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ANALYSIS OF THE IMPLEMENTATION OF OBLIGATIONS WITH CRYPTOCURRENCY FROM THE PERSPECTIVE OF AZERBAIJANI LAW

Abstract

With the development of technology, the attractiveness of the digital tools, such as cryptocurrencies is also increasing. Increase in the number of cryptocurrency owners leads to the debates on what type of property cryptocurrency is or general legal status of cryptocurrency. In this regard, some of the questions open to debate are: Whether cryptocurrency can be used as a security for the performance of contractual obligations and if yes, what type of a security would a crypto-collateral be. Uncertain legal status of a cryptocurrency as a digital “asset” could automatically direct us to the conclusion that it is not possible to use it as a collateral, however when researching the civil legislation of Azerbaijan, it seems that this conclusion is not as obvious as one might think. This article analyzes the possibility of using the cryptocurrency as a collateral under the civil legislation of the Republic of Azerbaijan and relevant legal issues around it.

Keywords: *security for the performance of obligations, cryptocurrency, pledge, pledge of rights, civil law*

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Öhdəliklərin icrasının kriptovalyuta ilə təmin edilməsinin Azərbaycan hüququ prizmasından analizi

Xülasə

Texnologiyanın inkişafı ilə kriptovalyuta kimi rəqəmsal alətlərə də maraq artmaqdadır. Kriptovalyutaya sahib olan şəxslərin sayı artdıqca, kriptovalyutanın hansı mülkiyyət növünə aid olduğu, ümumiyyətlə hüquqi statusu barədə müzakirələr də artmaqdadır. Bu baxımdan mülki hüquq sahəsində debata açıq olan suallardan biri də kriptovalyutanın öhdəliklərin icrasının təmin edilməsi vasitəsi kimi istifadəsinin mümkünlüyü və əgər mümkündürsə, kriptovalyutadan bu kimi istifadənin öhdəliklərin icrasının təmin edilməsinin hansı kateqoriyasına aid olmasıdır. Rəqəmsal “alət” kimi kriptovalyutanın hüquqi statusunun qeyri-müəyyən olması avtomatik olaraq öhdəliklərin icrasının təmin edilməsi vasitəsi kimi də istifadənin mümkünsüzlüyünə işarə edə bilər, lakin Azərbaycan Respublikası mülki qanunvericiliyini araşdırdıqda bu nəticəyə gəlməyin heç də açıq-aşkar olmadığı ortaya çıxır. Bu məqalədə kriptovalyutadan öhdəliklərin icrasının təminatı vasitəsi kimi istifadənin Azərbaycan hüququ baxımından mümkünlüyü və müvafiq hüquqi suallar və nəticələr analiz olunur.

Açar sözlər: *öhdəliklərin icrasının təmin edilməsi, kriptovalyuta, girov, hüquqların girovu, mülki hüquq*

Introduction

This thesis is about using cryptocurrencies as collateral. But, first of all, the basic questions as – What is a cryptocurrency? How does it work on blockchain technology? – must be answered for clarity. First of all, cryptocurrency is a digital currency secured by cryptography; therefore, it is almost impossible to counterfeit them (Swan, 2015: 2-3). For this reason, even famous businesses

start accepting payments with cryptocurrency or buy cryptocurrencies themselves (2). This kind of easier access to cryptocurrency is the main reason for it to be used as collateral. It is now much easier for people to buy, hold and sell cryptocurrencies. With the increasing number of cryptocurrency holders, the lenders in US started to use this opportunity and extend loans for cryptocurrency holders by holding their cryptocurrencies as security (Arcane, 2021: 3).

Different than other traditional collateral types, if cryptocurrency is collateralized, it does not have maintenance costs and costs necessary for its sale in case of default by borrower. Cryptocurrency is a digital asset; thus, it does not have to be maintained as various movables like cars, machines or equipment or when borrower defaults, there is no need to prepare auction.

Notwithstanding how effective this practice may seem, it also brings along legal questions, such as, in case of US, the issues of perfection of the security interest over the cryptocurrencies and in case of Azerbaijan, whether it is legal to use cryptocurrency as collateral in the first place. In the legal academia, it is suggested that cryptocurrency should be either considered as an investment property, money or general intangible (Tu, 2018: 205, Focroulle Ménard, 2020: 9). Each of these asset types has its own peculiarities that should be taken into account when putting the cryptocurrencies under these categories. These peculiarities and problems will be analyzed in the following chapters.

Firstly, it would be useful for the purposes of this thesis to give a general overview of the secured transactions law system in Azerbaijan. The main legislative basis for the secured transactions law in Azerbaijan is the Civil Code (CC). Section 24 of the CC is dedicated to securities for the performance of obligations, whereas section 12 is about right of pledge and mortgage (6). Section 24 includes provisions related to the traditional securities, as pledge, guaranty and suretyship.

