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The Development of Armenian Legislation on Pledge

Abstract: This article looks into the development of Armenian legislation related to pledge, specifically the non-judicial foreclosure process of collateral, as well as an analysis of the decisions made by the Constitutional Court and the Court of Cassation in Armenia. The article offers an overview of the legal framework for pledge in Armenia, examining the evolution of pledge legislation, and highlights the importance of the non-judicial foreclosure process of collateral and its significance in the context of Armenian legislation. It analyses the legal framework and the processes involved in non-judicial foreclosure, and also looks into the challenges that arise when applying this process in practice. Furthermore, the article analyses the decisions of the Constitutional Court and the Court of Cassation in Armenia that have dealt with issues related to pledge and non-judicial foreclosure. It provides an in-depth analysis of the reasoning for and implications of these decisions, as well as the impact they have had on Armenian legislation and practice. In conclusion, the article sheds light on the development of Armenian legislation on pledge and provides a critical analysis of the non-judicial foreclosure process and related court decisions.
Keywords: civil law, foreclosure, obligations, pledge

Introduction

One of the main regulations that ensures the constitutional right to engage in economic activity in Armenia is the mechanism for securing the performance of obligations. The purpose of these mechanisms is to protect the interests of both parties involved in a civil relationship. One of the most widely used means of securing the fulfilment of obligations is through a pledge, whereby the creditor (pledgee) is granted the right to the debtor's (pledgor's) property as security for the obligations owed to the creditor. It is crucial for entrepreneurs to clearly understand the guaran-

tees and consequences of their pledge agreements. However, it is important to find the right balance between private and public interests. Recent developments in Armenian law try to find this balance, but these attempts sometimes do not give the intended results and reduce the level of foreseeability in this area.

In the current article we will try to describe the development of the legislation, using the methods of comparative analysis and economic analysis of law to indicate the main problems of the new legal developments. We will show that when the regulation is not consistent, does not consider the whole legal environment and is not calculated correctly, the goal to protect the rights of the weaker side – in our case, the debtor – can bring the paralysis of the whole regulation, i.e. the institute of real security.

1. Overview

Armenia regained independence in 1991. Prior to that, the Armenian Soviet Socialist Republic was a part of the USSR. Being one of the member states, Armenia adopted all the principles of civil legislation that were formulated by the law 'On the Adoption of the Fundamentals of Civil Legislation of the USSR and Union Republics' that was passed on 8 December 1961.[1] Article 21 of this law indicated that the state had exclusive ownership of land. This law was adopted to develop the provisions of the USSR Constitution. The Soviet Constitution of 1977 as well as the Constitution of 1936 specified that the land, its natural deposits and its waters are the exclusive property of the state.[2]

The basis of the economic system of the USSR consisted of socialist ownership of the means of production in the form of state (belonging to all people) and collective farm/cooperative ownership.[3] It was prohibited to use the land, its mineral wealth, forests and waters, the basic means of socialist organizations, and grain and fodder reserves, as well as other circulating funds which are necessary for the normal activity of pledge.[4]

Western scholars describe the contracts between Soviet state enterprises as 'contracts in name only'.[5] Starting from Roman law, real security (*fiducia*, *pignus* and

1 USSR Law, On the Adoption of the Fundamentals of Civil Legislation of the USSR and Union Republics, Vedomosti VS USSR, 1961, No. 50, p. 525, https://docs.cntd.ru/document/901868109 (9.08.2023).

2 Soviet Constitution of 1977, https://archive.org/details/constitutionussr1977/page/n17/mode/2up (accessed 09.08.2023); Soviet Constitution of 1936, http://www.departments.bucknell.edu/russian/const/36cons01.html (9.08.2023).

3 O.N. Sadikov (ed.), Soviet Civil Law, London 1988, p. 115.

4 *Ibidem*, p. 195.

