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## **RETENTION OF TITLE BY THE SELLER IN CASES OF THE BUYER'S INSOLVENCY**

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**ABSTRACT**

The article analyzes the regulation and application of the retention of the title clause. Uncommon in Lithuania, though widespread in other countries, retention of the title clause is a measure for securing obligations in wholesales. In the first section of the article the concept of retention of the title clause is outlined and discussed. Although the Civil Code of the Republic of Lithuania stipulates that retention of title could be vested only in goods, the parties can agree on a so-called "enlarged" or "prolonged" retention of the title clause. The second section of the article deals with the formal requirements, such as content, form, registration, etc. for validity of reservation of title clause in Lithuania. Following this, the issues of qualification and the legal consequences of the buyer's titles to goods in which ownership is reserved by the seller are discussed. The buyer under sale agreement may enjoy different models of titles: trust, agency, and transfer of future claims. The administration and consequences of these models are discussed in detail in the third section of the article. The final segment of the article deals with the issue of the consequences of the retention of title clause in the event of the buyer's insolvency. The consequences may differ depending on the chosen model of buyer's title. Since the purpose of the reservation of title clause is to have priority over other creditors (even secured), the comparative analysis of the

legal consequences of reservation of title clause and legal pledge is presented in this final section of the article.

**KEYWORDS**

Retention of title clause, insolvency, legal pledge, legal title

## INTRODUCTION

Because of financial uncertainty in markets, the severely widespread nature of deferred payments in business transactions, and an increase in the number of late payments, sellers are frequently seeking not merely to sell their goods, but to be sure that buyers will pay them on time or, in the case of the buyer's foreclosure, to be certain they will be able to get back the goods sold on credit. The relevancy of this problem is also influenced by the concept of a company's limited liability as business carriage instrument. As a result, the effective and operative means for securing payments is significantly relevant for sellers.

Obviously this problem is most important for small and medium wholesale sellers. Because of high competition they are forced to stimulate sales not only by offering high quality goods at competitive prices, but also by introducing good payment conditions. As a result, selling goods on credit is a widespread practice in wholesale. In accordance with the Civil Code of the Republic of Lithuania<sup>1</sup> (further referred to in the text as CC), the contracts of purchase for a sale on credit is called a contract of instalment (CC, art. 6.411). In the CC only several means of security of the performance of obligation used by sellers are mentioned (penalty, pledge (hypothec), suretyship, guarantee or earnest money), most often especially penalty or pledge. Nevertheless the above-mentioned means of security of the performance of obligation cannot always protect the seller's interests. For example, if parties in the purchase-sale agreement have a stated penalty for late payment, this measure can be effective only in the case where the buyer is still solvent at the time of payment. Pledge (hypothec) is a very popular measure for securing obligations only in cases of selling immovable property, equipment or other valuable items. However, the processing of this security measure is quite expensive and time consuming. If the circulation of the collateral in the market is encumbered, then it is certainly not the most comfortable and operative security measure of payments in the sale of goods.

Since the CC does not settle the final list of measures for the security of an obligation, the question is if there are any other reliable measures to ensure the seller's right to get money for the sold goods. One of those measures, in my estimation, could be the retention of title. According to the general rule settled in the CC, art. 4.49, a buyer acquires the ownership right to the goods at the moment these are transferred to him. Retention of title means that the seller shall retain the right of ownership to the item that is being sold until the payment of the full sale

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<sup>1</sup> *Civil Code of the Republic of Lithuania*, Official Gazette (2000, no. 74-2262).

price set in the contract is received. It should be noted that in accordance with the general rule in the case of an instalment sale agreement, the seller shall retain the right of ownership to the item that is being sold until the full sale payment is received (CC, art. 6.411, part 1). The title retention clause in such contracts is presumed, thus the question is whether the retention of title clause provides more guarantees for the seller in case of the buyer's insolvency.

The retention of title clause is a widespread measure for securing buyers' payments not only in Lithuania but also in other countries.<sup>2</sup> This clause often occurs in international purchase sale contracts, but the effectiveness of its treatment depends on the legal regulation of the country in which the goods are transferred, as well on the phrasing of the clause in the contract. Since Lithuania is seeking to encourage investments and international trade, it should ensure not only validity of the retention of title clause, but also effective implementation of legal measures which could be used by the seller in case of the buyer's insolvency. At first sight it might seem that this clause is very simple. Its application in practice should not be a problem. However, the deeper analysis of Lithuania's and other countries' legal acts and practice show that legal regulation and practice of this unusual measure of payment security involve quite problematic issues:

- not only in the sphere of contract law (such as: clause validity for the parties and acquirer in good faith, the formal requirements for the content, form, registration and recording, etc. of a contract with retention of title clause),
- but also in the proprietary law sphere (such as: how this real right is treated, especially when the right of ownership retains not only the goods but also the proceeds for sold goods, what remedies can be used by the seller, what the rights of the acquirer are in good faith),
- moreover, in the sphere of insolvency law (such as: what is the efficiency of the clause in the case of the buyer's insolvency).

