

KEY POINTS

- Retention of title (ROT) clauses have become increasingly common in international trading contracts.
- The desire for greater protection for sellers of goods has created more complex ROT clauses, beyond the traditional simple retention of title in goods pending payment.
- There are conflicting juridical authorities across different jurisdictions on the enforceability and characterisation of complex ROT clauses.
- The authors examine the position in Hong Kong.

Authors Kingsley Ong and Sandy Yeung

The Enforceability and Characterisation of Retention of Title Clauses under Hong Kong Law

ROT clauses have profound impact, not just on the rights of trading parties in insolvencies, but also the rights of third parties in factoring transactions and securitisations. Certainty on the enforceability and legal characterisation of ROT clauses is important for trading parties, and it is even more important in Hong Kong given Hong Kong's position as a major financial and trading hub. Kingsley Ong and Sandy Yeung of Eversheds, discuss the enforceability of ROT clauses in Hong Kong.

A retention of title clause (ROT clause) is a provision in a sale of goods contract specifying that, even after delivery, the title to the goods will remain with the seller until certain requirements are met, generally upon full payment of the purchase price. It is also known as a *Romalpa* clause, named after the landmark English case, *Aluminium Industrie Vaasen BV v Romalpa Aluminium Ltd*,¹ which validated the use of ROT clauses and induced widespread popularity in incorporating ROT clauses in sale of goods contracts.

The reason for including such a clause in a sale of goods contract is to give assurance to the seller that the purchase price will be paid. Should the buyer fail to pay the purchase price, the seller is entitled to retake possession of the goods because the seller is merely taking back his own goods.² This is particularly important in the insolvency of the buyer. If the purchase price is not paid, the goods remain the property of the seller so in the event of the buyer's insolvency, the seller could rely on this ROT clause to ensure that the goods would not form part of the buyer's estate. In *Compaq Computer Ltd v Group Ltd Abercorn*,³ the goods remaining in the buyer's inventory were returned to the seller by the receiver without contest.

Following *Romalpa's* case, a variety of ROT clauses have developed in international

trade. In this article, we will consider the enforceability of various types of ROT clauses under Hong Kong law. It is beyond the scope of this article to examine conflict of law issues, and therefore for the purposes of this article, all references to the "buyer" shall be to a Hong Kong company or a Hong Kong registered non-Hong Kong company unless stated otherwise.

Since this article focuses on Hong Kong law, it is useful to note that under Hong Kong's Basic Law and s.7 of the *Hong Kong Reunification Ordinance (Cap. 2601)*, the laws in force in Hong Kong prior to 1 July 1997 (ie English common law, rules of equity, ordinances, subordinate legislation and customary law) shall be maintained, insofar as it does not contravene the Basic Law (subject to any amendment by the legislature in Hong Kong). Accordingly, English judicial authority prior to 1 July 1997 is generally binding on Hong Kong courts. English judicial authority on or after 1 July 1997 and those of other common law jurisdictions are persuasive, but not binding, on Hong Kong courts.

TYPES OF ROT CLAUSES

Simple ROT clause

The *Romalpa* concept of title passing only when certain requirements are met is recognised under Hong Kong law. Under

s.19 of the *Sale of Goods Ordinance (Cap. 26)*, "where there is a contract for the sale of specific or ascertained goods, the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred". Parties can stipulate under what circumstances the title to the goods would pass.⁴ In the absence of express or implied stipulation, the property in the goods is presumed to pass to the buyer when it is in a "deliverable state".⁵ Goods are in a "deliverable state" when they are in such a state that the buyer would, under the contract, be bound to take delivery of them.⁶

Where security is granted by a Hong Kong company or a registered non-Hong Kong company, a registrable security must generally be registered in Hong Kong within one month.⁷ Failure to do so would result in, among other things, that security being void against any liquidator or creditor of the security provider.⁸ Security registration of a simple ROT clause is not required for enforcement in Hong Kong because it is not considered to be a security interest (since the buyer does not obtain title to the goods pending payment).

Whilst simple ROT clauses are generally enforceable in Hong Kong and protect the seller, it is not foolproof. Instances where the seller's title to the goods may be lost include where:

- the goods are on-sold to a third party for value;
- the goods are no longer identifiable;
- the goods are irreversibly mixed with other goods;
- the goods are annexed or became a fixture (as part of a real property).⁹

Feature

Biog box

Kingsley Ong is a partner at Eversheds, an adjunct associate professor of law at the University of Hong Kong, and secretary-general of the Asia-Pacific Structured Finance Association (APSA). He leads Eversheds' derivatives, structured finance, securitisation, restructuring/insolvency and debt capital markets practices in Hong Kong. Email: kingsleyong@eversheds.com

Unless the goods sit in the buyer's warehouse until the buyer pays the purchase price, a simple ROT clause would not fully protect the seller from a buyer default. In practice, however, it is common for buyers to insist on, and for sellers to allow, the use of the goods to generate revenue pending payment of the purchase price. This has led to the creation of several innovative expansions of the simple ROT clause since *Romalpa*. Enforcement of more complex variations of ROT clauses that extends the seller's rights beyond just the original goods have created some challenge and conflict among judicial authorities. We consider three types of variations to the *Romalpa* ROT clause below.