5 V. Gsovski, Soviet Civil Law: Private Rights and Their Background under the Soviet Regime, vol. 2, Michigan 1949 p. 136.

hypotheca) was used as a means of securing the obligation or performance of an agreement.[6] So we can see that real security in the USSR was 'in name only', as the main purpose of real security is to ensure the performance of obligations. The development of the Armenian legislation of pledge therefore only started after 1991. In 1995 the law 'On Pledge' was adopted, which directly allowed the pledge of real property.[7] The Constitution of the Republic of Armenia was adopted in the same year, which provided the fundamental rights and freedoms for individuals and businesses operating in the country.[8] The Constitution has since been amended twice, in 2005 and 2015, to reflect changing circumstances and societal needs.

Among the various articles of the Constitution, three in particular provide the basis for business regulation in Armenia. Article 11 sets out the economic order of the country and emphasizes that the social market economy should be the basis of the economic system. This system is based on private ownership, freedom of economic activities, free economic competition and state policy aimed at achieving general economic well-being and social justice. The concept of a social market economy is similar to that found in other countries, such as Poland.

Article 59, Clause 1, guarantees the right of everyone to engage in economic and entrepreneurial activities. However, the conditions and procedures for exercising this right are subject to the laws of the country. This means that individuals and businesses must comply with various legal requirements, such as registration, licensing and anti-trust legislation, to operate in Armenia.

Article 60 establishes the right of individuals to possess, use and dispose of legally acquired property at their discretion. This includes property that is used in the operation of a business. However, the right of ownership may be restricted by law if it is deemed necessary to protect public interests or the basic rights and freedoms of others. Additionally, the government cannot deprive anyone of their property without following proper judicial procedures, as set out by law.

Overall, the Constitution of the Republic of Armenia provides a framework that supports the rights and freedoms of businesses and entrepreneurs. By establishing a social market economy and protecting property rights, the Constitution encourages economic growth and development in the country. A social market economy is an economic model that combines elements of free-market capitalism with social policies aimed at ensuring a fair distribution of wealth and opportunities. Under a social market economy, the government of Armenia intends to play an active role in regulating the market to ensure that competition is fair and that businesses operate

6 G. Mousourakis, Fundamentals of Roman Private Law, Berlin/Heidelberg 2012, pp. 176–182.

7 The Law of the Republic of Armenia of 28 June 1995 on Pledge (No. HO-142), https://www.arlis.am/documentview.aspx?docid=219 (9.08.2023).

8 The Constitution of the Republic of Armenia, https://www.president.am/en/constitution-2015 (9.08.2023).

in a socially responsible manner. By adopting social market economy principles, the country is trying to solve one of the major problems of new market economy countries – finding the right balance between private and public interests. This tension between the individual and the social function of private property ownership has increased during the course of privatization.[9]

The norms that have been mentioned in this context form the basis upon which other legal acts, such as laws concerning different types of legal entities, licensing and certification, have been adopted. Nevertheless, the primary source governing business activities in Armenia is the Civil Code, which was adopted in 1998 and has a pandect structure.[10] The Civil Code sets out legal rules and principles that govern civil relationships and transactions in Armenia. It is divided into several parts, each dealing with specific areas of law. One of the most important parts of the Civil Legislation is the section that deals with obligations, fulfilment of obligations, and responsibility for breach of obligations. It outlines the legal framework for creating and enforcing obligations, as well as the consequences of failing to fulfil them. The law covers a wide range of obligations, including contracts, torts and other civil relationships.

2. What is a pledge under Armenian law

One of the key features of the Armenian Civil Code is the mechanisms for securing the performance of obligations. This is outlined in Chapter 24 of the Code, which provides various ways to ensure that parties fulfil their obligations. These mechanisms include financial guarantees, pledge and other types of security. The purpose of these mechanisms is to protect the interests of both parties involved in a civil relationship. By providing security for the performance of obligations, the Civil Code helps to reduce the risks associated with such relationships and ensures that parties can rely on each other to fulfil their commitments.

One of the most widely used means of securing the fulfilment of obligations is through a pledge. In a pledge, the creditor (pledgee) is granted the right to the property of the debtor (pledgor) as security for the obligations owed to the creditor. The pledgee holds a preferential right to receive satisfaction from the value of the pledged property, ahead of the owner of the property's (pledgor) other creditors, in cases where the debtor fails to fulfil their obligations. If the debtor fails to fulfil their obligations or performs them improperly, the pledged property may be seized to satisfy the claims of the pledgee (creditor).