The object of this article is to discuss these problematic issues and to find solutions.

It should be mentioned that neither European legislation nor international contracts deal with ownership issues.<sup>3</sup> It is an exceptional and mandatory part of every country's jurisdiction. Therefore the requirement for EU Member States provides national provisions for retention of title clause validity settled in the Directive 2000/35/EC of the European Parliament and of the Council of 29 June,

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<sup>2</sup> Victor Cs Yeo, "Visiting an old friend – the "Romalpa" clause", *Singapore Academy of Law Journal* 9 (1997): 257.

<sup>3</sup> J. Michael Milo, "Retention of title in European business transactions," *Washburn Law Journal* 43 (2003): 121.

2000, *On combating late payment in commercial transactions*<sup>4</sup>, which is thought to be positive and to encourage trade as well as the safety of small and medium business steps. On the other hand, the above-mentioned directive regulates neither how this retention of title clause should be formulated nor solves the aforementioned issues. It should be noted that in the process of this directive's preparation there were suggestions to make a list of retention of title clause phrasings and allow the possibility to use this condition against the third parties in cases of buyer's bankruptcy.<sup>5</sup> However, these intentions have not been realized.

The retention of title clause in Lithuania cannot be called a popular measure of securing payment. Claims related to the retention of title clause are not typical in the Lithuanian court practice. It is obvious that its potential is not employed in our legal system due to tradition, the aforementioned legal uncertainties and the absence of discussion about them. In this article I am seeking not only to evaluate the effectiveness of legal norms applicable in Lithuania but also the conformity of application to the experience of other European countries and to propose possible decisions and opportunities to improve legal acts.

Considering the stated problematic issues the tasks of this research are:

- to describe the conception of the retention of title clause and the formal requirements for its validity in Lithuania;
- to analyze the titles (trust, power of attorney, cession) by which the buyer manages the goods while the seller reserves the ownership;
- to determine the consequences of the retention of title clause in the case of the buyer's insolvency (bankruptcy), and to answer whether the seller has the priority rights to sold items (if they are sold, the proceeds).

## 1. THE CONCEPT OF THE RETENTION OF TITLE CLAUSE

Retention of title means that the seller shall retain the right of ownership to the item that is being sold until the payment of the full sale price set in the contract is received. This is a general meaning of this clause.<sup>6</sup> The target of this unusual measure for securing obligations is the possibility for the buyer to use such features of property accordingly: absoluteness, elasticity, stability, safety and reliability, and

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<sup>4</sup> Directive 2000/35/EC of the European Parliament and of the Council of 29 June, 2000, *On Combating Late Payment in Commercial Transactions* (Official Journal (L 200) 35 (EC)), article 4: Retention of title: 1. Member States shall provide in conformity with the applicable national provisions designated by private international law that the seller retains title to goods until they are fully paid for if retention of title clause has been expressly agreed between the buyer and the seller before the delivery of the goods. 2. Member States may adopt or retain provisions dealing with down payments already made by the debtor.

<sup>5</sup> J. Michael Milo, *supra* note 3: 121- 139.

<sup>6</sup> The ownership right can be resolved into different titles or authorities. These titles are so real and they have such economic value that they can become an independent object of ownership right.

remedies typical for real rights, even if goods are in the possession of the buyer.<sup>7</sup> However, the use of retention of title clause in various countries is not the same due to a different concept of property law in civil and common law jurisdictions.<sup>8</sup> Retention of title rights in common law countries is often called a Romalpa clause. This title was obtained from the case *Aluminium Industrie Vaasen B.V. v Romalpa Aluminium Ltd.*<sup>9</sup>

The facts of the case: Romalpa Aluminium Ltd. (hereinafter – Romalpa) had claimed debt for sold aluminium foil against Aluminium Industrie Vaasen B.V. (hereinafter – AIV), which was in the process of bankruptcy, in priority to the secured creditors, relying on a standard clause in their supplied contract that provided *inter alia* that “the ownership of the material to be delivered by AIV will be the property of AIV until full payment was received.” This contract *inter alia* stated that if the purchaser made a new item with the foil, or mixed the material with other items, or if the material became a part of another product, the ownership of the items that contained the supplied aluminium would be the property of AIV until the full payment received. Until then Romalpa was to have possession of these items as fiduciary owner. The Court of Appeal ruled in the decision that Romalpa is entitled to receive not only supplied aluminium but also proceeds in priority to the secured creditors, in accordance with principals of trust law.

