Non-Official Translation

IN THE NAME OF THE REPUBLIC OF ARMENIA

DECISION OF THE CONSTITUTIONAL COURT OF

THE REPUBLIC OF ARMENIA

ON THE CASE OF CONFORMITY OF PART 2 OF ARTICLE 887 THE RA CIVIL CODE OF THE REPUBLIC OF ARMENIA WITH THE CONSTITUTION OF THE REPUBLIC OF ARMENIA ON THE BASIS OF THE APPLICATION OF ARMINE ATOYAN, HAYK NAZINYAN AND ARKADY VARDANYAN

Yerevan 12 June 2018

The Constitutional Court of the Republic of Armenia composed of H. Tovmasyan (Chairman), A. Gyulumyan (Rapporteur), A. Tunyan, A. Khachatryan, V. Hovhanissyan, H. Nazaryan,

with the participation (in the framework of the written procedure)

of representatives of the Applicant: lawyer S. Soghomonyan,

Respondent: official representatives of the RA National Assembly V. Danielyan, Head of the Legal Expertise Division of the Legal Expertise Department of the RA National Assembly Staff and S. Tevanyan, chief legal expert of the division of legislative expertise of the same department,

pursuant to Point 1 of Article 168, Point 8 of Part 1 of Article 169 of the Constitution of the Republic of Armenia, Articles 22, 40 and 69 of the Constitutional Law on the Constitutional Court,

examined in a public hearing by a written procedure the Case on conformity of Part 2 of Article 887 the RA Civil Code with the Constitution of the Republic of Armenia on the basis of the application of Armine Atoyan, Hayk Nazinyan and ArkadyVardanyan.

The Civil Code of the Republic of Armenia was adopted by the National Assembly of the Republic of Armenia on 5 May 1998, signed by the President of the Republic of Armenia on 28 July 1998 and entered into force on 1 January 1999. Article 887 of the Code is effective with the amendments adopted on 5 December 2000 and enacted by the RA Law (ՀՕ -116) of 22 December 2000.

The proceeding was initiated based on the application of Armine Atoyan, Hayk Nazinyan and ArkadyVardanyan submitted to the Constitutional Court on 23 February 2018.

Having examined the written report of the Rapporteur on the Case, the written explanations of the Applicant and the Respondent, as well as other documents of the Case, the Constitutional Court of the Republic of Armenia **ESTABLISHES:**

1. Applicants' positions and arguments

Applicants are challenging Part 2 of Article 887 the Civil Code of the Republic of Armenia (hereinafter referred to as the Code) titled "Credit Contract" according to which, "The rules provided by Chapter 46 of this Code shall be applied to the terms under the credit contract, unless otherwise prescribed by the rules of the present Chapter or follows from the nature of the credit contract." They request to recognize the above-mentioned legal provision as contradicting Article 60 of the Constitution and void as it deprives the person of his/her right to own, use and dispose of his/her property at his/her own discretion.

Applicants believe that it follows from the challenged legal provision that the credit contract may contradict other civil law provisions on contracts and in the case of non-fulfillment of the obligations under the credit contract they define such penalties which violate the right of the debtor and cause unfavorable consequences. Applicants consider such implications as the terms mentioned in the first Applicant's credit contract, such as the 73% annual interest rate of the overdue credit balance, the bank's right to dispose of funds credited on its bank accounts without the consent of the debtor.

In the Applicants' opinion, the term prescribed by the credit contract according to which the debtor "In case of starting the proceeding on bankruptcy shall immediately repay the credit, irrespective of the contractual maturity, paying interest and penalties for the actual term of the credit" contradicts the requirements of the **imperative norm** of the Sub point a of Part 1 of Article 39 of

the RA Law on Bankruptcy pursuant to which, "…From the moment of accepting the bankruptcy application for proceedings: (a) it shall be prohibited for the debtor to give satisfaction in cash or in other manner to the creditors in accordance with its contractual or other liabilities without a court decision, with the exception of liabilities related to day-to-day operations of the debtor."

2. Respondent's positions and arguments

According to the Respondent, the challenged provision and Chapter 46 of the RA Civil Code allow the parties to apply the principle of freedom of contract extensively, and the application of the credit contract rules to the credit relationships arisen between the parties may occur when the contract does not stipulate otherwise, and in that case it is necessary to take as grounds the circumstance of impermissibility of amending the imperative norms of the Code by the will of the parties and to be guided by the presumption that in the framework of the principle of freedom of the contract, different provisions may be defined only in the cases of dispositive nature of this regulation.

