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 1 OF ARTICLE 369 OF THE CIVIL CODE OF THE REPUBLIC OF ARMENIA WITH THE CONSTITUTION OF THE REPUBLIC OF ARMENIA ON THE BASIS OF THE APPLICATION OF GAGIK YEGHIAZARYAN

Yerevan **4 May, 2018**

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

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

representatives of the Applicant: lawyers G. Petrosyan, T. Yegoryan and L. Hakobyan,

representative of the Respondent: V. Danielyan, official representatives of the RA National Assembly Head of the Legal Expertise Division of the Legal Expertise Department of the RA National Assembly Staff

pursuant to Point 1, Article 168, Point 8, Part 1, 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 1 of Article 369 of the Civil Code of the Republic of Armenia with the Constitution of the Republic of Armenia on the basis of the application of Gagik Yeghiazaryan.

The proceeding was initiated based on the application of Gagik Yeghiazaryan and was registered in the Constitutional Court on January 29, 2018.

Having examined the written report of the Rapporteur on the Case, the written explanations of the Applicant and the Respondent, **as well as having analyzed** having studied the relevant

provisions of the Civil Code of the Republic of Armenia and other documents of the Case, the Constitutional Court of the Republic of Armenia **ESTABLISHES:**

1. Positions and argumentations of the Applicant

The Applicant challenges Part 1 of Article 369 of the RA Civil Code (hereinafter - the Code) titled "Concept of default penalty", according to which "Default penalty (fine, forfeit) shall be the monetary amount determined by law or contract, which the debtor is obliged to pay to the creditor in case of non-fulfillment of an obligation or improper fulfillment thereof, including in case of fulfillment default. The creditor claiming for the payment of default penalty shall not be obliged to prove that damage has been caused thereto".

In the Applicant's opinion, the challenged provision contradicts Articles 1, 3, 60 (Parts 1-4), Part 1 of Article 61, Part 1 of Article 63, Articles 75, 78, 79 and 80 of the RA Constitution.

According to the Applicant, Article 369 of the Code, having envisaged a penalty as a measure of liability applicable to the debtor in the case of failure to perform or improper performance of the obligation, "has not prescribed the maximum permissible amount of the penalty envisaged in the contract", as a result of which its collection is not connected with a lump sum, but with a fixed delay in a monthly or daily interest rate, but with the monthly or daily interest rate fixed for the default, which has turned into "…an interest under the loan or credit contract". In the Applicant's opinion, such a legal regulation enables "…for instance, a credit organization or a bank, which act as one of the parties to a contract, to establish freely such a penalty for violating a loan obligation by the borrower that ... exceeds the calculated bank interest rate established by the Central Bank of the Republic of Armenia."

The Applicant also considers that "... the possibility of calculating the penalty envisaged by the credit contract after applying to a court in the context of uncertainty of the period for the consideration of the case in court, as well as during the appeal of the judicial act, prior to the final judicial act, blocks the exercise of the rights prescribed in Articles 61 (1) and 63 (1) of the RA Constitution, stipulating this with disproportionate property consequences ... ". Such a legal regulation, according to which, after the court decision is made, before the actual performance of the obligation, there is no direct prohibition on continuing the calculation of the contractual default penalty, with such an interpretation in the law enforcement practice, according to its interpretation in law enforcement practice, contradicts Articles 1, 3, 60 (Parts 1-4), Part 1 of Article 61, Parts 1 of Article 63, Articles 75, 78, 79 and 80 of the RA Constitution.

2. Positions and argumentations of the Respondent

According to the Respondent, the Applicant did not challenge the constitutionality of the legal regulation envisaged by Part 1 of Article 369 of the Code, and provided reasons for its

unconstitutionality assessed by the reference with the provisions of Parts 2 and 3 of the same Article of the Code, Article 372 of the Code as amended on May 5, 1998, Part 3 of Article 208 of the Civil Procedure Code of RA. Taking as the basis the legal regulations prescribed in the Law HO-319-N on Making Amendments and Addenda to the Civil Code of the Republic of Armenia, the Respondent considers that "... the possible issues raised by the Applicant have already received a legislative solution " and "... it is impossible that on the day of collection of the outstanding part of the actual loan, the default penalty double, triple or even more exceeds the principal amount of the debt ... ".

Turning to the arguments of the Applicant about the procedure of calculating the default penalty, the Respondent believes that this follows from the essence of the default penalty institution, in particular that "... default penalty, in one case, as a measure of liability, in another case - as a measure of securing an obligation, may be established in the form of a certain fixed amount of monetary amount for violation of the obligation, and in the form of an interest rate for a certain period in case of delay, as well as in a mixed form, combining a certain unchanged amount of monetary amount with interest rates." At the same time, according to the Respondent, the settlement of the default penalty until the actual performance of the obligation serves for the creditor as an effective guarantee of the debtor's performance of the obligation in the very compressed time frame in the case of a delay in the obligation.

