

# SHORT ESSAY ON THE LEGAL EFFECTS OF SIMULATED CONTRACTS IN REGARD TO THIRD PARTIES

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## Abstract

*The simulation is a lie born out of the will of the parties to evade showing successors or third parties the truth. The Romanian legislation has a tolerant approach towards simulation, and permits it, in general. The New Civil Code does not sanction the mechanism of simulation with nullity, but offering the rather milder sanction of inopposability. This short paper will strive to give a short analysis on the effects of this simulation upon the third parties – the objective successors and the creditors of the parties. The New Civil Code has numerous stipulations in order to regulate these complex effects as to avoid harming the interests of these third parties who usually act in good faith and gain rights from the parties of the simulation. These parties should and are protected by law, exactly because they acted in good faith. The objective successor of the apparent acquirer will be protected against the true will of the parties, as, in general this true will harms his interests. Also, this paper will analyze the special situation of the creditors of the apparent seller and of the apparent acquirer, as their situation can vary according to the person they come into conflict with.*

**Keywords:** *simulation, sham contracts, good faith, third parties and creditors, inopposability*

## 1. Introduction

Simulated contracts are quite an often occurrence in our modern era, as more and more people are participating actively in the civil circuit, acquiring goods and services and trying to fulfill their interests.

The Romanian legislator, observing this increase in activity, in order to better protect individuals from the chaos of private initiative increased regulation. The typical example is the New Civil Code which is packed with stipulations. However this influx of legislation can cause a vicious circle as people, seeing all these norms which limit their possibility to engage in trade and other commercial activities, resort more and more often to the complex mechanism of simulation to hide their true intents.

The simulated contract, containing in its mechanism a duality of contracts - a public but sham contract and a secret, but true one - is well known to its parties, as they voluntarily committed to resort to this "lie". More problematic is the effect of this mechanism on third parties who acted in good faith and contracted with one of the parties of the simulation.

Thus, we consider essential in drawing up a short analysis on the effects of simulation upon these third parties, distinguishing between third parties who acted in good faith and those who manifested bad faith.

## 2. Types of third parties

First of all we must assess what participants form this category of "third parties" as to distinguish them from the parties who elaborated the simulated contract.<sup>1</sup>

The third parties, in general, are considered to be the people who are rightfully ignorant of the simulated contract, who do not know the existence of the hidden contract - the objective successors of the parties as well as the creditors.

The first category, the objective successors, are persons who inherit assets or rights from another person, but these rights and assets are individually determined and not part of an universality of goods. The objective successor thus gains these rights from the people who owned them previously and must adhere to all obligations linked to these assets or rights.

This category is in opposition to the subjective successor who is merely a continuation of the personality of a person who ended his existence. The subjective successor gains the universality of the rights and obligations of a personal, being also named a "universal successor".

The creditors of a person, unlike all other types of parties or successors of these parties, have merely a general claim on the assets of their debtor, all these assets comprising the entire collateral of the creditor. In case of default by the debtors, the creditor can foreclose on any of the assets of the debtor.

The major problem of the creditor is that he only has this general claim on the assets of the debtor and thus he must pay close attention to him and ensure that the debtor does not enter into fraudulent agreements in order to reduce the number of assets and thus harming the interests of the creditor.

It has also been said that, along with the objective successors, the creditors are more often than not the direct

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<sup>1</sup> For an analysis of the "third parties" in simulation see also F. Baias, "Simulația – Studiu de doctrină și jurisprudență", ed. Rosetti, Bucharest, 2003, p. 141.

victim of the intention of the parties to simulate<sup>2</sup>, the debtor trying through all means to reach a state close to bankruptcy or even bankruptcy in order for the creditor to be unable to fulfill his claim.

### 3. Effects of the simulation regarding third parties

The Old Civil Code had very succinct stipulations regarding this issue, for it had only one article dealing with the problem of simulation and its effects on the third parties, including the creditors and objective successors.

