overall, while the Philippines has over a thousand pending applications for intercountry adoptions, the children available for international adoptions have not significantly increased since it has ratified the 1993 convention. Converse to the figure of availability of children, the number of applications for international adoptions has continued to increase. However, as discussed in the recent Special Commission of the Hague Convention of 1993, receiving countries must acknowledge their concurrent responsibility to ensure that countries of origin must not be pressured to "produce" children for the growing demand for adoptions. The primary duty of the country of origin is to find local solutions for the children and only if no solutions exist, to open the opportunity to find a permanent family. The receiving countries must temper the number and kind of applications it sends to a receiving country to cater to the actual number and profile of children available for adoption.

It is an established fact that children are susceptible to abuse and neglect. As a global community, it is our responsibility to ensure that children should be with their own families when possible and have access to the opportunity for a permanent family if none exists.

The challenge is to persevere in furthering cooperation among all states to pursue the best interest of the world's children and to prevent the prevalence of abuse and other prohibited or unethical practices.

PRIVATE LAW OF THE PHILIPPINES AND SPAIN SCIENTIFIC CONGRESS.
Child protection system in Spain

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Abstract

We refer to the Child protection system as the entire set of legal, social , educational, health... measures, aimed to get the integral development of the minor, respecting principles integrated in Minor Law, in a determinate State and in accordance to its determined cultural parameters, and the system integrated by technicians and material resources to ensure child protection[1]

In this paper we will do reference only to the legal system of protection in Spain, which evolves measures of prevention and protection against neglect and abuse of children.

KEY WORDS

Children at risk of abuse or neglect, care order, child protection system, foster care, child protection ombudsman, child adoption, paternal responsibility, centre of child protection.

Protection System Domestic Law

Three dates in our recent past registry the situation of child protection legislation in Spain. The present Spanish child protection system started its most recent in-depth
modification of the Civil Code, Act 21/1987: child protection system was decentralised in autonomous communities. From that moment decisions about care order or fostering went over from Court to Administration. Ten years later was given an important impulse with the promulgation of Spanish Organic Law 1/1996, Law of Legal Child Protection and partial modification of the Law of Civil Prosecution. This law recognizes children as holders of a series of rights, reaches a legal framework for child protection, considers children as an active, participative and creative subject, with needs and rights that should be guaranteed.

After several years of work and consensus from all instances, 20 February 2015 has been announced by the Government two projects of Law, which will reform the current system of protection in Spain: best child interest, treatment of adolescents, adoption,... Both Civil Code and Law of Legal Child Protection[2], as well as many other regulations in relation with families,

1 La seguridad jurídica en el sistema de protección de menores, Julieta Moreno-Torres Sánchez, Editorial Aranzadi, 2009. ISBN 978-84-8355-900-0, full text available in http://dialnet.unirioja.es/servlet/autor?codigo=748237

2 http://www.congreso.es/public_oficiales/L10/CONG/BOCG/A/BOCG-10-A-130-1.PDF,

gender, civil prosecution, etc. are right now been reviewed. Not only the Convention on the Rights of the Child[3], but the Convention on Disabled People's Rights[4], are the main international instruments used to make a transversal legislation to rework on this new legislation.

Considering where we come from, and where we are going to, will expose in this brief paper the way the protection against neglect is taken under care in the Spanish Protection System.

The changes which are taken place in our legislation, have much to do with not only social influence but also international law, specially the Committee on the Rights of the Child, October 13th 2010, recommendations to Spain to *intensify its efforts to render appropriate assistance to parents and legal guardians in the performance of their child-rearing responsibilities, in particular for families in crisis situations due to poverty, absence of adequate housing or separation.* The proposed regulation about social risk in *intensify its efforts to render appropriate assistance to parents and legal guardians in the performance of their child-rearing responsibilities, in particular for families in crisis situations* mentioned, obey to this recommendation, as well as for *the new norms and protocols to define the scope and standards of the care given to children with conduct disorders*[5]. And the government bill about best child interest has been written following the General comment No. 14 (2013) on the right of the child to have his or her best interests taken as a primary consideration[6].

Juriprudence of Supreme and Constitucional Court of Spain have also had big influence in the new government bill, specially about right to family live and the respect of child right to be heard[7]. Also by the influence of the jurisprudence of the European Court of Human Rights, which has settled at an European level the guidelines of essential and fundamental rights – right of visits, child protection right against neglect and policies of intervention in families...[8]

Administrative organisation

Child protection is coordinated and centraly legislated from the Ministry of Equality, Health and Social Services, but has been completely decentralised by the way of establishing that in each Autonomous Government, with an administrative body, is responsible for the protection of all

http://www.congreso.es/public_oficiales/L10/CONG/BOCG/A/BOCG-10-A-131-1.PDF

3 http://www.ohchr.org/en/professionalinterest/pages/crc.aspx

4 http://www.un.org/disabilities/default.asp?id=150

5 http://www.ohchr.org/EN/HRBodies/CRC/Pages/CRCIndex.aspx

6 http://www2.ohchr.org/English/bodies/crc/docs/GC/CRC_C_GC_14_ENG.pdf

7 TC Sentence 221/2002, november 25th 2002, TC Sentence 11/2008, january 21st, 2008; TS Sentence july 31st, 2009 (http://hj.tribunalconstitucional.es/HJ/es)

8 Sentences such us may 10th, 2001 (TEDH 2001\332), case Z and others against UK, Sentence september 16th, 1999 (TEDH 1999\35), case Bruscemi against Italy (http://www.echr.coe.int/Pages/home.aspx?p=caselaw/HUDOC&c=#n1355308343285_pointer)

children in every region[9].

Each one of the these Autonomous Administrations assume functions and responsibilities:
To work with preventive measures, with children at risk of abuse or neglect so that children are not separated from their families.
To adopt administrative measures to protect any child and even separate from the family, when it does not appropriately protects them.
To relate with the judges and attorneys when required for cases which need judicial intervention.
To create resources, public and private (centres of child protection, Foster Associations...), available in its territory and to coordinate the protection.

The Committee on the Rights of the Child was generally positive in its 2011 report about Spain, with regards to the harmonisation of domestic law with the principles of the Convention. The Committee noted, however, that *laws and regulations applied in autonomous communities differed and that they were "not always consistent with the Convention in important areas". Particular attention was drawn to matters pertaining to the protection of children at risk*[10]. The new government bill, presented by the Ministry of Equality, Health and Social Services and Ministry of Justice pretends this situation to change so that all the Autonomous Communities work on social risk the same way, as will mention below.

Big role in the protection of children and in the changes of legislation, play in Spain this figures:
The State Ombudsman[11] and very specially the Autonomous Communities Child Protection Ombudsman, as an example in Andalusia[12], who have in the past years done several reports about situations such as minor foreigner not accompanied or centres of protection for adolescents[13].
The national and regional Observatories, which work supporting the development of measures and actions to promote the rights and well-being of the child as defined by the United Nations Convention on the Rights of the Child and the other international standards in force [14]
The Public Prosecutor, who has to look out both the situation of children at social risk of neglect or abuse – who already live with their families- and the measures adopted by de Administration

9 About the Spanish Protection System organisation, DE PALMA DEL TESO, A., «Administraciones públicas y protección de la infancia», Instituto Nacional de Administración Pública, Madrid, 2006
10 http://www.bettercarenetwork.org/enoc/resources/infodetail.asp?id=24765
11 http://www.defensordelpueblo.es/es/index.html
12 http://www.defensordelpuebloandaluz.es/nuestros-informes-y-estudios, «Informe especial sobre Menores Inmigrantes en Andalucía», BOPA núm. 18, de 8 de junio de 2004, «Informe Especial al Parlamento Andaluz sobre Menores con trastornos de conducta», BOPA núm. 778, de 12 de diciembre de 2007
13 Also the nets which work arround Europe, been Spain member, as http://www.wikiprogress.org/index.php/European_Network_of_Ombudspersons_for_Children_%28ENOC%29
14 http://www.observatoriodelainfancia.msssi.gob.es/ as well as the European net http://www.childoneurope.org/organization/membership.htm

– care order, foster care, child adoption...[15].

Prevention and protection

The system of protection has moved from prioritizing the enforce of measures which involve the separation of children from their own families, to measures to work from and with the family, to avoid the child having to get away from it. In 1987 Act, a formal declaration of social risk of neglect or abuse was not included; Organic Law 1996, article 17, introduced this concept, and in the present Project of modification of this Law, the importance of prevention is remarked with a wide regulation of children at social risk of abuse or neglect: from the moment the Law is approved, even a formal declaration of the situation of social risk will be done by the Administration before the declaration of care order.

If the social, psychological and educational intervention after declaring the social risk of neglect or abuse does not work, when has been proved that the child has to get out of the family to be protected, or when even is not possible to begin it, the Administrative measures will be:

Declaration of the situation of "*desamparo*" or care order. An Administrative Resolution will be served, as mentioned above, in Spain not though a judicial process, but by the Administration of Autonomous Communities. Care order ("*desamparo*") means: when the persons who, by law, should be responsible for the care and custody of a minor is missing or unable to carry them out, when any form of inadequate exercising of the duties of protection is noticed, or when they are lacking the basic elements for their integral development, when children show sings of physical, psychic or sexual abuse, or neglect, the Administration becomes – without any Court interference- tutor of the child. This declaration involves the automatic taking on of guardianship functions over the child and the suspension of the parental responsibility and custody for the time that this measure is applied. The involved parts are informed as well as the Public Prosecutor in order to guarantee the rights of those affected, within 48 hours, and may appeal to Court in case do not agree with the order.

Administrative custody ("*guarda*"): parents may ask the Administration to keep the custody of the minor, when the defenceless is due to a force major of a transitory nature, without the suspension of the parental responsibility, the Administration takes under the custody and care of the minor, but parents keep on having the paternal responsibility (*patria potestad*).

Consequence of care order or administrative custody is the decision about who will care the child: a foster or an adoptive family. Autonomous Communities are enable to select the family who will care the child when the parents cannot do it. First of all will be taken in consideration

15 Artícle 174 Civil Code.

the relatives, and if there are not or are not able to foster or adopt the child, the Administration will search other families to do it. In Andalucia every child under seven will always be in a family. But this does not happen in every Autonomous Community. The government bill terms in three years this age, and proposes children under six not to go to protection centers.

Adolescents

Chiefly have to make difference of the legislation applied to minors who are victims of neglect or abandonment, from criminal responsibilities of minors: from the age of 14, Organic Law 5/2000, Law for the Criminal Responsibility of the Children will be applied if the child is over fourteen years old. Before these age the child protection system will act in case the minor does any criminal action. From fourteen years old the minor can be under Law 5/2000, but the protection measures can also be applied at the same time.

Parents are primarily responsible for ensuring that their child attends school regularly, and they face statutory penalties if they neglect that responsibility. But nowdays we face not only parents who do not make sure their children regularly attend school, but parents who have no way to get their son or daughter adolescent going to classes, adolescents with problems of drugs or conduct disorder. Also truancy is often the first precursor to future juvenile delinquency.

Up to the 2015 Government bil, the State child protection legislation has not done a special mention to adolescents. Specially having both parents going to work, and the way education has got relaxed, has brought out true problems about this section of the minor population. The new regulation proposes new measures to encourage school absenteeism related or educational neglect and conduct disorder.

According to all this, the Government Bill regulates not only rights for children (as does Organic Law 1/1996), but also educational, social and family duties for children, specially adolescents: they have rights, of course, but also duties.

Individual plan – personal attention

The passing by of time has great influence in children. No terms are established in our present regulations about reports of child who have been declared in social risk or who have already a care order and are placed in a foster family or a Centre of child Protection. The new regulation proposes a intensive monitoring of each personal situation through a individual plan, with terms for professionals to report their situation to the Public Prosecutor.

Conclusions

Spain has a proper legislation to protect children from neglect. And this legislation is even

improved. Intervention from prevention, education and social policies are the key for a welfare children state.

Progressive and proportionality in the measures adopted, and legal certainty are the principles which should guide the new legal system of protection proposed.

Besides the economical crisis, the Administration has the responsibility to take care of children, which should never be separated from their parents because of poverty or not giving the families the help they need to keep their children with them.

ROOTS OF MODERNITY GROUNDED ON TRADITION: Select Civil Law concepts ingrained in Commercial Law

Atty. Nilo T. Divina*

It is my distinct honor and a cherished privilege to speak before you in the occasion of the Spain- Philippines Civil Law Congress against the background of this beautiful city of Malaga and interact with legal luminaries imbued with strong passion for education and love for the law. As everyone knows, the Philippines has deep historical and cultural ties with Spain. Other than our Catholic faith, Spain's most dominant influence in our culture is reflected and ingrained in our civil laws. I happen to teach and practice commercial law. The topic of my brief lecture is therefore apt and close to my heart- civil law concepts ingrained in commercial law. The topic can be extensive. After all, civil and commercial laws do intertwine. I have taken the liberty though of selecting certain legal principles consistent with my general topic which I consider interesting owing to questions they pose and in view of recent jurisprudence in our country. Kindly allow me to state these topics in question form.

I. What is the prescriptive period for the insurer to file an action against the wrongdoer?

A recent interesting jurisprudence in our insurance laws relates to the prescriptive period within which the insurer should file an action for recovery against the wrongdoer after the insurer has been subrogated to the rights of the insured.

Subrogation is defined as the transfer of all the rights of the creditor to a third person, who substitutes him in all his rights. It may either be legal or conventional. Legal subrogation is that which takes place without agreement but by operation of law because of certain acts. Conventional subrogation is that which takes place by agreement of parties.[1]

An example of legal subrogation that does not require and is not dependent upon the agreement of the parties is that which takes place under the law on insurance but which has its basis under the Civil Code. Article 2207 of the Philippine Civil Code provides that if the plaintiff's property has been insured, and he has received indemnity from the insurance company for the injury or loss arising out of the wrong or breach of contract complained of, the insurance company shall be subrogated to the rights of the insured against the wrong-doer or the person who has violated the contract.

The case of *Pan Malaysian Insurance Corp. v. Court of Appeals*[2] has construed this provision to mean that payment by the insurer to the assured operates as an equitable assignment to the former of all remedies which the latter may have against the third party whose negligence or wrongful act caused the loss. The right of subrogation is not dependent upon, nor does it grow out of, any privity of contract or upon written assignment of claim. It accrues simply upon payment of the insurance claim by the insurer.

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[1] Licaros v. Gatmaitan, G.R. No. 142838, August 9, 2001.

[2] G.R. No. 81026, April 3, 1990.

In the exercise of this right by the insurer, a relevant issue is the prescriptive period within which the insurer may proceed against the wrongdoer. This is now settled by the case of *Vector Shipping Corporation v. American Home Assurance Company*[3]. In this case, a collision occurred between the M/T Vector and the M/V Doña Paz in the evening of December 20, 1987. The collision led to the sinking of the vessels, which resulted in the loss of the petroleum cargo of Caltex on board the M/T Vector. Fortunately, the goods were insured and so after the filing of an application by Caltex, the insurer paid it for the loss of the petroleum cargo on July 12, 1988. On March 5 1992, the insurer filed a complaint against Vector, Soriano, and Sulpicio, Lines Inc. to recover the full amount it paid to Caltex.

In opposition, Vector, Soriano, and Sulpicio, Lines Inc. insisted that the action was premised on a quasi-delict or upon an injury to the rights of the plaintiff, which, pursuant to Article 1146 of the Civil Code, must be instituted within four years from the time the cause of action accrued. Since the cause of action accrued on December 20, 1987, which was the date of the collision, the insurer had only four years, or until December 20, 1991 to bring its action. Since the complaint was filed only on March 5, 1992, then the action is already barred for being commenced beyond the four-year prescriptive period.

In its decision, the High Court held that the action was not based upon a quasi-delict or upon a written contract, but upon an obligation created by law. This is because the subrogation of the insurer to the rights of Caltex as the insured was by virtue of the express provision of law embodied in Article 2207 of the Philippine Civil Code. Hence, it came under Article 1144 (2) of the Civil Code, which states that in an obligation created by law, an action must be brought within ten years from the time the cause of action accrues. Since the right of subrogation accrues simply upon payment of the insurance claim by the insurer, then the cause of action accrued as of the time the insurer actually indemnified Caltex on July 12, 1988. Henceforth, the action was not yet barred by the time of the filing of the complaint on March 5, 1992, which was well within the 10-year period prescribed by Article 1144 of the Civil Code.

It is therefore settled that the right of the insurer to proceed against the wrongdoer accrues from the time of payment to the insured and not from the time when the goods were lost or damaged.

II. Is a cashier's check or manager's check legal tender ?

One principle that gave rise to confusion in the history of Philippine jurisprudence is the issue of legal tender. The law mandates that all monetary obligations shall be settled in the Philippine currency which is legal tender in the Philippines. However, the parties may agree that the obligation or transaction shall be settled in any other currency at the time of payment.[4] Legal tender has been defined by BSP Circular No. 829[5] as notes and coins issued and circulating in accordance with R.A. No. 265 as amended and/or R.A. No. 7653, which, when offered for the payment of public or private debt must be accepted. Pursuant to Section 52 of

[3] G.R. No. 159213, July 3, 2013.

[4] Sec. 1, Republic Act No. 8183, AN ACT REPEALING REPUBLIC ACT NUMBERED FIVE HUNDRED TWENTY-NINE AS AMENDED, ENTITLED "AN ACT TO ASSURE THE UNIFORM VALUE OF PHILIPPINE COIN AND CURRENCY June 11, 1996.

[5] AMENDMENTS TO CONSOLIDATED RULES AND REGULATIONS ON CURRENCY NOTES AND COINS dated 13 March 2014, pursuant to Monetary Board Resolution Nos. 1097 dated 4 July 2013 and 48 dated 9 January 2014. March 13, 2014.

R.A. 7653[6] all notes and coins issued by the Bangko Sentral shall be fully guaranteed by the Government of the Republic of the Philippines and shall be legal tender in the Philippines for all debts, both public and private. However, the legal tender power of coins has been limited by BSP Circular No. 537[7] to be One Thousand Pesos (P1,000.00) for denominations of 1-Peso, 5-Peso, and 10 Peso coins and One Hundred Pesos (P100.00) for denominations of 1-sentimo, 5-sentimo, 10-sentimo and 25-sentimo coins.

Article 1249 of the Civil Code states that the delivery of promissory notes payable to order, or bills of exchange or other mercantile documents shall produce the effect of payment only when they have been cashed, or when through the fault of the creditor they have been impaired.

Our jurisprudence is replete with cases in answering the question of whether checks are legal tender. In the 1980 case of *New Pacific Timber v. Seneris*[8] the Court ruled that a cashier's check issued by a bank of good standing is deemed as cash. As a consequence, a judgment creditor cannot validly refuse acceptance of the payment of the judgment obligation tendered in the form of a cashier's check. However, in 1993, the Court reversed itself and ruled in the case of *Tibajia, Jr. v. Court of Appeals*[9] that a judgment creditor may validly refuse the tender of payment partly in check and partly in cash because a cashier's check tendered by the judgment debtor to satisfy the judgment debt is not a legal tender.

The Court was even more categorical in the case of *Roman Catholic Bishop of Malolos v. Intermediate Appellate Court*[10] when it held that a check, be it a manager's check or ordinary check, is not legal tender, and an offer of a check in payment of a debt is not a valid tender of payment and may be refused by the creditor.

In the subsequent case of *Tan v. Court of Appeals*[11] the Court seemed to returned to its earlier ruling when it held that a cashier's check by its peculiar character and general use in the commercial world is regarded substantially to be as good as the money which it represents. Then in the case of *Pabugais v. Sahijiwani*[12], it was held that payment in check by the debtor may be acceptable as valid, if no prompt objection to said payment is made. Thus, where the seller of real property tendered the return of the reservation fee in the form of manager's check because the sale agreement was not fully consummated owing to the failure of the buyer to pay the balance of the purchase price within the stipulated period, the tender of the manager's check was considered a valid tender of payment.

In the 2008 case of *Bank of Philippine Islands v. Royeca*[13], the Court held that since a negotiable instrument is only a substitute for money and not money, the delivery of such an

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[6] THE NEW CENTRAL BANK ACT, June 14, 1993.

[7] dated July 18, 2006 pursuant to Sec. 52 of Republic Act No. 7653 and Monetary Board Resolution No. 862 dated 6 July 2006.

[8] G.R. No. 41764, December 19, 1980.

[9] G.R. No. 100290, June 4, 1993.

[10] G.R. No. 72110, November 16, 1990.

[11] G.R. No. 108555, December 20, 1994.

[12] G.R. No. 156846, February 23, 2004.

[13] , G.R. No. 176664, July 21, 2008.

instrument does not, by itself, operate as payment. Mere delivery of checks does not discharge the obligation under a judgment. The obligation is not extinguished and remains suspended until the payment by commercial document is actually realized. Then in the 2011 case of *Halley v. Printwell Inc.* [14] , our Supreme Court held that since a check is not money and only substitutes for money, the delivery of a check does not operate as payment and does not discharge the obligation under a judgment. The delivery of a bill of exchange only produces the fact of payment when the bill has been encashed.

It must however be emphasized that said pronouncements apply only in the payment of an obligation but not in the exercise of a right[15] It was ruled in the case of *Fortunado v. Court of Appeals*[16] that a check may be used for the exercise of the right of redemption, the same being a right and not an obligation.

From the foregoing pronouncements, it is now a settled rule that a check is not legal tender. Indeed, a check should not considered as a legal tender. With the way how a check is used and issued, coupled with uncertainties as to encashment, payees of the checks are not assured of payment by their mere issuance including cashier's check or manager's check. That checks are not legal tender is clear under the New Central Bank Act of the Philippines[17] which provides that checks representing demand deposits do not have legal tender power and their acceptance in the payment of debts, both public and private, is at the option of the creditor: Provided, however, That a check which has been cleared and credited to the account of the creditor shall be equivalent to a delivery to the creditor of cash in an amount equal to the amount credited to his account. Since our law does not make a distinction between ordinary check and cashier's check/ manager's check, then, checks, regardless of kind, are not legal tender consistent with the basic rule in statutory construction that when the law does not distinguish, neither should we distinguish.

III. **If a corporation fails to materialize, are the incorporators/subscribers of the corporation deemed partners inter se ?**

Under the Philippine Civil Code, there are two kinds of persons with the capacity to enter into contracts, acquire property, incur obligations, sue and be sued in courts. These are the natural persons and juridical persons. Under Article 44 of the Civil Code, juridical persons are the State and its political subdivisions; other corporations, institutions and entities for public interest or purpose, created by law, and corporations, partnerships and associations for private interest or purpose to which the law grants a juridical personality, separate and distinct from that of each shareholder, partner or member. These juridical persons may acquire and possess property of all kinds, as well as incur obligations and bring civil or criminal actions, in conformity with the laws and regulations of their organization.[18]

There are likewise instances when a corporation is defectively formed. While it has been held that as between themselves the rights of the stockholders in a defectively incorporated association should be governed by the supposed charter and the laws of the state

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[14] G.R. No. 157549, May 30, 2011.