In the opinion of the Respondent, the issue raised by the Applicants refers to the possibility of charging proceedings against the subject of the credit contract (credit amount and calculated penalty), the consent regarding which the creditor provides in the contract concluded between him and the bank. It is believed that by virtue of concluding contract, the creditor authorized the borrower to empower the creditor to take measures independently if the creditor fails to perform or fulfills his obligation improperly.

The Respondent believes that the scope of this right is precise and distinct and cannot be extended to the entire property owned by the creditor or to the accounts in different banks, as the contract determines that this right may be exercised by the Bank regarding the specified sum and the sum due to recovery of the interest, penalties, forfeits and fines.

The Respondent concludes that "…insofar as, in the process of the formation of the contract relations, the person may freely define the other person's right to disseminate confiscation of the monetary assets belonging him/her by the property right as the fulfillment of his/her duties regarding the latter and simultaneously the possibility to preserve his/her judicial defense of his/her rights in any circumstance, as well as in cases of violating the legal powers assigned to the person who is creditor or in case of are groundless in the cases of their implementation of those legal powers, the challenged provision is precisely in concordance with principles of freedom and inviolability of the property of the contract." Insofar as in the course of formation of

contractual relations in extrajudicial procedure the person can freely establish the right of another person to seek penalties on the monetary assets belonging to him regarding this person of their obligations, while at the same time in any circumstances of transfer of the powers endowed to another person, as a creditor, the challenged position is in concordance with the principles of freedom of contract and immunity of property".

According to the Respondent, Part 2 of Article 887 of the RA Civil Code is in conformity with the Constitution.

3. Issues to be clarified within the scope of the case

In determining the constitutionality of the provision challenged in this case, the Constitutional Court considers it necessary to address the following issues:

- Does the challenged legal provision, envisaging the priority of the credit contract against the rules of credit stipulated by the Code, limit the right of a person to possess, use and dispose of his or her property at his or her discretion (Article 60 § 1 of the Constitution)?
- Does the term, prescribed by the credit contract regarding the indisputable and unacceptable rescheduling of the sum of total debt, mean that person is deprived of his/her property without taking into account his/her will or without the compliance with the guarantees specified in Part 4 of Article 60 of the Constitution?
- To clarify if due to implementation of the challenged norm the right to property is restricted or the principle of proportionality of restriction is preserved (Article 78 of the Constitution);
- To analyze the challenged norm in conjunction with the provisions of Article 39 of the RA Law on Bankruptcy and to clarify if there is a contradiction between them, which may lead to a breach of the constitutional principle of certainty and in which case the creditor will not be able to display appropriate conduct (Article 79 of the Constitution)?

4. The positions of the Constitutional Court

4.1. According to Part 1 of Article 10 of the RA Constitution, all forms of ownership shall be **recognized** and equally **protected** in the Republic of Armenia. Recognizing and protecting the right to property not only means that it is recognized by the state and is protected from the state intervention but also implies the positive obligations of the state to enact legal regulations that protect the person's property from unlawful acts by others.

Thus, according to the case law of the European Court of Human Rights (hereinafter referred to as the ECHR), Member States of the European Convention for the Protection of Human Rights and Fundamental Freedoms (hereinafter referred to as the ECHR) are obliged not only to abstain from violation of the right to property guaranteed by Article 1 of Protocol No. 1 to the ECHR but also to adopt enact such a legislation that would protect the right of the person from the encroachment of others. In some cases, Article 1 of Protocol No. 1 may oblige "Certain measures necessary to protect the right of property (…) even in cases involving litigation between individuals or companies ("Sovtransavto holding v. Ukraine", 25/07/2002, app. no. 48553/99, § 96).

The effective exercise of the right protected by that provision of the Convention does not depend merely on the State's duty not to interfere, but may require positive measures of protection, particularly where there is a direct link between the measures an applicant may legitimately expect from the authorities and his effective enjoyment of his possessions. ("Öneryildiz v. Turkey, GC 30/11/2004, app.no. 48939/99, §134).

Pursuant to Part 1 of Article 60 of the RA Constitution, everyone shall have the right to own, use and dispose the legally acquired property at his discretion.