9 K. Malfliet, La propriété c'est le vol: Property Is Theft Revisited. Private and Civil Law in the Russian Federation, Leiden 2009, p. 298.

10 The Civil Code of the Republic of Armenia of 5 May 1995 (No. HO-239), https://www.arlis.am/DocumentView.aspx?DocID=172116 (9.08.2023).

The Armenian Civil Code provides two procedures for foreclosure of the pledge. The first is the general (judicial) procedure: in cases where there is no agreement between the pledgee and the pledgor, the claims of the creditor shall be satisfied by a court judgment at the expense of the pledged property. The second procedure is the non-judicial procedure: if the contract of pledge provides for it or if there is a written agreement between the pledgee and the pledgor, the pledgee may levy execution on the collateral without applying to a court. This means that the pledgee has the right to realize the pledged property, including transferring it to their ownership or to a third party for the corresponding amount of the principal obligation, without the need for a court judgment on the realization of the pledged property. Overall, the pledge is a valuable tool for creditors to secure the fulfilment of obligations owed to them by debtors. With the right to seize and realize the pledged property, the creditor can have greater confidence that they will receive satisfaction for their claims in the event that the debtor fails to fulfil their obligations.

Entrepreneurs typically prefer to use non-judicial procedures to levy execution on collateral, as this approach offers a faster and more efficient way to recover debt than going through the court system. In Armenia, the court backlog can be significant, which means that a case may take several years to be examined. For an entrepreneur, this delay can be costly and could negatively impact their business operations. Especially taking into the account the length of the court procedure and the backlog in Armenia, which results in the examination of cases taking a couple of years, it is natural for an entrepreneur to indicate clauses on non-judicial execution on the collateral in their agreements. By including clauses in their agreements that allow for this type of execution, they can ensure a more streamlined and efficient debt recovery process. This gives them the ability to recover their debt by seizing and selling the collateral without going to court.

Non-judicial execution procedures can vary depending on the nature of the collateral and the terms of the agreement, but they generally involve notifying the debtor of the intention to execute on the collateral and giving them a chance to repay the debt before the collateral is seized. In cases of non-judicial execution, the pledgee must inform the pledgor and the debtor (if they are different entities) in writing and in a proper manner about the execution that will be levied on the collateral without resorting to court. This notification is referred to as the 'notification of execution'. It is important to note that the pledgee must follow the legal requirements for notification and execution, and that the pledgor or debtor has legal rights to protect their interests. The pledgor or debtor has the right to challenge the lawfulness of the execution through judicial procedures. If they choose to do so, the court may suspend the process of execution on the collateral until the matter is resolved. However, if the pledgor or debtor does not challenge the execution within the prescribed time limit, the pledgee has the right to realize the collateral on behalf of the pledgor. This means that the pledgee may sell or dispose of the collateral in order to recover the amount owed to

them. In the case of immovable property, the pledgee submits the necessary documentation to the state cadastre to demonstrate that the pledgor was notified. Upon receipt of this application, the transfer of rights to the collateral is registered.

Within the last couple of decades, Armenian legislation on pledge has been actively reformed. This trend is seen in nearly all newly independent Central and Eastern European countries.[11] The purpose is obvious: to create clear, internally consistent law, which fits logically into the general legal system, is just and is ready for use along with a set of legal institutions that make it functional.[12]

3. Practice regarding the non-judicial procedure of foreclosure of collateral

The Constitutional Court of the Republic of Armenia discussed the conformity of a non-judicial procedure for confiscating pledged property with the country's constitution in 2016.[13] The Court raised the question of whether the procedure aligns with the right to property protected by the Constitution. The Court determined that the procedure is consistent with the Constitution with regards to the expression of the owner's will and consent in legal relations related to non-judicial confiscation of pledged property. The Court's findings were based on the following:

- By signing the pledge agreement, the pledgor consents to the possible termination of their right of ownership of the pledged property in the case of non-fulfilment or improper fulfilment of the obligation secured by the pledge.
- The pledgor consents to the possibility of non-judicial confiscation of the property in the case of non-fulfilment or improper fulfilment of the obligation secured by the pledge.
- Before non-judicial confiscation, the pledgor has the opportunity to take measures to fulfil the obligation secured by the pledge and prevent the loss of ownership of the pledged property or to challenge the legality of the non-judicial confiscation.