[15] Biana v. Jimenez, G.R. No. 132768, September 9, 2005.

[16] G.R. No. 78556. April 25, 1991.

[17] Sec. 60, R.A. 7653, THE NEW CENTRAL BANK ACT, June 14, 1993.

[18] Art. 46, Civil Code.

relating thereto and not by the rules governing partners, it is ordinarily held that persons who attempt, but fail, to form a corporation and who carry on business under the corporate name occupy the position of partners inter se. Thus, where persons associate themselves together under articles to purchase property to carry on a business, and their organization is so defective as to come short of creating a corporation within the statute, they become in legal effect partners inter se, and their rights as members of the company to the property acquired by the company will be recognized. So, where certain persons associated themselves as a corporation for the development of land for irrigation purposes, and each conveyed land to the corporation, and two of them contracted to pay a third the difference in the proportionate value of the land conveyed by him, and no stock was ever issued in the corporation, it was treated as a trustee for the associates in an action between them for an accounting, and its capital stock was treated as partnership assets, sold, and the proceeds distributed among them in proportion to the value of the property contributed by each. *However, such a relation does not necessarily exist, for ordinarily persons cannot be made to assume the relation of partners, as between themselves, when their purpose is that no partnership shall exist*, *and it should be implied only when necessary to do justice between the parties; thus, one who takes no part except to subscribe for stock in a proposed corporation which is never legally formed does not become a partner with other subscribers who engage in business under the name of the pretended corporation, so as to be liable as such in an action for settlement of the alleged partnership and contribution*. A partnership relation between certain stockholders and other stockholders, who were also directors, will not be implied in the absence of an agreement, so as to make the former liable to contribute for payment of debts illegally contracted by the latter.[19]

IV. **May a corporation by estoppel be sued independently of the persons assuming themselves to be corporation ?**

An interesting principle in commercial law is a corporation by estoppel. This results when a corporation represented itself to the public as such despite its not being incorporated. As such, it is neither a natural nor a juridical person. Section 21 of the Corporation Code of the Philippines[20] governs the liability of a corporation by estoppel which states that all persons who assume to act as a corporation knowing it to be without authority to do so shall be liable as general partners for all debts, liabilities and damages incurred or arising as a result thereof: Provided, however, That when any such ostensible corporation is sued on any transaction entered by it as a corporation or on any tort committed by it as such, it shall not be allowed to use as a defense its lack of corporate personality. Likewise, one who assumes an obligation to an ostensible corporation as such, cannot resist performance thereof on the ground that there was in fact no corporation. Thus, in the case of *People v. Garcia*[21], it was held that the persons who illegally recruited workers for overseas employment by representing themselves to be officers of a corporation which they knew had not been incorporated are liable as general partners for all debts, liabilities and damages incurred or arising as a result thereof. Even a person who did not directly act on behalf of the corporation but having reaped the benefits of the contract entered into by persons with whom he previously had an existing relationship, he is deemed to be part of said association and is covered by the scope of the doctrine of corporation by estoppel.[22]

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[19] Pioneer Insurance & Surety Corporation, G.R. No. 84197, July 28, 1989.

[20] BATAS PAMBANSA BILANG 68, May 1, 1980.

[21] G.R. No. 117010. April 18, 1997

[22] Lim Tong Lim *v*. Philippine Fishing Gear Industries, Inc., G.R. No. 136448, November 3, 1999.

However, this doctrine applies only to a third party when he tries to escape liability on a contract from which he has benefited on the irrelevant ground of defective incorporation. Thus, when he is not trying to escape liability from the contract but rather the one claiming from the contract, the doctrine of corporation by estoppel is not applicable.[23] Likewise held in the case of *Lozano v. De Los Santos*[24] that where there is no third person involved and the conflict arises only among those assuming the form of a corporation, who therefore know that it has not been registered, there is no corporation by estoppel.

The question that arises then is whether a corporation by estoppel can be sued independently of the persons assuming themselves to be a corporation. This is answered by the case of *Macasaet v. Francisco*[25] with the Philippine Supreme Court ruling that a corporation by estoppel may be impleaded as a party defendant considering that it possesses attributes of a juridical person, otherwise, it can not be held liable for damages and injuries it may inflict to other persons. There is no ruling yet on the liability of such corporation. The only issue raised before the Supreme Court is the propriety of the order of the lower court granting the motion to drop a " corporation " as party defendant considering that it is not registered with the Securities and Exchange Commission and as such, has no juridical personality. It will be interesting to see how the Supreme Court will eventually rule on how to enforce a judgment against a corporation by estoppel (independently of those who represented themselves as a corporation who, under the law are liable as general partners) considering that a corporation by estoppel can not possibly acquire properties unlike regularly- organized corporations.

V. **Should there be a minimum bid price requirement if the mortgagee is a bank ?**

Another concrete example of how commercial law and civil law are very well-intertwined is mortgage. It is a security commonly used in commercial transactions that is clothed with characteristics that are civil in nature. Mortgage has been classified by the Civil Code as having the following requisites:

(1) That they be constituted to secure the fulfillment of a principal obligation;

(2) That the pledgor or mortgagor be the absolute owner of the thing pledged or mortgaged;

(3) That the persons constituting the pledge or mortgage have the free disposal of their property, and in the absence thereof, that they be legally authorized for the purpose.[26]

For a person to validly constitute a valid mortgage on real estate, he must be the absolute owner thereof as required by Article 2085 of the New Civil Code. The mortgagor must be the owner, otherwise the mortgage is void. In a contract of mortgage, the mortgagor remains

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[23] International Express Travel & Tour Services, Inc. *v.* Hon. Court Of Appeals, G.R. No. 119002, October 19, 2000.

[24] G.R. No. 125221, June 19, 1997.

[25] GR No. 156759, June 5, 2013.

[26] Art. 2085, Civil Code.

to be the owner of the property although the property is subjected to a lien. A mortgage is regarded as nothing more than a mere lien, encumbrance, or security for a debt, and passes no title or estate to the mortgagee and gives him no right or claim to the possession of the property. In this kind of contract, the property mortgaged is merely delivered to the mortgagee to secure the fulfillment of the principal obligation.[27] It therefore highlights the importance of mortgage as an assurance to ensure prompt payment and not as a mode of transferring ownership like that of a sale.

In the event the debtor fails to pay the loan, the creditor has the option to foreclose whatever security has been constituted over the loan by selling the same at a public auction. This could be done either judicially, by filing a petition with the court pursuant to Rule 68 of the Rules of Court or extra-judicially if there is an agreement between the parties.

After the foreclosure, the debtor is given a chance to reacquire the property sold at public auction by giving him the right of redemption. Redemption has been defined as "the right of a debtor, and sometimes of a debtor's other creditors, to repurchase from a buyer at a forced sale, property of the debtor that was seized and sold in satisfaction of a judgment or other claim against the debtor, which right is usually limited to forced sale of real property. The concept of redemption is to allow the owner to repurchase or to buy back, within a certain period and for a certain amount, a property that has been sold due to debt, tax, or encumbrance.[28]

If the foreclosure is done judicially, an equity of redemption is given to the debtor, but not a right of redemption. In *Huerta Alba Resort, Inc. v. Court of Appeals*[29]*,* the Philippine Supreme Court held that the right of redemption is not recognized in a judicial foreclosure, thus:

> The right of redemption in relation to a mortgage–understood in the sense of a prerogative to re-acquire mortgaged property after registration of the foreclosure sale–exists only in the case of the extrajudicial foreclosure of the mortgage. No such right is recognized in a judicial foreclosure except only where the mortgagee is the Philippine National bank or a bank or a banking institution.
>
> Where the foreclosure is judicially effected, no equivalent right of redemption exists. The law declares that a judicial foreclosure sale, 'when confirmed by an order of the court, x x x shall operate to divest the rights of all the parties to the action and to vest their rights in the purchaser, subject to such rights of redemption as may be allowed by law.' Such rights exceptionally 'allowed by law' (i.e., even after the confirmation by an order of the court) are those granted by the charter of the Philippine National Bank (Act Nos. 2747 and 2938), and the General Banking Act (R.A.337). These laws confer on the mortgagor, his successors in interest or any judgment creditor of the mortgagor, the right to redeem the property sold on foreclosure–after confirmation by the court of the foreclosure sale–which right may be exercised within a period of one (1) year, counted from the date of registration of the certificate of sale in the Registry of Property.

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[27] Heirs of Eduardo Manlapat *v*. Court of Appeals, G.R. No. 125585, June 8, 2005.

[28] Iligan Bay Manufacturing Corp. *v*. Dy, G.R. Nos. 140836 & 140907, June 8, 2007.

[29] G.R. No. 128567, September 1, 2000.

> But, to repeat, no such right of redemption exists in case of judicial foreclosure of a mortgage if the mortgagee is not the PNB or a bank or banking institution. In such a case, the foreclosure sale, 'when confirmed by an order of the court, x x x shall operate to divest the rights of all the parties to the action and to vest their rights in the purchaser.' There then exists only what is known as the equity of redemption. This is simply the right of the defendant mortgagor to extinguish the mortgage and retain ownership of the property by paying the secured debt within the 90-day period after the judgment becomes final, in accordance with Rule 68, or even after the foreclosure sale but prior to its confirmation.
>
> x x x
>
> "This is the mortgagor's equity (not right) of redemption which, as above stated, may be exercised by him even beyond the 90-day period 'from the date of service of the order,' and even after the foreclosure sale itself, provided it be before the order of confirmation of the sale. After such order of confirmation, no redemption can be effected any longer."

Thus, as a general rule, there is no right of redemption in a judicial foreclosure of mortgage. The only exception is when the mortgagee is the Philippine National Bank or a bank or a banking institution. They merely have an equity of redemption, which, to reiterate, is simply their right, as mortgagor, to extinguish the mortgage and retain ownership of the property by paying the secured debt prior to the confirmation of the foreclosure sale.[30]

In the case of redemption in extrajudicial foreclosure of mortgage, Sec. 6 of Act No. 3135, as amended by Act No. 4118 provides:

> SEC. 6. In all cases in which an extrajudicial sale is made under the special power hereinbefore referred to, the debtor, his successors-in-interest or any judicial creditor or judgment creditor of said debtor, or any person having a lien on the property subsequent to the mortgage or deed of trust under which the property is sold, may redeem the same at any time within the term of one year from and after the date of the sale; and such redemption shall be governed by the provisions of sections four hundred and sixty-four to four hundred and sixty-six, inclusive, of the Code of Civil Procedure, in so far as these are not inconsistent with the provisions of this Act.

Thus, when a mortgaged property is foreclosed extrajudicially, the debtor is given one year to redeem the property, which is counted from the date of the registration of the certificate of sale. This gives the debtor an opportunity to buy back his property.

However, Section 47 of R.A. No. 8791 otherwise known as "The General Banking Law of 2000", amended Act No. 3135. Said provision reads:

> SECTION 47. Foreclosure of Real Estate Mortgage. — In the event of foreclosure, whether judicially or extrajudicially, of any mortgage on real estate which is security for any loan or other credit accommodation granted, the mortgagor or debtor whose real property has been sold for the full or partial payment of his obligation shall

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[30] Sps. Rosales *v*. Spouses Suba, G.R. No. 137792, August 12, 2003.

have the right within one year after the sale of the real estate, to redeem the property by paying the amount due under the mortgage deed, with interest thereon at the rate specified in the mortgage, and all the costs and expenses incurred by the bank or institution from the sale and custody of said property less the income derived therefrom. However, the purchaser at the auction sale concerned whether in a judicial or extrajudicial foreclosure shall have the right to enter upon and take possession of such property immediately after the date of the confirmation of the auction sale and administer the same in accordance with law. Any petition in court to enjoin or restrain the conduct of foreclosure proceedings instituted pursuant to this provision shall be given due course only upon the filing by the petitioner of a bond in an amount fixed by the court conditioned that he will pay all the damages which the bank may suffer by the enjoining or the restraint of the foreclosure proceeding. Notwithstanding Act 3135, juridical persons whose property is being sold pursuant to an extrajudicial foreclosure, shall have the right to redeem the property in accordance with this provision until, but not after, the registration of the certificate of foreclosure sale with the applicable Register of Deeds which in no case shall be more than three (3) months after foreclosure, whichever is earlier. Owners of property that has been sold in a foreclosure sale prior to the effectivity of this Act shall retain their redemption rights until their expiration.

The case of *Asia Trust Development Bank v. Tuble*[31], expounded on the terms of this right, based on Section 47 of the General Banking Law, as follows:

1. The redemptioner shall have the right within one year after the sale of the real estate, to redeem the property.

2. The redemptioner shall pay the amount due under the mortgage deed, with interest thereon at rate specified in the mortgage, and all the costs and expenses incurred by the bank or institution from the sale and custody of said property less the income derived therefrom.

3. In case of redemptioners who are considered by law as juridical persons, they shall have the right to redeem not after the registration of the certificate of foreclosure sale with the applicable Register of Deeds which in no case shall be more than three (3) months after foreclosure, whichever is earlier.

Under the new law, an exception is thus made in the case of juridical persons which are allowed to exercise the right of redemption only "until, but not after, the registration of the certificate of foreclosure sale" and in no case more than three (3) months after foreclosure, whichever comes first. A shorter term is deemed necessary to reduce the period of uncertainty in the ownership of property and enable mortgagee-banks to dispose sooner of these acquired assets. It must be underscored that the General Banking Law of 2000, crafted in the aftermath of the 1997 Southeast Asian financial crisis, sought to reform the General Banking Act of 1949 by fashioning a legal framework for maintaining a safe and sound banking system. In this

[31] G.R. No. 183987, July 25, 2012.

context, the amendment introduced by Section 47 embodied one of such safe and sound practices aimed at ensuring the solvency and liquidity of our banks. [32]

If the mortgagee is a bank, quasi-bank or trust entity (" banking institution"), a minimum bid price during foreclosure sale equivalent to at least the appraised value or zonal value of the property should be imposed. The rationale that the lesser the price the easier it is for the owner to redeem the mortgaged property is not accurate because for banks, the redemption price is fixed at an amount equivalent to the outstanding loan obligation plus the interest stipulated in the real estate mortgage agreement.

The Supreme Court has ruled in many cases that mere inadequacy of the bid price at a forced sale is immaterial and does not nullify the sale on the theory that when the law gives the owner the right to redeem as when a sale is made at a public auction, upon the theory that the lesser the price the easier it is for the owner to effect the redemption.[33]

For banking institution, however, the redemption price is the outstanding amount of the loan plus interest stipulated in the agreement, regardless of the amount of the bid price.[34] Therefore, nothing precludes the bank from making a low bid during the foreclosure sale (provided it is not unconscionable) because the redemption price anyway is pegged by law at a fixed amount. Worst, the mortgagor is still liable to pay deficiency. Thus, to be fair and equitable, if the mortgagee is a banking institution, a minimum bid price during foreclosure sale should be set equivalent to at least the appraised value or assessed value of the mortgaged property.

Indeed, commercial transactions of all sorts abound. The foregoing sampling illustrations show how civil law concepts are very much ingrained in the field of commercial law. Indeed, these laws primarily govern our business transactions and are understandably intertwined. For sure, there can be more illustrations and applications on their seamless harmony- present and future. Admittedly, I am biased for commercial law since I teach and practice it. But, my love and passion for commercial law do not in any way diminish my appreciation and liking for civil law. I hope that was evident in my brief lecture.

Thank you.

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[32] Golden Way Merchandising Corporation *v*. Equitable PCI Bank, G.R. No. 195540, March 13, 2013.

[33] BPI Family Savings Bank *v*. Spouses Avenido, GR No. 175816, December 7, 2011; Spouses Rabat *v*. PNB, G.R. No. 158755, June 18, 2012.

[34] Section 47 of the General Banking Law; Heirs of Burgos *v*. Heirs of Trinidad, GR No. 185644, March 2, 2010.

RELATIONS BETWEEN THE SPANISH AND PHILIPPINE COMMERCIAL CODES

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Abstract:

Spain and the Philippines share more than just three centuries of common history, but they also have in common a legal background that still links nowadays both countries. This is the case of Commercial Law, for both countries have shared and still share the provisions of the same Code of Commerce of 1885. However the evolution of the Code and the rest of the Commercial regulations in both countries has followed two different ways in order to answer to the legal, political and economic requirements of both countries. In this presentation we will consider some of these evolutions in order to conclude that Commercial Law is –above all- a historical notion.

Keywords:
Code of Commerce – Spain – Philippines – Evolution of Commercial Law – Maritime Law – Sainz de Andino – Codification – Re-codification

The common beginning of the Spanish and Philippine Commercial regulation

The scope of this intervention is to discuss the different evolutions that both Spanish and Philippine Commercial Law have suffered throughout the last two Centuries and to reflect on the reasons of this diverse evolution. The starting point –but also the main conclusion- of these reflections is undoubtedly the historical character that defines Commercial Law. The most important authors in the Commercial Law literature have agreed that Commercial Law is a historic notion. This means that the problem of defining the concept of "Commercial Law" is not a conceptual matter but a historical one, for its definition depends on a determinate historical moment and a concrete legislation. Among this authors we must point out professor Joaquín Garrigues in Spain and Francesco Galgano in Italy. In these pages we will discuss how along with the historical moment that the regulation must face, the geographical situation, the international relations and the different problems of every country constitute important elements that determine the evolution of Commercial Law.

The first connections between Spanish and Philippine Commercial Laws date back to the common historical background of both Countries in the colonial times and the very starts of the Spanish Codification. This way, the Spanish Constitution of 1812 stablished that the Civil, Criminal and Commercial Codes will be common for the whole Monarchy, without prejudice to the variations that for particular circumstances the Parliament might introduce. This constitutional precept set up the unity of legislation for all the Spanish territories in the fields of private and criminal Law. To comply with this constitutional mandate, the Andalusian jurist

Pedro Sainz de Andino drew up the first Spanish Commercial Law, which was adopted by the King Fernando VII the 30th May 1829.

This first Spanish Commercial Code was enforced in all the territories that in the moment were part of the Spanish Monarchy, including the East Indies and, obviously, the Philippines. From a legal point of view the Code of 1829 was considered the best code of commerce of its time. This Code followed the footsteps stablished by the French Code de Commerce of 1807, but the Spanish did modernize the regulation in many aspects. However the influence of the French Code in the first Spanish Commercial Code was not so strong as the influence that the French Civil Code had -60 years latter- on ours. Despite of being wholly influenced by the French code in its nuclear parts, the Sanz de Andino's Code followed closely the Spanish Commercial Law tradition already stablished in the Bilbao Ordinances of 1737 and the Law of Castile. In parallel to the redaction of this Code in 1829 were also enforced the Consular Ordinances of Málaga, whose effects were very limited because of the adoption of the Code.

The Spanish Code of 1829 produced two important effects on the basis of the Spanish private Law. First of all, and because of the delay of the first Spanish Civil Code until 1889, the Commercial Code had to face some legislative lacks that had to be filled by a Civil Law regulation that was not born yet. And secondly –and mainly- the Spanish Commercial Code stablished the division of the Spanish private Law in a Commercial and a Civil regulation, a division that is not present in all the Countries. This way, the Code of 1829 set the basis of the Spanish dual regulation of the private Law that lasts until our days, despite the legislative efforts to unify the private Law at least with regards to the contracts.

The Code of 1829 was followed by several development laws, such as an Act for the Commercial and Business Proceeding (1830), and many regulations regarding to the stocks market, banking, corporate Law and other commercial topics. This profusion of commercial laws justified the need for a new Code of Commerce, which was approved in 1885. According to the memorandum of this text, its redaction was a response to the situation of legal confusion and anarchy generated by the proliferation of laws after the Code of 1929, which needed some consolidation.

The second Spanish Commercial Code was approved the 22nd August 1885 and it replaced the earlier. It was composed of four Books, divided in titles, sections, paragraphs and articles. The first book referred to the «Merchants and commerce in general» (arts. 1-115); the second one to the «special commercial contracts» (arts. 116-572); the third, to «maritime commerce» (arts. 573-869); and the Fourth to the «suspension of payments, bankruptcies and prescriptions» (arts. 870-955).

The redaction of this Code was a reaction to the need of a new regulation of Commercial matters. The works for its redaction started in 1834 and they implied a long and complex process of reform and modernization of the Code of 1829, in which seven different Commissions took part trying to improve the regulation of the Spanish Commercial Law.

The initial geographical scope was defined in article 1 of the Royal Decree, which considered that «The Code of Commerce referred to shall be observed as a law in the Peninsula and adjacent islands, from January 1, 1886». This Royal Decree implementing the Code of Commerce was signed by the King Alfonso XII and the Secretary of Grace and Justice, Francisco Silvela, and it stated:

> *«Don Alfonso XII, by the grace of God, constitutional King of Spain:*
> *Known all ye who see and understand these presents, that the Cortes have decreed and we have sanctioned the following:*
> *First and last article. The Secretary of Grace and Justice is hereby authorized to publish as a law the annexed project of a Code of Commerce.*
> *Therefore, we order all superior courts, justices, chiefs, governors, and other authorities, civil as well as military and ecclesiastical, of whatsoever class and dignity, to observe and enforce the observance, comply and execute the present law in all its parts»*

The need to extend its implementation to the territory of the colonies that in that moment were limited to Cuba, Porto Rico and the Philippines was faced by successive decrees. This way, a Royal Decree of January 28th 1886 extended the Code to the islands of Cuba and Porto Rico and another Royal Decree of August 6th 1888 extended it to the Philippines. After its extension to the Philippines, the Code was amended by the Law of June 10th 1897.

The Royal Decree of August 6th 1886, extended the Code of Commerce in force in the Peninsula to the Philippines, considering some modifications. This Decree stated:

> *«The general commission on codes of the colonial department having introduced in the code of commerce in force in the Peninsula the modifications and changes required by the different culture, commercial usages, and the geographic situation of said islands, in order that it may be applied in the same in accordance with said commission, on the recommendation of the colonial secretary and by virtue of the authority granted my government by article 89 of the constitution of the Monarchy, in the name of my August Son, the King*

Don Alfonso XIII, and as Queen Regent of the Realm, I hereby decree the following:

Article 1. The annexed code of commerce for the Philippine Islands is hereby approved.

Art. 2. This code shall go in operation in the same fifteen days following its publication in the Gaceta de Manila (…)».

