

# Fictitious employment contracts in loan recovery processes in Latvia

R. Neilands

Rīga Stradiņš University, Riga, Latvia

**Abstract.** Latvia from 2008 till 2013 experienced serious financial crisis. The results of the crisis were significant financial loss in banking area, plenty of foreclosures, plenty of corporate and private bankruptcy processes. One of issues Latvia faced in the foreclosure proceedings was the reaction of debtors – some of them used all possible means (including illegal) to obstruct foreclosure. One of such means is a conclusion of fictitious employment contracts on the mortgaged real estate maintenance and later obtaining a court judgment on a wage recovery.

The aim of the paper is to research how fictitious employment contracts are used and to propose a solution for the fictitious labour agreements issue.

Methods of qualitative research were employed in the paper – comparative method, analytic method, inductive method, and deductive method.

**Key words:** loan recovery; fictitious employment contracts.

## 1 Fictitious employment contracts

One of the ways how legitimate interests of mortgagees are infringed is entering into fictitious employment contracts for maintenance of the mortgaged real estate and obtaining of a court judgment on recovery of a salary therefore. Pursuant to sub-paragraph 1 of paragraph one of Article 628 of the Civil Procedure Act, first the judgment execution costs related to sale of the real estate are to be covered from the funds received for mortgaged real estate that is sold, and subsequently claims of those employees shall be satisfied who are involved in maintenance of the real estate along with social insurance contributions associated with their salaries. The claims secured by mortgages come only fourth in the ranking (after the salaries paid for maintenance of the mortgaged real estate, taxes and real burdens related to the real estate, which are due and payable).

In practice, the said provision of the Civil Procedure Act is widely abused. A debtor (mortgagor), fully aware of a pending recovery in respect of the mortgaged real estate owned by him caused by his failure to perform his commitments towards the creditor, enters into a fictitious employment contract with some friend or acquaintance for maintenance of the mortgaged real estate. No salary is actually paid. Instead, judicial proceedings are used as a way to legalize the claim for salary. The fictitious employee brings an action in court against the employer (owner of the mortgaged real estate) for recovery of the salary due for maintenance of the real estate. During the judicial proceedings the fictitious employer acknowledges the claim brought against him resulting in the court passing a ruling to fully satisfy the fictitious employee's claim for the salary. Later on, a writ of execution is issued based on such judgment, which entitles the fictitious

employee to take precedence over the mortgagee and receive the funds, which, in essence, are due to the mortgagee. If such malicious scheme succeeds, the mortgagor and the fictitious employee share the monies received among them.

The category of fictitious salary claims also has an inherent aspect that the salary established for such employee is usually incommensurately high in comparison with work remuneration for a similar job in the relevant period and in the particular region; it is brought for a period of several years; since the beginning of employment the employee usually has not once received any salary at all, and no social insurance contributions or the personal income tax has been paid for him; the employer has not reported to the State Revenue Service on hiring the employee and on the fact that such employment relationship exists under the procedure set forth by law [1].

## **2 Case law in matters of fictitious employment contracts**

The Department of Civil Cases of the Supreme Court has evaluated legality of one scheme of fictitious salary in its judgment of 9 November 2015 in case No. SKC-184/2015. On 26 November 2010, JSC “Rietumu banka” had brought a claim against a mortgagor and a fictitious employee for recognition of the said transaction null and void stating that it has become aware of a claim of the fictitious employee against the mortgagor being satisfied by the judgment of the Riga City North District Court of 7 June 2010, where recovery of a salary in the amount of LVL 4230 was claimed on the basis of an employment contract, under which the mortgagor had hired the fictitious employee as a manager of an apartment. In the opinion of JSC “Rietumu banka”, the employment contract is fictitious, entered with retroactive effect and for the purpose to reduce the compensation due to the bank from the sale of the real estate [2].

By the judgment of 13 March 2012 of the Riga City North District Court, the claim of JSC “Rietumu banka” was dismissed; and, upon adjudicating the matter in the court of appeals, the Civil Court Panel of the Riga Regional Court also resolved to dismiss the claim on 28 December 2012. However, the Department of Civil Cases of the Supreme Court recognized that the judgment of the Riga Regional Court is to be dismissed based on the following reasoning:

1. Article 1415 of the Civil Act stipulates that unauthorized and indecent act, the purpose of which is contrary to religion, law, or moral principles, or which is intended to circumvent the law, may not be a subject-matter of a lawful transaction; consequently, such a transaction is void. Even though the abovementioned legal provision is incorporated in the section of the Act concerning the subject-matter, it actually regulates the issues concerning objective and motive (*causa*) of the transaction, which is an autonomous and independent element of the transaction and should be assessed in isolation from the subject-matter of the transaction. Consequently, even if a transaction is lawful in appearance, upon evaluating underlying motives, there is a possibility to recognize such a transaction null and void. So, in order to establish elements of the legal contents of Article 1415 of the Civil Act, establishing of circumstances, in which the transaction was closed, and actual motives of intentions of the parties to the transaction is necessary [2].

