

## CLIENT MEMORANDUM

**FROM: Alain-Xavier BRIATTE**, Notary | 2, avenue des Fleurs | F • 06230 Saint-Jean-Cap-Ferrat | Tel: +33 4 93 91 73 19 | Email: alain-xavier.briatte@notaires.fr

**SUBJECT: OPTIMISING REPAYMENT OF A MORTGAGE**

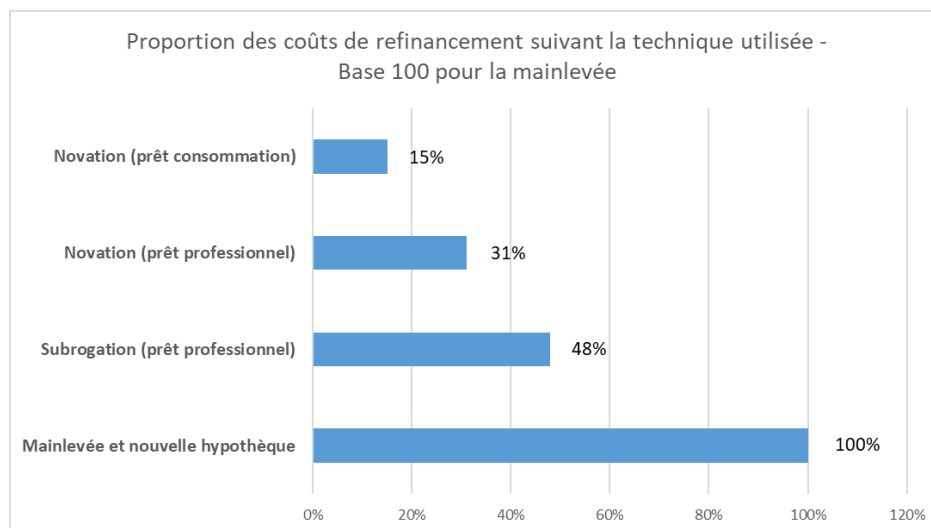
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### Optimising real estate refinancing

(Techniques of the so-called 'substitute' loan)

#### Overview

The choice of technique for repaying an existing loan is a considerable economic challenge in a period of competitive rates. The cost of this repayment should be optimised, while guaranteeing the security of the new lender, with a technique adapted to the refinancing situation envisaged. We will focus on **large mortgages for professionals** or private individuals, for which **optimisation makes sense**, and we will compare the cost of release, subrogation and novation techniques; the latter technique (novation) may ultimately become the preferred technique in the refinancing environment. The costs of refinancing a **professional loan**, using the techniques of novation and subrogation, **respectively represent 31% and 48%** of the total amount of notary costs compared to the old technique of release followed by a new mortgage (based on 100%).



## Development

### I - Should the release scenario be a technique that is automatically used?

In terms of the techniques for repaying an existing loan, it is necessary to begin by mentioning the best-known, simplest, and certainly the most expensive technique, consisting of entering into a new loan followed by using money borrowed to repay the original loan, without it being possible to establish a link between the old and the new loan. This technique requires the potential release of the original registration, and payment of its cost, by the borrower prior to establishing a new security for the future, namely a new conventional mortgage. Rearranging a new mortgage will lead to payment of an amount of land registration tax, namely the amount of 0.715% calculated on the basis of the amount of the new guarantee obligation.

**The risk of circumventing payment of the costs of the release** – In this case (in the absence of subrogation or novation), some lenders agree, exceptionally, not to obtain release of registrations "unsupported by consideration and without an underlying debt", and thus accept the benefit of a second rank registration, in order to circumvent the costs of release of the original debt at the expense of the borrower. This leads to maintaining a justified registration "unsupported by consideration and without an underlying debt" (first rank) either by the fact that the debt is reimbursed or by the fact that the said obligation expires in a short amount of time. Even if the risk for the new lender is reduced, or very marginal, if the new lender is already second rank, this scenario of exemption from release (and therefore absence of first rank registration for the benefit of the new lender) implies that the former lender officially remains the holder of the original registration with the land registry service, which is not without risks as regards informing third parties<sup>1</sup>, especially for large loans. That's why our advice to the lender is to demand prior release for this type of large loan.