The Code was published –with the modifications necessary for its adaption- in the Philippines in the Gacetas of Manila of November 3 to 16 of 1888, from which latter date the fifteen days are to be computed, which, according to the Royal Decree of August 6th 1888, must pass from the date of its publication in order that it might be considered in force in the archipelago. Thanks to the royal decrees of 1886 and 1888, the provisions of the Spanish Code of Commerce of 1885 were of general application in the entire Kingdom, the Spanish Antilles and the Philippines. It was thus decided by the Supreme Court with regards to the code of 1829 in its decisions of May 26th 1866 and April 2nd 1862 according to which said code was promulgated for the entire Kingdom as a universal law with regard to commercial subjects and questions, with the high purpose of unifying the legislation in this respect and founded on the unalterable principles of Justice.

However, provided that the Spanish Code of 1885 did not contain any derogative clause, we had to consider that –until the adoption of the Spanish Insolvency Act 2003- some precepts of the previous Code of 1829 continued in force, mainly regarding to bankruptcy.

After the Spanish loss of the Philippines in 1898, the Code remained in force during the period of American Rule of the Philippine Islands. This way, the legal inheritance that the Philippines received from Spain influenced the foundations of its legal system. The Spanish Codification stablished a legal system of civil law in the Philippines which was maintained during the period of American Rule, even though the United States is a common law jurisdiction. To maintain the validity of the Spanish Code, the Division of Customs and Insular Affairs of the War Department adopted a translation of the Code of Commerce in October 1899 which is partly still into force. However, as we will consider, some American common law principles influenced the Philippine legal system by way of legislation and by judicial pronouncements.

The Code of 1885 takes the basis of an objective conception of Commercial Law even when it introduces many connections with a subjective system. In order to define the scope of Commercial Law –and in contrast to Civil Law- article 2 of the Code states that «Commercial transactions, be they executed by merchants or not, whether they are specified in this Code or not, shall be governed by the provisions contained in the same (…)». Thus, without regard of the fact that the executor of the acts is a merchant or not, the commercial transactions specified in the Code or similar to those will be subjected to commercial regulations. Nevertheless, along

the text of the Code of Commerce we find many references to the need of the participation of a merchant in order to consider a transaction or a contract of commercial nature (e.g. joint accounts –art. 239-, agents –art. 244-, commercial deposits –art. 303-, commercial loans –art. 311-, transportations –art. 349-, etc.). Along with that the current system of Commercial Law into force both in Spain and in the Philippines is based on the idea of the entrepreneur as the subject of commercial regulations.

Considering its contents, this Code has been said to have been obsolete since its very adoption in many aspects (maritime transport, for instance). However its regulation is far richer than the one of the Code of 1829. It considers some institutions that did not have any regulation under the previous code (stock market, checks, fire insurance…), but we find in it some important deficiencies, among which, the most important is the weak and deficient regulation of corporations. These lacks had to be filled with successive reforms and laws that followed two different ways in Spain and in the Philippines and that were influenced by different factors in both Countries.

I. Diverse legislative developments from 1898

After 1898, and notwithstanding the fact that the Spanish Code of 1885 was still into force in the Philippines, the successive evolutions of the Commercial regulations of both countries have followed different paths and have been defined by the historical situation of both Countries throughout the XX Century so as by the different legislative requirements.

In Spain, the evolution of the Commercial Law during the last 100 years has been defined by the historical moment of the Country. This way, we can consider two different stages of evolution. The first one started with the adoption of the Code of Commerce of 1885 and lasted until the end of the dictatorship of Franco in 1975. This phase was defined by a limited decodification process and a limited legislative activity. The Code of Commerce was becoming more and more obsolete as time passed and reforms were not faced. Nevertheless, during this period we have to point out some important laws, such as the Public Companies Act of 1951; the Private Liability Companies Act of 1953; the Commercial Registry Regulation of 1956; the Law for the repression of anticompetitive practices of 1963; the Statute of the Industrial Property of 1929; or the Law of the Maritime Transport of Goods under Bill of Landing of 1949.

The second stage of the evolution of the Spanish Commercial Law has had a broaden impact. This phase is defined by two main factors: firstly the consolidation of democracy and its principles which have influenced the whole legal system; and, secondly, and with more impact in the Commercial matters, the accession of Spain to the European Union in 1986 and the influence of the Community regulations. Under this phase, the most important laws were approved, such as the Public Companies Act of 1989 and the Private Liability Companies Act of 1995 –both recast in the Spanish Companies Law of 2010-; the current Commercial Registry

Regulation of 1996; the Competition Acts of 1989 and 2007; the Act against unfair competition of 1991; the Patent Act of 1986; the Trademark Acts of 1988 and 2001; the Intellectual Property Law of 1992, refunded in the one of 1996; the Cooperatives Act of 1999; the Bill of Exchange and Check Law of 1985; the Insurance Contract Act of 1980; the Act on the Agency Contract of 1992; the Insolvencies Act of 2003; or the recent Maritime Navigation Act of 2014 (among many others).

This legal evolution represents the current process of decodification that has suffered the Spanish Commercial Law throughout the last decades. The Code of Commerce has been progressively emptying and new acts have regulated some topics that once where part to the Code (companies, bill of exchanges and checks, insolvency regulation, recently sea transportation…). However in the late years we find two tendencies. The first one aims to rationalize the existing rules by offering a new regulation, recasting in one act the scattered and antiquated legislation in some topics (companies, insolvencies, intellectual property…). The second tendency is of greater interests and refers to the efforts to create a new Mercantile Code. The 7th November 2006 an Order of the Ministry of Justice entrusted the Commercial Section of the General Codification Commission the elaboration of a Mercantile Code in order to substitute the old Code of Commerce and integrating and delimitating the current commercial regulation, modernizing and completing as far as needed the existing regulation affecting to the private legal relations according to the exigencies of the market unity. The proposal for a Code was finished and delivered to the Ministry of Justice the 17th June 2013. Maybe the most important novity of the draft text is to consider the «market operator» as a center of the system, and not the old concepts of entrepreneur or undertaking. Thus, as the main subject of Commercial Law, the market operator might be an entrepreneur or any other professional, that is, any person executing an organized economic activity in the market consisting in the production or exchange of goods or the provision of services (including the agriculture, handcraft and liberal professions).

This important change of the optic of the text means that the proposed Code is not just a modernization of the existing Code of Commerce, but it tries to stablish a new system for the Spanish commercial law that overpasses the old conceptions and enshrines the Commercial Law as the Law of the Market. To do that the Code disciplines new contracts and new institutions that, although they are currently used, are atypical in our system, for example electronic commerce. Finally, the Code aims to guarantee the needed unity of Law requested to regulate the economic activity in the market of goods and services.

The Proposal for a Code of Commerce became a draft bill for a Code last May 2014, even when its future adoption is still under doubts. The text under processing is composed by a Preliminary Title considering the scope of Commercial Law and seven books, dedicated respectively to:

I. The entrepreneur and the undertaking
II. Commercial companies
III. Competition Law
IV. Commercial obligations and contracts in general
V. Commercial contracts in particular
VI. Letters of commerce and other instruments for the payment and the credits
VII. Limitation and prescription periods

The Philippines also had to face the problem of the inadequacy of the regulations of the Spanish Code of Commerce during the XX Century. In this case, although its provisions were conserved into force during the period of American Rule, as time passed the provisions considered in the Code became more and more inappropriate to discipline the Commercial issue.

However, in this case the evolution suffered by the Philippine Commercial Law was influenced by the very needs and special requirements of the islands. This way, there are still some important portions of the Spanish Code of Commerce that are still applicable –after its official translation into English-. Along these parts that remain still into force, we can mention:

- The regulation merchants, the book of merchants and the general provision of contracts
- The joint account association
- The commercial barter
- Transfers of non-negotiable credits
- Commercial contracts of overland transportation
- Letters of credit
- Maritime commerce

In other topics, the need to modernize the old Spanish regulation was greater, and this motivated the adoption of some special commercial laws regarding some important issues. Among them, it is to point out the following:

- *Corporation Code of the Philippines (Batas Pambansa Bilang 68, May 1, 1980)*

Before the adoption of this Corpora Law, the part of the Code of Commerce considering that issue had already been abrogated. This Code is formed by an act providing for the formation and organization of corporations defining their powers, fixing the duties of directors and other officers thereof, declaring the rights and liabilities of shareholders and members, prescribing the conditions under which such corporations may transact business, and repealing

certain articles of the Code of Commerce and all laws or parts of laws in conflict or inconsistent with this act.

However, not all the commercial partnership are regulated in the Code of commerce, for the Philippine Civil Code still provides some rules regarding the partnership contract, and among them, we have to consider some regulation of the personal partnerships. This way, article 1767 of the Civil Code states that «by the contract of partnership two or more persons bind themselves to contribute money, property, or industry to a common fund, with the intention of dividing the profits among themselves».

Along with the general partnership articles 1843 and following of the Philippine Civil Code set the regulation of the limited partnership, which would be the equal to the Spanish *sociedad comanditaria*. The very definition of this partnership states that «A limited partnership is one formed by two or more persons under the provisions of the following article, having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the obligations of the partnership».

- *Intellectual Property Code (Republic Act No. 8293, June 6, 1997)*

The very limited regulation of Intellectual Property matters in the Spanish Civil Code and the Code of Commerce revealed the need for a new regulation of intellectual property issues. Being a part of the World Intellectual Property Organization since 1970 also contributed to the reform of the Philippine Intellectual Property Law.

It is noteworthy the fact that in this very topic the American influence has been higher, for in the new regulation, the Philippines adopt a system of Intellectual Property of an Anglo-Saxon nature, that is, considering this integrated by copyright, trademarks, patents, and other rights of industrial nature. As is generally known, Spain and other European countries still have the traditional distinction between Intellectual Property –referring mainly to copyright- and Industrial Property –which refers to patents, trademarks and other intellectual rights used in the industry and commerce-.

The Intellectual Property Code of the Philippines is then divided into 5 parts, regarding successively to the Intellectual Property Office, the Law on patents, the Law on trademarks, service marks and trade names, the Law on copyright and some Final provisions.

The Philippine Intellectual Property regulation was amended by the Republic act No. 9150, providing an act for the protection of layout-designs (topographies) of integrated circuits, modernizing the regulations with regards to the informatics industry.

- *Negotiable Instruments Law – Act No. 2031, February 3, 1911*

Because of the important deficiencies of the Spanish code on this topic and the important development that negotiable instruments had had in the United States since the XIX Century, one of the first Commercial provisions adopted in the Philippines during the XX Century was the Negotiable Instruments Law.

According to section one of the Law, «An instrument to be negotiable must conform to the following requirements:

a) It must be in writing and signed by the maker or drawer;
b) Must contain an unconditional promise or order to pay a sum certain in money;
c) Must be payable on demand, or at a fixed or determinable future time;
d) Must be payable to order or to bearer; and
e) Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty».

- *Competition Law*

Without a doubt, Competition Law is the part of Commercial Law that has suffered a more unequal evolution in Spain and in the Philippines. While Spanish regulation was boosted by its integration in the European Union, which required the adoption of the whole regulation of the Union and the Common Market, the Philippines have not been influenced by that integration and, neither, for any integration in a supranational institution.

Because of that, the regulation of Competition Law in the Philippines is still very incipient, does not face all the competition problems and is mostly influenced by the way of understanding Competition Law and policy in the United States.

Nowadays, the main base for the Philippine Competition Law is section 19 article XII (National Economy and Patrimony) of its Constitution, which states that «the State shall regulate or prohibit monopolies when the public interest so requires. No combinations in restraint of trade or unfair competition shall be allowed».

This provision has been followed by a criminal prosecution of anticompetitive practices. This penal sanction of monopolies is a characteristic of the American system. Concretely, article 186 of the Philippine Penal Code states a provision about monopolies and combinations in restraint of trade:

> «*The penalty of prision correccional in its minimum period or a fine ranging from 200 to 6,000 pesos, or both, shall be imposed upon:*

1. *Any person who shall enter into any contract or agreement or shall take part in any conspiracy or combination in the form of a trust or otherwise, in restraint of trade or commerce or to prevent by artificial means free competition in the market;*
2. *Any person who shall monopolize any merchandise or object of trade or commerce, or shall combine with any other person or persons to monopolize and merchandise or object in order to alter the price thereof by spreading false rumors or making use of any other article to restrain free competition in the market;*
3. *Any person who, being a manufacturer, producer, or processor of any merchandise or object of commerce or an importer of any merchandise or object of commerce from any foreign country, either as principal or agent, wholesaler or retailer, shall combine, conspire or agree in any manner with any person likewise engaged in the manufacture, production, processing, assembling or importation of such merchandise or object of commerce or with any other persons not so similarly engaged for the purpose of making transactions prejudicial to lawful commerce, or of increasing the market price in any part of the Philippines, of any such merchandise or object of commerce manufactured, produced, processed, assembled in or imported into the Philippines, or of any article in the manufacture of which such manufactured, produced, or imported merchandise or object of commerce is used.*

If the offense mentioned in this article affects any food substance, motor fuel or lubricants, or other articles of prime necessity, the penalty shall be that of prision mayor in its maximum and medium periods it being sufficient for the imposition thereof that the initial steps have been taken toward carrying out the purposes of the combination.

Any property possessed under any contract or by any combination mentioned in the preceding paragraphs, and being the subject thereof, shall be forfeited to the Government of the Philippines.

Whenever any of the offenses described above is committed by a corporation or association, the president and each one of its agents or representatives in the Philippines in case of a foreign corporation or association, who shall have knowingly permitted or failed to prevent the commission of such offense, shall be held liable as principals thereof».

An important instrument used in the Philippines to protect commerce mainly in some periods of special need is the Price Act (Republic Act No. 7581, May 7, 1992), stating an act providing protection to consumers by stabilizing the prices of basic necessities and prime commodities and by prescribing measures against undue price increases during emergency situations and like occasions. This act contains some instruments to ensure the availability of basic necessities and prime commodities at reasonable prices at all times without denying legitimate business a fair return on investment. It also aims to provide effective and sufficient protection to consumers against hoarding, profiteering and cartels, with respect to the supply, distribution, marketing and pricing of said goods, especially during periods of calamity, emergency, widespread illegal price manipulation and other similar situations.

- *Maritime Commerce*

The old Spanish regulation contained in the Code of Commerce is still into force to regulate the maritime commerce of the Philippines. However this regulation must be completed

with articles 1732 to 1766 of the Civil code, regulating the contracts of work and labor by a carrier. The importance of this regulation in the Philippines is noteworthy because of its own geographical configuration, formed by an archipelago of 7.107 islands and the need of the maritime transport –both of goods and of passengers- to cover these distances.

However the regulation of the Code of Commerce is no longer suitable to offer solutions to most of the problems in the field of see transportation. This inadequacy has been revealed from the fact that the Spanish doctrine brought to light time ago that some of its norms offered incomplete solutions to most of the legal problems in sea transportation. Because of that –and after a long time of discussion and processing- the Maritime Navigation Act was finally adopted in July 2014, modernizing the regulation of the Code of Commerce and giving solution to most of the problems that the old regulation generated.

From an International point of view, despite the fact of the importance of the transport of passengers by sea in the Philippines, the Archipelago is not party to the Athens Convention relating to the carriage of passengers and their luggage by sea (13 December 1974). The regulation of the liability of the carrier is contained in the Civil Code, whose article 1759 offers the general rule when stating that «Common carriers are liable for the death of or injuries to passengers though the negligence or willful acts of the former's employees, although such employees may have acted beyond the scope of their authority or in violation of the orders of the common carriers. This liability of the common carriers does not cease upon proof that they exercised all the diligence of a good father of a family in the selection and supervision of their employees».

- *Other acts*

Other important Philippine commercial law acts are the Insurance Code (Presidential Decree No. 612); the Insurance Act (Act No. 2427) and the Electronic Commerce Act of 2000.

II. Conclusions and future developments

The comparison of the different developments that Commercial Law has suffered in the Philippines and in Spain shows how Commercial Law is an answer to the needs of the time and a response to the requirements of the economy and the political environment of every state. Even when both States start with the same regulation contained in the Spanish Code of Commerce, the evolution that its regulation has experimented is different in both of them.

In Spain, the Code of Commerce soon demonstrated its inadequacy to solve some of the main problems of the commercial practice in many aspects (contracts, corporations, transportation…). This led to the need of different reforms that took part during the XX Century. But the need of a new Commercial Law was accentuated by the incorporation of Spain to the European Community and the need to adapt its regulation to the provisions for the Common

Market. All this changes have led to the elaboration of a draft bill for a new Mercantile Code, whose regulation modernizes the system, giving solutions to the requirements of the new era.

In the Philippines, the regulations of the old Spanish Code of Commerce have been influenced by the American way of understanding Law and commerce. Thus, even when the Code of Commerce maintains its force, its provisions have been modified throughout the XX and XXI Century and new laws have been approved. In this case, the need for new acts is an answer to the situation and requirements of the islands, and the new laws consider those matters that are most important for the commerce in the Philippines –which are not necessarily the same that in Spain-.

MORTGAGE FORECLOSURE AND UNFAIR TERMS IN BANKING CONTRACTS

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Abstract: Mortgage foreclosure in Spain has been in the spotlight of all legal practitioners since the economic crisis started. At the time many debtors find themselves with severe difficulties to meet the payments of their debt secured by a mortgage and, in addition, losing their homes, the privileges of the proceedings set forth in the Spanish Civil Procedure Act arose. As a consequence of this, many courts started to refer questions for preliminary rulings to the Court of Justice of the European Union, in order to examine the compatibility of them with European standards. Due to many rulings of the European Court, Spanish legislation has been modified accordingly. We have arrived to a point where social awareness has imposed and the consumer´s protection has been increased. The aim of this paper is to show the way this change has been generated.

Key words: mortgage foreclosure, enforcement, unfair terms, dation in payment, preliminary rulings, fresh start.

I. Introduction.-

The western economic crisis has particularly affected our country, thus leading to a rise in enforcement proceedings, notably mortgage enforcement proceedings. The causes for this explosion of mortgage defaults and subsequent foreclosures can be described as the combination of heavy household indebtedness levels secured by mortgages and a rising unemployment rate together with a decrease in household revenues[1]. As we are told, the situation is tending to change slowly, and so the figures show.

Spanish mortgage foreclosure has been always a speed way, different from the "general" enforcement proceedings, for the creditor to enforce the debt secured by the mortgage. In these proceedings, the debtor has very little chance to object it, either because the price for the auction is set in the deed, with no possibility to new appraisal if the value changes or because there are not possibilities for him to claim for the staying of the proceedings nor to allege other causes of objection. For these and other reasons, these type of proceedings have been questioned of unconstitutionality before the Constitutional Court, but this Court has always ruled the legality of them.

[1] GÓMEZ POMAR, F. and LYCZKOWSKA, K. "Spanish Courts, the Court of Justice of the European Union, and Consumer Law. A theoretical model of their interaction" *Indret* 4/2014, pág. 5.

At the moment when the crisis hit strongly the consumers, social movements and civil platforms were born claiming for a solution for the people losing their homes[2], because of their inability to pay the installments of the debt, and the banks filing "inevitably" enforcement claims. Fortunately, all legal operators started to realize that mortgage foreclosure in Spain was a privileged procedural instrument which affected consumer´s rights and did not comply with European Law. Specially, two different problems broke into scene:

-The situation when a debtor, after the repossession of his home, found himself in the position that the price of the mortgaged asset was insufficient to cover the whole debt, so he still had to pay back the outstanding amount to the bank.

-The numerous unfair terms the mortgage contracts incorporate and the helplessness of the debtor to void them with effect in mortgage foreclosure.

This being so, Spanish courts have been very active in referring questions for preliminary rulings to the Court of Justice of the European Union (CJEU) related with the compatibility of Spanish procedural rules with European Law, basically with Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts.

At the same time, or better, as a consequence of different CJEU rulings, the government started to enact legislation in order to protect consumer in this field. Though, the protection has been being enacted very gradually and always almost after a *"slap in the wrists"* of the CJEU[3].

Although these different provisions have changed the scenario in mortgage foreclosure in Spain, yet we have a way to go. The CJUE insists in that one remaining aspect of Spanish mortgage proceedings does not comply Directive 93/13 but Spanish government refuses to modify the rules of procedure in that direction.

II. Mortgage enforcement proceedings in Spain: recurrent problems related with consumers.-

As aforementioned, in case of a default on payment, creditors with their credits guaranteed by a mortgage can bring action to demand its payment through special proceedings –different from the normal enforcement proceedings- regulated in articles 681 to 698 of Civil Procedure Act. As their security is documented in a public deed, the creditor is exempted from going to a declaratory trial in first instance to obtain an enforcement title[4].

[2] PAH is the most famous in Spain.

[3] The different provisions enacted are as follows: RD-Ley 8/2011, 1st July, RD-Ley 6/2012, 9th March, Rd 27/12, 15th November, Ley 8/2013, 26th June, Ley 10/2014 26th June, Rd-Ley 11/2014, RD 1/2015 27th February.

[4] Creditors can also bring action through a normal enforcement proceeding, a declaratory proceeding or extrajudicial proceedings to be followed before a Notary Public. The election implies

The use of these special proceedings means that enforcement shall be directed against the mortgaged assets, laying aside other debtor´s assets. In other words, the proceedings shall be focused only on the repossession of the mortgaged asset. If the debt is not covered fully with the proceeds obtained with the sale or awarding of the mortgaged asset, the mortgagee will continue to enforce the debt through general enforcement proceedings. This situation was very common before the latest reforms were enacted, because the price for the award of the asset by the bank –in case there were no bidders, which was very often- was really low (50% of the price set in the public deed). Moreover, the mortgagee also enjoys the speediness of the proceedings, due basically to the lack of grounds to challenge foreclosure by the mortgagor.

It is required to bring action in these proceedings that the mortgage deed shall include the price at which the mortgage property is valued (based on an official appraisal). This might serve as a rate in the auction. It is also required an address of the debtor for notifications and summons that shall be included in that deed.

The proceeding shall begin with an enforcement claim that must be made against the debtor. It can also be made, if applicable, against the non debtor party which has taken on the mortgage or against the third party which owns the assets mortgaged, the latter on condition that had accredited the acquisition of the assets to the creditor.

A certificate of ownership from the Registry shall be claimed, together with a statement that the mortgage in favour of the mortgagee subsists and has not been cancelled. If the registration certificate shows that the person in whose favour the last registration of ownership was made has not been requested to pay in any notary or judicial form, this person shall be notified of the existence of the procedure so that he may intervene in the proceedings.

The mortgagor has very little grounds to challenge foreclosure in case the enforcement claim has been correctly filed, mainly the payment of the debt and, after Law 1/2013 the inclusion of some unfair terms in the contract.

