

## Unfavorable court ruling in relation to credit institutions' use of negotiable instruments

**In a recent case by the Swedish Supreme Court (Sw. *Högsta domstolen*) (T 4904-08), the burden of proof of payments made by the debtor in relation to a negotiable promissory note was placed on the creditor. Since the borrowers had not confirmed that the debt had not been paid, the transferees were not in good faith in relation to the payment of the debt.**

**The effect is that the difference between negotiable promissory notes and ordinary claims has been blurred. Another consequence is that banks and other credit institutions are reconsidering their use of negotiable promissory notes.**

### Background

The case relates to a loan made to a couple of SEK 110,000 which was used to acquire a cooperative flat (Sw. *bostadsrätt*). The couple received the loan from a finance company and entered into a customary loan agreement issued to the finance company or to order (i.e. a negotiable promissory note). The promissory note was immediately transferred from the finance company to a bank. After payment of the loan amount to the bank prior to the maturity date, the promissory note was transferred several times with a guarantee that the original principal amount had not been paid.

Under Section 15 of the Promissory Notes Act (Sw. *skuldebrevslagen* (1936:81)), if a person has acted in good faith when acquiring possession of a negotiable instrument, it is not possible to raise a defense on the ground that, prior to the transfer, the debt has been extinguished or altered due to payment. However, the transferee shall not be considered to have acted in good faith if it was aware of the circumstances upon which the defense was based or had reasonable cause to believe that such circumstances existed. If a written notification has been made on the promissory note regarding payment, and where such notification could not be removed without difficulty but has nevertheless been removed, this fact may be raised as a defense notwithstanding that the new creditor has acted in good faith.

The transferee argued that even if the debtors had already paid off the debt, they were obliged to pay the full amount again, since they had issued a negotiable promissory note and each transferee was in good faith as regards the payment when taking the note in their possession.

### Market Practice

The Association of Swedish Finance Houses (Sw. *Finansbolagens Förening*) and the Swedish Bankers' Association (Sw. *Svenska Bankföreningen*) were invited to issue

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statements regarding market practice in relation to the use of negotiable promissory notes.

They stated that it is common practice in the Swedish financial markets that negotiable promissory notes are transferred but mainly in larger stocks in relation to a change or structural transformation of the creditor's business or for the purpose of collecting debts. Payments are never noted on the promissory notes and the notes are very rarely returned to the debtors when the final payment has been made.

When promissory notes are transferred to another credit institution, the transferee is given the opportunity to carry out a due diligence to see whether the debts have already been paid, but will generally only do so on a sample basis. It is also market practice that the transferor guarantees the validity of the claim up to a certain date, in case the debtor objects to the claim after receiving notice that the transfer has taken place.

### **Ruling of the Supreme Court**

The Supreme Court held that Section 15 of the Promissory Notes Act is not working satisfactorily if borrowers have to pay twice on the basis that the transferee did not have reasonable cause to believe that the debt had already been paid.

It was noted that the banks have changed their payment routines since the commencement of the Promissory Notes Act. A payment in advance is almost never noted on the promissory notes and the notes are rarely returned to the debtors after the final payment has taken place.

At least in situations where the transferee is a part of the financial sector – for example where the transferee is a bank, a financing company or a debt collection firm – and the debtors are not, such transferee must realize that advance payments may have taken place that are not clearly stated on the promissory note as assumed at the time when the Promissory Notes Act came into force. Such transferee must, in order to be considered to have acted in good faith, prior to the transfer, have asked and received a confirmation from the debtor that he or she has no objection in relation to the debt.

Since the debtors had not confirmed that the debt had not been paid, none of the transferees were considered to have acted in good faith pursuant to Section 15 of the Promissory Notes Act. For this reason they carried the risk for the payment.

### **Consequences**

The Swedish Supreme court's ruling means that the burden of proof of payments made by the debtor is placed on the creditor in situations where the transferee is a member of the financial sector and the debtor is not. It also means that the difference between negotiable promissory notes and ordinary claims has been blurred.

It is not clear what effect the court ruling will have on the Swedish financial market.

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According to some experts, the ruling will not have a great effect since the banks have adapted to it by applying longer deadlines for complaints. The banks have also decreased their use of negotiable promissory notes.

One consequence is that transaction costs will increase since it no longer is sufficient that due diligence is carried out on a sample basis. Transferees will instead have to receive a confirmation from each debtor that their debt has not already been paid.