Mr. Goode, in commenting on the case, stated that “it is doubtful whether any other case ruling in this century has created a greater impact on the commercial law.”<sup>10</sup>

A retention of the title clause in purchase–sale agreements is worded like this or similarly: “The ownership of the goods in question shall be reserved to, or retained by, the seller until the buyer has paid the price in full.” The clause is *inter alia* often coupled with various extensions, e.g. a provision that the buyer may resell the goods but the proceeds of sale shall belong to the seller and shall be held by the buyer as his agent or trustee until the price owed by the buyer to the seller has been paid. Such a provision is known as a prolonged retention of title clause. This provision could include the extension of the retention of ownership so that sub-purchasers did not acquire ownership of the goods until they were paid for (this provision is often coupled with an obligation to the buyer to include a retention of ownership clause in favour of the seller that enters into contracts for the resale of

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<sup>7</sup> The beginning of contemporary law of real rights are in Roman private law that have formed the system of real right (rights of possessing and using) remedies, which is different, in a sense, from the remedies typical for obligations.

<sup>8</sup> According to J. Michael Milo the effect of retention of title clause in countries of civil and common law jurisdictions, differs because of particular understanding of property law (see more about in J. Michael Milo, *supra* note 3: 126-129).

<sup>9</sup> *Victor Cs Yeo, supra* note 2: 251-252. This case was heard in common law country – England.

<sup>10</sup> *The Times* (May 11, 1977), cited from Victor Cs Yeo, *supra* note 2: 258.

the goods) and provision that the buyer may use the goods sold to fabricate other products, but the ownership of the resulting product shall vest in the seller until the goods supplied by him have been paid for, or that the seller shall become a co-owner of the product for a share proportionate to the value or price of goods supplied; this is the so-called enlarged retention of title clause.<sup>11</sup>

The question is then whether the buyer that has acquired goods but has not acquired ownership of them, has the right to resell them. Therefore, one of the issues related with retention of title clause in purchase–sale agreements is that under general rule, the buyer cannot dispose goods as he is not the owner (CC, art. 6.307). According to the CC,<sup>12</sup> the buyer shall have no right to sell or otherwise dispose of the goods, unless the purpose of the contract or characteristics of the goods determine otherwise. It means that if parties seek to allow the buyer to resell the goods or to use them in manufacture, it should be clearly discussed in the contract. After the goods are resold by the buyer, the question arises how to secure the seller's interests as the seller's right to recover the goods from the buyer releases<sup>13</sup> as the buyer has already resold them to the third party, which in this event is the acquirer in good faith (CC, art. 4.96, part 1). There are several possible models of how to secure sellers' interests, such as the assignment of future claim, creation of trust or agency relations with the buyer.<sup>14</sup> The possibilities of implementation of these models are analyzed in section 3 of this paper. The purchase–sale agreement with retention of title clause is the document proving ownership of sold goods vested in the seller; therefore I agree with the opinion of J. Michael Milo, that this type of document shall be considered a security right.<sup>15</sup>

The CC stipulates that retention of title could be vested only in goods,<sup>16</sup> but referring to the principal of freedom of contract the parties can agree on a so called "prolonged" or "enlarged" retention of title clause, i.e. to consider that the ownership right remains not only to sold goods, but also to proceeds or manufactured products. In this case, the proceeds of sale belong to the seller and shall be held by the buyer as his agent or trustee. Then these proceeds shall be recorded in buyers' accounting as sellers' property.<sup>17</sup>

From another angle, in the purchase–sale agreement there could be a clause under which the seller reserves the ownership right only to the proceeds but not the goods. In this case the buyer transfers a future sub-purchaser's claim to the

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<sup>11</sup> Robert R. Pennington, „The Pactum Reservati Domini In Twentieth-Century Europe,“ *Acta Juridica* (1977): 260.

<sup>12</sup> CC, *supra* note 1, art. 6.349, part 1.

<sup>13</sup> *Ibid.*, art. 6.349, part 2.

<sup>14</sup> J. Michael Milo, *supra* note 3: 128.

<sup>15</sup> According to J. Michael Milo, retention of title should be considered to be a security right, regulated within the framework of UCC (Uniform Commercial Code), article 9 (J. Michael Milo, *supra* note 3: 129).

<sup>16</sup> CC, *supra* note 1, art. 6.349 and art. 6.411, 1 part.

<sup>17</sup> For more details see chapter 3 of this article.

seller. This clause operates as an assignment of future claim in French and German law.<sup>18</sup>

## 2. FORMAL REQUIREMENTS FOR THE RETENTION OF TITLE CLAUSE AND THE SIGNIFICANCE OF ITS REGISTRATION

The Directive 2000/35/EC of the European Parliament and of the Council of 29 June, 2000, *On combating late payment in commercial transactions*<sup>19</sup> regulates that Member States shall provide the provisions that guarantee the effect of retention of title clause, but this directive does not regulate formal requirements, such as content, form, registration, etc. for validity of reservation of title clause. As already mentioned, Lithuanian legal acts stipulate the opportunity to assess retention of title clause in contracts<sup>20</sup> and in some cases the effect of this clause is even presumed<sup>21</sup>. It should be noted that the CC, art. 1.73, stipulates that contracts of purchase and sale of goods by installments shall be made in written form.