The Court found that the will of the owner of the pledged property is expressed through active actions in the first two situations, by signing the appropriate contract or agreement, and that this is mandatory. In the third situation, the owner's will can be expressed through a passive action by not taking any action prescribed by law

11 E.A. Summers, Recent Secured Transactions Law Reform in the Newly Independent States and Central and Eastern Europe, 'Review of Central and East European Law' 1997, vol. 23, pp. 177–203.

12 *Ibidem*, p. 202.

13 Decision of the Constitutional Court of the Republic of Armenia of 19 July 2016, No. SDO-1294, https://www.arlis.am/DocumentView.aspx?docid=107503 (9.08.2023).

to stop the non-judicial seizure upon learning about it. Based on these findings, the Court declared that the non-judicial procedure for levying execution on pledged property is in line with the Constitution. In addition to making the finding, the Constitutional Court also highlighted some flaws in the legislation and implementation procedures related to the notification process and the debtor's rights to challenge the lawfulness of the execution. These concerns were duly noted and, in response, corresponding amendments were made to the Civil Code in 2019 to address them.

Until the end of 2022, the non-judicial procedure for the execution of the pledge was a highly useful tool that was widely used by entrepreneurs. This procedure allowed them to effectively enforce the execution of obligations or to receive compensation for damages in the event of non-execution. The popularity of this procedure can be attributed to its efficiency, its ease of use and the benefits it offered to entrepreneurs. Overall, the amendments made to the Civil Code in response to the Constitutional Court's findings have helped to improve the efficiency and effectiveness of the non-judicial procedure for the execution of the pledge. This has been a positive development for entrepreneurs, who have continued to rely on this tool as a means of protecting their rights and interests.

As can be seen, the primary guarantee for the pledgor and debtor to defend their rights is notification of non-judicial execution of the pledge. The Civil Code of the Republic of Armenia indicates three procedures for notification that must be applied successively – the next one is applied if the prior procedure is not applicable:

1. If a corresponding law provides a mandatory notification procedure, the party must be notified only through the indicated procedure.
2. If no mandatory notification procedures and conditions are provided by law, parties may agree, in a contract, on a procedure for notifying each other.
3. If no mandatory notification procedures and conditions are prescribed by law or a contract, a notification shall be considered proper where it has been made through a registered letter accompanied by a delivery notice or by handing it over in person.

The Civil Code also prescribes the public notice procedure through electronic means of communication, using the public system of notifications. However, due to problems with the implementation of the e-governance system in Armenia, this procedure is not applied to notifications of execution of pledges.

In late 2022, the Constitutional Court reviewed the constitutionality of the notification procedure in a specific case. The background of the case is that the pledgee had the authority to execute the collateral without seeking court approval. The pledgee exercised this right, notified the pledgor and then requested the state cadastre to register the transfer of the rights to the collateral after a two-month period had elapsed. The pledgor filed a claim in the Administrative Court, arguing that the state

cadastre did not inform him about the transfer of the rights to the collateral. He contended that the state cadastre was obligated to initiate an administrative procedure and allow the pledgor to participate in this process. The Administrative Court, the Court of Administrative Appeals and the Court of Cassation all heard the case. The Court of Cassation ultimately ruled that the postal delivery receipt or the pledgor's signature on the delivery receipt serves as evidence of the notice's delivery to the pledgor, according to the law.[14] The Court of Cassation emphasized that the cadastre, as an authorized entity, performs state registration of property rights and limitations as a result of administrative proceedings launched on the basis of the relevant application, and it registers the right if there are no barriers. The administrative agency has no legislative procedure for examining and evaluating the confiscation notice's content. Based on this finding, the Court of Cassation determined that the transfer of rights could be executed if the postal notification is presented to the state cadastre.