At art. 1.175 C.civ., the Old Civil Code merely stated that the secret contract, as part of the simulation mechanism, cannot be enforced against third parties.<sup>3</sup>

The New Civil Code, however, which came into force on October 1<sup>st</sup> 2011, has a much more elaborate take on the norms concerning the effects of the simulation against third parties.

Art. 1.290 C.civ. stipulates that the simulation cannot be enforced by the parties, their personal successors, their objective successors, nor by the creditors of the apparent seller against third parties who manifesting good faith gained rights from the apparent acquirer.

Art. 1.291 par. 1 of the New Civil Code stipulates that the secret contract is not effective against the creditors of the apparent acquirer who, in good faith, registered their foreclosure proceedings in the land registry or obtained a seizure of the asset object of the simulation.

It is worth mentioning that the simulated agreement made up by the parties is not, in the Romanian legal system, subject to nullity, but merely the true will of the parties, the true contract, is inopposable to the third parties who, in good faith, gained rights from a sham owner.

This is in opposition to quite a number of law systems in Europe who deal much more “violently” with this type of fraudulent behavior, declaring the entire simulated operation as null and void and incapable of producing effects against any person.

#### 3. 1. What is good faith in matters of simulation?

Entire treaties have been written regarding the notion of “good faith”, and in our short essay we cannot even hope to give an accurate and complete definition on this complicated affair.

We shall mention, however, that acting in good faith a person must follow only the paths that the law has permitted him to take and must act seeking only just and reasonable goals.

A person acted in good faith in matters of simulation when he was rightly ignorant of the simulation mechanism. This does not mean that he was

negligent or he ignored the existence of the simulation with malice, for his own unjust reason, but rather undertook all means at this disposal to make sure that the apparent contract which he himself bases his decisions on is the true contract, containing the true will of the parties.

For example, if he acquired a house from a seller, only if he acted with good will, in good faith, and he took all the necessary measures, including checking the land registry, as to ensure that the seller is the true owner of the house, will he receive the benefit of inoposability in case the person who sold him the house was only a “strawman” or an apparent owner.

If he was of bad faith, if he knew that the person who sold him the right, was nothing more than an apparent owner, than he will not be protected when the true owner claims his right.

#### 3.2. Inoposability of the secret contract in regard to objective successors

Thus, the objective successor, in order to gain the benefits awarded by art. 1.290 C.civ. must always manifest good faith and must enter into an agreement with the apparent acquirer only manifesting this good will.

The objective successor, thus, gained rights from the apparent acquirer who himself gained these rights from the apparent seller.

For us to better understand these stipulations we must define the notions of “apparent seller” and “apparent acquirer”.

Simulated contracts, usually, take three forms:

- simulation through the interposing of a third person, a so called “strawman” who although is mentioned as part of the agreement, is merely a front in order to present to the “outside” world an apparent and untrue contract.

- simulation through fictitiousness. The parties of the simulation enter into an agreement which is only apparently real, but in true fact, it is merely a sham contract, the true agreement between parties stating the unreal character of the transaction.

- simulation through disguise. The parties apparently choose a type of agreement (for example, a sale contract), although in reality they chose another type of contract (for example, a donation contract). They simulate reality in order to better protect their interests against limiting factors such as third parties or even the law, when the latter does not permit them to enter into the real agreement.

The “apparent seller” is party to simulation and chooses to fictitiously enter into an agreement with the “apparent acquirer”, all these parties knowing full well that the apparent contract is a sham one.

The real contract may be a contract in which the parties merely have leased the asset. The parties may have even resorted to a fictitious act, where the true

<sup>2</sup> F. Baias, “Simulația – Studiu de doctrină și jurisprudență”, ed. Rosetti, Bucharest, 2003, p. 154.

<sup>3</sup> See also G. Chivu, “Simulația în teoria și practica dreptului civil”, ed. Argonaut, Cluj-Napoca, 2001, p. 78.

owner is still the “apparent seller” who held onto his rights fully.

It is irrelevant for the objective successors the nature of the contract. The only thing that matters is that they, in good faith and considering the apparent contract, entered into an agreement not with the true owner of the right, but with merely an „apparent acquirer” and thus with a non-owner.