In most jurisdictions of the European Union there are no specific formalities for setting retention of title clause in purchase–sale agreements, (e.g. England, Germany, Austria, France, Slovenia)<sup>22</sup>, but in Italy, Spain, Switzerland as well as in Lithuania these contracts should be registered in the public register under the requirements of legal acts.<sup>23</sup>

In most developed jurisdictions a public register (or registers) of various property encumbrances functions under company law. These registers are used by individuals in order to verify the reliability of partners, and to find out information about the claims and rights of other persons to companies' possessions.<sup>24</sup> Although under Lithuanian civil law in the case of the contract of purchase–sale in credit the seller shall retain the right of ownership to the thing which is being sold until the payment of the full sale price (CC, art. 6.411, part 1), but the reservation of ownership in respect of the thing acquired for the service or operation of an enterprise, has an effect on the third person only if the purchase-sale contract has

<sup>18</sup> Robert R Pennington, *supra* note 11: 273.

<sup>19</sup> Directive 2000/35/EC, *supra* note 4, article 4: Retention of title

1. Member States shall provide in conformity with the applicable national provisions designated by private international law that the seller retains title to goods until they are fully paid for if retention of title clause has been expressly agreed between the buyer and the seller before the delivery of the goods.  
2. Member States may adopt or retain provisions dealing with down payments already made by the debtor.

<sup>20</sup> CC, *supra* note 1, art. 6.349. and art. 6.411, part 1.

<sup>21</sup> According to the general rule, in case of contract of installment (credit) the seller shall retain the right of ownership to the thing which is being sold until the payment of the full sale price set in the contract, unless the contract provides otherwise (*ibid.*, art. 6.411, part 1). It means that this clause is presumed.

<sup>22</sup> P. Flere, "Retention of title clauses within the common market," *Slovenian Law Review* 2 (2005): 127.

<sup>23</sup> J. Michael Milo, *supra* note 3: 132.

<sup>24</sup> E.g. in Great Britain, Australia, Singapore (Victor Cs Yeo, *supra* note 2: 257).

been registered in the public register (CC, art. 6.411, part 2).<sup>25</sup> Public registration of items, possessory rights, legal acts and legal persons is acceptance of official legality and the method to justify the legality of acts and facts. A public register stipulates accountability, as well as reliable and thorough information about market participants, and their movement.<sup>26</sup> The importance of the registration of purchase sale agreements is justified by Lithuanian court practice.<sup>27</sup> The Supreme Court of Lithuania stated that this legal requirement is explained by the nature of ownership as a real right as well as the necessity to guarantee the stability of civil turnover, assure the security of persons' rights and interests and avoid possible abuse of rights. In Lithuania, as well as in other countries,<sup>28</sup> the non-registration of a legal fact (in our case, retention of title clause) does not invalidate it; however, the parties of an unregistered transaction may not invoke the fact of the transaction against third persons and argue their rights against third persons by relying on other means of proof.<sup>29</sup>

One of the difficulties related with the registration of transactions could be in cases when the seller concludes a large amount of purchase-sale agreements and in which the registration of each of them may be physically impossible or

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<sup>25</sup> Purchase-sale agreements of installment are registered by Register of Contracts at Central Mortgage Office. Register of Contracts is public register. The main functions of the register are to register contract of installment (credit), contract for sale with a right for redemption and leasing contracts, the object of which is a thing which has not/ cannot be registered, acquired for the business or services. Register of Contracts was established on the 17 of July of 2002 by the Resolution of Government of the Republic of Lithuania.

<sup>26</sup> File records shall warn everyone, who intends to use the property, if this property is encumbered by pledge, easement, bailment, loan or its turnover is restricted because of bankruptcy, monumental or environmental protection or other special requirements.