Once the above has been complied with, and at the request of any of the parties at the proceeding, the property or asset mortgaged shall be auctioned. In order to attend the auction, bidders must deposit the 5% of the auction price (it was 30% before Royal Decree 8/2011 and 20% before Law 1/2013). The enforcing party may only bid when there are other bidders and will not be required to make a deposit. These are the possible scenarios in the auction:

Bid equal to or higher than 70% of the price for which the asset is auctioned: the Court Clerk shall, by order issued on the same or the following day, award the foreclosed asset to the highest bidder.

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different types of protection for the mortgagee or the mortgagor. For the advantages and disadvantages of all of them, see RUIZ-RICO RUIZ, J.M and DE LUCCHI LÓPEZ-TAPIA, Y. "*Ejecución de préstamos hipotecarios y protección de consumidores. Análisis y propuestas para una adecuada conciliación de los intereses en juego*". Madrid, 2013, págs. 21 to 44.

Bid higher than 70% of the appraisal value with payment in instalments: if only bids in excess of 70% of the appraisal value are made, but offering to pay in instalments with sufficient bank or mortgage guarantees of the deferred price, the said bids shall be notified to the enforcement creditor who, within the next twenty days, may request the adjudication of the real property at 70 percent of the start value. If the enforcement creditor does not make use of this right, the final bid shall be approved in favour of the most favourable of the said bids, with the conditions of payment and guarantees offered in the latter.

Bid lower than 70% of the appraisal value: the enforcement creditor may, within a time limit of ten days, present a third party improving the bid by offering an amount in excess of 70 percent of the appraisal value or that, albeit lower than the said amount, proves to be sufficient for the complete satisfaction of the right of the enforcement creditor.

Awarding of the asset by the mortgagee. If, upon expiry of the said time limit, the enforcement debtor has failed to present a third party paying in excess of 70 percent of the appraisal value or that, albeit lower than the said amount, proves to be sufficient for the complete satisfaction of the right of the enforcement creditor, the mortgagee may, within the time limit of five days, seek the awarding of the property at 70% of the aforementioned value or for the amount owed to him for all items, provided that such amount does not exceed sixty per cent of its appraisal value and of the highest bid.

Bid higher than 50% of the appraisal value. If the mortgagee does not make use of this faculty, the final bid shall be approved in favour of the highest bid provided that the amount offered by the latter is higher than 50 percent of the appraisal value or, if lower, covers at least the amount for which the enforcement was dispatched, including the provision for interests and costs.

Bid lower than 50% of the appraisal value: if the best bid does not meet the above requirements, the parties may allege whether or not the award is admissible and the Court Clerk will resolve on the basis of a series of circumstances, mainly the attitude of the foreclosed debtor regarding its obligations under the agreement.

No bidders: if there are no bidders to the auction the mortgagee may request the award of the asset. Depending on the consideration of the immovable asset as primary residence or not, the awarding price would be different. If it is, the awarding would be for an amount equal than 70% of the appraisal value (it was 50% before Royale Decree 8/2011 and 60% before Law 1/2013) or 60% if the amount owed is lower than that. If it is not, the awarding would be for an amount equal than 50% of the appraisal value.

When the secured creditor fails to use this faculty within a time limit of 20 days, the Court Clerk will order the lifting of the attachment over the asset at the request of the foreclosed debtor.

This brief outlook of the mortgage proceedings in Spain lead us to highlight where the difficulties were in order to comply European Consumer Law and over all, to protect consumers from the devastating effects of the economic crisis.

a) **Dation in payment**.

Dation En Paiement" (comes from French) means giving in lieu of payment. It is an act by which a debtor gives a movable or immovable asset or property to the creditor, instead of paying a debt he or she owes in money. The creditor is generally willing to receive it, in payment of a sum which is due. It is similar to cession of assets, as well known as "datio pro solvendo", established in section 1175 Civil Code. Under the dation in payment the credit is paid and discharged fully by giving the property or asset to the creditor, who becomes the new owner of the property, whereas the cession of assets does not discharge the debt until the creditor sells and gets the full amount of debt, this means the creditor does not become the owner of the property and only gets profit through a sale, then the debt will be considered cancelled. The Spanish jurisprudence states that although dation in payment is not expressly regulated under civil law, rules of purchase and sale must be applied[5].

Under the provisions set in Article 140 of the Mortgage Act, the parties can agree that the guaranteed obligation is subject only to the mortgaged properties. In the event of the default on the payments, the obligation of the debtor and the action of the creditor will be limited to the amount of the mortgaged properties and will not refer to the rest of the estate of the debtor. Agreeing this type of mortgage contract means higher interest rates and more difficulties in getting the loan, as a result of the limited liability. Furthermore, it is a voluntary agreement between creditor and debtor.

This type of contract is wrongfully called dation in payment. On the contrary, what society demands as dation in payment is the total cancelation of the remaining debt after mortgage foreclosure, so the creditor cannot prosecute other debtor´s assets.

The situation works as follows: If there is not such agreement of limited liability, normal conditions shall apply. Those conditions are basically set in article 1911 of the Civil Code which sets forth t the debtor´s universal liability for the performance of his obligations with all present and future property. In connection with this provision, article 579 of the Civil Procedure Act sets forth that, if the proceeds from auctioned mortgaged are insufficient to cover the debt, the enforcement creditor may seek the enforcement of the remaining amount against whomever it may be appropriate –the guarantor-, and the enforcement action shall proceed in accordance with the normal rules that apply to any enforcement action. So, once the special mortgage proceedings have ended, and the amount obtained in the auctioning of the asset or the price for which the creditor has awarded the asset is below the amount owed, the creditor shall continue the enforcement proceedings, bringing action towards the rest of the debtor´s assets.

Having said so, dation in payment involves necessarily the breakage of the principle of universal debtor´s liability and cannot be a general rule in our enforcement proceedings. It is certainly

[5] "http://www.legaltoday.com/blogs/civil/legal-english-blog/dation-en-paiement-or-datio-pro-solutio#n2.

true this has not been an immovable principle and could have been moderate by the legislator, but certain conditions will have to apply.

As we stated in our introduction, dation in payment is a general demand that social groups have been claiming just right from the starting point of the crisis, where lots of people were evicted from their homes and they still had a remaining debt to the bank. They claimed for the changing of the law to set dation in payment as a general rule. The courts also started to move towards the consideration of dation in payment within our regulations before all the legal reforms where enacted, which was a bit forced.

In December 2010 and February 2011, the Court of Appeal in Navarra issued two different and opposite rulings. The first one, in which the BBVA bank was obliged to accept the solution of dation in payment to cancel the debt and the second one ruled just the opposite. The Court of Appeal's first judgment considered that by giving the house to the bank with its value was enough to cover the debt, so discharged it, moreover, if the bank granted the loan was because the house had a higher value than the credit. On the other hand, the second judgment was totally different and stated that, even if the value of the property was then 70.000€ lower than when it was firstly valuated, the court challenged what the previous court issued and stated that, applying a principle of Spanish Civil Code, the debtor will have to pay all the debts with current or future assets and that judges should be independent and fulfill the law accordingly. After those judgments, most of the court started to issue rulings trying to interpret the law according with the consumer´s interest, but forcing the statutory law.

A situation of legal uncertainty was being generated, because depending on the court the mortgage foreclosure had been filed, you would have had the luck of seeing your debt cancelled as a consequence of court interpretations of article 579 of the Civil Procedure Act.

So, preliminary rules in this sense were asked to the CJUE, which ruled that dation in payment is a decision the internal legislative body of each country has to enact. In this context, Spanish government has been aware of the situation and important changes have been made in Spanish legislation towards that end. Indeed, many recent laws have provided a case-by-case dation in payment –always with the bank consent- and related to it, the staying of the eviction of their homes of families in risk of social exclusion –meeting specific requirements that successively have been amplified- for up to four years.

b) Unfair terms

The second issue brought here that initially affected mortgage foreclosure proceedings was the one related with unfair terms in mortgage contracts with banks and the possibility of the debtor to challenge the unfairness of them.

Following rulings of the CJUE[6], the concept of *unfair term* within Article 3(1) and (3), and Annex I, of Directive 93/13 is a contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.

In order to determine whether this imbalance arises "contrary to the requirement of good faith", courts must assess whether the seller or supplier, dealing fairly and equitably with the consumer, could reasonably assume that they would have agreed to such a term. Lastly, the unfairness of a contractual term should be assessed taking into account all the circumstances in which the contract was concluded, and the nature of the goods or services for which it was.

In relation with mortgage contracts, unfair terms would be the inclusion of acceleration clauses in long-term contracts that allows the bank to call in the totality of the loan after a single failure to meet a due payment of principal or interest; a high default interest rate of automatically applicable to sums not paid when due; the clause on unilateral quantification of the unpaid debt stipulates that the bank may immediately quantify that amount in order to initiate mortgage enforcement proceedings; and what we called ground clause -a minimum interest rate that banks and other financial institutions applied to the loans so the client would pay a minimum monthly amount even if the *Euribor* rate would fall below this limit-[7].

At the beginning of the situation that caused this stir in the legal world, neither in the general enforcement proceeding nor the mortgage proceedings, the debtor could contest the enforcement alleging the inclusion of an unfair term in his contract. There was not either a procedural way for the court to deem that unfairness, although many courts had been doing so.

Having stated that initial impossibility –it has already been amended in our legislation, as we will see afterwards-, the only solution for the debtor to challenge such unfairness was bringing the action to declaratory proceedings which will take longer. Moreover, the interrelation between the

[6] Aziz case. Judgment 14th March 2013 (C-415/11)

[7] The so-called ground clause is still causing a legal debate in Spain. The Supreme Court ruled the unfairness of it when its consequences had not been carefully explained to customers and they did not know or clearly understood the effects it would have in their monthly payments. In this ruling the banks or financial institutions were forced to withdraw the "ground clause" from the conditions of the mortgage loan and the loans title deeds. This directly affected at least 400,000 contracts from BBVA bank, 90,000 contracts in the case of Novagalicia Bank and 100,000 in the Cajamar entity. But he Supreme Court ruled that the banks shall refund the amounts illegally charged from the date of the ruling and not from when the contract was signed. We are now awaiting for a new ruling from that court to clarify the situation. Vid. DE TORRES PEREA, J.M. *Nulidad de la cláusula suelo por falta de transparencia fundada en una insuficiente información del cliente bancario. En especial, sobre la idoneidad de su impugnación mediante el ejercicio de la acción de cesación* . Revista jurídica valenciana, Nº. 2, 2014 , págs. 23-62.

declaratory proceedings and the enforcement proceedings could be disastrous; if a debtor want to challenge the unfairness of a term, which leads into the illegality of the entire enforcement proceeding, he would have to file a claim into a declaratory proceeding. During those declaratory proceeding, the mortgage enforcement proceedings will continue because it is absolutely forbidden the staying of the proceeding for that specific cause. Indeed, article 698 of the Civil Procedure Act provides that "*any claim that the debtor, a third-party holder or any other interested party may bring which is not included under the preceding articles, including any concerning the nullity of title or on the expiry, certainty, extinction or amount of the debt, shall be dealt with in the relevant trial without ever having the effect of staying or hindering the proceedings set forth in this chapter".*

This meant that, when the court issue a ruling stating the unfairness of the term which leads into the illegality of the enforcement, the enforcement proceedings would have already finished and the asset sold to the best bidder. The only way to grant relief to the debtor would be a compensation on the price of the asset. This solution is way too far from the right to effective protection of the court (due process) guaranteed in Article 24.1 of the Spanish Constitution.

The situation provoked different referrals to the CJEU for preliminary rulings in the matter of deeming unfair terms in mortgage proceedings, most of them are analyzed in next section.

II. The CJEU rulings in the subject an its consequent changes in Spanish legislation.

As the situation was precarious, with many homeowners losing their homes, a number of cases regarding the compliance of Spanish law on mortgage enforcement with EU consumer law started to make its way through preliminary reference proceedings before the CJEU[8]. A point that draws the attention is the interaction between national and supranational judiciaries in this field, in which the principle of effectiveness functions as leverage for 'upgrading' national laws to EU standards. As a consequence of this, Spanish legislation has been amended to meet those EU standards.

[8] Hans-W. **Micklitz**, Norbert **Reich**, "The Court and Sleeping Beauty: The revival of the Unfair Contract Terms Directive (UCTD)" 51 *Common Market Law Review*, 20014.Issue 3, pp. 771–808. *The paper gives an overview of the increased litigation leading to innovative case law of the CJEU concerning the scope and effects of the Unfair Contract Terms Directive (Directive 93/13/EEC) on consumer contracts, in particular financial services and services in the general economic interest. The originally limited impact of the Directive on Member State contract law and procedure has been substantially extended - as a metaphor, one may even say that a "Sleeping Beauty has been kissed awake" by the Court.*

a) Calderón case: Judgment 14th June 2012 (C-618/10)

One of the first rulings coincident with the economic situation was this case. Although the dispute is not about a mortgage contract, the ruling was interesting if we compared it with one of the latest of the CJEU.

Mr Calderón Camino entered into a loan agreement for the sum of EUR 30 000 with Banesto in order to purchase a vehicle. The nominal interest rate was 7.950%, the APR (Annual Percentage Rate of Charge) 8.890% and the rate of interest on late payments 29%. In September 2008, reimbursement of 7 monthly repayments had not yet been made. Thus, Banesto submitted, before the Court of First Instance, No 2 of Sabadell, in accordance with Spanish law, an application for an order for payment in the amount of EUR 29 381.95, corresponding to the unpaid monthly repayments plus contractual interest and costs. The Court of First Instance held of its own motion that the term relating to interest for late payment was automatically void, on the ground that it was unfair. It also fixed that rate at 19%, referring to the statutory rate of interest and to the rates of interest for late payment included in national budget laws from 1990 to 2008, and ordered Banesto to recalculate the amount of interest for the period at issue in the dispute before it.

Banesto appealed against that order to the Audiencia Provincial de Barcelona, who found, that the Spanish legislation on the protection of the interests of consumers and users does not empower the courts before which an application for order for payment has been brought to hold, of their own motion and *in limine litis*, that unfair contract terms are void, so they referred the preliminary ruling to the CJEU, referring also the question whether the court that finds that an unfair term in a contract concluded between a seller or supplier and a consumer is void, can modify that contract by revising the content of that term instead of merely setting aside its application to the consumer.

The answers of the CJEU for the questions referred were as follows:

-Firstly, the CJEU ruled that Directive 93/13 had to be interpreted as precluding legislation of a member state which did not allow the court before which an application for an order of payment has been brought to assess of its own motion, in limine litis or at any other stage of the proceedings, if a term shall be considered unfair.

-Secondly, the Court insisted on the necessity to delete an unfair clause within the meaning of Article 3 of Directive 93/13. If a national court deems the unfairness of a term, the legislation that allows the court to modify the contract by revising the content of that term does not comply within the Directive 93/13. The idea would be to invalid the term and not moderate it. The reason behind the ruling of the court is that if it was open to a national court to revise the content of unfair terms, that power would seriously undermine the dissuasive effect for sellers or suppliers of the straightforward non-application with regard to the consumer of those unfair terms, because those sellers or suppliers would still be tempted to use those terms in the knowledge that, even if they were declared invalid, the contract could nevertheless be adjusted,

to the extent necessary, by the national court in such a way as to safeguard the interest of those sellers or suppliers. An exception to this case-law is made where the invalidity of the unfair term would require the court to annul the contract in its entirety, thereby exposing the consumer to disadvantageous consequences.

b) Aziz case: Judgment 14th March 2013 (C-415/11)

The most famous ruling of the CJEU in the matter of unfair terms and mortgages is the Aziz case which attracted the media and caused a great stir. This case is directed related with mortgage contracts.

This court judgment is originated from a preliminary ruling handed down by the Commercial Court nº 3 of Barcelona, as a result of the mortgage foreclosure procedure between Aziz and *La Caixa* Bank.

Mr. Aziz concluded with Catalunyacaixa, before a notary, a loan agreement secured by a mortgage. The immovable property subject to the mortgage was Mr Aziz's family home. The principal sum lent by Catalunyacaixa was EUR 138 000. It was to be reimbursed in 396 monthly instalments. That loan agreement entered into with Catalunyacaixa provided for annual default, interest of 18.75%, automatically applicable to sums not paid when due, without the need for any notice. In addition, clause 6a of that agreement conferred on Catalunyacaixa the right to call in the totality of the loan on expiry of a stipulated time-limit where the debtor failed to fulfil his obligation to pay any part of the principal or of the interest on the loan. Finally, clause 15 of that agreement, concerning the agreement on determination of the amount due, stipulated not only that Catalunyacaixa had the right to bring enforcement proceedings to reclaim any debt but also, for the purposes of those proceedings, that it could immediately quantify the amount due by submitting an appropriate certificate indicating that amount. Mr Aziz paid his monthly instalments regularly from July 2007 until May 2008 but stopped payments with effect from June 2008. Having called in vain upon Mr Aziz to pay, Catalunyacaixa instituted enforcement proceedings against him before the Court of First Instance No 5 de Martorell, seeking recovery of the sums owed. Since Mr Aziz failed to appear, that court ordered enforcement. Mr Aziz was then sent an order for payment but he neither complied with it nor objected to it. Accordingly, a judicial auction of the immovable property was arranged, but no bid was made. Therefore, in accordance with the provisions of the Code of Civil Procedure, the Court of First Instance No 5 of Martorell consented to the awarding of that property at 50% of its value. Mr Aziz had however applied to the Commercial CourtNo 3 de Barcelona for a declaration seeking the annulment of clause 15 of the mortgage loan agreement, on the ground that it was unfair and, accordingly, of the enforcement proceedings. In that context, the Juzgado de lo Mercantil No 3 de Barcelona expressed doubts concerning the conformity of Spanish law with the legal framework established by the directive.

The questions referred were related to; firstly, determine if the restricted grounds of objection of the Spanish mortgage proceedings, as seen before in Section II, consisted of a clear limitation of consumer protection in the terms of Directive 93/13; and secondly, the national court asked

about several terms included in Aziz´s mortgage contract and how can they be understood in terms of disproportion as in Directive 93/13 set forth.

The court recalls two important principles of implementation of European Law in order to rule the case; the principle of equivalence -legislation may not be any less favourable than that governing similar situations subject to domestic law- and principle of effectiveness –legislation must not make it in practice impossible or excessively difficult to exercise the rights conferred on consumers by EU law-.

In the absence of harmonization of the national mechanisms for enforcement, the grounds of opposition allowed in mortgage enforcement proceedings and the powers conferred on the court hearing the declaratory proceedings are a matter for the national legal order of each Member State. However, taking into account those two principles, the answer to the alluded case are that Spanish legislation listed the grounds, which were very limited, upon which a debtor might object to mortgage enforcement proceedings. Those grounds did not include the existence of an unfair term in the mortgage loan agreement.

Moreover, the Court considers that the Spanish procedural system impairs the effectiveness of the protection which the directive seeks to achieve. That is so in all cases where enforcement is carried out in respect of the property before the court hearing the declaratory proceedings declares the contractual term on which the mortgage is based unfair and, accordingly, annuls the enforcement proceedings. Since the court hearing the declaratory proceedings is precluded from staying the enforcement proceedings, that declaration of invalidity allows the consumer to obtain only subsequent protection of a purely compensatory nature. That compensation is thus incomplete and insufficient, and would not constitute either an adequate or effective means of preventing the continued use of those terms. That applies all the more strongly where, as in this case, the mortgaged property is the family home of the consumer whose rights have been infringed, since that means of consumer protection is limited to payment of damages and interest and does not make it possible to prevent the definitive and irreversible loss of the home. It would thus be sufficient for sellers or suppliers to initiate mortgage enforcement proceedings in order to deprive consumers of the protection intended by the directive.

The Court therefore holds that the Spanish legislation does not comply with the principle of effectiveness, in so far as it makes impossible or excessively difficult, in mortgage enforcement proceedings initiated by sellers or suppliers against consumer defendants, to apply the protection which the directive confers on those consumers.

Following Aziz´s rulings, Spanish legislation in mortgage proceedings was amended in *Law 1/2013 14th of May, laying down measures for the strengthening of the protection of mortgagors, the restructuring of debt and social rent.* The provisions of the law changed substantially the situation, so much in procedural law as well as in substantive law.

The main amendments were as follows:

Amendments to the mortgage market

-Limitation of default interest on mortgages created on primary residences to three times the statutory interest rate.

-Acceleration of payment clause must be applicable only within three months of default of payment or on a number of installments equivalent to three monthly payments.

Amendments to the enforcement proceedings

-The law grants judges the power to deem, at their own initiative or at the request of the interested party, the existence of unfair terms in the enforceable title. Article 552.1 of the Civil Procedure Act has been amended, to authorize Judges to be able to warn the parties if they discern that some of the clauses of the enforceable nonjudicial ownership instrument might be unfair, granting them a five-day hearing.

-The mortgagor also can object the enforcement alleging unfair terms in the enforceable title. New grounds for opposition in nonjudicial foreclosure processes have been included in article 557.1 of the Civil Procedure Act, one of which is if the instrument contains unfair clauses. In cases where one or more clauses are found to be unfair, the court will rule that the foreclosure is unjustified, or it will carry out the foreclosure without applying those unfair clauses, as appropriate (article 561.1 of the Civil Procedure Act). The same provision has been included in mortgage proceedings, where the mortgagor can object the unfairness of a clause, but the grounds are more restrictive in this type of proceedings, because the unfairness can only be objected if the contractual term constitutes the grounds for enforcement or has determined the amount due.

Judicial auction

-The auction will be announced, not only by edict, but also on a judicial and electronic auctions portal belonging to the Ministry of Justice (article 668 of the Civil Procedure Act).

The period within which the price at which the property is awarded must be deposited has been extended to 40 days (article 670.1 of the Civil Procedure Act)

- The starting price at auction set out in the mortgage deed cannot be lower than 75% of the appraisal value –in mortgage proceedings where the auction price is set in the deed-

-It possible to remit part of the outstanding debt in the monetary foreclosure proceeding following the foreclosure of a mortgage on a principal residence;

-Reduction by up to 2% of the debt if permission to inspect the mortgaged property is granted. During the 20-day auction announcement period, anyone interested in the auction may ask the court for permission to inspect the mortgaged property, in which case the court will ask the owner of the property for permission and the mortgage debt could be reduced by up to 2% of the repossession value (article 691.2 of the Civil Procedure Act).