In this constitutional norm the emphasis of the wording "at his/her discretion" means that the realization of the right of ownership is based on the precisely expressed will of the owner; the latter is considered as a mandatory precondition for the realization of the right of ownership; and in the process of realization of property the will of a person is decisive. As it follows from the content of this provision the implementation of property rights should be based on the principles of inviolability of ownership and freedom of contract, which assume, inter alia, **property independence and autonomy of will of the participants in civil legal relations** (Point 5, DCC-1009).

4.2. According to Part 1 of Article 887 of the Code, under a credit contract, the bank or other credit organization (the creditor) shall be obliged to provide money funds (credit) to the borrower in the amount and on the conditions provided for by the contract, and the borrower shall be obliged to return the monetary amount received and to pay interests on it.

Any civil contract must be concluded based on the principle of freedom of the contract as prescribed in Article 437 of the Code. Citizens and legal entities acquire and exercise civil rights at

their own discretion. They are free to define their rights and obligations on the basis of the contract, to determine any term of the contract that contradicts the law.

At the conclusion of a credit contract, the initiating party is the client of the bank or a credit institution applying to the bank or the credit organization for the purpose of obtaining a credit. The customer agrees the amount and terms of the credit with the bank or credit organization. If the bank or credit organization prescribes a credit contract with unacceptable terms for the creditor, the latter has the right to refuse to conclude a credit contract, and the bank or credit organization cannot impose a credit contract on unacceptable terms on a client.

The Constitutional Court states that the credit contract is of consensus nature; it is a bilateral and compensable contract that may be concluded only if the parties agree on the terms of the contract, in particular regarding the interest, different cost of the bank service and in case of breach of contract terms have reached an agreement on property liability of the parties. Nevertheless, state intervention in credit relations is not entirely excluded.

Thus, it derives from the case law of ECHR that even in horizontal relations there might be public interest considerations involved, which may impose some obligations on the State. (“Kotov v. Russia“, app. no. 54522/00, 22.04.2012, §109):

In particular, the fairness of a system of law governing the contractual or property rights of private parties is a matter of public concern and therefore legislative measures intended to bring about such fairness are capable of being "in the public interest", even if they involve the compulsory transfer of property from one individual to another. (”James and others v. the United Kingdom”, app. no. 8793/79, 21.02.1986, § 41).

In another case, the ECHR, in relation to individuals, stated, “In the Court’s view, the State has a positive obligation to protect citizens and to require that banks, in view of the potentially adverse consequences of limitation periods, should inform the holders of dormant accounts when the limitation period is due to expire …. Not requiring any information of this kind to be provided is liable to upset the fair balance that must be struck between the demands of the general interest of the community and the requirements of the protection of the individual’s fundamental rights” (“Zolotas v. Greece“ app. no. 66610/09, 29.01.2013,§ 53).

4.3. The Applicants challenge the provision of Part 2 of Article 887 of the Code, according to which “The rules provided by Chapter 46 of this Code shall apply to relations deriving from the credit contract, unless otherwise prescribed by the rules of this Chapter or the credit contract.”

Thus, Chapter 46 titled "Loan" of the Code regulates the legal relations arising from the credit contract stipulated in Article 879, and defines the legal regulation of the interest rate of the credit contract, which may also be used for the civil legal relations regarding issuing credits by the banks or credit organizations.

According to the above-mentioned Article 879, the lender shall be entitled to receive interest on credit amount from the borrower unless otherwise provided by the credit contract. The credit contract shall clearly prescribe the rate of interests and procedure for calculation thereof. At the time of conclusion of the credit contract, the amount of the interest may not exceed the **double** size of the bank rate of the Central Bank of the Republic of Armenia. Interests shall be paid every month, unless otherwise provided for by the credit contract.

The above-mentioned article of the Code, along with the observance of such core principles of civil legislation as property independence and autonomy of the will of participants in civil law relations, freedom of contract, the inadmissibility of arbitrary interference of anyone in private affairs, at the same time, based on the need for reasonable and balanced protection of the private legal relations, limited mandatory norms established by the credit contract on the rate of interest granted to the parties (third sentence of Part 1 of Article 879). Part 1 of Article 438 of the Code establishes a provision according to which "the contract must comply with the binding rules (imperative norms) for the parties prescribed by law or other legal acts in effect at the time of conclusion of the contract

4.4. As to the annual interest rate for the overdue loan, the Constitutional Court referred to that issue in Decision DCC-1412 of May 4, 2018 and hereby reaffirms the legal positions expressed by that decision.