In addition, there is a separate Statute “On the Encumbrance of Movables”. Despite its name, this statute is not only dedicated to the creation of security interest over movable properties, but also to intangibles such as rights and claims, as pointed out in article 3.1 (7). However, this statute is for the most part applicable to the creation of security interest over movable properties, except for those that are to be registered in an official registry (like certain motor vehicles). The statute follows the UNCITRAL Model Law and the functional approach (8). We can see in the article 4.3 of the statute, that it is not only restricted to specific types of security agreements, but to any agreements that may create a security interest within the framework of the statute. However, we cannot see the similar approach in the Civil Code. Under the CC, creation of the security interest is classified according to the type of the asset – movable or immovable. There are different rules that apply to each type of asset and rules in both CC and the statute must be followed. According to the article 270.1 of the CC, pledge and mortgage are created with an agreement. However, as to the article 281.1, if there is a requirement to register the security interest, pledge right is established after such registration. For example, such attachment and perfection method are required for motor vehicles. Within the framework of pledge, there is also classification as to the type of asset being collateralized. For instance, article 300 of the CC stipulates the types of pledge as possession, pawn pledge, pledge of rights, pledge of money, fixed pledge and the pledge of goods in circulation. Expectedly, there are not any rules regarding specifically digital assets or cryptocurrencies in the CC. Therefore, cryptocurrencies do not fit within the classic classification of assets under the Azerbaijani law. Hence, the main question is firstly, what type of asset cryptocurrency would be under the Azerbaijani civil legislation. Secondly, can cryptocurrency be used as a collateral under the current legal regime? Finally, what can be done to create a more suitable legal system to make crypto-collaterals possible?

Before analyzing the legal status of cryptocurrency, we should emphasize that the analysis about the asset type of cryptocurrency is only for the purposes of secured transactions law of Azerbaijan. Thus, cryptocurrency may be considered completely different asset in light of, for example, tax law or criminal law. Hence, we will try to consider the current legal regime of the

secured transactions in Azerbaijan and find out which type of asset fits best to the characteristics of cryptocurrency.

In this sense, article 135 of the CC must be taken into account that provides definitions for property and things. According to that article, the notion of property comprises things (which are physical objects, money and certificated instruments (securities) and intangible properties. As to the article 135.5 of CC intangible property includes claims and rights that are inalienable or are for demanding something from third persons.

Cryptocurrency cannot be classified as a claim, because it does not inherently provide a specific right to demand or claim something from third parties. As an example, claim can be a debt that is owed to the creditor – thus, creditor have a claim to ask for the repayment of the debt. However, holding cryptocurrency can be seen as a right that can be alienated and has its own intrinsic value. By buying the cryptocurrency, a person obtains a right to hold, sell or gift that cryptocurrency. On the other hand, CC does not specify any other type of asset that may be fit for cryptocurrencies (for the purposes of secured transactions law). Therefore, right as an intangible property is the best option for cryptocurrencies under the current Azerbaijani law. At any event, it would be useful to clarify whether cryptocurrency might fall under the notion of money or security under the Azerbaijani law.

Statute of the Azerbaijan Republic “On Investment Activity” gives a definition for the investment and investment object (9). According to the article 1 of that statute, the investment consists of the financial, material and intellectual assets that is being invested in the entrepreneurial or other activities with the purpose of profits or social benefits. Thus, the object which is being invested into must be related to the entrepreneurial activity.

It should be emphasized that as a type of investment object, security is defined in the Civil Code. According to the article 997.1 of the CC, securities include shares, bonds, promissory notes, depository receipt, investment fund share, pledge paper, mortgage paper and immovable property certificate. Azerbaijani law does not specifically require the third element of the *US Howey test* (*SEC v. Howey*, 1946: 22), namely the effort of others, at least in a statutory law. Since there is no case law that can provide more clear analysis of this definition, we can conclude that cryptocurrencies can actually be investment objects under Azerbaijani law. They are not securities, however from the statutory definition of investment objects, we can derive that any property right that is being invested into with the purpose of profit can be an investment object. There are investors who invest money into the cryptocurrencies with the purpose of price speculation and for future profit. Thus, we can conclude that cryptocurrencies cannot be denied being considered as an investment object under the Azerbaijani law.

Regarding the classification of cryptocurrency as money under the Azerbaijani law, it should be mentioned that there is no exact definition of “money” in the legislation. However, the famous Constitutional Court decision in Azerbaijan, dated 14.05.2015 might be useful to define money (11). In that decision, the Court found that in civil legislation of Azerbaijan, money does not include only national currency, but also foreign currency. This statement does not restrict the scope of money to national and foreign currencies, however its formulation in this way might be convincing that the money includes national and foreign currencies and according to the Statute “On Currency Regulation” the foreign currency must be authorized by the relevant foreign government (12). Cryptocurrency is not to be considered as money, because it is not backed or authorized by any government, at least most of them. On the other hand, again from the statements of the Central Bank officials, we can see that they refer to the cryptocurrency as an investment tool or investment asset. Thus, considering all these factors we can find that cryptocurrency is not money under the Azerbaijani legislation.