-The amount secured by the guarantee needed to take part in the auction from decreases from 20% to 5% of the appraisal value (article 674 Civil Procedure Act)

- The percentage at which the property (primary residence) will be awarded if there are no bidders at auction increases to 70% of the starting price;

-The period afforded to the successful bidder to deposit the price at which the property is awarded extends from 20 to 40 days;

Monetary foreclosure following foreclosure of a mortgage on a primary residence (Art. 579 Civil Procedure Act)

If the proceeds from auctioned mortgaged assets are insufficient to cover the debt, the enforcement creditor may seek the enforcement of the remaining amount against whomever it may be appropriate, and the enforcement action shall proceed in accordance with the normal rules that apply to any enforcement. As aforementioned, this is the provision that do not cover what we have defined as dation in payment. However, Law 1/2013 has amended that article and now two cases are set out in which the foreclosed borrower may be released: where 65% of the borrower"s outstanding debt at the time of approval of the bid is paid off, in 5 years, plus, exclusively, the statutory interest accrued until the time of payment; or where 80% is paid off in 10 years. Also, to allow the debtor to benefit from a future increase in value of the foreclosed property, the debt may be reduced by 50% of the gain obtained on a sale made within 10 years of the repossession.

As can be noticed, there is no amendment in fully to this article, which would have meant the entry in force of a general dation in payment, which is not the solution to the mortgage market, as we mentioned before.

One of the points the CJEU ruled in Aziz´s case was the opposition of Spanish legislation to the Directive 93/13 in the grounds of potential staying of the mortgage proceedings while declaratory proceedings are being heard to determine the unfairness of a term. Since article 698 of Civil Procedure Act does not permit this staying, the Court concluded that Council Directive precludes Spanish legislation insofar as it does not allow the court before which declaratory proceedings have been brought, which does have jurisdiction to assess whether such a term is unfair, to grant interim relief, including, in particular, the staying of those enforcement proceedings, where the grant of such relief is necessary to guarantee the full effectiveness of its final decision.

However, Spanish legislation has not been amended in this sense. It is true that with the changes already made by Law 1/2013 the unfairness can de deemed in the enforcement proceedings and it will be not necessary to seek protection under a declaratory proceeding.

c) Case Sánchez/Chacón: Judgment 30 April 2014 (c-280-13)

The dispute in this case is about the possibility of dation in payment within spanish legislation:

The debtors concluded a loan contract with the Caja de Ahorros y Monte de Piedad de Baleares for EUR 91 560. In order to secure that loan they mortgaged the dwelling in which they lived. The parties included in the mortgage deed a specific term providing that, in the event of any auction which might be held, the reference value of the dwelling would be EUR 149 242.80. According to Barclays, the parties to the contract also agreed to the unlimited personal liability of the debtors, without limiting that liability to the value of the mortgaged property. Barclays was substituted to the contractual position of the lender. Barclays and the debtors agreed by an act of the same date to an increase in the capital lent to EUR 153.049,08. The estimation of the value of the property mortgaged and the term relating to the liability of the debtors was not changed. As regards the points which were not expressly set out in the new act, the provisions of the original mortgage loan contract were to apply. Having ceased the debtors to pay the monthly loan instalments Barclays brought an action before the Court of First Instance, Palma de Mallorca, seeking the enforcement of the whole debt against the debtors. The property was auctioned, but no bidders were present, so the property was awarded to Barclays, in accordance with the wording of Article 671 of the Civil Procedure ACt in force at that time, that is, 50% of the estimated value which the parties had entered in the .mortgage deed.

Barclays request an order for enforcement for the oustanding debt, which was granted. Within the statutory period prescribed for that purpose, the debtors lodged an objection to that order. They claim that the debt must be deemed to have been cleared and repaid in full because of the value estimated in the deed. They also rely on abuse of rights and unjust enrichment by Barclays.

The questions referred a preliminary ruling in this case can be resumed in two points:

The first matter concerns whether Directive 93/13 precludes on mortgage regulation which, although it provides that the mortgagee may request an increase of the security where the valuation of a mortgaged property decreases by 20%, does not provide, in the context of mortgage enforcement proceedings, that the debtor may request, following a valuation involving the parties concerned, revision of the sum at which the property was valued, at least for the purposes stipulated in Article 671 of the Civil Procedure Act, where that valuation has increased by an equal or higher percentage during the period between the creation of the mortgage and the enforcement thereof.

A we studied in the second section of this paper, Spanish procedural rules on mortgage enforcement provide that the creditor seeking enforcement may be awarded the mortgaged property at 50% at the time of the judgment (now 70% for primary residence) of the sum at which the property was valued, which entails an unjustified penalty for the debtor equivalent to 50% (30% in case of primary residence) of that valuation. The referring court asked whether Directive 93/13 is precluding such dispositions.

The second question settled for a preliminary ruling was whether Directive 93/13 could be interpreted as meaning that there is abuse of rights and unjust enrichment where, after being awarded the mortgaged property at 50% (now 70% for primary residence) of the sum at which

the property was valued, the creditor applies for enforcement in respect of the outstanding amount in order to make up the total amount of the debt, despite the fact that the sum at which the property awarded was valued and/or the actual value of the property awarded is higher than the total amount owed, even though such action is permitted under national procedural law.

The answer of the CJEU was completely different from the case Aziz, because in this case, the national court did not invoke any contractual term that could be classified as unfair. On the contrary, it did invoke national Spanish provisions, which are laws or regulations that were not set out in the contract at issue in the main proceedings. Such provisions do not fall within the scope of that directive which aims to prohibit unfair terms in contracts concluded with consumers.

This means that, in relation with the prior section, an eventual request for installing dation of payment into Spanish legislation on the grounds of incompatibility to European consumer law is not applicable.

d) Case Sanchez Morcillo: Judgment 17 July 2014 (C-169-14)

The case of Sánchez Morcillo and Abril García v Banco Bilbao once more concerned the weak position of consumers under Spanish law regarding the enforcement of mortgage contracts by banks. The home owners found themselves in the position where the contract allowed the bank to claim payment of the entire amount of the mortgage loan upon the failure to pay a certain number of monthly instalments.

In this case, the CJEU again came to the conclusion that the Spanish rules on enforcement of mortgages do not live up to the standards of the Unfair Terms Directive. This time, moreover, the Court explicitly grounded its assessment on Article 47 of the EU Charter of Fundamental Rights, which safeguards the right to an effective remedy and a fair trial in accordance with the principle of equality of arms.

Indeed, the question arising in this case is a direct consequence of the reform of Article 695 of the Civil Procedure Act following the *Aziz* judgment, as we will see in next paragraph. Procedure stipulated that in such cases appeals might only be brought against a judicial order staying the proceedings or displaying an unfair contract term. This effectively offered the bank a possibility to immediately appeal against the sustenance of a home owners objection to enforcement, whereas the party against whom enforcement was sought (the owner of the house) might not appeal if his or her objection is dismissed. In other words, Article 695(4) allowed the bank to appeal against the staying of proceedings, whereas the debtors did not have similar possibilities. The national judge in the present case doubted whether this is in line with the consumer protection offered under the Unfair Terms Directive, read in combination with Article 47 of the EU Charter, as aforementioned.

The CJEU ruled that this different treatment to the mortgagee and the mortgagor violated the principle of equality of procedural defense mechanisms available to the parties involved in mortgage enforcement proceedings.

This ruling soon provoked changes in Spanish legislation. Indeed, by RD Law 11/2014 5th September, about urgent measures in Insolvency Law, article 695.4 was modified entitling the debtor to seek appeal in case of dismissal of his objection.

And once more, the CJEU insisted that Spanish system of mortgage enforcement does neither offer adequate nor effective protection (in the sense of Article 7 of the Unfair Terms Directive) to home owners, insofar as it still does not effectively prevent unjustified evictions. A judge in enforcement proceedings may assess the unfairness of contract terms, but this assessment is not mandatory and bound by time restrictions. Furthermore, in case a judge in parallel declaratory proceedings eventually establishes that the terms of the mortgage contract were unfair, the consumer can only claim monetary compensation, because of the prohibition of the staying of the proceedings for this reason (art. 695 Civil Procedure Act).

e) Case: Unicaja v. various (Joined cases): Judgment 21 January 2015.

The last CJEU´s ruling in this scenario is the one issued a couple of months ago. The questions referred for preliminary ruling were again about the judicial assessment of general terms and conditions applying to Spanish mortgage contracts. Soon after Law 1/2013 entered into force, many courts started to refer preliminary rulings to the CJEU about the following issue:

Known that Spanish legislation, for the sake of Law 1/2013, allows a judge to assess whether a term is unfair or not in any enforcement proceeding, the next step is asking the European court if, in order to ensure the protection of consumers and users in accordance with the principles of equivalence and effectiveness, must a national court, when it finds there to be an unfair default-interest clause in mortgage loans, declare the clause void and not binding or, on the contrary, must it moderate the interest clause, referring the matter back to the party seeking enforcement, or to the lender, for adjustment of the interest. This issue was already referrer to preliminary ruling in Calderón case and the European Court ruled that unfair terms should not be moderate.

In this case, the question has necessarily to do with the Second Transitional Provision of Law 1/2013‘[9] which requires a moderation of default interest for loans or credit for the purchase of a

[9] "*The limitation of default interest on mortgages on habitual dwellings, provided for in Article 3(2), shall apply to mortgages created after the entry into force of this Law. Likewise, that limitation shall apply to default interest, provided for in mortgage loans secured on habitual dwellings and created before the entry into force of the Law, which falls due subsequently, and to any interest which, having accrued and fallen due by that date, has not been paid. In proceedings for enforcement or extra-judicial sale commenced and not concluded by the time of the entry into force of this Law, and in proceedings in which the sum in respect of which an enforcement order or order for extrajudicial sale is sought has already been fixed, the Judicial Officer [Secretario judicial] or*

principal residence and guaranteed by mortgages on the dwelling at issue. Accordingly, it is laid down that in proceedings for enforcement or extra-judicial sale commenced and not concluded by the time of the entry into force of that law, that is, on 15 May 2013, and in proceedings in which the sum in respect of which an enforcement order or order for extrajudicial sale is sought has already been fixed, that amount must be adjusted by applying default interest at a rate at most equal to three times the statutory rate, if the rate of default interest under the mortgage contract is higher than that rate.

Linking those two ideas, the referral court asked if the Second Transitional Provision of Law No 1/2013 implicitly imposes upon the court the obligation to moderate a default-interest clause that could be considered to be unfair, adjusting the interest stipulated and maintaining in force a stipulation which was unfair, instead of declaring the clause to be void and not binding upon the consumer.

The answer of the European court was an eclectic one. It divides between unfair default interest term (in the light of Directive 93/13) and not unfair default interest term. When assessing the unfairness of a default interest rate, even if it is under the ceiling set by Law 1/2013 –three times the statutory rate-, the consequence is the annulment of the term, without moderating it.

On the contrary, when the national court is faced with a contractual term relating to default interest at a rate higher than that provided by Law 1/2013 but not considered unfair, the court shall moderate the term.

III. The current situation in the mortgage market

After so many reforms in the recent years, the current situation has obviously improved. Moreover, the latest reform which affects directly mortgagors with difficulties in paying back their debt is the Royale –Decree 1/2015 27 th of February, of the mechanism of second chance, reduction of the financial charge and other social measures. Among other measures, the one to highlight here is the regulation of what is called *fresh start*[10]*.* It follows the American system of a second chance or 'fresh start', which businesses in Spain have been demanding for a long time.

A fresh start means a discharge of debts granted to debtors in specific circumstances, so a natural person will have, despite an economic breakdown, the opportunity to restart his life, without having to carry out debts that will never be able to satisfy.

According to this law, a debtor can, within an insolvency proceeding, cancel once and for all any debts that could not be satisfied with their property and assets that are present. The scope of this fresh start is restricted, however, because it will only be available to certain types of

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the notary shall allow the party seeking enforcement a period of 10 days in order to recalculate that sum in accordance with the preceding paragraph".

[10] Although it had been implemented for the first time, not fully, in Law 14/2013, 28th September, to support entrepreneurs and their internationalization.

debtors; it does not apply for public law claims and requires the debtor to satisfy certain classes of claims in full.

This means that, in the context of a debt secured by a mortgage in which the debtor is unable to meet the payments, he could initiate an insolvency procedure and within it, once the secured asset has been sold or awarded to the creditor and the proceeds from auctioned mortgaged or pledged assets are insufficient to cover the debt, the mortgagor could claim a discharge of the remaining amount of debt, understanding that he meets the requirements set forth in the Insolvency Act.

The introduction of this second chance implies, together with the possibility of dation in payment, as we mentioned before, a rupture of the traditional principle in Spanish Civil Law of unlimited personal liability of the debtor set forth in Article 1911 Civil Code, according to which, the debtor is liable for the performance of his obligations with all present and future property.

With this second chance, the debtor will be no longer liable for the debts with future assets. It is not technically a dation in payment, because certain requirements have to be met, but in overall means a relief for debtors overwhelmed by bad economics decisions or bad personal situations –such as divorce-. Moreover, the discharge can also be denied or revoked by the court based on certain misconduct of debtors, including fraudulent actions or failure of a debtor to disclose all assets during a bankruptcy case. In this sense, one of the Government's main worries about bankruptcy and fresh start is the high level of fraud often linked to it, which makes it harder for those honest business failures to get help. The new legislation comes with stringent checks to ensure that no fraud will have taken place.

As a recall of the situation, we are being witnesses of very important changes in the traditional´s view of the mortgage market. The tendency is to move towards a more social perspective of it, restructuring the initial imbalance of the previous situation.

On the other side of the coin is the impact on the economy the new system will have; in other words, would it mean that the regulation of the fresh start will discourage banks? Would it mean they will restrict the range of potential debtors by requiring more guarantees or increasing interests? Or, on the contrary, the new regulation will potentiate wealth and prosperity by promoting new businesses?. Time will say.

BANKRUPTCY: AN AGREMENT WITH CREDITORS

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Abstract:

This exposition has as a main objective to analyze the different possibilities currently establish in the insolvency law to solve the insolvency proceeding through agreements with creditors, within or outside the process, because this is, in fact, the only way to finish the process successfully. For this reason, in recent years, the insolvency law has changed its own nature, increasingly leveraging this solution to insolvency situations. So, we analyze also the most significant reforms that in this direction have been made. Finally, we will discuss the situation of the natural person in insolvency and the advances that have been made in this area, as well as the improvements we have left to do.

Key Words: arrangements with creditors, early proposal composition, refinancing agreement, out of court payment agreement, natural person insolvency

1. Introduction

Currently, Insolvency Law is one of the most important areas of law, as it is a matter deeply related to national and international economic situation, due to the forced insolvency law relationship with the economy. In fact, the undeniable economic crisis, social and financial we are living in a time, has led to reflection on the current economic structure which has led to many changes occurring in recent years for this field of law, because, though it may seem ironic, insolvency law is in crisis, also internationally, because today all states have reconsidered their own structure and insolvency process model that seems to not respond effectively in the economic and social times convulsed in which we live, to that for which, however, was designed.

Thus, we find that in recent times all states mired or infected with this crisis, have reformed their insolvency system looking for an improvement that allows to respond to the needs and current economic conditions. Also in the Spanish State have been carried out these reforms, being, in our case, very important and necessary reforms, while Spanish Insolvency Law was greatly lagging behind other legislation, European and Anglo-American, who had been developing and gradually adapted to the current situation.

In this sense, the real revolution in this area occurred in 2003, when is enacted our new Insolvency Act. This law supposed undoubtedly a change in the mindset of the legislature

regarding the insolvency matters, producing a radical change in the structure, consideration, principles, and in general, the pillars on which the Insolvency law is based.

However, despite its good intentions, the fact is that this law is born with some deficiencies that are soon to become apparent and have been trying to overcome by partial reforms. Indeed, since the entry/come into force of this Act in 2004, there have been several modification on it.

Nevertheless, this new Insolvency Act means a substantial change in all aspects of the Spanish Insolvency Law, beginning with the very name of the law as Insolvency Act, a term that has been applauded from all sectors to understand that is a return to classical Spanish terminology. But this term go beyond a simple historical reference. This term underlies one of the true and most important innovations of this law: to set the insolvency procedural unity, being that the distinction between proceedings for traders, bankruptcy procedure and receivership, and not traders, creditor insolvency procedure and the discharge of debts and stay of payment procedure, disappears.

Furthermore, the use of this term instead of bankruptcy that historically denote a punitive nature and that are used in other legislation, emphasizes the procedural nature of the act and highlights its new objectives.

In this sense, we can say that this law is born with four well-defined objectives:

- To modernize Insolvency Law,
- To achieve the satisfaction of creditors
- To promote the continuity of the businesses
- To provide greater flexibility, agility and transparency to the insolvency proceedings

So, we devote some reflections here to analyze whether these objectives are being met.

2. The arrangements with creditors within the Insolvency Proceeding

Although at the beginning of this exposition we have said that the new insolvency law is a major change in Spanish economic scene, the fact is that basically, the main purpose of Insolvency law still gets the satisfaction of the rights of creditors. And it is important not to forget this point, because that will mark the regulation and the evolution that has taken this matter in Spain.

However, in spite of this objective, it is true that the new regulation wish to satisfy creditors trying, at the same time, to encourage the continuity of the business. But this goal

appears in the new legislation as a secondary objective, being that the idea is to get the satisfaction of creditors but trying as far as possible, to promote the continuity of business. But for getting that, it is vital to have the effective possibility to make agreements with creditors.

Then, the Insolvency Act tries not only to allow, but also to encourage such agreements taking the following measures:

A) The possibility of submitting an early proposal of composition

This is one of the most important additions made by this Insolvency Act, in relation to the measures that have been taken to facilitate the resolution of the insolvency proceeding through the arrangements with creditors. It is entitled to request only the debtor himself, unlike what happens in an ordinary proposal of composition in which are also legitimated creditors, provided they meet certain requirements. The proposal can be submitted to the Court by the debtor as from the petition fro voluntary insolvency or as from declaration of compulsory insolvency and, in both cases, until expiry of the term to lodge claims.

In order for a proposal to be admitted to consideration, it must be accompanied by adhesions by creditors of any kind whose claims exceeded one fifth of the liabilities presented by the debtor, but when the proposal is submitted at the same time that the voluntary insolvency petition it shall suffice for the adhesions to amount to one tenth to the same liabilities.

Submitted the proposal, the Court shall resolve on its admission. When the early proposal of composition has been submitted with the petition for voluntary insolvency or prior to this judicial declaration the Court shall resolve on its admission in the actual order declaring the insolvency proceeding open. In other cases, the Court shall resolve by reasoned order on its admission to proceedings within the three days following that of submission of the early proposal of composition.

Once the early composition proposal has been admitted to consideration, must be notified it to the insolvency administrator for evaluating its content according to the payment scheme. If the evaluation is favourable, it shall be attached to the insolvency administrator report. But if the valuation is unfavourable, it shall be submitted to the Court in the shorter possible time which may make admission of the early proposal ineffective. From admission to consideration of the early proposal of composition and until expiry the term to challenge the inventory and list of creditors, any creditor may declare his adhesion to the proposal.

Expired the term to challenge the inventory and list of creditors, or the term to revoke the adhesions, the Court Clerk shall verify whether the adhesion presented reach the legally required majority, in which case he shall proclaim the result, and after that the Court shall hand

a ruling of approval. This ruling shall put the end to the common phase on the insolvency procedure without opening the ordinary composition or the winding-up phase.

In other cases, if the approval of the composition is not appropriate, the Court shall require the debtor without delay to declare whether he maintains the early composition proposal for submission thereof to creditors' meeting or whether we wish to petition for winding-up, handing then a order opening the composition or the winding-up phase, as appropriate.

B) The composition phase as the normal solution to the insolvency proceeding

Once the common phase has ended without an early proposal of composition approval or maintained, the second phase of the insolvency proceeding is opened, and its can be resolve by a composition with the creditor o with a winding-up phase. In this sense, the preamble of the own Insolvency Act takes into consideration the composition phase as the normal solution to the insolvency proceeding, although we can not forget that there is more than possible solution through winding-up.But it can be seen as the legislator considers the winding-up phase as a secondary alternative by which can be solve the insolvency proceeding.

However, the fact is that the winding-up phase has the same opportunities to rise as a solution to the insolvency proceeding, being that, firstly, it can be requested by the debtor at any time during the process, but also because when it is nor possible to end by a composition, it is necessary the winding –up phase, and this indeed is not always possible.

Regarding to the legal nature of the composition, that has been widely discussed by our the legal doctrine and in our jurisprudence, but in general, it could be said that the composition should be seen as a bilateral legal act that requires court approval for its completion.

The proposal of composition can be submitted by the insolvency debtor that even he can to maintains the early composition proposal in case that it had been presented but not approved, but also by the creditors whose claims are recorded in the insolvency proceedings and that exceeded, jointly or individually, one fifth of the total liabilities recorded on the definitive list of creditors. Submitted the proposals, the Court shall admit to consideration if they fulfil the conditions established in the Insolvency Act, ordering, at the same time, to serve notice of the proposal to the insolvency administrator so that he may issue in writing an evaluation of the content. Submitted the evaluation and until to the moment of closing the list of attendees at the meeting, adhesions by creditors to the proposal of compositions shall be admitted.

The meeting shall be held on the day and at the time set in the summoning notice. The Court Clerk shall explain the proposal or proposals admitted to consideration that bare

submitted for discussion stating their origin, and when appropriate, the amount and ranking of the claims held by those who have submitted them. Explained the proposals, it shall be the moment for the discussion. In this sense, discussion and voting shall first take place on the proposal submitted by the insolvent debtor. If it is not accepted, the meeting shall proceed likewise with those submitted by the creditors, successively and in order from greater to lesser, in terms of the total claims held by those signing them. Once a proposal has been accepted, discussion of the remaining ones shall not proceed.

Accepted the composition, the Court Clerk shall submit the minutes to the Court and shall submit the composition accepted for approval thereof. However, the insolvency administrator, the creditors who have not attended to the meeting, those who had been illegitimately deprived of their vote thereat and those who have vote against the proposal of composition accepted by the majority shall be actively legitimated to formulate an opposition. Respecting to the insolvency debtor, may oppose or submit to open the winding-up phase, but only in case that he has not formulated the proposal of composition accepted by the meeting nor has given his approval.

Once the term of opposition has elapsed without any opposition being raised, the Court shall hand down a ruling approving the composition accepted by the meeting. In other case, being raised any opposition, this shall be raised through the channels of an insolvency procedural plea and resolve by a ruling that shall approve o reject the composition accepted.

Approved the composition by the Court and ceased all the effects of the declaration opening the insolvency proceeding, the insolvency debtor shall report to the Court on the fulfilment thereof on a six months bases, and when he deems the composition to be completely fulfilled he shall deliver to the Court the report with the relevant evidences and shall petition for the judicial declaration of fulfilment. If the Court deems the competition to have been fulfilled it shall declare so by order.

However, any creditor who deems the composition to be breached with regard to matters affecting him may petition to Court to have that infringement declared. The petition shall be processed as an insolvency procedural plea and it shall resolve with a ruling by the Court. If this ruling declare the infringement of the composition by the debtor shall give rise to the termination thereof and the winding-up phase shall be opened.