<sup>27</sup> In the decision of the 1<sup>st</sup> of March, 2004, which involved a car acquired by a contract of installment, the Supreme Court of Lithuania stated: the contract obligates only its parties (under the CC, art. 6.154 and art. 6.184) the principle of closure of conventional relations stipulates that contract can influence the third parties only in the cases established by the law. When under a purchase sale agreement parties agree that the seller shall retain the right of ownership to the thing which is being sold until the payment of the full sale price, this clause is valid only for parties of the contract. As this clause may not be known by third parties, so parties may not invoke the fact of transaction against third persons in good faith and argue their rights against third persons by relying on other means of proof, if this retention of title clause was not registered in public register. An ownership right is a real right, so it is required that it would be public, which means that the fact of ownership can be invoked against third parties only in case that this right was publicized and the third parties have the opportunity to check who the owner of the item is. Note that according to the CC, art. 6.411, part 2, the fact that the bought unregistered items, the ownership right is reserved for the seller, when the object of contract is a thing acquired for the business of services it can be invoked against third parties only in cases, when purchase-sale agreement is registered in the public register according to the procedure established by law. Such requirement can be explained by nature of ownership as a real right as well as necessity to guarantee the stability of civil turnover, security of person rights and interests and avoid possible abuse of rights. Under the law it is required to register the purchase - sale agreement of installment of even unregistered items, thus this requirement (argumentum a fortiori) is valid for registered items, and it means that the purchase - sale agreement of installment of registered item, shall be registered in the register, in which, the item is registered (*L. E. enterprise v bailiff A. B., UAB "Jūsu Aušrė", UAB "Mineraliniai vandenys"*, the Supreme Court of the Republic of Lithuania, 2004, no. 3K-3-146/2004).

<sup>28</sup> Victor Cs Yeo, *supra* note 2: 258

<sup>29</sup> CC, *supra* note 1, art. 1.75, part 2.

complicated,<sup>30</sup> especially because at the moment it is impossible in Lithuania to register these contracts by electronic devices.<sup>31</sup>

It should be noted that, on the one hand, in Lithuania there is no requirement to indicate the retention of title clause in accounting documents. On the other hand, the question is whether such a requirement could additionally help to secure the sellers' interests against third parties. In Italy the requirement for the buyer to record the retention of title clause in accounting documents, was legalized,<sup>32</sup> but the European Court of Justice, while measuring the application of this requirement in context of EU directive, art. 4, part 1,<sup>33</sup> noted that application of the retention of title clause against creditors is an essential element of this clause. Thus if in accordance with the aforementioned Italian regulation this clause could be invoked against third parties only if the buyer upholds the stated requirements, then the seller can lose the opportunity to defend his rights. Therefore, such a regulation contradicts the aforementioned EU directive.

### **3. QUALIFICATION OF THE BUYER'S TITLES TO ITEMS WHICH ARE OWNED BY THE SELLER**

It is obvious that if the seller who has concluded purchase-sale agreement does not transfer ownership of goods, then the buyer manages the transferred goods (the received proceeds) by another title than ownership right (it could be the trust, agency, transfer of future claim), which should be discussed by the parties, seeking clearance in a contract execution process.

It is also important not only to phrase the retention of title conditions of purchase-sale agreements properly and in some cases to discuss the reservation of title of received proceeds, as well as to describe the titles by which the buyer will possess the transferred goods, but also by active actions of the seller to exercise his ownership right. The buyer shall control the storage and accounting of transferred items as well as received proceeds. These measures could be useful in

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<sup>30</sup> The person, willing to register purchase-sale agreement of installment shall submit an application to the Contract register. The form of the application and data that should be filled in is defined by The Minister of Justice and the fee of 5 Lt shall be paid for registration of agreement.

<sup>31</sup> It would be more convenient to register or receive the data of registers as well for third parties immediately with the possibility to pay for these services by electronic devices (SMS message, credit card etc.).

<sup>32</sup> Under legal acts of Italy, the retention of title clause could be invoked against buyers' creditors only in cases if buyer while reselling the goods made a record in invoice about reservation of ownership and described the operation in book keeping (*European Commission v Italy*, ECJ (European Court of Justice) case C-302/05, Official Journal C 229, 17/09/2005).

<sup>33</sup> Directive 2000/35/EC, *supra* note 4, article 4: Retention of title

1. Member States shall provide in conformity with the applicable national provisions designated by private international law that the seller retains title to goods until they are fully paid for if retention of title clause has been expressly agreed between the buyer and the seller before the delivery of the goods.  
2. Member States may adopt or retain provisions dealing with down payments already made by the debtor.

case of dispute while proving the fact of ownership, as formal documentation might not be enough.<sup>34</sup> It is obvious, however, that the aforementioned arrangements (to keep records of transferred goods, clearly arrange for the goods to be separately stored and accounted) require additional administrative costs. Therefore also in the case in which the retention of title clause is stated in the contract, the parties shall discuss the issue of who will cover the administrative costs.

If under the contract parties agree that the transferred items will be managed by the buyer by the trust right, so the seller maintains the ownership right of the goods even if the property is economically separated. In this case the buyer is a trustor and beneficiary at the same time, while the buyer is a trustee.<sup>35</sup> Although the legal relations of trust in Lithuania have no traditions of regulation and application, except the management of public property in trust, because the civil code, which was valid until 2001, did not provide the possibility to manage private assets by trust, the currently valid CC regulates the legal relations of trust quite thoroughly (CC, art. 4.106-4.110, art. 6.953-6.968). The economical separation of property in trust is accessible by ensuring the separate keeping of records of these assets. Therefore the property assigned to the trustee by the trust right shall be separated from the property of the trustor and the trustee. The trustee shall make and manage the accounting (the balance-sheet) of the property assigned to it, and shall open a separate bank account for settlements (CC, art. 6.961, part 1). The trust relations mean that the trustee (buyer), under purchase-sale agreement, is fulfilling the sellers' mandate. The trustee can dispose property in trust; therefore, his authority is analogous to the authority of owner in its content and scope if there are no restrictions under the contract of trust. Consequently, the trustee (buyer) is acting in respect of third parties as the title owner of the property in his name, but he represents the interests of the seller. The trustee shall inform the covenantee about this situation.