'The proper legal treatment is important because if an extended ROT clause is a registrable security in Hong Kong it must be registered within the required time limit'

All moneys ROT clause

In an all moneys ROT clause (also known as all sums or current account clause), title only passes once all moneys owed by the buyer (instead of just the purchase price for that particular transaction) are paid to the seller.

Such a clause is convenient for parties that have an ongoing sale and purchase relationship as the seller does not have to link certain goods to a specific invoice (especially when the goods supplied are identical in several contracts and difficult to differentiate). The seller can just claim title to all the goods remaining in the buyer's inventory.

An all moneys ROT clause was considered by the Hong Kong High Court in *Re FiveOceans Supply Services Limited*.¹⁰ His Honour Judge Poon indicated *obiter* that he was prepared to accept the enforceability of an all moneys ROT clause, which would entitle the seller to reclaim possession of the unpaid goods from the buyer "and its customers".¹¹

However, it would seem unfair to allow a seller to potentially double-profit from taking the majority of the purchase price already paid and the sale proceeds from reselling

the goods it repossessed. Notwithstanding the Hong Kong Court's *obiter* statement in *FiveOceans*, it remains unclear how far the Hong Kong Courts will enforce an all moneys ROT clause under such circumstances.

An all moneys clause was upheld by the English court in *Clough Mill Ltd v Martin*¹² although the court in that case did not have to consider whether part payment should be taken into account when the goods are repossessed by the seller and resold.

Extended ROT clause

In an extended ROT clause, the seller attempts to trace its ownership interest to, or claim security over, the sale proceeds of

the goods should the goods be on-sold by the buyer to a third party. The seller is essentially claiming beneficial ownership over the sale proceeds from an on-sale.

There are two possible characterisations of an extended ROT clause:

- Trust: potentially, the buyer holds the sale proceeds as the seller's fiduciary;¹³ or
- Security: potentially, an extended ROT clause is a charge over the buyer's book debt.

The proper legal treatment is important because if an extended ROT clause is a registrable security in Hong Kong, it must be registered within the required time limit or risk becoming void against any liquidator or creditor of the buyer. A trust, on the other hand, would not need to be registered.

Whilst the proper legal characterisation of an extended ROT clause has not been considered before the Hong Kong courts, there has been some divergence of judicial authority in England and Australia.

In *Tatung (UK) Ltd v Galex Telesure Ltd*,¹⁴ the extended ROT clause provided

that the buyer had the liberty to on-sell the goods on the express condition that the buyer would on-sell as agent and bailee for the seller and the entire proceeds thereof are to be held in trust for the seller and not to be mingled with any other monies and shall at all times be identifiable as the seller's monies. However, despite such clear words expressing the sale proceeds to be trust assets, the clause was held to create merely a charge which was void for non-registration.

The reason why the English courts are reluctant to interpret a fiduciary relationship is that "any contract which, by way of security for payment of a debt, confers an interest in property defeasible or destructible upon payment of debt must necessarily be regarded as creating a mortgage or charge,"¹⁵ otherwise the parties are faced with the difficulty of allocating the leftover money after discharge of the debt.

However, in *Associated Alloys Pty Ltd v CAN 001 452 106 Pty Ltd*,¹⁶ the Australian High Court held that an extended ROT clause which created a trust over the proceeds of sale of finished goods was valid and enforceable and did not constitute a registrable charge.

The Australian High Court reasoned that a term was implied into the contract that upon actual receipt of the sale proceeds by the buyer, a trust was constituted and the obligation to pay the purchase price is discharged. In other words, the buyer's obligation to pay the purchase price is replaced by the buyer's obligation to hold (as trustee) the sale proceeds under the extended ROT clause. The Australian High Court held that the clause was an agreement to constitute a trust of future-acquired property and was therefore not a charge.

In general, there must be specific intention in order to infer a trust relationship between two parties dealing at arm's length. If the buyer is not bound to keep the sale proceeds separately and is entitled to mix them with its own money and deal with them as the buyer pleases, then the buyer is not a trustee of the sale proceeds, but merely a debtor.

The *Associated Alloys* case has not been

Biog box

Sandy Yeung is a registered foreign lawyer at Eversheds (Hong Kong). She advises banks and financial institutions on a broad range of finance matters, including bilateral and syndicated lending, securitisations, derivatives and capital market transactions. Email: sandyyeung@eversheds.com

applied in any Hong Kong or English cases, but was applied by the Australian appellate court in *Rondo Building Services P/L v Casaron P/L & Another*¹⁷ (an appeal to the Supreme Court of Queensland). In *Rondo*, the buyer's guarantor tried to argue (based on *Associated Alloys*) that once a small fraction of the sales proceeds was received by the buyer from the sub-buyer, the debt owed by buyer to seller was discharged, and replaced with a trust (and since the debt was discharged, there was nothing for the guarantee to apply to). While the Supreme Court of Queensland rejected this argument based on certain specific facts of that case, it accepted the general principles in *Associated Alloys*.