In the next section we will show that the classification of cryptocurrencies as investment objects or intangible goods (rights) does not matter for the purposes of perfection of the security interest in cryptocurrencies. Or, in other words, the security interest created in them would be valid in both cases. The reason is that neither the Civil Code nor the Statute “On the Encumbrance of Movable

Properties” stipulates specific way of attachment or perfection for the investment objects (except for the bearer securities). There is only a special provision (article 303.5 of CC) that requires certificated securities to be deposited in a bank or in a notary account. In addition, the Statute “On the Encumbrance of Movable Properties” requires the collateralization of the securities that must be registered in the state registry to be perfected through possession.

Regarding the question whether cryptocurrency can be used as collateral under the Azerbaijani law, it should be declared that as to the Civil Code and the Statute “On the Encumbrance of the Movable Property”, money, security, investment objects and intangible goods can be encumbered. As mentioned in the last paragraph of the previous section, we will analyze that, for the purposes of crypto-collateralization, the classification of cryptocurrency as investment object or intangible property does not really play a role.

Firstly, article 460.1 of the CC must be paid attention. According to that article: “The performance of the obligation may be secured by pledge, earnest money, possession of the borrower’s property, suretyship, guaranty, deposit or any other means provided for in this Code or agreed upon by the contract”. This article is an introductory article to the section 24 of the CC which is named as security for the performance of obligations. In this regard, the main point to consider in the mentioned article is the part “other means ... agreed upon by the contract” – CC does not restrict the means to create a security interest only to those specifically named in the provision. Parties may agree upon another type of security interest, unless it is not against the requirements of the legislation. This position is confirmed in the decision of the Constitutional Court of Republic of Azerbaijan dated 14.07.2015 (13), where the court decided that taking into account the principle of the freedom of contract the parties are free to identify a security type as long as it is not contradictory to the civil legislation of the Republic of Azerbaijan. In this case, the surety did not conclude a suretyship contract, but merely wrote a letter indicating his suretyship for the obligation of the debtor. This type of security is not indicated in the Civil Code; thus, the Constitutional Court first analyzed the article 460.1 of the CC and concluded that the list is not exhaustive, the “any other means agreed upon by the contract” permits to agree on any security that is not contradictory to the civil legislation. For the sake of clarity, it should be mentioned that because of the specific requirements of suretyship contract, the letter was not held to be compatible with civil legislation, however, the highlighted position of the court in this case on security agreements is crucial.

We established that the list of securities for the performance of obligations is not exhaustive, thus we should now focus on whether or not there is already a type of pledge suitable for cryptocurrency. For clarity, especially for readers who are not familiar with the Azerbaijani law, pledge under the Azerbaijani civil legislation is the security interest over any movable property (except for those movable properties that is a subject of mortgage – need registration) and rights and claims. Therefore, different from common law definition, under which pledge is only related to the possessory security interest, main distinction under Azerbaijani law is the type of asset that is being collateralized – movable or immovable. Thus, pledge under the Civil Code should be understood as a security interest over the movable properties that do not need state registration (filing) and rights and claims, regardless of whether the collateral is in the possession of the secured party or not.

The Civil Code stipulates various types of pledges as pledging in pawnshop, pledging of money, pledge of rights, pledge by possession, fixed pledge and the pledge of goods in circulation. Pledging in pawnshop, pledge by possession, fixed pledge and the pledge of goods in circulation is applicable only to tangible, physical goods, therefore, we will not go into details of these pledge types. As established in the previous section, the best classification for cryptocurrency is that it is either an intangible asset or investment object under the CC. Intangible assets include rights and claims. This is so because, firstly, from the abovementioned article, we can see that there is no specific regulation regarding the pledge of investment objects or securities. The Statute “On the Encumbrance of Movable Property” only states the perfection method by possession for the securities. It should be mentioned that other investment objects, such as immovable properties or

securities themselves are regulated separately when they are collateralized. However, there is no general all-catching regulation of investment objects as collateral. For this reason, even if we consider cryptocurrency as investment object, we would still apply the provisions on pledge of rights, because it is the only suitable type of pledge in the legislation. Thus, within the framework of CC, security interest in the cryptocurrency can be attached through pledging of rights according to article 303 of CC. As to that article, when the rights are being pledged, the subject matter of the pledge is alienable right. Since right to hold cryptocurrency is alienable right and has its own economic value, this article is applicable.

In this stage, the point that the classification of cryptocurrency as investment object or intangible property must be emphasized again. As mentioned above, due to the classification of pledging in CC, there is no need to make a definite differentiation between holding a cryptocurrency as a right and cryptocurrency as an investment object. From this point of view, we can think that using cryptocurrency as collateral is not prohibited *a priori*.

Conclusion

In conclusion, despite no case law still exists in Azerbaijan, we cannot directly say that nobody can use their cryptocurrencies as collateral to get a loan. It depends on the principle of the freedom of contract and since there is no direct prohibition it is not illegal *per se*. However, how courts in a civil law country as Azerbaijan would address this issue was an important question to address, especially because of the lack of perfection method over the cryptocurrencies in legislation. For eliminating this uncertainty, it was suggested that legislature should take a stance and specifically address the security interest over the digital assets and provide certainty in that regard.

In conclusion, effective regulation of the crypto-lending may lead to economic gain in Azerbaijan, therefore legislature should consider the advantages thereof and ensure an efficient regulation.

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