But, alternately, it is not clear how this model, used in other countries,<sup>36</sup> would function in practice, as there is no tradition for the application of trust law in Lithuania. One more issue is whether the transfer of goods (proceeds) to the buyer by title of trust, until the goods have been paid for, does not contradict the nature of purchase sale and trust agreements. It is obvious that the buyer will seek to sell the goods for a higher price in order to make a profit, but all proceeds for sold goods are an integral part of the property assigned by the trustor (CC, art. 6.963, part 2). This means that not only the proceeds but also the profit for goods are the

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<sup>34</sup> Victor Cs Yeo, *supra* note 2: 259-260.

<sup>35</sup> The legal relations of trust are fiduciary relations. The transfer of property to trustee is related with risk, so the trustor shall rely on trustee. On the other hand, this reliance is of factual character and has no effect on nature of legal relations.

<sup>36</sup> Victor Cs Yeo, *supra* note 2: 259-260.

seller's (trustor) property. Profit alienation would surely infringe on the rights of the buyer. However, the parties can agree that the profit gained is the buyer's (trustee) remuneration for performing the trust (CC, art. 6.966). Nonetheless it is relevant for the parties to discuss the issue of transfer of the risk of the accidental perishing or damage of the goods, as under the general rule it shall pass to the acquirer at the moment that he acquires the ownership rights, unless otherwise stipulated by law or by contract (CC, art. 4.52).

A similar relation would arise among parties if they would stipulate that the buyer manages the goods as the sellers' agent or commercial agent.<sup>37</sup> According to the CC, art 2.133, the agent (buyer) shall act in the principal's name and in his interests by disclosing the fact of agency. The agent shall be obliged without delay to inform the mandator accordingly, and submit a report with documents of justification appended<sup>38</sup>; this means that the agent shall be obliged to transfer to the represented person without delay all property, money, etc., received in the performance of the mandate. In addition, the property and proceeds transferred by the represented person shall be held separately from the property of the agent. As well, parties can agree about the remuneration of the agent (CC, art. 2.159, 6.758).

It should be noted that in Lithuania there is no court practise which could really reveal whether these models of buyers' rights to transferred goods are insolvency resistant, i.e., if in case of buyers' bankruptcy, the seller would have priority over other creditors of the buyer and would recover transferred goods (proceeds for them). According to the CC, art. 6.414, part 1, and art. 6.349, part 2, in a case in which the buyer fails to comply with the schedule of payment of regular instalments laid down in the contract, the seller may demand immediate payment of the instalments due or take back the sold thing. If the buyer has paid more than a half of the price of the thing, the seller shall have no right to take back the thing, unless the contract provides otherwise. Therefore if the seller has complied with formal requirements while concluding the contract (which is discussed in section 2 of this article) the seller shall avoid any legal problems recovering the goods, except difficulties while separating items, which do not have individual features. The situation is different in case of recovering proceeds for such goods. Exactly because of this possibility to recover the proceeds in the event of buyers' insolvency, it is important to discuss the model of buyers' title to the transferred goods in the contract and apply this model factually.<sup>39</sup> The weakness of the discussed trust and agency models is that they require additional administrative

<sup>37</sup> CC, *supra* note 1, art. 2.132 – 2.175, art. 6.756 – 6.765.

<sup>38</sup> *J.B. v P.B.*, Supreme Court of the Republic of Lithuania (2004, no. 3K-3-425/2004).

<sup>39</sup> For more details see chapter 4 of this article.

costs (for separate storing, keeping records and etc.). It could be quite difficult or even impossible in the case of multiple flows of goods.

Another model that is related to proceeds for transferred goods is the transfer of future claim. This model is applied quite widely in Germany.<sup>40</sup> In this case, parties not only provide a reservation of title clause in the contract, but also couple it with the provision that the buyer transfers the sub-purchasers' claims to the seller. Although at the moment of concluding the contract, these claims still do not exist, the CC does not prohibit the transfer of even the future claim (CC, art. 6.101, part 1). So in the event of buyers' insolvency, the seller could enjoy the direct recovering of transferred goods (proceeds) from the property of third parties (sub-purchasers), avoiding the litigation in buyers' bankruptcy case.