In other case, once the order declaring the fulfilment is final and the term for actions to declare infringement has expired, or when appropriate, those lodged are rejected by final judicial resolution, the Court shall hand down and order of conclusion of the insolvency proceedings.

But, the most contentious issue regarding to the composition is above the content that it can be have. In this sense, it has been criticized that the Insolvency Act has limited and restricted in excess the private autonomy of the debtor and its creditors. Under the Insolvency Act, the proposal of composition must contain propositions for discharge of debts or stay of payment or both. With regard to ordinary claims, the proposals for discharge of debts may not exceed half the amount of each one of them, nor those of stay of payment five years from the judicial resolution approving the composition becoming final. Exceptionally, in the case of the insolvency proceedings affecting businesses whose activity may have a special transcendence for the economy, as long as a feasibility plan submitted so provides, the insolvency Court may, at a party's request, authorise, giving the reasons, those limits being exceeded.

The proposed composition may also contain alternative proposals for all creditors, or for those of one or several classes, including offers for conversion of claims into shares, stakes or corporate quotas, or into participation loans. The proposed composition may also include disposal proposals, either of the set of assets and rights of the insolvent debtor assigned to his business or professional activity, or of certain productive units, to a specific natural or legal person. The proposals must include undertaking by the acquirer to continue the business or professional activity inherent to the productive units affected and to pay the claims to the creditors, under the provisions set forth in the composition proposed. In these cases, the legal representatives of the workers shall be heard.

But under no circumstances whatsoever may the proposal consist of assignment of assets and rights of the creditors in payment or for payment of their credits, or any other means of general winding up of the insolvent debtor's estate to settle his debts, nor alteration of the classification of claims established by the law, nor the amount of these set in the proceedings, without prejudice to the acquittals that may be agreed and the possibility of merger, split or general assignment of assets and liabilities of the insolvent debtor that is a legal person.

3. The arrangements with the creditors as an effective alternative to the insolvency proceedings

Although the regulation we just have expose in relation to the empowerment of agreements between the insolvency debtor and his creditors, the fact is that once initiated insolvency proceedings, the continuity of the business remained difficult. A significant lack of the Insolvency Act in this regard is then manifested: the insolvent situation should try to be resolved before entering in a insolvency proceedings. Thus arises successive legal reforms in this direction, trying, not only to make the insolvency process ends by arrangement with creditors but also, to avoid that the insolvency proceedings begin encouraging that these agreements with creditors are made before.

Thus, one of the most important changes was the introduction of what was called pre-insolvency. This term alludes to the possibility introduced by the Insolvency Act according to which the insolvent debtor who has a duty to petition for a declaration opening the insolvency proceeding, could try to reach agreement with its creditors to avoid that proceeding, and in this case, this duty shall be suspended. That is, if the insolvency debtor reports to the Court that negotiations with creditors have been initiated, his duty to petition for a declaration opening the insolvency proceeding shall be suspended for a time.

These negotiations may consist in to get a refinancing agreement, the necessary creditors' adhesions for approval the early proposal of composition or to come to an out of court payment agreement.

Regarding with to the refinancing agreements, recent reforms have quite an impact on this possibility. On one hand, these agreements have received what has been called a shield against a possible reintegration action, in so far as the law declares this agreements irrevocable when they mean a significant expansion of the credit available or a modification or termination of the debtor's duties, and just in case that it has a feasibility plan submitted that allows the continuity of the businesses in the short and medium term. Also the agreements have to be came before the declaration opening the insolvency proceeding and some more requirements and formalities.

And on the other hand, these reforms have even introduced the possibility of getting a judicial approve of these agreements provided it they meet certain requirements. This possibility has been introduced in order to be able to extend and apply the effects of these agreements to those creditors who had not signed them, or had shown their displeasure with the refinancing agreement or whose credits are not secured claims.

With these reforms, the insolvency law has tried to promote that the creditors of a person in a delicate economic situation confer him the possibility of refinancing their debts to avoid an insolvency situation and an insolvency proceeding.

In relation to the out of court payment agreements, are entered in the Insolvency Act as an alternative to the proceeding. Such agreements may be requested by the debtor to the Registrar or the Notary. The request shall be made by an application form and it has been included an inventory of cash and liquid assets available, the assets and rights held by him and expected regular income. Furthermore, it has been also accompanied by a list of creditors.

Submitted the application form, the registrar or notary shall admitted the petition if it meets the requirements and he appoints an insolvency mediator who has to verify the existence and the amount of loans and who convene the debtor and creditors on the list submitted by the debtor to a meeting. Prior to the meeting, the insolvency mediator shall send to creditors, with

the consent of the debtor, a proposal for payment agreement. This proposal shall include a payment plan detailing the resources provided for compliance and a viability plan and also it shall contain a proposal to regulate the compliance with the new obligations. However, creditors may submit alternative proposals or proposals for amendments.

If an agreement is eventually reached, it must be formalized in a public deed and the Registrar or the Notary must notify the end of the procedure to the Court that had jurisdiction to its insolvency proceeding. But in case that it is not possible an agreement, the insolvency mediator shall petition to the Court for a declaration opening the insolvency proceeding, and the Court shall order it immediately.

The most important idea in relation to these out of court payment arrangements is that, once the procedure begins, the debtor may continue with his employment, business or professional activity, but shall refrain from any act of administration and disposition in excess of acts or own operations of its activity. In addition, during the negotiation period of the out of court payment agreement and regarding credits potentially affected by it, the accrual of interests shall be suspended.

However, with the latest amendments in this sense, the possibility to begin a pre-insolvency phase, means, not only to try to avoid the insolvency proceeding and gain time so important in these cases, but also that this method has been configured as an authentic method of protection to the insolvent debtor from its creditors, being that as an important new effect is introduced: the insolvency creditors may not file a petition for a compulsory insolvency proceeding against the debtor that is in a pre-insolvency phase.

Furthermore, the prohibition of commencement of judicial executions on goods that are necessary for the continuity of the insolvency debtor’s the business and the suspension on executions that are in force is also introduced, in the same line of protection to the insolvent debtor, while it is at this stage, although with some exceptions.

Therefore, these changes have been assessed very positively, since they are an effective protection of the debtor who is trying to avoid reaching a insolvency situation.

4. Conclusions

As can be seen, the change that has occurred in the Spanish Insolvency Law since 2003 can be described as "radical". In this sense, we understand that we have change our mind because before this date, the insolvency proceeding could be described as a process of punitive nature whose main objective was to liquidate the debtor's assets to satisfy the claims of creditors, but since this date, we can say that the insolvency law try to protect the debtor who is immersed in that situation and although the purpose of it is still the effective satisfaction of

creditors' claims, also a second goal to achieve as far as possible, is the continuity of the business.

In this sense, to get that second goal, increasingly important, the insolvency law has focused on strengthening the agreements with creditors as the real effective solution to the insolvency situation.

Because, although initially negotiating climate within the own insolvency process was favored by the possibility of submit an early proposal of composition with the application of insolvency proceeding and configuring the phase of agreements as preferential to the liquidation one in insolvency proceedings which remains only as applicable in cases where no agreement is reached achieved between debtor and creditors, it soon becomes clear that this measures are insufficient to satisfactorily resolve situations of insolvency, whereas, despite favoring the possibility agreements, the fact of having to initiate a insolvency proceeding itself and having to wait for the expiry of the procedure leave this possibility as an ineffective solution, since in insolvency agility and speed of reaction is an important note, and these agreements reached, in most cases late, so the good intentions of the law setting the arrangement phase as principal, remaining in that, just good intentions.

That is why, aware of this problem, are introduced over the years, successive reforms aimed not only to further boost the resolution of the insolvency proceeding through agreements with creditors, but also, the most important, try to anticipate the insolvency situation.

That is why they are introduced in the insolvency law, as we have seen, other pre-insolvency techniques that treat rightly prevent that persons in economic difficulties starts a insolvency proceeding. These mechanisms, such as refinancing agreements and the out of court payment agreements, represent a real alternative to insolvency proceedings, and in a way tremendously effective: they are faster, less expensive, and more flexible and agile.

Indeed, the fact is that the successive reforms that have been undertaken in this legal parcel, will all aimed at reforming these ideas. The legislator has understood that the insolvency law has a mission within the legal framework that goes beyond serving as a channel for the fulfillment of obligations. The insolvency law is now rediscovered as a tremendously effective in combat situations of economic crises instrument. In fact, we can say that an agile, strong and well configured insolvency law is a defense mechanism not only, but also protective, highly effective to stop the effects of crisis in the financial sector.

We can therefore praise the change of legislative mentality that has occurred in our country, but we must remember that insolvency law is alive and must be constantly adapt to the state of the financial markets, and in this sense, then it must be borne in mind it is a legal parcel

must be in constant change and revision. In addition, it is also true that there is still much to do. Despite these reforms, it is certain that insolvency law is still encountering great difficulties, weaknesses and shortcomings in implementation. But the change of mentality to which we have referred provides a reliable foundation to reach achieve the main goal: to set an effective insolvency law.

5. Last reflection: about the non-traders insolvency proceeding

We said at the beginning of this exposition that one of the new elements in the Insolvency Act 2003, is that the application of the principle described above: the principle of Unit, led to the elimination of the distinction between traders and non-traders, so the insolvency law can be applied to any type debtor, whether natural or legal person, leaving only excluding agencies and entities of public law. This effectively represents a novelty in our legislation which, prior to the reform, could find up to four different procedures, depending on the characteristics of the insolvency debtor. However, this development has caused, and despite the many reforms, more disadvantages than facilities.

Nobody is aware that the insolvency situations of a non-trader person have absolutely different characteristics from a trader person. Normally, in these cases, we can see people who usually have a single good value, a property which normally is mortgaged; over-indebtedness caused by the latest economic situations in which it was not difficult to get funding, and in many cases, moreover, to complete the scene, with the addition of a situation of unemployment and lack of obtaining income from such person or the family unit itself.

With this perspective, the fact is that insolvency law, neither the old nor the new or renovated one, stands as no feasible solution to these situations of insolvency. Firstly, the complexity of this process exceeds the needs of a natural person insolvency situation that, as we say, is often characterized by no many creditors, and even fewer goods, in addition with the existence of a mortgage in most cases. But also because shown especially in these cases, as particularly unwieldy and excessively expensive to be undertaken by an individual debtor.

For these reasons, recently, some important reforms related precisely with the non-traders insolvency proceeding have taken place. In this regard, one of the most important news is that natural persons will be able to use these extra-procedural mechanisms to reach an agreement with creditors. This possibility, prohibited at first, is now open for individual debtors.

However, the main problem facing these debtors was quite another. When it comes to the insolvency preceding of a legal person, except in cases of culpable contest, terminated the proceeding and the winding-up phase, whether creditors had been fully or partially satisfied, the legal person is extinguished. This assumes that claims not satisfied in the process fail to never

pay. However, this mechanism did not exist for individual debtors who remained responsible for unsatisfied debts in the insolvency process for all its life.

This situation changed with the reform of 2013, from which the possibility that individual debtors can also see that the outstanding claims after completion of a insolvency process is regulated remain extinguished. However, this regulation had two serious problems of practical application: the first is that although it applied to individual debtor, they should develop a business or professional economic activity, so it did not apply to all individuals, just to individual traders, being outside the scope of application the natural person, the non-trader person who have commented previously.

But also, and secondly, this law appeared to be more ambitious than it really was, because required as a prerequisite to apply this exemption that in the insolvency proceeding all claims against the estate and the preferential claims, special and general, had been satisfied, and even if there were no prior attempt mediated an out of court payment agreement, at least the 25% of the ordinary claims, which actually occurs in a small percentage of proceedings. Therefore, this attempt to articulate what is named as fresh start for the individual debtor was simply reduced to good intentions.

Trying to solve, once again, these deficiencies in the insolvency legislation, there was barely a couple of months the last reform in this respect. This new reform really introduces an authentic fresh star of the natural and non-trader person. The exemption system has two pillars: the debtor must be in good faith and its assets must be liquidated previously (or that the Court orders the conclusion due to insufficiency of the aggregate assets).

However, to apply this mechanism, continuous being required as a prerequisite to apply this exemption that in the insolvency proceeding all claims against the estate and the preferential claims, special and general, had been satisfied, and even if there were no prior attempt mediated an out of court payment agreement, at least the 25% of the ordinary claims, although it also provides for the possibility that it can be applied even if it has not been possible if the debtor is subject to a payment plan for the next five years. Thus, the debtor may be temporarily relieved of all claims except the public ones and for right to be supported, against the estate and those who enjoy a general privilege.

For the final release of debts, the debtor must satisfy in that period not exempt claims or make a substantial effort for it, understood as having intended to deliver, at least half of the income received during the period which did not have the consideration of non-forfeitable assets. Therefore, in the circumstances of the case may declare the final exemption from unsatisfied liabilities of the debtor but had not completed in full the payment plan but had made this substantial effort.

Now, it can be said that has been introduced in Spain the real possibility of a fresh star for the natural and non-trader insolvency debtor, which has been warmly welcomed by the doctrine, courts and society in general.

However, we want to raise two issues in this regard. The first is that it continues to use the insolvency process to try to solve the problem of insolvency of natural persons, despite having shown that it is not suitable or designed for this purpose.

In this regard, note that all our neighboring countries (Italy, France, Germany, United Kingdom, etc.) provide for different procedures depending on the insolvency debtor, and they all have a special process adapted to the insolvency of a natural and non-trader debtor. And the second is that, despite the supposed benefit to debtors the possibility of being exempted from their debts, no one seems to have arisen as the markets will react and financial systems to this new concession, because certainly entities financial will react, I understand that minimizing lending and financing, which in turn will impact on the financial and economic system of the country.

Any case, it is soon to know what is going to happens in this sense, so we have to wait how it is received this reform by the financial sector.

HOW TO SECURE THE ENFORCEMENT OF PENALTIES IN INTERNATIONAL COMMERCIAL CONTRACTS

Ignacio Marín García*

Abstract: This paper claims the need of transnational rules to secure the enforcement of penalty clauses in international commercial contracts, since the contractual toolkit that parties may use seems to be insufficient to address both the clash between the civil and the common law traditions, and the existing disparities among civil laws in this area. The international community acknowledged this need a long time ago, but unfortunately the tremendous effort exerted in many different harmonization projects is unlikely to lead to the certainty that actors in international trade demand. Nevertheless, instead of transnational rules, the statutory recognition at national level of penalties in international commercial contracts is proposed as the most feasible solution to shield the enforcement of penalties in common law jurisdictions.

Keywords: Contract Penalties, Liquidated Damages, Enforcement, International Commercial Contracts.

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Introduction

In the field of penalty clauses, defined as any agreement for the payment of a fixed sum on breach of contract, one of the most distinctive features among civil and common law systems is the extent of the judicial review of the stipulated sum. While common law courts may declare unenforceable such agreement by virtue of the principle of just compensation,[1] civil law courts may only reduce a grossly excessive stipulated sum. The agreed sums exceeding the actual loss of the promisee are unlikely to be enforced by Anglo-American judges,[2] and those deemed extremely high by Continental European judges are also moderated. Therefore, broadly speaking, the principle of non-enforcement of contract penalties governs in common law, and the principle of enforcement of penalties subject to reduction controls in civil law.

The main difference between these two legal traditions lies on their different notions about contract liability: in common law systems, the payment of damages constitutes true fulfillment of the contractual promise. Whereas, in civil law systems, contract liability is an effect arising from the breach or a sanction.[3] Thus, for a civil lawyer, the amount stipulated is always intended to be higher than the loss.[4]

In a comparative view, the major objection against the common law of penalties is that parties are placed in the worst of all possible scenarios, without the flexibility of enforcement of penalties subject to reduction (most civil law systems), and without the certainty of literal enforcement of penalties (Spain).[5] Indeed, from the economic analysis of law, the extreme rigidity of common law courts has been criticized on account of judges disregarding upon these

[1] In these jurisdictions, contract law does not aim to force the promisor to perform, but to compensate adequately the aggrieved promisee, E. Allan Farnsworth, *Contracts* (4th edn, Aspen 2004) 811. Regarding the principle of just compensation, the holdings of two cases, one American and the other English, are very illustrative of the fact that in common law systems freedom of contract encompasses such a wide autonomy for the parties to enter a contract, but a much more restrictive one to arrange remedies against its breach. First, in *Jaquith v Hudson* 5 Mich 123 (Mich 1858), the Supreme Court of Michigan stated that 'courts will not permit the parties by express stipulation, or any form of language, however clear the intent, to set it aside'. Second, in *Addis v Gramophone Co.* [1909] AC 488 (HL), the House of Lords insisted that 'damages for breach of contract [are] in the nature of compensation, not punishment'.

[2] Nevertheless, English law and American state laws present substantially different regimes governing liquidation of damages, with respect to the analysis of its validity and the legal consequences for a penalty clause.

[3] Judge Holmes noted that 'the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,- nothing else' (Oliver W Holmes, Jr, 'The Path of the Law' (1897) 10 Harv L Rev 457, 477). See also Fernando Pantaleón Prieto, 'Las nuevas bases de la responsabilidad contractual' (1992) 46 Anuario de Derecho Civil 1719, 1737-40.

[4] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp Law 427, 428.

[5] GH Treitel, *Remedies for Breach of Contract. A Comparative Account* (Clarendon 1988) 233.

provisions with disfavor,[6] since any judicial review resulting in the unenforcement of penalties threatens the function of this remedy against breach.[7] However, in international commercial contracts, the enforcement of those penalties constitutes an even major concern, since uncertainty is much higher due to the applicable law and the court decision when adjudicating the dispute or enforcing a judgment or an arbitration award.

Part I briefly presents the rules governing penalties in three different jurisdictions: a common law jurisdiction, the United States (Section I.1), and two civil law jurisdictions with fundamental distinctions, France and Spain (Section I.2). Next, Part II denounces the lack of transnational rules to secure the enforcement of penalties in international commercial contracts (Section II.1). Furthermore, Part II explains why the will of the contracting parties may be at risk in an international litigation or arbitration in the absence of coordination instruments among the several jurisdictions (Section II.2). Finally, instead of transnational rules, the statutory recognition at national level of penalties in international commercial contracts is proposed in Part II as the most feasible solution to shield the enforcement of penalties in common law jurisdictions (Section II.3).

[6] Aaron Edlin and Alan Schwartz, 'Optimal Penalties in Contracts' (2003) 78 Chi-Kent L Rev 33, 37. See also Steven Walt, 'Penalty Clauses and Liquidated Damages', *Encyclopedia of Law and Economics* (2d edn, 2011) vol 6, 178, defending that the wrong conviction that courts are capable of determining the value of contract performance for the promisee explains the judicial review of liquidated damages in common law systems.

[7] The selective enforcement of these provisions is controversial not only for economic efficiency reasons, but also for reasons of fairness. Phillip R Kaplan, 'A Critique of the Penalty Limitation on Liquidated Damages' (1978) 50 S Cal L Rev 1055, 1071-72; James Arthur Weisfield, '"Keep the Change!": A Critique of the No Actual Injury Defense to Liquidated Damages' (1990) 65 Wash L Rev 977, 993-95. In the United States, the unequal treatment of very similar cases bags the question about the real set of rules applied by courts. See also Elizabeth Warren, 'Formal and Operative Rules Under Common Law and Code' (1983) 30 UCLA L Rev 898 , dealing with loss above the stipulated sum; Ann Morales Olazábal, 'Formal and Operative Rules in Overliquidation Per Se Cases' (2004) 41 Am Bus LJ 503, examining cases of absence of loss. Moreover, under highly discretionary judicial review of contract penalties, parties would prefer to directly let the ascertainment of damages to courts instead of setting them in advance. Aída Kemelmajer de Carlucci, *La Cláusula Penal* (Depalma 1981) 109.

I. The Civil-Common Law Comparison of Rules Governing Penalties

I.1. United States: the Principle of Non-Enforcement of Penalties

American state laws stick to the common law rule of non-enforcement of penalties. Liquidation of damages is a permissible method of limiting the defaulting promisor's liability for compensatory damages: the parties agree at the time of contracting that damages for breach will be limited to a prescribed formula. Nonetheless, if the stipulated amount entails an undue oppression on the promisor, liquidated damages may be held to be a penalty and, therefore, unenforceable. This rule has been characterized as anomalous, particularly because contracting parties lack power to bargain over their remedial rights in a legal system in which freedom of contract is a deeply rooted principle.[8]

The most illustrative case on the American common law of penalties is Banta v. Stamford Motor Co. (1914),[9] opinion which firstly delineated the test to determine whether a provision for the payment of a stipulated sum in the event of a breach of contract will be regarded as one for liquidated damages. This test was formed by three conditions:

> These conditions . . . are (1) the damages to be anticipated as resulting from the breach must be uncertain in amount or difficult to prove; (2) there must have been an intent on the part of the parties to liquidate them in advance; and (3) the amount stipulated must be a reasonable one, that is to say, not greatly disproportionate to the presumable loss or injury.[10]

The subsequent case law further elaborated this test in such a way that the second condition, the intent of the parties, did not survive over time;[11] and the third condition has been relaxed in the sense that the reasonableness of the amount stipulated may also be ascertained in the light

[8] Joseph M Perillo, *Calamari and Perillo on Contracts* (6th edn, West 2009) 531; Farnsworth (n 1) 811. See also Robert A. Hillman, 'The Limits of Behavioral in Legal Analysis. The Case of Liquidated Damages' (2000) 85 Cornell L Rev 717, 733-38, arguing that agreed damages provisions must be subject to judicial scrutiny but treated like any other contract term; Larry DiMatteo, 'A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages' (2000) 38 Am Bus LJ 633, 733, defending the same claim.

[9] *Banta v Stamford Motor Co.* 92 A 665 (Conn 1914), the Supreme Courts of Errors of Connecticut upheld as a valid liquidation of damages the agreed sum of $15 a day for delay in the delivery of a luxury yacht priced at $5,500.

[10] ibid 667-68.