In *Hong Kong Hua Guang Industrial Company v Midway International Limited and Others*,¹⁸ the Hong Kong Court of Appeal appeared to be prepared to accept the concept of an extended ROT clause, and noted that "the very purpose of a *Romalpa* clause is to protect the seller where he is not to retain possession but to release it to the purchaser who will, no doubt, be selling the goods".¹⁹ However, this was *obiter*, and the Court of Appeal also did not consider the proper legal characterisation or registration requirements of extended ROT clauses. It remains to be seen how the case law of extended ROT clauses will develop in Hong Kong.

Enlarged ROT clause

In an enlarged ROT clause, the seller attempts to retain title over goods that are mixed with other goods or new goods that were produced using the goods. Similar to the extended ROT clause, any attempts to retain title over commingled goods is considered to be a charge over the commingled goods that has to be registered.²⁰ As for new goods that were produced using the original goods, this remains an area of contention. In *Modelboard Ltd v Outer Box Ltd*,²¹ Judge Hart Q.C. remarked: "I see no reason why the [seller] should not retain property in the [goods] so far as it remained identifiable notwithstanding its having had value added to it ... if that is what the contract on its true construction provides."

However, in *Re Peachdart Ltd*,²² although it remained identifiable which new goods were made from the goods, the English court held that title had passed to the buyer and the enlarged ROT clause was a charge over the new goods that was void for non-registration.

SECURITY REGISTRATION UNDER HONG KONG'S NEW COMPANIES ORDINANCE

Hong Kong recently enacted a new *Companies Ordinance* (Cap. 622), which became effective on 3 March 2014. During the Government's consultation process for this new legislation, Hong Kong's Financial Services and the Treasury Bureau (FSTB) specifically considered whether legislative clarification regarding the proper legal characterisation and security registration requirements of different kinds of ROT clauses should be included in the new Companies Ordinance.

FSTB rejected such legislative clarification in its "Second Public Consultation on Companies Ordinance Rewrite" published on 2 April 2008: "We do not recommend providing a legislative clarification of the kinds of retention of title clause that constitute a registrable charge. It appears that this has not been a major issue in Hong Kong, and it would be very difficult to provide a statutory definition. The question of whether a particular retention of title clause should be registrable is best decided by the courts as under the current practice." (Appendix V, para 4 of *FSTB Consultation Paper*).

CONCLUSION

ROT clauses have grown to become an increasingly common feature of international trading contracts. As illustrated in the above cases, the effectiveness of ROT clauses has fundamental impact on the rights of trading parties in insolvencies.

However, beyond just the trading parties, ROT clauses also have very profound and significant impact on the rights of third parties – especially in factoring and trade receivables securitisations. As international

trade and more sophisticated financings and trade receivables securitisations grow in Hong Kong, questions about the enforceability, proper legal characterisation and registration requirements of ROT clauses will become increasingly important legal considerations.

However, in Hong Kong, questions remain, especially for the more complicated ROT clauses. The rejection by the Hong Kong Government to provide legislative clarification in the new Companies Ordinance highlights a more fundamental problem for legislators: the rapid development of new innovative variants of ROT clauses makes it difficult "to provide a statutory definition" of ROT clauses that are (or are not) registrable charges. ROT clauses are an example of legal innovation pushing the boundaries of the law. ■

- 1 [1976] 1 WLR 676.
- 2 *McEntire v Crossley Brothers Ltd* [1895] AC 457.
- 3 1991 B.C.C. 484 (Eng. Ch.)
- 4 See *Re Goldcorp Exchange Ltd* [1995] 1 A.C. 74; *Austin v Craven* (1812) 4 Taunt. 644; *Hayward Bros v Daniel* (1904) 91 L.T. 319.
- 5 See s.20, *Sale of Goods Ordinance* (Cap 26).
- 6 See s.2(4), *Sale of Goods Ordinance* (Cap 26).
- 7 *Companies Ordinance* (Cap 622), s.335.
- 8 *Companies Ordinance* (Cap 622), s.337(4).
- 9 *Young's Engineering Company Limited v Gold Cherry Company Limited*, HCA7511/1984 (Hong Kong High Court).
- 10 HCCW1379/2001.
- 11 HCCW1379/2001, para 18.
- 12 [1985] 1 WLR 111.
- 13 See *Re Andrabell Ltd*, [1984] 3 All ER 407 (Eng. Ch.).
- 14 1989 BCC 325 (Eng. QB 1988).
- 15 *Re Bond Worth Ltd.*, [1980] 1 Ch. 228, 248 (Eng. 1979).
- 16 [2000] HCA 25.
- 17 [2003] QCA 78.
- 18 CACV207/1999.
- 19 CACV207/1999, para 47.
- 20 *Tatung (UK) Ltd v Galax Telesure Ltd*, 1989 BCC 325 (Eng QB 1988).
- 21 1992 BCC 623 (Eng Ch).
- 22 [1984] Ch 131.