#### 4. CONSEQUENCES OF THE RETENTION OF TITLE CLAUSE IN THE EVENT OF BUYERS' INSOLVENCY

It is obvious that the most relevant issue of the retention of title clause is whether it is insolvency resistant. The main task of a reservation of title clause is that in case of buyers' insolvency the seller would have the right to recover the goods from the buyer until the payment of the full sale price or proceeds in cases stipulated by the contract in priority with other creditors (even secured).<sup>41</sup> In this context it should be noted that in accordance with the influence of principles of equality and good faith in bankruptcy law, one of the most important principles of bankruptcy law is *pari passu*<sup>42</sup>, which means that priority rights for creditors should be avoided as well as privileged creditors in the bankruptcy process.<sup>43</sup> Thus in this case we have the collision of two very important principles in private law, i.e.

<sup>40</sup> Robert R. Pennington, *supra* note 11: 271-277.

<sup>41</sup> CC, art. 2.113, stipulates such sequence of and procedure for the satisfaction of claims of a legal person's creditors:

In the event of legal person's liquidation (bankruptcy) the following sequence of and procedure for the satisfaction of creditors' claims shall be established:

- 1) priority in satisfying creditors' claims shall be given to claims secured by the mortgage of property of a legal person in liquidation – from the value of the mortgaged property;
- 2) first in sequence for the satisfaction of claims shall be employees' claims connected with labor relations; claims of compensation for maiming or other physical injuries, occupational disease or deprivation of life resulting from an accident in the place of work as well as claims of natural persons to settle accounts for agricultural produce supplied for processing;
- 3) second in sequence for the satisfaction of claims shall be the claims related to taxes and other payments to the budget as well as compulsory state social insurance and health insurance contributions and foreign loans granted the State guarantee;
- 4) third in sequence for the satisfaction of claims shall be all other claims of creditors.

2. The claims of creditors of each successive sequence shall be fulfilled upon fully satisfying the claims of creditors of the preceding sequence. If assets are insufficient to fulfill all the claims of one sequence in full, said claims shall be satisfied in proportion to the amount of claims due to each creditor.

<sup>42</sup> This term is also often used in bankruptcy proceedings where creditors are said to be paid *pari passu*, or each creditor is paid *pro rata* in accordance with the amount of his claim. Therein its meaning is "equally and without preference" (see [http://en.wikipedia.org/wiki/Pari\\_passu](http://en.wikipedia.org/wiki/Pari_passu) (accessed February 6, 2009)).

<sup>43</sup> See more at Paul Varul, „On the Development of Bankruptcy Law in Estonia,” *JURIDICA INTERNATIONAL* IV (1999): 176; Victor Cs Yeo, *supra* note 2: 269.

freedom of contracts (i.e., that the will of parties to agree about a reservation of title clause shall be respected) and *pari passu*, which originated from the equality of persons principle. The effectiveness of this principle is very restricted in most countries. However, the collision of law principles shall be solved by looking for a balance of interests. For example, in most countries the claims secured by the mortgage (hypothec or pledge) have priority rights over other claims in the bankruptcy procedure.

Therefore, for the sake of clarity, a differentiation should be made between the consequences of the retention of title clause and the pledge in the event of the buyer's (debtor) insolvency. Both are measures for security of obligations. It should be noted that if under the purchase sale agreement the right of ownership passes to the buyer from the moment of delivery of the thing, it shall be considered from the moment of delivery of the thing to the buyer until the payment of the full price that the thing has been pledged to the seller seeking to secure performance of obligations by the buyer (legal pledge<sup>44</sup> (hypothec) (CC, art. 6.414, part 2). If within the time period indicated in the mortgage bond the debtor fails to discharge the obligation, the creditor (seller) may exercise his rights by applying to the mortgage judge with a request to sell the mortgaged thing in a public forced auction sale in order to be fully paid the due sum from the proceeds that he is entitled to receive before other creditors, even in the case of the debtor's (buyers') insolvency.<sup>45</sup> In such a case the creditor sells the collateral in the manner agreed by the creditor and the debtor or, upon their mutual agreement, the collateral is transferred into the ownership of a creditor; the agreement failed, it is sold at the auction. When the collateral (pledged items) is sold, the proceeds are transferred to the deposit account of the Office of Mortgages and distributed in accordance with the procedure established by the Civil Procedure Code of the Republic of Lithuania (CC, art. 4.219). Comparing the needed formalities for a validity of reservation of title clause and a legal pledge, it should be noted that execution of the legal pledge is more complex and expensive than completing the pledge bond. As well, evidence and documents that shall be submitted to the court require additional time and costs. Furthermore the legal pledge can be registered only if items are not seized or the process of the bankruptcy of the debtor was not commenced in the court.