Since the court's decision on the recovery of the default penalty related to the Applicant's arguments about the unpredictability of the amount of the default penalty to be collected from the debtor and the alleged uncertainty of the challenged legal regulation, the Respondent believes that, despite the fact that in law enforcement practice "... no clear criteria were formed, nevertheless in practice "... courts, invoking the default penalty, may envisage in the judgment the maximum amount the default penalty, during actual performance of the obligation the default penalty calculated above this amount will be considered as disproportionate to the consequences of breach of the obligation," therefore, according to the Respondent, "... the question was mainly in the area of practical interpretation, and not in the legislative area."

3. Issues to be clarified in the framework of the case

When determining the constitutionality of the legal regulation challenged in the present case this Case, the Constitutional Court considers it necessary to address the following issues:

- What are the constitutional legal criteria for the default penalty as a mechanism to ensure the performance of civil legal obligations, as well as the procedure for its application?

- Are the necessary conditions for the exercise of the rights of a person prescribed in the Constitution, including the right to judicial protection and right to a fair trial, guaranteed by the challenged legal regulation?
- Are the legal relations between private entities that have been the subject of consideration in this case subject to the regulation of the Constitution?

In the framework of this present case, the Constitutional Court considers it necessary to assess the constitutionality of Part 1 of Article 369 of the RA Civil Code in the context of this Article and systematically related Articles 370, 371, 372 (as amended on December 14, 2017) and Article 372.1 (as amended on 14.12.2017) of the Code.

4. Positions and explanations of the Constitutional Court

4.1. The issues submitted by the Applicant in terms of their legal nature and content relate to the constitutionality of the legislative grounds for the emergence, modification and termination of civil rights and obligations related in particular to relations arising from the performance of civil obligations, whereby the Constitutional Court primarily identifies the following constitutional legal regulations.

According to Parts 2 and 3 of Article 3 of the Constitution of the Republic of Armenia, respect for and protection of the fundamental rights and freedoms as a directly acting right is the duty of public authority, which is the limit of this power.

Article 11 of the Constitution of the Republic of Armenia, as a principle of regulating public-legal economic relations, envisages the guarantee by means of state policy of private property, freedom of economic activity, free economic competition and thereby general economic welfare and social justice.

According to Article 39 of the RA Constitution no one may bear obligations that are not prescribed by law. At the same time, the constitutional legal requirement is that laws shall define organizational mechanisms and procedures necessary for effective exercise of these fundamental rights and freedoms (Article 75 of the Constitution), including also the right to effective judicial protection and the right to fair trial (Articles 61 and 63 of the Constitution).

The Civil Code of the Republic of Armenia, based on the tasks of the latter, intends, within the framework of the aforementioned constitutional requirements, to prescribe such necessary legal regulations that will guarantee the performance of civil-legal obligations.

4.2. According to Articles 368, 369 and 370 of the Code, the default penalty (fine, forfeit) is a measure of securing the performance of civil obligations, which is a monetary amount determined by law or contract in written form, which the debtor is obliged to pay to the

creditor in case of non-performance of an obligation or improper performance thereof, including delay in performance.. Moreover, upon the demand for payment of the default penalty, the creditor is not obliged to prove damages caused to him. At the same time, the debtor is released from the obligation to pay a default penalty if s/he is not liable for the failure of the fulfillment of the obligation.

Thus, a penalty in the manner prescribed by law is paid in cases where there is a breach of a contractual obligation provided for by law or by contract.

As follows from the normative content of the aforementioned Articles of the Code, the default penalty as a mechanism within the framework of the constitutional legal regulation of Articles 3 (Parts 2 and 3), 11 and 39 of the Constitution, is designed to ensure, in the conditions of free market relations, civil legal effective activities of legal entities and is aimed at creating prerequisites, necessary for the timely and proper performance of contractual obligations by providing the legal responsibility in this area of activity, thereby guaranteeing also the freedom of the economic activity and free economic competition based on private property.

The Constitutional Court considers that the default penalty mechanism with the similar legal regulations pursues the goals prescribed by the Constitution of the Republic of Armenia, and therefore, cannot provoke the issue of constitutionality.

4.3. Comparative analysis of Articles 372 and 372.1 of the Code in connection with guaranteeing an effective institutional procedure for the application of a default penalty in the framework of constitutional legal regulation prescribed in Article 75 of the Constitution of the Republic of Armenia shows that as a result of amendments and addenda to the Law HO-319-N of 14.12.2017, the legislator envisaged legal terms aimed at ensuring the certainty and predictability of the law enforcement, in particular, if the law does not prescribe otherwise, then the maximum annual amount of the default penalty specified in the contract cannot exceed fourfold amount of the bank interest rate established by the Central Bank of the Republic of Armenia and the amount of all the default penalties specified in the contract cannot exceed the principal amount of the current debt (Part 1 of Article 372), and moreover, according to Part 2 of Article 372 of the Code, the consent contradicting the mentioned legal conditions shall be null.

According to information provided by the RA Central Bank on the basis of Article 42 of the Constitutional Law on the Constitutional Court, the legal term stipulated in Part 1 of the above-mentioned Article 372 of the Code is realized by the bank interest rate prescribed by the Central Bank of the Republic of Armenia.