In the absence of art. 1.290, their position might have been quite precarious, as they would have been extremely vulnerable against the „apparent seller”, the true owner of the right.

But this is exactly where art. 1.290 comes in and protects the objective successors from losing their right – if they entered into an agreement with the „apparent acquirer” and in good faith gained rights from this person who is not the true owner, the true contract, the real but hidden one, cannot be effective against them – they can ignore the true will of the simulation parties.

This is the typical sanction of the simulation mechanism – the true intent of the parties of the simulated contract is not effective against the third party who contracted in good faith the apparent acquirer.

Thus, the third party, the objective successor of the apparent acquirer, is protected from losing his right, although he did not enter into agreement with the real owner of that right.

All this is because he manifested good faith and accepted the apparent contract as true.

Of course, between the parties of the simulated contract this situation is difficult, as the apparent acquirer, knowing full well that he is just a sham owner, chose to sell further on this right in order to gain pecuniary advantages, harming in a deliberate manner the ownership right of the apparent seller, the true owner.

The parties of the simulated contract will have to sort this complex legal situation for themselves, as this is completely irrelevant for the objective successors who gained rights from the apparent acquirer, in good faith.

They will be able to keep the rights they acquired, as if they had entered into an agreement with the true seller.

### 3.3. Inopposability of the secret contract in regard to creditors

As we mentioned above, the creditors merely have a general claim on the assets of the debtor, they, generally speaking, have no special position or special guarantee concerning these assets and thus are prone to all kinds of fraudulent behavior by the debtor who tries to evade them and not satisfy their claim.<sup>4</sup>

This is why debtors enter constantly into fraudulent agreements, including resorting to simulation in order to trick these creditors into thinking they have no assets.

Knowing full well this behavior, the Romanian lawmaker stipulated that the secret agreement born between two parties who hide their true intentions through a sham, apparent contract cannot be effective against third parties, including creditors.

This conclusion can be extracted by interpreting the stipulations at art. 1.289 – 1.291 C.civ. It is worth mentioning that the norms at art. 1.290 and 1.291 in the New Civil Code are special applications of the general rule enshrined at art. 1.289 C.civ. They are nothing more than the materialization of the will of the lawmaker to put an end to several debates concerning the effects of simulation in regard to third parties.

Thus, the main rule will be that the parties and their personal successor cannot oppose the secret agreement in regard to creditors, as they are third parties to the mechanism of simulation.

However, although the legislator has not made this distinction, we must further our study and see if it matters if the claim of the creditor is previous to the simulation or if the claim was born after the secret agreement.

#### *In the case of the creditor of the apparent seller:*

If the creditor’s claim is previous to the simulated contract, then the above shown articles are fully applicable, even if the creditor knew that his debtor would enter into the secret agreement because he couldn’t do anything about it, he cannot prevent his debtor into entering secret agreements.

If the creditor’s claim is born after his debtor entered into the secret agreement, than his good faith is essential, because if he knew about the simulation, then he accepted the role of creditor knowing the full extent of his debtor’s assets. In this case, he will have interest in claiming that the true contract is the one effective between parties, as this contract is the one containing the true will of the parties.

If he didn’t know and couldn’t be known about the real contract, then he is of good faith and can act in any way he considers fit, but he mostly will act in the same way, having interest in bringing forth the true contract, as this one ensures that the will of the simulation parties is the true one and that the assets he could foreclose upon are still in the possession of his debtor.

Anyway, in general, the sanction which the law enshrines in this case is not nullity, of course, but rather the creditor, having interest, can ask that only the true contract be effective against him, as it is the true contract.

This is one of the cases in which a third party, does not ask for inopposability of the true will of the parties, but rather for the inopposability of the sham contract, having interest in maintaining the true intent of the parties.

#### *In the case of the creditor of the apparent acquirer*

<sup>4</sup> See also F. Baias & other authors, “*Noul Cod civil. Comentariu pe articole*”, ed. CH Beck, Bucharest, 2012, the analysis at art. 1.290-1.291 C.civ.