The pledgor then brought the case to the Constitutional Court of the Republic of Armenia, and in November 2022 the Court delivered its decision.[15] The Court stated that in the context of notifying a mortgagor about non-judicial seizure of pledged property, protection of the right to ownership is closely linked to the right to judicial protection. This means that guaranteeing the right to judicial protection involves assessing the accessibility of justice and the legal conditions for appealing to the Court. The Constitutional Court emphasized that ensuring a person's right to appeal to the Court is a priority prerequisite for the judicial protection of constitutional rights and freedoms. The Constitutional Court noted that the legislature has provided certain guarantees for accessing information about the non-judicial foreclosure process, which are necessary for the effective exercise of rights. Although the possibility of non-judicial foreclosure has been established, the legislature has also ensured that the pledgee's clear voluntariness regarding the confiscation of the pledged property is expressed in the confiscation notification. As a result, the Constitutional Court stated that in order to register the transfer of ownership, a document confirming the delivery of the confiscation notification, expressing the pledgee's clear voluntariness regarding the non-judicial confiscation of the pledged property, must be submitted to the state cadastre.

This decision by the Constitutional Court mandated that the state cadastre examine not only the postal receipt but also the content of the notification. This decision has raised concerns about the ability of pledgees to prove that they have notified pledgors, especially given the limitations of the Armenian e-government system and postal service, which do not provide clear means to state the content of the sent letter.

14 Decision of the Court of Cassation of the Republic of Armenia of 24 June 2022, No. VD/7078/05/18, https://www.arlis.am/DocumentView.aspx?DocID=170697 (9.08.2023).

15 Decision of the Constitutional Court of the Republic of Armenia of 15 November 2022, No. SDO-1668, https://www.arlis.am/documentview.aspx?docid=170744 (9.08.2023).

As a result, pledgees may find it quite challenging to provide convincing evidence to the state cadastre that the pledgor was indeed notified. Furthermore, the criterion of 'clear voluntariness' is ambiguous and open to interpretation. This ambiguity creates a wide scope for the state cadastre to reject requests to register the transfer of the right to the property. The lack of clarity in the interpretation of this criterion puts the pledgees at risk of having their rights infringed upon.

Conclusions

After regaining its independence, the Republic of Armenia tried to develop its market economy; one of the hardest tasks here is to balance private and public interests. Armenia must solve the same issues as the other former republics of the USSR and the Eastern bloc, as these countries have confronted questions of how to implement a regulatory structure that enables the maximum amount of trading and the most economically efficient allocation of capital in the shortest time.[16]

At first the Constitutional Court had a very liberal approach, basically allowing non-judicial procedure for the execution of the pledge without any restriction. But the latest development shows that the Court is leaning more towards the protection of the debtor, trying to find the right balance between private and public interests. Although there is currently no statistical data to determine whether the Court's most recent decision has hindered the rights of pledgees, the absence of modern and efficient procedures of notification poses a significant obstacle to the implementation of the constitutional rights of entrepreneurs.

Many countries have directly or indirectly accepted the principle of freedom of contract as a constitutionally rebuttable presumption.[17] But sometimes the state decides to narrow the freedom of contract to protect the weaker side. In cases where the regulation is not consistent, does not consider the whole legal environment and is not calculated correctly, the goal to protect the rights of the weaker side – the debtor – can bring the paralysis of the whole regulation, i.e. the institute of real security. In our case, the state should have reformed the notification system prior to implementing new requirements for the registration of the transfer of the right to the property.

16 C.R. Taylor, Capital Market Development in the Emerging Markets: Time to Teach an Old Dog Some New Tricks, 'American Journal of Comparative Law' 1997, vol. 45, no. 1, p. 72.

17 A.G. Karapetov, Economic Analysis of Law, Moscow 2016, p. 290; J. Basedow, Freedom of Contract in the European Union, 'European Review of Private Law' 2008, vol. 6, pp. 902–923.

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