Consequently, the Constitutional Court states that the question issued by the Applicant in connection with the need to establish the maximum permissible amount of the default penalty

prescribed in the contract, is regulated by law and pursues the general legal-regulatory objectives stipulated in Article 75 of the RA Constitution.

4.4. Turning to the specific issues raised by the Applicant on effective judicial protection of the fundamental rights and freedoms within the framework of ensuring the performance of civil obligations through a default penalty, the Constitutional Court considers it necessary to consider them primarily in terms of guaranteeing fair and effective judicial protection prescribed in Articles 61 and 63 of the RA Constitution, taking into account, in particular, the need for both protection of the debtor's rights and the fulfillment of the constitutional legal requirement of the inadmissibility of a possible abuse in the implementation of the debtor's rights (Article 77 of the Constitution).

The analysis of the norms of Parts 3 and 4 of Article 372 and Article 372.1 of the Code systematically interrelated with the challenged legal regulation of the Code shows that when considering a case at the request of payment of a default penalty, the court, and, in extrajudicial order, also the financial system reconciler likewise, are required in the case of presence and in compliance with certain objective legal terms, on the will of the debtor, to reduce the amount of the default penalty payable or already paid, which is specified in the contract and the amount already paid, if the penalty is clearly disproportionate to the consequences of the violation of the obligation. At the same time, in the case of a reduction in the amount of the default penalty by the court or the conciliator of the financial system, the creditor, on the basis of the application of the debtor, from the entry into legal force of the judicial act or from the moment when the decision of the financial system conciliator becomes mandatory recalculates, and if the default penalty has already been paid, the amount corresponding to the reduced amount of the paid default penalty is returned to the debtor.

The legislator also provided grounds for the termination of the obligation to pay the default penalty. In particular, Article 372.1 of the Code provides for grounds stipulated by the certain factual circumstances, in the case of which the penalty for a certain period is not calculated or, upon agreement of the parties, the term of the main obligation or the beginning of the collection process is extended.

Thus, the aforementioned legal regulations are called to guarantee effective protection of the rights of the debtor - as a person obliged to pay a default penalty - not within the limits of judicial discretion, but under certain legal conditions that, within the meaning of Articles 61 and 63 of the RA Constitution, guarantee the exercise of the right to a fair and effective judicial protection.

4.5. Turning to the international legal practice of ensuring the performance of contractual obligations through a default penalty, the Constitutional Court ascertains the

institutional diversity of the application of this measure and at the same time the generality that the default penalty is a legal incentive for the proper execution of contracts in civil law relations (for example, the Netherlands, France, the Czech Republic, Lithuania, Spain, Croatia, United Kingdom).

Within the framework of the European Union (the Principles of European Contract Law, adopted by the Commission on European Contract Law), more unified rules for the application of a default penalty in contractual relations are envisaged, according to which:

1) if the contract stipulates that the party not-performing duties who did not perform duties shall pay the other party the fixed amount for failure to fulfill the obligation, then this amount must be paid regardless of actual losses;

2) nevertheless, the fixed amount irrespective of the agreement may be reasonably reduced if it is too big in comparison with the losses caused by non-performance of the obligation or other circumstances. (THE PRINCIPLES OF EUROPEAN CONTRACT LAW - Parts I and II revised 1998, Part III 2002, Section 5-Damages and Interest, Article 9:509-Agreed Payment for Non-performance)

(http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002).

The Constitutional Court states that the legal regulation considered in the present Case in its systemic integrity is consonant with the aforementioned criteria.

4.6. The Constitutional Court also considers it necessary to emphasize that Part 2 of Article 3 of the Constitution prescribes that the public power is the addressee of the duty to protect the basic rights and freedoms of the human being and the citizen thereby essentially **excluding the direct exercise of this function by individuals** in the legal relationships that arise between them. The norms of the Constitution, especially those that establish fundamental basic rights and freedoms, are directly realized in relations arising between individuals only by the Constitution and in cases and in the manner provided for by the law. The content of the aforementioned constitutional obligation of public authority power directly indicates that the state is obliged through legislative regulations to protect the basic rights and freedoms from undue interference by third parties. And in the sphere of private law, this means that the legislator, in case of conflicting interests (conflicts) between the individuals, in accordance with the requirements of Article 78 of the Constitution, on the basis of the principle of proportionality of regulation as a constitutional legal goal, to bring to the balance the realization of the fundamental rights and freedoms of participants in private legal relations, if there is no reason, based on factual circumstances, to provide one of the parties with a legal preference for the realization of these rights and freedoms. From this point of view, the challenged provisions of

the RA Civil Code concerning the default penalty institution are consonant with the aforementioned purpose.

Based on the review of the Case and governed by Point 1 of Article 168, Point 8 of Part 1 of Article 169 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 1 of Article 369 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 102 of the Constitution of the Republic of Armenia this Decision shall be final and shall enter into force upon its promulgation.

Chairman **H. Tovmasyan**

4 May 2018

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