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<sup>1</sup> For a detailed study of the risks of failing to inform third parties: Alain-Xavier BRIATTE, *Revue de Droit bancaire et financier* n° 5, September 2014, study 22, Outstanding debts and notarial practice of adding information in the margin; Laurent Aynès, *Recueil Dalloz* 1990 p. 389, Role of adding information in the margin of a mortgage registration: "*the subrogated deposit must be invested, in the event of the sale of a building, from the original debt with all its advantages and ancillary costs. The fact remains that third parties must be able to know the identity of the current holder of a mortgage. In the case judged in 1987, the subrogated creditor made himself or herself known. In this case, the subrogating banker disclosed the identity. But it may well be that a less aware subrogating party, who is more careless or less honest, fails to preserve the rights of "solvens". Adding information in the margin thus retains its usefulness, which is also one of the functions of land registration: informing third parties.*"

## II - Optimising refinancing

**Alternative optimisation techniques which require precautions when drafting-** Refinancing optimisation techniques, which are briefly presented below, have been largely strengthened by the reform of the law of obligations introduced by order no. 2016-131 of 10 February 2016. Among these techniques which were already known but whose mechanisms have been sanctioned, we can mention novation, subrogation, or, for the record only, assignment of contract, which are techniques nevertheless requiring precautions as regards drafting.

**The refinancing optimisation techniques aimed at maintaining existing registrations** - Once one of these techniques is used - subrogation or novation - the aim is to maintain existing registrations for the benefit of the new lender, which enables the borrower to avoid having to bear the additional cost of release on the one hand and cancelling the rights relating to rearranging a new mortgage for the future on the other hand.

### **A - *Ex parte debitoris* subrogation, at the instigation of the debtor**

**The advantages of *ex parte debitoris* subrogation, at the instigation of the debtor, and with the assistance of the creditor** – The reform of the law of obligations introduced by order no. 2016-131 of 10 February 2016 now facilitates recourse to *ex parte debitoris* subrogation with the intervention of the original creditor pursuant to Article 1346-2, paragraph 1 (the notarial deed is not necessary), or **without its assistance** pursuant to Article 1346-2, paragraph 2 (the notarial deed becomes necessary again). From reading Article 1346-2, paragraph 1, of the French Civil Code, it now appears that there is no longer any doubt that subrogation may be imposed on the original lender when the said original lender has authorised the early repayment in the contract, once the subrogation is recorded by a notarised deed and can be carried out without the assistance of the original creditor (Article 1346-2, paragraph 2). Indeed, where early repayment is possible, which is the case most of the time, the original creditor not having a legitimate reason to object to the payment but refusing to provide assistance, the debtor could overcome their resistance by using the new procedure whereby the creditor is formally informed: the receipt issued by the Caisse des dépôts et des consignations shall then serve as a receipt<sup>2</sup>. In addition, reversing a Court of Cassation judgement dated 29 October 2002<sup>3</sup>, the mortgage transferred no longer only guarantees interest at the legal rate, but can now guarantee the new rate contractually amended for the future up to the limit of the original registration.

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<sup>2</sup> François Chénéde, The new law of obligations and contracts, Dalloz, no. 44.113, page 334

<sup>3</sup> Civ. 1st, 29 Oct 2002: Bull. Civ. I, No. 257.

**The first weakness with subrogation: the transfer of the debt with its attributes and defects** –Through subrogation, the debt is transferred *as is* even though it was subject to a payment. Payment does not constitute extinguishment of the debt but transfer of it<sup>4</sup>. The transfer *as is* enables the debtor to enforce against the subrogated party all the exceptions (Article 1346-5), regardless of whether they are exceptions inherent in the debt (for example invalidity, the exception of non-performance, resolution, compensation), but also exceptions external to the debt (for example the granting of a deadline, debt cancellation and writing off unrelated debts).

**The second weakness with subrogation: a higher cost related to the need to guarantee ancillary costs for the future** – In practice today, the CRIDON consultation committee, in a decision of 15 September 2016, invites notaries to take out mortgage on the basis of the ancillary costs of the debt transferred. As Professor Mathias Latina<sup>5</sup> points out, we cannot fail to note that, if Article 2423 of the French Civil Code distinguishes between "interest" and "other ancillary costs", Article 1346-4 only provides for coverage, by the security transferred, of "interest", without mentioning these "other ancillary costs

". A purely literal reading of Article 1346-4 could therefore lead to the exclusion of these "ancillary costs" from the coverage provided by the security transferred. For these "other ancillary costs", we will need to wait for the clarification announced by the reform of the law on securities, a reform which should take place in 2019. That is why, pending the reform announced for 2019, the use of the subrogation technique requires taking out an additional mortgage on the ancillary costs transferred which are generally calculated at 20% of the guaranteed obligation. Conversely, novation (with reservation of the registrations) makes it possible to transfer (or "reserve") the ancillary costs of the original debt.