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<sup>44</sup> The conceptually new type of pledge (hypothec) is presented in the new CC (issued 2001) – legal pledge. Legal pledge arises by operation of law on the debtor's property without debtor's will as it is in case of contractual mortgage. The application to register the legal (compulsory) mortgage shall be executed as a mortgage bond. If the mortgage is legal (compulsory), the mortgage bond is signed only by the creditor. The mortgage is registered in the Register of Mortgages upon the decision of the mortgage judge and upon the submission of the mortgage bond to the Mortgage Office of the locality wherein the mortgaged thing is located (CC, *supra* note 1, art 4.185).

<sup>45</sup> A creditor must notify a debtor in writing that if the obligation secured by a pledge within the time period stipulated is not performed, the enforcement shall commence. If a pledge is registered in the Register of Mortgages, a written warning notice to a debtor is delivered through the Office of Mortgages.

The pledge follows the thing if it is described by individual features and if the seller has registered the legal pledge in the public register. In these circumstances the seller would be able to recover his debt of the transferred goods even if the goods were sub-purchased by third parties. The goods in stock or in circulation (goods, raw materials, semi-finished goods, finished goods) could be encumbered by a legal pledge; however when such pledged goods are sold, the pledge of goods is released. Although both reservation of title clause and legal pledge are novelties in Lithuania, the application of legal pledge is more predictable as the procedures of recovering of debts from the property encumbered by pledge are much more ordinary in the courts, including cases of bankruptcy. However, the effectiveness of a reservation of title clause in the event of insolvency could only be projected as there is no court practice in this field in Lithuania. In most European Union jurisdictions the reservation of title clause is insolvency resistant, although in France and Belgium the relevant changes of legal regulation were made quite recently (in France – in 1980, in Belgium – in 1998).<sup>46</sup> In Estonia, in the event of buyers' insolvency, the seller can take back the sold goods, which were not paid for, and proceeds, if money for the goods has been paid, before the buyer has become insolvent.<sup>47</sup> Referring to the experience in the aforementioned countries, it may be predicted that the seller can expect to take back the transferred goods, whereas the possibility to return proceeds would depend on the model of buyer's titles to transferred goods (see section 3) and the moment when proceeds flowed into buyers' chests. In most cases it is quite real to expect the return of proceeds if they were paid for, before the buyer has become insolvent.

## CONCLUSIONS

1. The retention of title clause is an unusual, although very widespread measure for securing buyers' payments in other countries. While seeking to encourage investment and international trade, Lithuania should ensure not only validity of the retention of title clause, but also effective implementation of legal measures which could be used by the seller in case of the buyer's insolvency.

2. Although, according to the CC, retention of title is vested only in goods,<sup>48</sup> referring to the principal of freedom of contract the parties can agree on a so called "prolonged" or "enlarged" retention of title clause.

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<sup>46</sup> J. Michael Milo, *supra* note 3: 132.

<sup>47</sup> Leho Pihkva, "Retention of title – securing your claim more effectively," *The Baltic Times* (2005 05 11).

<sup>48</sup> CC, *supra* note 1, art. 6.349 and art. 6.411, 1 part.

3. The CC stipulates that contracts of purchase and sale of goods by installments shall be made in written form and registered in public register under the requirements of legal acts.

4. One of the most relevant issues related to the application of the retention of title clause is how to secure sellers interests to recover the goods (proceeds) from the buyer after the goods are resold by the buyer. There are several possible models of how to secure sellers interests, such as the assignment of future claim, legal pledge of goods and the creation of trust or agency relations with the buyer.

5. Although the legal relations of trust in Lithuania under legal regulation are possible and currently valid, the CC regulates legal relations of trust quite thoroughly. But it is not clear how trust model of seller-buyer relations would function in practice, as there are no traditions for application of trust law in Lithuania. A similar relation would arise among parties if they would stipulate that the buyer manages the goods as the sellers' agent or commercial agent. The weakness of discussed trust and agency models is that they require additional administrative costs (for separate storing, keeping records and etc.). Furthermore in Lithuania there is no court practice, which could really reveal whether these models of buyers' rights to transferred goods are insolvency resistant.

6. Another model that is related with proceeds for transferred goods is the transfer of future claim. Although at the moment of concluding the contract, these claims still do not exist, the CC does not prohibit the transfer of even the future claim. In the event of buyers' insolvency, the seller could enjoy the direct recovering of transferred goods (proceeds) from the property of third parties (sub-purchasers), avoiding the litigation in the buyers' bankruptcy case.

7. Although both the reservation of title clause and legal pledge are novelties in Lithuania, the application of legal pledge is more predictable as the procedures of recovering of debts from the property encumbered by pledge are much more ordinary in the courts, including cases of bankruptcy. With reference to the experience of most European Union jurisdictions where the reservation of title clause is insolvency resistant, it may be predicted that the seller in Lithuania may expect to take back the transferred goods, whereas the possibility to return proceeds would depend on the model of buyer's titles to transferred goods and the moment when proceeds flowed into buyers' chests.

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