This creditor will, in general, have an interest to ensure that the sham contract will prevail over the true one in relation to any other person.

This is because the creditor of the apparent acquirer gained rights from the apparent buyer and thus has interest to maintain the apparent contract as it offers him more assets to foreclose upon in case his debtor, the apparent acquirer, can't settle his claim.

However, the creditor of the apparent acquirer must have entered into an agreement with the apparent acquirer, in good faith, ignorant that his debtor has an asset which is the object of a simulation.

If the creditor of the apparent acquirer knew that the respective asset is, in reality, not his debtor's, than he will have the status of creditor of bad faith concerning the simulation and will now be able to ask for the benefit of inopposability.

It may be even the case that the creditor is in collusion with the parties of the simulation, being himself a party and trying to further the dishonest and fraudulent activity in order to harm the interests of other creditors or objective successors.

In this case, of course, the creditor will be held by the true contract which contains the true will of the parties, as he was truly aware of its existence.

However, is the creditor of the apparent acquirer is of good faith he will be able to prevent the effectiveness of the real, but hidden contract, but only under the special conditions of art. 1.291 C.civ. : the secret contract is not effective against the creditors of the apparent acquirer who, in good faith, registered their foreclosure proceedings in the land registry or obtained a seizure of the asset object of the simulation.

Thus, unlike the protection offered by the Romanian lawmaker for the creditor of the apparent seller, the legislator offered the special benefit of inopposability for the creditor of the apparent acquirer only if he fulfills the conditions mentioned above because of one important factor : the creditor of the apparent buyer will fight to obtain an extra benefit, another asset for him to foreclose upon, while the creditor of the apparent seller will fight to prevent a loss, than of an asset. Between these contrary interests, naturally, the Romanian law maker preferred the person who is fighting to prevent a loss, rather than the person fighting to win further benefits.

### 3.4. Effects of the simulated contract between third parties

The lawmaker of the New Civil Code has not only included norms to settle the relationship between the parties of the simulation and third parties, but also between third parties.

Art. 1.290 stipulates that the true contract cannot be opposed by the creditors of the apparent seller

against the third parties, objective successors, who gained rights from the apparent acquirer.

So in this case, the law states that the objective successors of the apparent acquirer are preferred rather than the creditors of the apparent seller simply because the first ones, in good faith, gained rights in light of the apparent contract, while the creditors of the apparent seller will bring forth the true will of the parties. This true will manifested in the true, but hidden contract, cannot be made effective against the objective successors who entered into an agreement with the apparent acquirer considering, in good faith, that the sham contract is real.

On the other hand, art. 1.291 par. 2 stipulates that when there is conflict between the creditors of the apparent seller and the creditors of the apparent acquirer, the first ones are preferred if their claim is previous to the sham contract.

Indeed, this position of the lawmaker is contrary to the previous one, giving priority not to the creditors of the apparent acquirer who considered, in good faith, the apparent contract to be the real one, but rather to the creditors of the apparent seller.

This is because, as mentioned above, the creditor of the apparent seller is generally the direct "victim" of the simulation and he fights against a loss, while the creditor of the apparent acquirer fights only to enrich the assets of this own debtor.

## 4. Conclusions

The typical effect against third parties of the simulation is usually inopposability of the true will of the parties, as the sham, but apparent contract will be the only one to be effective against these third parties because it is the only one who is shown to the world and any person, entering into an agreement with the parties of the simulation will know only of the apparent contract and not of the true will of the parties.

Thus, the Romanian lawmaker gave this important benefit to the third parties taking into consideration that they acted in good faith and deserve to win against the fraudulent intent of the parties who chose to "lie" in order to protect their interests.

However, as we have seen, difficulties may appear when third parties have conflicting interests, some having interests to uphold the real, but hidden contract, while others choosing to uphold the sham, but apparent contract.

In this situation the New Civil Code offers us just solutions, trying to curtail the myriad of interpretation given in the past by the Romanian courts as well as the Romanian law literature.

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