[11] Restatement (Second) of Contracts § 356 cmt c (1981): 'Neither the parties' actual intention as to its validity nor their characterization of the term as one for liquidated damages or a penalty is significant in determining whether the term is valid'. See also *Wassenaar v Panos* 331 N.W.2d 357 (Wis 1983), ruling the Supreme Court of Wisconsin that the 'subjective intent of the parties has little bearing on whether the clause is objectively reasonable'; Farnsworth (n 1) 817, explaining that the inquiry goes to whether the effect of upholding the stipulation improperly compels performance; Joseph M Perillo, *Corbin on Contracts*, vol 11 (11th edn, Lexis Nexis 2005) 427, stating that, even in those jurisdictions which formally keep intention as an independent factor, intention is derived from an objective test, so this prong of the test is redundant.

of both the anticipated or actual loss, instead of only the anticipated loss at the time of contracting (in *Banta*, the so-called 'presumable loss').[12]

In addition, the difficulty of proof of loss at the moment of contracting still continues as the other relevant factor for the assessment of the reasonability of the amount stipulated,[13] although the ease of proof alone should not be purported to deem the agreed sum as a penalty.[14]

Hence, American courts apply today one single test of reasonableness with two elements, namely the disproportion of the agreed sum and the difficulty of proof of loss, in order to determine whether a liquidation of damages is a penalty.[15]

I.2. Civil Law: the Principle of Enforcement of Penalties Subject to Reduction (France) and the Principle of Literal Enforcement of Penalties (Spain)

The literal enforcement of conventional penalties was a rule of classical Roman law that entitled the aggrieved party to recover the agreed sum without any restriction.[16] In the XIXth century, the codification brought back the principle of literal enforcement of penalty clauses to Continental European laws.[17] In this vein, the French Civil Code, as enacted in 1804,

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[12] This clash between the classical requirement that the sum must be a genuine pre-estimate of the harm (reasonableness ex ante) and the alternative that the sum must be reasonable at the time of breach when compared with the actual harm (reasonableness ex post) remains unsolved. In this vein, the Restatements have never opted for one of them, and the Uniform Commercial Code either. Restatement (First) of Contracts § 339(1) (1932), without referring to any of the two criteria; Restatement (Second) of Contracts § 356 cmt b (1981), explicitly admitting both criteria, albeit acknowledging that each one leads to different results; UCC § 2-718(1) (1977).

[13] Restatement (Second) of Contracts § 356 cmt b (1981): 'If the difficulty of proof of loss is great, considerable latitude is allowed in the approximation of anticipated or actual harm. If, on the other hand, the difficulty of proof of loss is slight, less latitude is allowed in that approximation'.

[14] Dan B Dobbs, *Law of Remedies*, vol 3 (2nd edn, West 1993) 251, claiming that this is the right interpretation of Restatement (Second) of Contracts § 356(1) (1981); William D Hawkland, *Uniform Commercial Code Series* § 2-718:03, vol 2 (Clark Boardman Callaghan 1994), with respect to the UCC § 2-718(1) (1977), advocating that, in contrast with other common law jurisdictions, the difficulty of proof of loss at the moment of contracting has never been a requirement for the validity of the agreed damages clause in American contract law.

[15] In comparison with the above mentioned sections of both Restatements, the UCC § 2-718(1) (1977) added a new parameter, 'the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy'. Although incorporated into state laws, courts rarely apply this additional factor. In fact, the American Law Institute has declared that the factors enumerated by the UCC do not operate as independent requirements for the validity of the clause, Motion Concerning Section 2-718(1) (May 11, 2001). See also Hawkland (n 14) § 2-718:04, arguing that the inclusion of this third factor is reiterative, since the difficulty of proof of loss already points to the availability of other adequate remedies; Ian R Macneil, 'Power of Contract and Agreed Remedies' (1962) 47 Cornell L Q 495, 528, asserting that historically court decisions had conferred great importance to this third additional factor when examining the validity of agreed remedies clauses.

[16] Paulus (D. 44, 7, 44, 6).

[17] The Justinian Code (C. 7, 47) limited the amount of damages claimable to the double of the value of what had been promised. *Ius commune* was also influenced by Canon law, which considered an unjustified gain those amounts that punished with severity the party in breach. Aristides N. Hatzis, 'Having the Cake and Eating It Too. Efficient Penalty Clauses in Common Law and Civil Contract Law'

established the literal enforcement of conventional penalties in Article 1152: *'[l]orsque la convention porte que celui qui manquera de l'exécuter paiera une certaine somme à titre de dommages-intérêts, il ne peut être alloué à l'autre partie une somme plus forte ni moindre'.*[18] The Napoleonic Code was the model for the neighboring nations (Belgium, Italy, Portugal and Spain) and their laws copied this regulation. Nonetheless, the liberal Roman principle of literal enforcement of penalties was progressively abandoned,[19] and most European legislations converged on allowing the judge to moderate those contract penalties which are grossly excessive. Thus, the judicial review of penalty clauses on the grounds of equity is the solution widely accepted by Continental European laws, since Germanic legal systems do also opt for it (Austria, Germany and Switzerland).[20]

In contrast with the majority of European civil law systems, Spanish law solely allows courts to reduce the penalty whether the breach of contract has less entity that the one anticipated by the contracting parties in the provision,[21] so the judicial review on the grounds of equity is

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(2003) 22 Int'l Rev L & Econ 381, 399. See also Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (OUP 1996) 95-113.

[18] 'Where an agreement provides that the party who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater or lesser sum', French Civil Code <http://www.legifrance.gouv.fr>.

[19] The Italian Civil Code enacted in 1942 (Article 1384); the Portuguese Civil Code enacted in 1966 (Article 812); and in Belgium, without any statutory reform, after the Belgian *Cour de cassation* Judgment, 24 November 24, the case law considers that extravagant contract penalties are against the public order and, for this reason, void. In 1975, the French Civil Code was reformed too. Law No 75-597 of 9 July 1975, JO 10 July 1975 7076, added a second paragraph to Article 1152: '*Néanmoins, le juge peut modérer ou augmenter la peine qui avait été convenue, si elle est manifestement excessive ou dérisoire. Toute stipulation contraire sera réputée non écrite*' ('Nevertheless, the judge may moderate or increase the agreed penalty, where it is obviously excessive or ridiculously low. Any stipulation to the contrary shall be deemed unwritten', French Civil Code <http://www.legifrance.gouv.fr>). This article let the judge to increase or decrease a penalty found to be disproportionate. Moreover, Law No 75-597 reformed Article 1231, governing the reduction of the penalty in case of partial performance, stating that Article 1152 was also applicable: '*Lorsque l'engagement a été exécuté en partie, la peine convenue peut être diminuée par le juge à proportion de l'intérêt que l'exécution partielle a procuré au créancier, sans préjudice de l'application de l'article 1152. Toute stipulation contraire sera réputée non écrite*' ('Where an undertaking has been performed in part, the agreed penalty may be lessened by the judge in proportion to the interest which the part performance has procured for the creditor, without prejudice to the application of Article 1152. Any stipulation to the contrary shall be deemed not written', French Civil Code <http://www.legifrance.gouv.fr>). Therefore, the same penalty might be reviewed by a French judge on the grounds of partial performance and on the grounds of equity.

[20] German Civil Code (BGB § 343), although the German Commercial Code (HGB § 348) excludes contracts between professionals in the scope of their activity. Both Austrian law (§ 1336.2 Austrian Civil Code, ABGB) and Swiss law (Article 163-3 *Code des obligations*) admit the judicial review of disproportionate penalties too, but without a different regime for commercial contracts.

[21] Fernando Gómez Pomar, 'El Incumplimiento Contractual en Derecho Español' (2007) 3 InDret 29 <http://www.indret.com/pdf/466_es.pdf>. However, in lieu of the Spanish Civil Code, Navarrese civil law may apply, which is the only particular civil law of the Autonomous Communities with its own rules in the field of contract penalties. Actually, under Navarrese civil law, the coercive function of the penalty is especially protected, since the New Navarrese Code of Laws (Article 518) expressly provides that 'the agreed penalty should not be reduced by judicial discretion', so the penalty would not be adjusted on any ground, Navarra Superior Court Judgments, 27 January 2004 (RJ, No 2668), and 9 November 2005 (RJ, No 2006\377). See also José Ignacio Bonet Sánchez, 'La cláusula penal' in Ubaldo Nieto Carol and José Ignacio Bonet Sánchez (eds), *Tratado de Garantías en la Contratación Mercantil*, vol 1 (Civitas 1996) 887, 964-65. Recall that the Superior Courts of those Autonomous Communities with particular civil law

excluded.[22] The Spanish Civil Code (Article 1154) imposes on the judge the duty to moderate the penalty if, and only if, the undertaking has been partially or irregularly performed.[23] To moderate the penalty, the judge must assess the proportion between the actual performance and the performance that would have barred the claim of the penalty.[24]

Albeit the above mentioned differences concerning the grounds of the judicial review, European civil law systems share the same concept of penalty clause: a provision seeking to deter breach by requiring the payment of extra-compensatory damages.

Beyond the grounds of the judicial review, which serve to classify a civil law system as one of enforcement of penalties subject to reduction or one of literal enforcement of penalties, there exist other minor but significant differences among the several penalty clause regimes pertaining to the civil law tradition. Next, the French and the Spanish law of penalties are compared in order to point out the most basic traits of each of them.

a) Even though the judicial review under Spanish law is much more restricted, the judicial intervention of the penalty is still exceptional in French law, because the disproportion must be an abuse of the coercive function, being obviously excessive, and having no justification.[25]

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have jurisdiction to adjudicate cases in which arise an issue related to the corresponding particular civil law.

[22] The Spanish Supreme Court has constantly rejected the judicial review of penalty clauses on the grounds of equity, STS, 15 October 2008 (RJ, No 5692), STS 17 January 2012 (RJ, No 287), and STS, 10 March 2014 (RJ, No 1467). However, among other relevant changes, a tentative draft bill aimed to explicitly introduce the judicial review on the grounds of equity, *Comisión General de Codificación, Propuesta de Anteproyecto de Ley de Modernización del Derecho de Obligaciones y Contratos* (2009), Article 1150. Within Spanish legal scholars, the majority position has always defended the need of a law reform that allows the judicial review of penalty clauses on the grounds of equity, María Dolores Mas Badía, *La Revisión Judicial de las Cláusulas Penales* (Tirant Lo Blanch 1995) 216; Isabel Espín Alba, *Cláusula Penal. Especial Referencia a la Moderación de la Pena* (Marcial Pons 1997) 86. In this regard, pointing out that the current Article 1154 of the Spanish Civil Code (n 23) excludes judicial review of contract penalties on the grounds of equity, Silvia Díaz Alabart, *La Cláusula Penal* (Reus 2011) 108-9. Nonetheless, a minority position had advocated the referred Article 1154 embraces judicial review on the grounds of equity, since the single requirement for the reduction is the disproportion between the penalty and the actual harm, Francisco Jordano Fraga, *La Resolución por Incumplimiento en la Compraventa Inmobiliaria. Estudio Jurisprudencial del Artículo 1504 del Código Civil* (Civitas 1992) 199-200; José Miguel Rodríguez Tapia, 'Sobre la Cláusula Penal en el Código Civil' (1993), 46 Anuario de Derecho Civil 511, 578-80.

[23] Article 1154: '*El Juez modificará equitativamente la pena cuando la obligación principal hubiera sido en parte o irregularmente cumplida por el deudor*' ('The Judge shall proportionately modify the penalty where the principal obligation should have been performed partially or irregularly by the debtor', Spanish Civil Code <http://www.mjusticia.es/cs/Satellite/es/1215198252168/DetalleInformacion.html).

[24] Manuel Albaladejo García, *Comentarios al Código Civil y a las Compilaciones Forales*, vol 15(2) (Edersa 1983) 486. In consequence, there would be no moderation if the penalty was agreed upon the partial performance actually occurred, STS, 14 September 2007 (RJ, No 5307).

[25] Geneviève Viney and Patrice Jourdain, *Traité de Droit Civil. Les Effets de la Responsabilité* 486-89 (2d edn, LGDJ 2001).

b) While in Spanish law the judicial intervention of the penalty may consist only in the reduction of the sum stipulated,[26] in French law the judge may reduce the penalty if manifestly excessive, or increase it if ridiculously low.[27]

c) If applicable, Spanish courts must reduce the penalty,[28] although the question about the possibility of an ex officio judicial intervention is more debatable.[29] On the contrary, the French Civil Code (Articles 1152 and 1231) authorizes courts to exercise their judicial discretion when reviewing the '*clause pénale*', once it has been determined that the sum stipulated is manifestly excessive or pitiful and also in the event of partial performance. Furthermore, in French law, the adjustment of the sum stipulated on the judge's own motion is statutorily granted,[30] which reinforces the discretionary judicial review of penalties.

In addition, in both legal systems, the question whether to adjust the sum stipulated and in which degree are reviewable by the appellate court but not by the highest court of ordinary jurisdiction, since each of these issues is considered a matter of fact instead of a matter of law. Therefore, the Spanish Supreme Court may decide these issues only on the basis of the prior finding that the lower court erred in qualifying promisor's performance.[31] In this regard, the French *Cour de cassation* balances the stronger discretionary judicial review of penalties with a demanding requirement of accountability, reversing those judgments which alter the sum stipulated without articulating the factual reasons why the amount set fits into the above mentioned category of 'manifestly excessive'.[32]

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[26] Cristina Guilarte Martín-Calero, *La Moderación de la Culpa por los Tribunales (Estudio Doctrinal y Jurisprudencial)* (Lex Nova 1999) 139.

[27] Article 1152 of the French Civil Code (n 19). Actually, this judicial power to increase the agreed sum when ridiculously low constitutes a distinctive feature of French law in comparison with other European civil law systems. Unlike other regimes of contract penalties from the decade of the 70s (n 41) only the 1975 reform of the French Civil Code grants this faculty to the courts. Jean Thilmany, 'Fonctions et Révisibilité Des Clauses Pénales en Droit Comparé' (1980) 32 Revue Internationale de Droit Comparé 17, 40-1.

[28] Article 1154 of the Spanish Civil Code (n 23). The Spanish Supreme Court finally settled this historical controversy with consistent case law since mid 80s, STS, 7 February 2002 (RJ, No 2887).

[29] The Spanish Supreme Court has ruled so in some scattered decisions, being the last one STS, 12 December 1996 (RJ, No 8976). However, there is a tension with the rules of civil procedure, since an ex officio judicial intervention would imply a judicial action beyond the claims raised by the litigants, Luis Díez-Picazo y Ponce de León, *Fundamentos del Derecho Civil Patrimonial*, vol 2 (6th edn, Civitas 2008) 468. See also Charles Calleros, 'Punitive Damages, Liquidated Damages, and Clauses Pénales in Contract Actions: A Comparative Analysis of the American Common Law and the French Civil Code' (2006) 32 Brooklyn J Int'l L 67, 104-5, pointing out the same concern with respect to ex officio judicial review of penalties in French law, as mentioned below.

[30] Law No 85-1097 of 11 October 1985, JO 15 October 1985 11982, amended both Articles 1152 and 1231 of the French Civil Code, introducing the expression '*méme d'office*' ('even of his own motion').

[31] STS, 20 December 2006 (RJ, No 2007/388), and STS, 20 September 2006 (RJ, No 8401).

[32] Cass 3e civ, 12 January 2011, Pourvoi No 09-70.262, <http://www.legifrance.gouv.fr/initRechJuriJudi.do>; Cass 3e civ, 13 July 2010, Pourvoi No 09-68.191 <http://www.legifrance.gouv.fr/initRechJuriJudi.do>; Cass 3e civ, 12 January 2010, Pourvoi No 09-

d) The French and the Spanish law of penalties have in common the application of an objective, retrospective test: despite not being entirely consistent,[33] French courts compare the sum stipulated with the actual damages,[34] and Spanish courts the breach anticipated in the provision with the actual breach.[35] Whereas, the American common law of penalties and the Uniform Commercial Code provide not only the use of the applicable test retrospectively (reasonableness ex post), but also prospectively (reasonableness ex ante).[36] Notwithstanding, in French law, the breaching party's bad faith in the performance is a relevant factor in the determination of whether a penalty is 'manifestly excessive',[37] unlike Spanish law, since this argument does not have any relevance.[38]

e) Lastly, another significant difference between the French and the Spanish law of penalties is that the former bans the cumulative penalty, i.e. the aggrieved party is not jointly entitled to the payment of penalty and the performance of the obligation,[39] while the latter allows the cumulative penalty, as long as this right has been clearly granted.[40] French law makes a single exception: the penalty for breach due to delay, which does not properly constitute a cumulative penalty, because the creditor will never obtain a timely performance of the already lately performed obligation. In the context of European civil law systems, the cumulative penalty is not a singularity of Spanish law.[41]

11.856 <http://www.legifrance.gouv.fr/initRechJuriJudi.do>; Cass 1e civ, 28 November 2007, Pourvoi No 05-17.927 <http://www.legifrance.gouv.fr/initRechJuriJudi.do>.

[33] Calleros (n 29) 105.

[34] Denis Mazeaud, *La Notion de Clause Pénale* (LGDJ 1998) 57-58.

[35] Gómez Pomar (n 21).

[36] Restatement (First) of Contracts § 339(1) (1932); Restatement (Second) of Contracts § 356 cmt b (1981); UCC § 2-718(1) (1977) (n 12).

[37] Calleros (n 29) 106, specifying that the *Cour de cassation* rejects the behavior of the parties as the sole basis to find a penalty manifestly excessive, Cass com, 11 February 1997, Bull civ II, No 47.

[38] However, some scholars have defended the use of the argument of the bad faith to expand the grounds on which the reduction of the penalty is permitted, Jaime Santos Briz, 'Comentario a los arts. 1152 a 1155 CC' in Ignacio Sierra Gil de la Cuesta (ed), *Comentario al Código Civil*, vol 6 (Bosch 2000) 289, 296-97. Against, María Corona Quesada González, 'Estudio de la Jurisprudencia del Tribunal Supremo sobre la Pena Convencional' (2003) 14 Aranzadi Civil 45, arguing that the claim of the sum stipulated may not be deemed against the good faith, since contract penalties are allowed in Spanish law.

[39] Article 1229 of the French Civil Code: '*Il [le créancier] ne peut demander en même temps le principal et la peine, à moins qu'elle n'ait été stipulée pour le simple retard*' ('He [the creditor] may not claim at the same time the principal and the penalty, unless it was stipulated for a mere delay', French Civil Code <http://www.legifrance.gouv.fr>).

[40] Article 1153 of the Spanish Civil Code: '*Tampoco el acreedor podrá exigir conjuntamente el cumplimiento de la obligación y la satisfacción de la pena, sin que esta facultad le haya sido claramente otorgada*' ('Neither may the creditor request jointly the performance of the obligation and the payment of the penalty, unless this power has been clearly granted', Spanish Civil Code <http://www.mjusticia.es/cs/Satellite/es/1215198252168/DetalleInformacion.html>).

[41] German Civil Code (BGB § 341(1)), allowing the claim of performance in addition to the payable penalty when the penalty was promised for improper performance. On the contrary, following the French solution, the Italian Civil Code (Article 1383), the Portuguese Civil Code (Article 811), and the Austrian Civil Code (§ 1336.1 ABGB), including this latter the non-compliance with the promised place of performance too. In accordance with French law, the mandatory prohibition of the cumulative penalty is

On a comparative account limited to Western Europe, French law cannot be generalized, and deemed as the European civil law model of contract penalties, due to the judicial power of increasing an unreasonably small agreed sum, since usually the penalty may only be reduced. Nevertheless, French law features the other characteristics of the wide majority of European civil laws: (1) the validity of contract penalties, which may have the effect of coercing a party to perform her obligation; (2) the judicial review of penalties on the grounds of equity as a discretionary faculty, based on a retrospective test considering the actual harm, or on the grounds of partial performance; and (3) the promisee's entitlement either to the penalty or to specific performance, with the exception of delay, being deprived of claiming statutory damages.

Regarding this third common characteristic, German law is neither representative: not only the cumulative penalty is permitted,[42] but also the promisee is entitled to claim statutory damages, operating the penalty as the minimum amount of damages.[43]

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the solution recommended by the Council of Europe, Committee of Ministers Resolution (78) 3 Relating to Penal Clauses in Civil Law (1978) [hereinafter Council of Europe Resolution (78) 3], Article 2: 'The promisee may not obtain concurrently performance of the principal obligation, as specified in the contract, and payment of the sum stipulated in the penal clause unless that sum was stipulated for delayed performance. Any stipulation to the contrary shall be void'. In fact, the cumulative penalty is not permitted in the tentative draft bill for the reform of the Spanish Civil Code (n 22) Article 1149; Isabel Arana de la Fuente, 'Algunas Precisiones sobre la Reforma de la Cláusula Penal en la Propuesta de Modernización del Código Civil en Materia de Obligaciones y Contratos' (2010) 4 InDret 8-9 <http://www.indret.com/pdf/775_es.pdf>. Notwithstanding, shortly before the Council of Europe Resolution (78) 3, the Common Provisions Annexed to the Benelux Convention on Penalty Clauses (1973) Article 2(1)-(2), contained the exclusion of the cumulative penalty but as a default rule instead of mandatory, being excludable by the parties' agreement, Thilmany (n 27) 41. The exclusion of the cumulative penalty unless otherwise stipulated by the parties was also the solution adopted by the UN Commission on International Trade Law [UNCITRAL] in the Text of Draft Uniform Rules on Liquidated Damages and Penalty Clauses, together with a Commentary thereon (1981) UN Doc A/CN.9/218 [hereinafter UNCITRAL Draft] Article E: '(2) Where the agreed sum is to be recoverable or forfeited on non-performance, or defective performance other than delay, the obligee is entitled either to performance, or to recover or forfeit the agreed sum, unless the agreed sum cannot reasonably be regarded as a substitute for performance. (3) The rules set forth above shall not prejudice any contrary agreement made by the parties'. Despite acknowledging that the cumulation of the two remedies might unjustly enrich the obligee in some circumstances, the Revised Text of Draft Uniform Rules on Liquidated Damages and Penalty Clauses (1983) UN Doc A/CN.9/235 [hereinafter UNCITRAL Revised Draft], this revised draft of uniform rules does not follow the recommendation of the Council of Europe: Article E(3) was deleted, but Article E(2) was amended by including an exception under which the obligee is entitled to performance and the agreed sum when proving that the later cannot reasonably substitute the former, and Article X was added, providing that '[t]he parties may by agreement only derogate from or vary the effect of articles D, E and F of this (Convention)(law)'. See also the final endorsement of this solution, contrary to the recommendation of the Council of Europe, Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance (1983) UN Doc A/CN.9/243 [hereinafter UNCITRAL Uniform Rules] Annex I, Articles 6(2) and 9.

[42] German Civil Code (BGB § 341(1)).

[43] ibid BGB §§ 340(2) and 341(2), both referring to the obligee's assertion of additional damage in cases of non-performance and defective performance. Swiss law (Article 161-2 *Code des obligations*) also allows the recovery of the additional damage.

In sum, in spite of the common traits already mentioned, there are not uniform rules governing contract penalties in Continental Europe, and historically there has not been a real political will of unifying contract law within the European Union,[44] even though some signs of change in 2010.[45] These signs of change led to a highly mature and innovative proposal of contract law harmonization, the Proposal for a Regulation on a Common European Sales Law, [46] the scope of which are those aspects which pose real problems in cross-border transactions without extending to aspects that are best addressed by national laws. Notwithstanding, this Common European Sales Law proposed by the Commission does not deal with contract penalties.