2. JSC “Rietumu banka” has submitted evidence, which confirms that: (1) the mortgagor was notified about withdrawal from the facility agreement and possible aiming of the recovery of the debt at the mortgaged apartment on 18 February 2009; (2) the employment contract between the mortgagor and the employee hiring the latter as the manager of the apartment is dated 10 March 2009; (3) the mortgagor’s title to the real estate was corroborated with the Land Register on 18 April 2007; (4) as at 1 April 2009 the mortgagor had a debt accrued in the amount of LVL 1498.49 towards the manager of the respective residential building – LLC “Realko” – for the services rendered. Arising out of

the foregoing, the mortgaged real estate was already in freehold of the mortgagor before the contract for management thereof was concluded; however, there is no information in the case file how and whether at all the real estate owned by the mortgagor was managed before conclusion of the contested employment contract [2].

Furthermore, arising out of the evidence filed, on 10 March 2009 the mortgagor had undertaken a new obligation to pay LVL 470 per month to the employee as the apartment manager in a situation, where, first of all, he already had a debt of almost one and a half thousand Latvian lats accrued towards building manager LLC "Realko" (a fact that casts doubt on his solvency and financial capacities in general); and, secondly, he undertook to pay for a service (apartment manager), which he did not need before. Furthermore, there is no information in the database of the State Revenue Service about income gained by the employee and his work place during the period between 1 March 2009 and 31 May 2009, and the mortgagor has not been registered as an employer during the same period; as well as, irrespective of the absence of a dispute between litigants in respect of this aspect (which is confirmed by the fact that the mortgagor has, without reservation, acknowledged the employee's claim for recovery of the salary) and the salary not being received since 1 June 2009 (for almost a year he allegedly had worked without remuneration), the employee has brought an action in court to protect his interests only on 9 April 2010, when a judgment was passed on recovery of the loan facility in favour of the bank [2].

In the opinion of the Department of Civil Cases, the aggregate of all abovementioned aspects infers interconnection, which suggests that the employment contract was not entered into for a purpose to establish employment relationship. In view of the procedure established in Article 628 of the Civil Procedure Act for division of the funds received from sale of a mortgaged real estate, satisfaction of the claim arising out of the employment contract unambiguously infringes the right of JSC "Rietumu banka" to receive the funds obtained from enforcement of the mortgage in full. The Department of Civil Cases considered that the circumstances outlined by the claimant definitely shed doubts about legitimacy of the employment contract. However, the Riga Regional Court has assessed the established facts in isolation and individually, thus failing to gain correct idea about circumstances of the dispute conformant to the objective reality. To this end, the legal doctrine stipulates that facts are to be evaluated in their entirety and not in isolation for the purpose to clarify actual circumstances of the case. Selection of individual facts and erroneous interpretation thereof precludes arriving at the truth. Individual facts, isolated from their causal relationship, forfeit their effect as evidence [2].

Based on the foregoing reasons as well as other reasons, the Department of Civil Cases of the Supreme Court revoked the judgment of the Civil Court Panel of the Riga Regional Court and forwarded the case for repeated adjudication in the court of appeals.

In another case, a complaint of an employee about actions of a bailiff and a calculation made omitting the employee's claim therein was dismissed by the decision of the Aizkraukle District Court of 28 February 2012. In the reasoning section the court, among other, pointed out a necessity to tie the salary with the period of recovery. By the decision of Zemgale Regional Court of 10 April 2012 the decision of the Aizkraukle District Court was left unmodified [1], and the decision has come into effect.

### **3 Prospective solution in counteracting fictitious employment contracts**

Priority of the salaries paid for maintenance of the mortgaged real estate enjoyed over satisfaction of mortgage claims is no modern-day invention. Historically, the salary for

maintenance of mortgaged real estate had to be satisfied before covering the mortgage claims either.

Chronologically, the Civil Procedure Statute (*Civilprocesa nolikums* in Latvian) promulgated in 1914 in the Russian language, the Civil Procedure Statute in Latvian passed by the Codification Department of Saeima (Parliament) in 1932, and the Civil Procedure Act passed in 1938, were in force during the first period of independence in Latvia. All these statutory laws had priority set for salaries to be compensated before mortgages.