At the same time, considering that, in accordance with Article 78 of the Constitution, the means chosen to restrict the right should be appropriate and necessary to achieve the goal established by the Constitution and are proportional to the significance of the restricted fundamental right; in the present case, the Constitutional Court deems it necessary to raise the issue of the upper limits of the contractual penalties provided by law.

The Constitutional Court, in interpreting this issue, also takes into account the ECHR's position regarding the proportionality of violations and interference with property, according to which, Article 1 of Protocol No. 1 also requires that there be a reasonable relationship of proportionality between the means employed and the aim sought to be realized, and such term is not deemed to be exercised if the person concerned has had to bear "an individual and excessive burden" ("Hakansson and Sturesson v. Sweden," app. no. 11855/85, 21.02.1990, § 51).

Thus, Part 1 of Article 372, titled "Maximum amount of default penalty and its reduction" states, "The maximum annual limit of the default penalty specified by the contract may not exceed the **fourfold** of the bank interest rate set by the Central Bank of the Republic of Armenia, unless otherwise provided for by law. The amount of all penalties determined by the contract may not exceed the principal amount of the debt at the moment". Moreover, Point 2 of the same Article defines the imperative norm, according to which the contract violating terms is void. In fact, the legislature regulates all cases where the amount of contractual default penalty envisaged by the parties may be disproportionate to the principal amount of the contractual obligation, setting the upper limit which a contractual fine may not exceed.

In addition, the challenged article clearly points to the situations in which, with an obvious disproportionality between the default penalty and the consequences of a breach of contract, the court or the financial system mediator, *at the request of the debtor, are obliged to reduce the amount of the contractual amount of the payable default penalty or already paid default penalty*.

In fact, apart from setting the upper limit of contractual default penalties, the legislator considers necessary in some cases, in view of the protection of the property interests of certain categories of entities, for the further reduce of the amount of the contractual default penalty to oblige the relevant body to reduce the amount of default penalties defined by the contract. Moreover, proceeding from considerations of more comprehensive protection of the property rights of the subjects listed in the provision, the legislator has distributed the above obligation of the body that carries out the proceedings, both to unpaid contractual default penalties and to those already paid. as a guarantee of the return of the already paid contractual default penalty Part 4 of Article 372 of the RA Civil Code as a guarantee of the return of the already paid contractual penalty provides that if the court or the financial system mediator reduces the default penalty, and the creditor on the basis of the debtor's application from the moment the legal act enters into force or from the moment when the decision of the financial system mediator becomes mandatory, carries out

recalculation, and in case the penalty has already been paid, returns to the debtor the amount corresponding to the reduced amount of the paid default penalty.

It should be noted that, taking into account the principle of freedom of the contract (including the principle of freedom of the contract in the framework of a credit contract), the legislator subjected to mandatory regulation of the legal relations related to contractual default penalties, limiting the ability of the parties to provide contractual default penalties that are disproportionate to the underlying obligation.

At the same time, the Court states that, based on the principles of the rule of law and legal certainty, the issue of establishing the legal content of the upper limit of the institution of contractual default penalties and the possible further modification of the said regulation is within the competence of the National Assembly.

The Constitutional Court considers it necessary to note that according to Article 189 of the Comprehensive and Expanded Partnership Agreement between the Republic of Armenia and the European Union and the European Nuclear Energy Agency and their Member States, the Republic of Armenia should appropriately approximate its legal regulations of financial services with the legislation of the European Union. The European Union, leaving in this sphere the choice of penalties at the discretion of the member states, believes that the envisaged forfeits must be effective, proportional and restraining (EU Consumer Credit Directive (Directive 2008/48/ EC).

4.5. Regarding the Applicants' argumentation on the bank's right to dispose the debtor's funds in the bank accounts without his/her consent, the Constitutional Court states that Parts 3 and 4 of Article 60 of the RA Constitution enshrine the most important guarantees for ensuring the inviolability of property, i.e. the right to property may be restricted only by law aiming to protect the interests of the public or the fundamental rights and freedoms of others, and deprivation of property is possible only by court procedure and in the cases prescribed by law.