II. How to Secure the Enforcement of Penalties in International Commercial Contracts

The General Assembly of the United Nations, when recommending the states to consider the adoption of the UNCITRAL Uniform Rules (1983),[47] summarized with brilliance the reasons for the harmonization of the conflicting common law and civil law rules governing penalties in the sphere of international commercial contracts:

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[44] The European Union lacks a general legislative competence in contract law, since its competence is limited to those areas related to consumer protection, which has been extensively exercised (the so-called consumer *acquis*). The enactment of a European Civil Code may be perceived as an expression of European identity, but this view is conflicting with the widespread opinion that national codes reflect their own national legal values and legal cultures, factor which explains the political opposition to move towards to the unification of private law, Simon Whittaker, '*The 'Draft Common Frame of Reference'. An Assessment'* (2008) 23-4 <http://www.justice.gov.uk/publications/eu-contract-law-common-frame-reference.htm>. The origin of the Europeanization of private law has scholarly roots, since the 1980s academics from different European countries formed research groups to embark on the harmonization of private law. Despite the shy institutional support that firstly arrived from the European Parliament, the series of Resolutions from 1986 to 2003, the Commission on European Contract Law, chaired by Professor Ole Lando, elaborated the Principles of European Contract Law [hereinafter PECL], meant to provide black letter rules of soft law using the drafting style of a restatement rather than a code in the civil law meaning of the term, Ole Lando and Huge Beale (eds), *Principles of European Contract Law, Parts I and II, Combined and Revised* (Kluwer Law International 2000); Ole Lando, Eric Clive, André Prüm and Reinhard Zimmermann (eds), *Principles of European Contract Law, Part III* (Kluwer Law International 2003). The second great achievement of this arduous process was the Draft Common Frame of Reference [hereinafter DCFR], commissioned by the European Commission, which combined rules from the PECL, rules from the existing European *acquis*, and rules from several teams of academics, Christian von Bar, Eric Clive and Hans Schulte-Nölke (eds), *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference* (Sellier 2008). See also Luisa Antoniolli and Francesca Fiorentini (eds), *A Factual Assessment of the Draft Common Frame of Reference* (Sellier 2010) 7-10.

[45] These signs of change were the setting up of the Expert Group to review the DCFR for the European legislation harmonization in the matter of contract law, Commission Decision No 2010/233 [2010] OJ L105 119, and the launch of a public consultation, 'Commission Green Paper on Policy Options for Progress towards a European Contract Law for Consumers and Businesses' COM (2010) 348 final. See also Fernando Gómez Pomar and Marian Gili Saldaña, 'El Futuro Instrumento Opcional del Derecho Contractual Europeo: Una Breve Introducción a las Cuestiones de Formación, Interpretación, Contenido y Efectos' (2012) 1 InDret 4-13 <http://www.indret.com/pdf/872_es.pdf>.

[46] Commission, 'Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law' COM (2011) 635 final. This proposal made by the Commission coincides with the widespread thinking according to which the most likely is that an European Regulation adopts, totally or partially, a harmonized body of rules as an optional instrument which contracting parties may choose as the applicable law to their contract in order to opt out of their national laws (the so-called 'blue button'), Hans Schulte-Nölke, 'EC Law on the Formation of Contract—from the Common Frame of Reference to the "Blue Button"*'* (2007) 3 European Review of Contract Law 332, 348-49.

[47] See n 41.

Recognizing that a wide range of international trade contracts contain clauses obligating a party that fails to perform an obligation under contract to pay an agreed sum to the other party,

Noting that the effect and validity of such clauses are often uncertain owing to disparities in the treatment of such clauses in various legal systems,

Believing that these uncertainties constitute an obstacle to the flow of international trade,

Being of the opinion that it would be desirable for the legal rules applicable to such clauses to be harmonized so as to reduce or eliminate the uncertainties concerning such clauses and remove these uncertainties as a barrier to the flow of international trade,[48]

II.1. Indetermination or Failure of the International Instruments of Coordination: Treaties and Soft Law

Besides the UNCITRAL Uniform Rules, many other serious attempts have been made to broaden the enforceability of penalties in international trade, but nowadays there are no transnational rules that secure the enforcement of penalties in international commercial contracts. The lack of transnational rules in this area of law results from both the profound divergence between the civil and the common law traditions, and the relevant differences within the civil law countries.

The Benelux Convention on Penalty Clauses (1973)[49] was the earliest and perhaps the most courageous of these attempts, despite being addressed solely to three signatory states (Belgium, Netherlands and Luxemburg), with very similar national laws, and all members of the same regional trade organization.

Afterwards, the question was deliberately skipped in the Vienna Convention (1980),[50] the most successful treaty offering uniform commercial law rules.[51] In my view, the CISG represented a lost chance to establish a path for the harmonization of contract penalties, given that its sphere

[48] General Asseembly, Resolution 38/135 (1983) 270, UN Doc A/RES/38/135.
[49] Of course, the legality of contract penalties was not a controversial issue. This Convention deals with other questions such as the statute of limitations (Article 7). See n 41.
[50] United Nations Convention on Contracts for the International Sale of Goods (1980) 1489 UNTS 3 [hereinafter CISG]. Farnsworth (n 1) 812, n 5: 'Because of the wide gulf between common law systems and other legal systems, the Vienna Convention contains no provision on the important subject of stipulated damages'.
[51] Bruno Zeller, *CISG and the Unification of International Trade Law* (Routledge 2007) 94, in spite of relevant absences like Brazil, India, and United Kingdom.

of application is well-tailored (Article 1, 'contracts of sale of goods between parties whose places are in different States'), and parties to a contract may exclude or vary its application (Article 6).

Outside the domain of treaties, a wide variety of instruments have tackled this issue, however, none of them is legally binding for states, albeit potentially useful because parties may designate one of them as applicable law.

In the international arena, the UNCITRAL Uniform Rules (1983) were optimistically accompanied with a draft convention, mirroring the Vienna Convention,[52] even though the UNCITRAL Uniform Rules were never adopted.[53] The UNCITRAL Uniform Rules aimed to find a worldwide standard to balance the civil law enforceability, unless manifestly excessive, and the common law rule of unenforceability. The UNCITRAL Uniform Rules refer to 'contract clauses for an agreed sum due upon failure of performance' and non-sophisticated parties are excluded from its scope (Article 1),[54] providing that these clauses are presumptively valid, so the judicial intervention may consist only in the reduction of the agreed sum if 'substantially disproportionate' with respect to the actual harm (Article 8).[55] Nevertheless, the civil approach turned out to be predominant,[56] as evidenced by the non-trivial dropping of the 'genuine pre-estimate' between the revised draft (Article G) and the definitive version (Article 8).[57] For common law countries, the public policy concern against inequitable bargains together with the application by courts of two standards of justice, one for domestic and another for international

[52] Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance (1983) UN Doc A/CN.9/243, Annex II.

[53] Jonathan S Solórzano, 'An Uncertain Penalty: A Look at the International Community's Inability to Harmonize the Law of Liquidated Damages and Penalty Clauses' (2009) 15 Law & Bus Rev Am 779, 813: 'What is clear, however, is that somehow the proposal died. Model law or convention was ever adopted or entered into . . . The question we are left is *why*?'.

[54] Article 1 of UNCITRAL Uniform Rules: 'These Rules apply to international contracts in which the parties have agreed that, upon a failure of performance by one party (the obligor), the other party (the obligee) is entitled to an agreed sum from the obligor, *whether as a penalty or as compensation*' (emphasis added).

[55] Article 8 of UNCITRAL Uniform Rules: 'The agreed sum shall not be reduced by a court or arbitral tribunal unless the agreed sum is substantially disproportionate in relation to the loss that has been suffered by the obligee'.

[56] Against, Larry A DiMatteo, 'Enforcement of Penalty Clauses: A Civil-Common Law Comparison' (2010) 5 Internationales Handelsrecht 193, 199, for whom the UNCITRAL Uniform Rules had a 'middle ground approach', arguing that '[b]y using the word "disproportionate" the Rules adopt the disproportionate standard found in American law and provides a wider scope to the voiding or reforming of penalty clauses in the civil law', statement which ignores the relatively higher familiarity with the term "disproportionate" or equivalent ones in civil law.

[57] Solórzano (n 53) 811-12. Article G of UNCITRAL Revised Draft: '(1) The agreed sum shall not be reduced by a court or arbitral tribunal. (2) However, the agreed sum may be reduced if it is shown to be grossly disproportionate in relation to the loss that has been suffered by the obligee, and if the agreed sum cannot reasonably be regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee'. Nonetheless, already in the UNCITRAL Revised Draft, the prevailing view was that this element was not required for reduction, see UNCITRAL Revised Draft (n 41) 13, n 29.

transactions, or just the lack of interest may explain the failure of the UNCITRAL Uniform Rules.[58]

In the international arena too, the UNIDROIT Principles (Article 7.4.13),[59] the major instrument of soft law in the field of international commercial contracts, have also resolved the question following the civil law principle of enforcement of penalties subject to reduction:[60] after giving an broad definition intended to include both liquidated damages and penalties,[61] 'agreed payment for non-performance', the general rule is the recoverability of stipulated damages regardless of the actual harm (Article 7.4.13(1)), but the court may reduce those 'grossly excessive amounts' (Article 7.4.13(2)).

Within the European context, the scholar-made soft law rules of both the Principles of European Contract Law (Article 9:509),[62] and the Draft Common Frame of Reference (Article III-3:712)[63] stuck to the pattern set by the UNIDROIT Principles: stipulated damages are named again 'agreed payment for non-performance' in the PECL, or 'stipulated payment for non-performance' in the DCFR, and in the both texts the governing norm is the recoverability of the sum irrespective of the actual harm, unless the court finds it to be 'grossly excessive', case in which the sum will be reduced. The antecedent of them was the Council of Europe Resolution (78) 3,[64] a set of eight non-binding rules that the member states were recommended to adopt in order to harmonize the civil law regimes.

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[58] Solórzano (n 53) 804 and 813-14. The general lack of interest is a highly plausible explanation, especially regarding the common law countries, since only eighteen countries responded when the UNCITRAL Draft was circulated, and only one of them was a true common law country (Canada).

[59] International Institute for the Unification of Private Law, UNIDROIT Principles of International Commercial Contracts (1994) [hereinafter UNIDROIT Principles]. The Article dealing with contract penalties (7.4.13) has the same content in both the 2004 version and the 2010 version of the UNIDROIT Principles. Article 7.4.13 UNIDROIT Principles: '(1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non- performance, the aggrieved party is entitled to that sum irrespective of its actual harm. (2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances'.

[60] DiMatteo (n 56) 199.

[61] Ewan McKendrick, 'Article 74.13' in Stefan Vogenauer and Jan Kleinheisterkamp (eds), *Commentary on the Unidroit Principles of International Commercial Contracts (PICC)* (OUP 2009) 919, 923. See also Michael Joachim Bonell (ed), *The Unidroit Principles in Practice. Caselaw and Bibliography on the Unidroit Principles of International Commercial Contracts* (2nd edn, Transnational Publishers 2006) 342.

[62] See n 44. Article 9:509: '(1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of its actual loss. (2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances'.

[63] See n 44. Article III-3:712: '(1) Where the terms regulating an obligation provide that a debtor who fails to perform the obligation is to pay a specified sum to the creditor for such non-performance, the creditor is entitled to that sum irrespective of the actual loss. (2) However, despite any provision to the contrary, the sum so specified in a contract or other juridical act may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances'.

[64] See n 41.

The Council of Europe Resolution (78) 3, considered as a whole, contains much more detailed and elaborated rules than the soft law instruments examined until now (UNIDROIT Principles, PECL, and DCFR). Not only for using an inclusive definition of penalty (Article 1),[65] and turning to the principle of enforcement of penalties subject to reduction (Article 7), but also for dealing with the prohibition of cumulative penalties (Article 2), and the compatibility of the penalty with claims for specific performance, statutory damages, and additional damages (Articles 3, 5 and 6). The impact on the current civil law codes was minimal, since most reforms of the national laws towards the aforementioned principle occurred years before,[66] as described in Section I.2. Nonetheless, the Council of Europe Resolution (78) 3 might be viewed as the European civil law model of contract penalties, given that the main characteristics of European civil laws are captured: (1) the validity of contract penalties, which may have the effect of coercing a party to perform her obligation; (2) the judicial review of penalties on the grounds of equity as a discretionary faculty, based on a retrospective test considering the actual harm, or on the grounds of partial performance; and (3) the promisee's entitlement either to the penalty or to specific performance, with the exception of delay.

II.2. Fighting Uncertainty: Contractual Arrangements for the Enforceability of Penalties and their Effectiveness

The lack of transnational rules that control the enforceability of penalty clauses in international commercial contracts, as shown in Section II.1, puts at risk the will of the contracting parties. In addition to this lack of transnational rules, the absence of coordination instruments among the several jurisdictions at a national level[67] entails that parties are unable to secure the enforceability of contract penalties by resorting to the available contractual devices, such as choice of law, forum selection, and arbitration clauses.[68] These contractual arrangements might turn out to be ineffective for several reasons, in particular whether the enforcement of the penalty is sought in common law courts, either adjudicating the dispute or executing the judgment or the arbitration award, since the mandatory rules against penalties might never be displaced.[69]

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[65] Arana de la Fuente (n 41) 6.

[66] Against, DiMatteo (n 56) 199, defending the influence of the Resolution in the later legislation regarding the generalization of the 'manifestly excessive' standard and the preference for reformation or reduction of the stipulated damages.

[67] Besides transnational rules, coordination instruments might also be unilaterally provided by purely national rules, for instance, by granting the application of the foreign penalty law designated by the parties, or by granting the execution of a foreign judgment or arbitral award.

[68] Pure drafting techniques intended to increase the chances of enforceability of penalty clause if a common law regime is applicable are not considered here, because these techniques are not capable to provide a minimum level of certainty under the case-by-case approach and the selective enforcement of stipulated damages. See n 7. See also DiMatteo (n 56) 200-01, making useful suggestions for drafting a penalty clause under American state laws.

[69] Farnsworth (n 1) 812, n 5, fearing that soft law may not derogate from this common law prohibition, albeit designated as applicable law by the parties: 'Whether this provision [Article 7.4.13 UNIDROIT Principles] can have any effect on a mandatory rule such as the common law rule prohibiting penalties is an open question'.

Obviously, the effectiveness of these contractual arrangements is likely to be higher when parties have chosen a civil law, and the court involved in adjudication or enforcement is also a civil law one, since general policy considerations that may render the penalty void will not arise so long as *lex contractus* and *lex fori* belong to the same legal tradition. For instance, if parties designate Spanish law as applicable, and the selected forum is Chile.[70] Within the European Union, the effectiveness of these clauses is even higher, due to the general rules of international private law in the area of contracts,[71] which even allow that parties derogate from certain mandatory rules. As an illustration, if parties decide to severely limit contract liability by using a penalty clause with an unreasonable small agreed sum, Italian law may be the applicable law designated to trump the French Civil Code (Article 1152) when the selected forum is France in order to prevent the judge from increasing a ridiculously low penalty ('*dérisoire peine*') on the grounds of equity. The Rome I Regulation (Articles 3.3 and 9.1)[72] grants this possibility — only the 'overriding mandatory provisions' of the law of forum will resist the law chosen by the parties. In this regard, this French rule is mandatory,[73] but it can hardly be deemed an 'overriding mandatory provision' in accordance with the law of the European Union.

Conversely, the effectiveness of these contractual arrangements is uncertain when the parties intended to avoid the common law prohibition of penalties, and the court deciding the case or enforcing the foreign judgment or arbitral award is a common law court. The likelihood of success increases in the next order: (1) only a pro-penalty choice of law, (2) a pro-penalty choice of law in conjunction with the selection of a civil law forum, and (3) a pro-penalty choice

[70] In the example, the parties of an international commercial contract intended the literal enforcement of the agreed penalty, avoiding the objective limit for pecuniary obligations imposed by the Chilean Civil Code (Article 1544), i.e. the penalty may not exceed the double of the value of the undertaking not performed.

[71] In the realm of contract law, Council Regulation (EC) 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels I) [2001] OJ L12; European Parliament and Council Regulation 593/2008 on the law applicable to contractual obligations (Rome I) [2008] OJ L177.

[72] Article 3.3 of Rome I Regulation: 'A contract shall be governed by the law chosen by the parties. The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable to the whole or to part only of the contract'. Article 9.1 of Rome I Regulation: 'Overriding mandatory provisions are provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under this Regulation'. See Ana Quiñones Escámez, 'Ley Aplicable a los Contratos Internacionales en la Propuesta de Reglamento "Roma I" de 15.12.2005' (2006) 3 InDret 16-7 <http://www.indret.com/pdf/367_es.pdf>, explaining the origin and evolution of the concept of overriding mandatory provisions (*leyes de policía*) in the case law of the Court of Justice of the European Communities.

[73] Article 1152 of the French Civil Code (n 19), providing that '[a]ny stipulation to the contrary shall be deemed unwritten'.

of law and arbitration in a civil law country, which is the safest way to secure the enforcement of penalties in international commercial contracts.[74]

However, considering the third solution to secure the enforcement of penalties in common law jurisdictions, one may doubt whether the enforcing court would refuse the recognition and enforcement of the arbitral award, since even the New York Arbitration Convention[75] grants this refusal if the recognition or enforcement would be contrary to the public policy of that country (Article V(2)(b)).[76] This ground under the New York Arbitration Convention casts doubt on the enforcement of an arbitral award in common law countries, in particular, in the United States, one of the jurisdictions analyzed here. Absent any decision from an American court, there is not a definitive answer to this question yet. Nevertheless, in accordance with the case law from another common law jurisdiction, the award would be enforced.[77]

An additional precaution that might be taken, as DiMatteo cleverly suggests,[78] is the prepayment of the penalty by means of an escrow account within the jurisdiction of the selected civil law forum, or within the same civil law country agreed for the arbitration. Notwithstanding, the contract may provide several penalties or penalties of a considerable amount, then none of the potential breaching parties will be prone to deposit the full amount of the penalties stipulated in the contract. Therefore, albeit the payment of the potentially due penalty is not completely secured, the deposit in the escrow account secures at least the partial payment, acting as well as a powerful incentive to ensure performance.

II.3. A Quick and Safe Solution: To Shield the Enforcement of Penalties in International Commercial Contracts in Common Law Jurisdictions

After having examined prior attempts for the harmonization of the conflicting common law and civil law rules governing penalties, the main reason of the failure of all these harmonization projects (treaties or bodies of soft law) has always been that the root principles of each legal tradition are not compatible, therefore the adoption of one root principle necessarily supersedes the other. In this regard, treaties and bodies of soft law have usually opted for the principle of

[74] DiMatteo (n 56) 200, sharing the same view in this regard, despite a more pessimistic opinion about the enforcement of the award in the United States.
[75] Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958) 21 UNST 2518 [hereinafter New York Arbitration Convention].
[76] Article V(2)(b) of the New York Arbitration Convention: 'Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that . . . (b) The recognition or enforcement of the award would be contrary to the public policy of that country'.
[77] Dirk Otto and Omaia Elwan, 'Article V(2)' in Herbert Kronke et alii (eds), *Recognition and Enforcement of Foreign Arbitral Awards. A Global Commentary on the New York Convention* (Kluwer Law International 2010) 345, 401 n 268, referring to a very recent Hong Kong court decision ruling that the Danish arbitration award providing for overcompensatory liquidated damages does not violate public policy, *A v R* [2009] HKCFI 342 (Court of First Instance of the High Court, Hong Kong). Against, DiMatteo (n 56) 200, sustaining that the award is likely to be questioned by American courts.
[78] ibid 202.

enforcement of penalties subject to reduction, the civil law principle, a choice that has involved the understandable rejection of common law countries.

Under this dilemma, the demand of legal certainty in the field of enforcement of penalty clauses by the actors in international trade points to a relatively easy response: shielding the enforcement of penalties in international commercial contracts in common law jurisdictions by means of their statutory recognition at national level. Statutory recognition at national level that should be narrowly tailored to penalties expressly agreed by the parties in contracts in which at least one party is non-national, and the choice of law designates a foreign law according to which penalties are permissible.

In my opinion, the proposed solution is the most feasible for the enforceability and effectiveness of penalties in international commercial contracts because (i) it would be unilaterally adopted by each single common law jurisdiction, which implies that it has no coordination costs and that its success does not depend on an agreement among a high number of states; and (ii) it would be legally binding, which of course means a stronger effect than an optional regime designated in a body of soft law.

Nevertheless, there exists the well-founded fear of the rejection of the proposed solution by the legislatives of the common law countries, since it would lead to the application of two standards of justice, one for domestic and another of international transactions. This reasoning was one of the grounds to turn down the UNCITRAL Uniform Rules.[79]

Conclusion

After having explored the clash between the civil and the common law traditions, and the existing disparities among civil laws in the field of penalty clauses, this paper urges the adoption of transnational rules to secure the enforcement of penalty clauses in international commercial contracts in order to provide the actors in international trade with the certainty that they demand.

The international community acknowledged this need more than three decades ago, when the first UNCITRAL Draft was submitted in 1981, but the final UNCITRAL Uniform Rules and other harmonization projects have failed in that respect. Basically, the reasons that might explain this failure are two: on the one hand, all these projects have always aligned with the civil law legal tradition — in particular, the UNCITRAL Uniform Rules —; and, on the other hand, common law countries are unwilling to give up the prohibition of penalties, and tend to be prejudiced against the enforcement of penalties, even when the parties to a contract are merchants.

In the absence of coordination instruments among the several jurisdictions, the will of the contracting parties is at risk. Nevertheless, this lack of transnational rules is much more

[79] Solórzano (n 53) 804 and 813-4.

detrimental for the parties if a common law jurisdiction is involved. Not only civil law jurisdictions usually do not present sharp differences, but also the effectiveness of the contractual arrangements (choice of law, forum selection and arbitration clauses) is generally higher, especially within the European Union. On the contrary, whether a common law jurisdiction is involved, parties can only fight uncertainty by incurring substantial transaction costs to secure the enforcement of contract penalties, since all the available contractual devices have to be employed to diminish the likelihood of unenforcement. In this second scenario, the contractual toolkit may turn out to be insufficient, and therefore the need of transnational rules to bridge the gaps between civil and common law systems becomes critical.

Nevertheless, from a practical point of view, given the failure of all the attempts of the international community in the field of the enforcement of penalties, a quick and safe solution is the shielding of the enforcement of penalties in international commercial contracts in common law jurisdictions by means of their statutory recognition at national level. This recognition in each state would be restricted to penalties expressly agreed by the parties in contracts in which at least one party is non-national, and the choice of law designates a foreign law according to which penalties are permissible. Paradoxically, despite the need of transnational rules in this realm, the most feasible solution consists of the approval of national rules of limited scope but amazingly positive effects in international trade.