Professor Bukovskis has noted in 1933 when speaking about priority of salaries that the new law has returned to the principle stipulated in paragraph 4 of Article 1890 of the Civil Procedure Statute, according to which there has to be definite relation between claims of employees and the real estate sold. In the legislative body's opinion, work of these persons employed at the real property is aimed at maintenance of the real property in good order during such a period, when its owner, in view of the pending public sale of the property, has taken poor care of it (neglected) [3]. Professor Bukovskis has stated the foregoing in response to comments of A. Hasmanis and Baron A. Nolkens, officials of the Ministry of Justice of the Russian Empire, on Article 153 of the Statute for Transformation of the Judicial System in Baltic Provinces [4]. It should be noted that paragraph 4 of Article 153 of this Statute prescribed that the salary for property management or for performance of work at the property shall be satisfied for one year before the date of auction.

Professor Bukovskis has also noted that it is impossible to extend priority of the salary to claims of a schoolteacher for delivering lessons to children of the debtor in the houses on sale; whereas, claims of a gardener or another worker, if these persons have performed any work at this real property or outside it, while, nevertheless, for this real property, such work being aimed at preservation or maintenance of this property, shall be satisfied under the procedure set out by the Civil Procedure Statute [3].

Through this historical retrospect a solution can be found for the issue with fictitious salaries. Since initially the objective of prioritizing the salary over mortgages was to ensure maintenance of the mortgaged property, because its owner/proprietor ceased to take care of the property, this objective should be reinstated, thus precluding possibility of abuse of this priority in bad faith.

Article 603 of the Civil Procedure Act prescribes a procedure for attachment of the real estate. Pursuant to paragraph one of this article a bailiff attaches the real estate upon a request of a debt collector.

Conversely, Article 605 of the Civil Procedure Act stipulates:

- 1) The attached real estate shall remain under management of the former possessor or manager until conveyance thereof to the new owner.
- 2) The possessor or manager shall preserve the attached real estate in the same condition as it was at the time of attachment and together with the same movable assets.
- 3) If the possessor or manager of the real estate is not known, the bailiff may appoint a manager of the real estate at his/her own discretion. The real estate manager appointed by the bailiff bears the same liability as the custodian of the movable assets referred to in this act.
- 4) The possessor and the manager of the real estate shall provide accounts to the bailiff for the period of management of the attached real estate. The revenues gained from the real estate shall be transferred to the bailiff and added to the amount received from sale of this real estate.

Attachment and management of the real estate is aimed at preservation of the real estate in the condition as it was at the time of attachment. Consequently, the salaries associated with maintenance of the real estate should be specifically tied to management of the real estate after attachment thereof. In such a way priority of the salaries would be ensured in line with

its historical objective (to ensure maintenance of the property in proper order until auction), as well as the possibility to make use of paragraph one of Article 628 of the Civil Procedure Act for the purpose to procure fictitious salaries would be precluded. In order to comprehensively prevent dishonest use of this provision, it should be stipulated that only an account of a real estate manager (reports on work performed and expenses on maintenance of the property) approved by the bailiff can serve as basis for disbursement of the manager's salary.

## 4 Conclusion

Taking into account the foregoing considerations, sub-paragraph 1 of paragraph one of Article 628 of the Civil Procedure Act should be restated in a new wording:

“Article 628. Division of funds received from sale of mortgaged real estate

(1) First expenses on enforcement of a judgment related to sale of the real estate shall be covered from the funds received for such mortgaged real estate sold, and then claims shall be satisfied in the following order of priority:

1) A claim of the real estate manager for payment of a salary approved by the bailiff, including social insurance contributions associated with the manager's salary. The claim referred to in this paragraph shall be applicable only to the period between the date of attachment of the real estate and the date of conveyance of the real estate to the new owner.”

## References

1. Stepanovs J. Četrpadsmītā sadaļa. Piespiedu izpildes līdzekļu piemērošana. 75. Nodaļa. Piedzīto summu sadalīšana starp piedzinējiem. No: Torgāna K. zin. red. Civilprocesa likuma komentāri. III daļa (61.-86. nodaļa). Rīga: Tiesu namu aģentūra **546** (2014)
2. Judgment of the Department of Civil Cases of the Supreme Court of the Republic of Latvia of 9 November 2015 in case No SKC-184/2015. Available on: <https://manas.tiesas.lv/eTiesasMvc/nolemumi/pdf/238166.pdf>
3. Bukovskis V. *Civilprocesa mācības grāmata*. Rīga: Autora izdevums **656** (1933)
4. Гасманъ А., Нолькенъ А. Положенія о преобразованіи судебной части и крестьянскихъ присутственныхъ мѣстъ въ Прибалтійскихъ губерніяхъ и правила о приведеніи означенныхъ положеній въ дѣйствіе. 2-ое пересмотрѣнное и дополненное изданіе Министерства Юстиціи. С.-Петербургъ Типографія правительствующаго сената **137** (1890)