**In summary, the characteristics of subrogation by the debtor, with the assistance of the creditor, are as follows:**

- 1) Subrogation at the instigation of the debtor, with the assistance of the original creditor, takes the form of a *bipartite contract* between the original creditor and their debtor ("subrogation release"). This agreement is intended to transfer the debt of the original creditor to the lender of funds that permitted the payment.
- 2) Subrogation transfers the debt with its characteristics and ancillary costs. The subrogated creditor therefore benefits from securities up to the amount, insofar as they have been constituted by third parties, of their original commitments (if they do not agree to undertake more) and, for real property securities, up to the amount of the original registration.

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<sup>4</sup> Alain Bénabent, Law of Obligations, LGDJ, Précis Domat, 15th edition, No. 721, page 556

<sup>5</sup> Mathias Latina, Gaël Chantepie, The reform of the law of obligations, Dalloz, June 2016.

- 3) Interest accruing after the transfer under the new rate agreed upon by the new creditor and the debtor is covered by the securities transferred up to the same amounts.
- 4) Since the claim is transferred from the original creditor to the subrogated creditor, with its characteristics, the latter may have enforced against them all the exceptions inherent to the debt as well as the personal exceptions arising from the debtor/original creditor relationship before payment is made.
- 5) Subrogation at the instigation of the debtor, with the assistance of the original creditor, is enforceable against third parties, without formality, once payment is made. As the debtor is a party to the subrogation contract, the question of the enforceability of subrogation against them does not arise.

### **B - Novation**

Pursuant to Article 1329 of the French Civil Code, novation is "*a contract which aims is to substitute an obligation, which it extinguishes, with a new obligation it creates*". Novation has three variants:

- Novation by substituting an obligation between the same parties.
- Novation by changing debtor.
- Novation by changing creditor.

Novation by changing creditor has long been considered an "outdated" instrument, i.e. like a relic of a bygone era (Roman law) during which it was *legally* forbidden to transfer debts. Novation by changing creditor has, however, been **modernised by the order of 10 February 2016** concerning the reform of the law of obligations in order to offer practitioners an alternative to the assignment of debt and personal subrogation. It makes it possible to *circulate* an obligation, *from an economic point of view*, without proceeding with its legal transfer, the effect of the novation being a substitute: it extinguishes the old obligation and replaces it with a new obligation.

**The advantages of novation** - The new Article 1329 defines novation as "*a contract that aims to substitute an obligation, which it extinguishes, with a new obligation it creates*" (Article 1329, para. 1) and moreover adds "*by changing creditor*" (Article 1329, para. 2). Novation is becoming an extremely useful technique in the refinancing environment, the interest of which sometimes seems to supplant subrogation in two respects. On the one hand, unlike subrogation which is weak on this point, the new lender substituting the original lender through novation cannot have the exceptions enforced against them which were enforceable against the original

lender. On the other hand, another advantage of novation, shared in part with subrogation this time, is that the new lender can benefit from maintaining registrations as subrogation permits, pursuant to Article 1334, paragraph 2, of the French Civil Code: "*By way of exception, the original securities may be reserved to guarantee the new obligation with the consent of third-party guarantors*". Thus, the comparative advantage of novation compared to subrogation is here to allow, for novation, the maintenance of ancillary costs relating to the reserved security, with this maintenance of ancillary costs under the reserved security being controversial with respect to the subrogation.

***In summary:***

- 1) Novation by changing creditor is a *tripartite contract* entered into between the original creditor, the debtor and the new creditor.
- 2) Novation shall *extinguish* the obligation uniting the original creditor and the debtor to *create* a new obligation that will unite the debtor and the new creditor. This obligation may be identical, in essence, to the obligation extinguished or different to it.
- 3) Since novation has a *substituting effect* (and non-transferable), it means the exceptions from the original contract obligation, which is extinguished, *cannot be enforced* against the new creditor, except in the event of invalidity of the old obligation.
- 4) The parties may decide, by way of exception, *to transfer the original real property securities* to secure the new obligation, within the limits of the registration.
- 5) Novation is *enforceable against third-parties on its date*, the burden of proving this date is with the new creditor, whose task shall be facilitated by the execution of a notarial deed.

**Alain-Xavier BRIATTE**

Notary in Saint-Jean-Cap-Ferrat, 3 June 2019.