Article 926 of the Code stipulates that "Limitation of the rights of the customer to dispose the monetary means in the account shall not be allowed, with the exception of seizure of funds in the account, or termination of transactions in the account in cases provided for by law."

Pursuant to Part 2.1 of Article 46 of the Law of the Republic of Armenia on Judicial Acts Compulsory Enforcement Service if sufficient financial fund of the debtor is available, the bank or other credit organization servicing the debtor's accounts is obliged to seize the debtor's financial resources only in the amount indicated in the decision of the bailiff. In case of non-observance of these requirements, the bank or other credit organization servicing the debtor's accounts in respect of the exceeded amount for each day is obliged to pay a fine in the amount of 0.1. percent of the specified amount.

As a result of the analysis of the above-mentioned legal regulations, the Constitutional Court considers that in such cases the person's right to property is not endangered, since banks are not entitled, as the Applicants claim, "to dispose freely the amounts in bank accounts." **The arrest on the accounts of the debtor can be imposed only on the amount established by the contract and which the debtor did not pay as the performance of contractual obligations.**

In this connection, it should also be noted that according to the ECHR case law, the demand for payment by the debtor of an unjustifiably received amount cannot be considered as an interference with respect to the property right of the debtor's monetary resources, since **the debt cannot be considered as "property"** within the meaning of Article 1 of Protocol No. 1 ("Cheminade v. France" (Dec.), app. No. 31599/96, 26.01.1999).

4.6. The RA Constitutional Court has repeatedly appealed to the principle of legal certainty enshrined in Article 79 of the Constitution, considering that its significance lies in the fact that laws should be such that the participants in the relevant relations within the reasonable framework are able to foresee the consequences of their behavior and be sure of the immutability of their officially recognized status and the acquired rights and obligations (DCC-630, DCC-1142, DCC-1270).

The Constitutional Court considers it necessary to emphasize that the principle of legal certainty presupposes not only the conformity of a particular legal provision or law to certain definite qualitative features, such as clarity, predictability and accessibility, but also that it cannot contradict the provisions of other laws aimed at settling the same legal relations that will allow the participants in legal relations to form a definite idea on the nature and scope of their rights and obligations.

The Applicant raised the issue of the controversy of the relevant clause of the credit contract with the imperative provision of the law during the trial of the case in the First Instance Courts and the Courts of Appeal. However, the courts did not address this issue in any way in their judicial acts. Nevertheless, with regard to the challenged contradiction, it should be noted that the issue is resolvable within the framework of the legal norms provided for in the Civil Code of Armenia and the RA Law on Bankruptcy.

First, according to Part 4 of Article 437 of the Code, the terms of the contract are determined at the discretion of the parties, except for the cases when the content of the relevant condition is established by law or other legal acts, and Part 1 of Article 438 establishes that the contract must comply with the rules binding for the parties established by law and other legal acts (mandatory norms) in effect at the time of its conclusion.

Secondly, the credit contract of the first Applicant was secured by the surety contracts concluded with the other Applicants and, in accordance with Article 377 of the RA Civil Code and Article 43 of the RA Law on Bankruptcy, the creditor's claims, including default penalties, and payable interests shall be paid.

4.7. Based on the aforementioned, the Constitutional Court finds that due to the need for a reasonable and balanced protection of the interests of private legal relations of parties, the Code provides for the necessary safeguards in respect of the limits of the interests and default penalties imposed by the credit contracts. At the same time, the Constitutional Court, interpreting the challenged legal provision, concludes that first, **credit contracts cannot be contrary to the requirements of the imperative norms of the RA legislation, and secondly, the default penalties for overdue loans cannot exceed the defined limits and should be effective and be constrained without violating the constitutional principle of proportionality.**

Based on the review of the Case and governed by Point 1 of Article 168, Point 8 of Part 1 of Article 169, Article 170 of the Constitution of the Republic of Armenia, Articles 63, 64 and 69 of the Constitutional Law on the Constitutional Court, the Constitutional Court of the Republic of Armenia **HOLDS:**

1. Part 2 of Article 887 of the Civil Code of the Republic of Armenia is in conformity with the Constitution of the Republic of Armenia.

2. Pursuant to Part 2 of Article 170 of the Constitution of the Republic of Armenia this Decision shall be final and shall enter into force upon its promulgation.

Chairman **H. Tovmasyan**

12 June 2018

DCC -1418