

# Case Law and Reform of the Civil Code Regarding Security Interests in Movable Property

## Establishing Priority between Retention of Title and Mortgages

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### I. INTRODUCTION

The Japanese Civil Code (民法 *Minpō*<sup>1</sup>) provides only for a pledge (質権 *shichi-ken*) as a security interest in movable property. To create a pledge, it is necessary to deliver the movable, which is the object of the pledge, to the creditor. For this reason, methods have been sought in business and legal practice to create security interests in movable property without the need for a transfer of possession.

One of these devices is a mortgage (譲渡担保 *jōto tanpo*)<sup>2,3</sup>. A creditor and a debtor enter into a contract to transfer ownership of a movable from the debtor to the creditor in order to secure the claim. To satisfy the requirements for perfection concerning the transfer of ownership, it is necessary to deliver the movable to the person who has acquired ownership (Art. 178). However, possession of the movable usually remains with the debtor,

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1 Law No. 89/1896 and No. 9/1898; articles cited are those of the Civil Code unless otherwise indicated.

2 The term “mortgage” is often used as translation for 抵当権 *teitō-ken* (hypothec). 抵当権 is a security interest provided for in the Civil Code; it can be created only as concerns real estate. Even if this right is established, the ownership of the real estate remains with the debtor (Art. 369). This paper focuses on the point at which the ownership of goods is transferred to the creditor, and the term “mortgage” is used as translation for 譲渡担保.

3 H. DŌGAUCHI [道垣内弘人], 担保物権法 [Law of real security] (4<sup>th</sup> ed., 2017) 301.

since delivery is made by means of a constructive transfer with retention of possession (Art. 183) or by registration of the assignment of the movable (Art. 3 para.1 of the Act on Special Provisions, etc. of the Civil Code Concerning the Perfection Requirements for the Assignment of Movable and Claims).<sup>4</sup> Under this provision, once the movable transfer is registered, it is deemed to have been delivered under Article 178 of the Civil Code. If the debtor subsequently fails to pay the debt, the creditor may sell the movable to collect the debt. Movable that are replaced, such as inventory goods, can also be the object of a mortgage.

Another method of securing claims is through a retention of title (所有権留保 *shoyū-ken ryūho*)<sup>5</sup>. The seller and the buyer of the goods make a covenant in the sales contract that the seller retains ownership of the goods until the buyer pays the seller the full amount of the sales price. At that point, the goods are delivered to the buyer. If the buyer fails to pay the seller the purchase price, the buyer may recover the goods from the seller and sell the goods to collect the debt.

There is no legal provision for either a mortgage or a retention of title. For this reason, the rights and obligations of creditors and debtors have been clarified by case law in only a piecemeal fashion. Thus, when a retention of title and a mortgage are set up on the same movable, the question arises as to which has priority over the other.

Preparations are currently underway to introduce rules into the Civil Code regarding security interests in movables and claims where the object at issue is a movable or a claim, and the issue of how to handle a situation where a retention of title and a mortgage compete is attracting a great deal of attention. This is because the Supreme Court has addressed this issue relatively recently. This paper outlines the case law and the initial steps taken in the revision of the Civil Code.

## II. SUPREME COURT, DECISION OF 7 DECEMBER 2018<sup>6</sup>

### 1. *Summary of the Case*

Y and A entered into an agreement on 10 March 2010 under which Y was to sell scrap metal to A on an ongoing basis. The agreement contained the following provisions.

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4 動産及び債権の譲渡の対抗要件に関する民法の特例等に関する法律 *Dōsan oyobi saiken no jōto no taikō yōken ni kansuru minpō no tokurei-tō ni kansuru hōritsu*, Law No. 104/1998.

5 *Ibid.*, 365.

6 民集 *Minshū* 72, 1044.

- (i) The sales price was to be calculated based on the quantity of goods delivered from the 21<sup>st</sup> of each month to the 20<sup>th</sup> of the following month; A was to pay the invoice amount calculated accordingly on the 10<sup>th</sup> of the following month.
- (ii) A acquired ownership of the goods upon A's full payment of the price.
- (iii) A could also resell goods for which Y still had ownership.

On 11 March 2013, X and A entered into an agreement to transfer ownership of the entire inventory of goods and other property owned by A and stored at A's factory to X in order to secure X's present and future claims regarding loans made to A, satisfying in the process the requirements for perfection of X's rights by way of a constructive transfer with retention of possession by A. The goods and other items in stock which were the object of the contract between X and A included goods sold by Y to A.

A paid for Group  $\alpha$  goods ordered from Y between 20 May 2014 and 10 June 2014, but it did not pay for Group  $\beta$  goods ordered between 21 May and 18 June 2014. In January 2015, Y retrieved Group  $\alpha$  and Group  $\beta$  goods that were stored at A's factory, sold them to B, and retained the proceeds in satisfaction of its initial sale to A. In response, X brought suit, claiming that the sale and purchase contract entered with B as made by Y violated X's right of ownership and that Y was liable for damages in tort (Art. 709).

The first trial court dismissed X's claim. The second trial court granted X's claim only in part. The ownership of the Group  $\alpha$  goods, for which A had already paid the sales price, was transferred to A. Therefore, a transfer of ownership to X by contract between A and X also occurred with respect to the Group  $\alpha$  goods. Y's act of selling the goods group  $\alpha$  to B constituted an infringement of X's ownership rights, and Y was liable for damages caused thereby. However, as to the Group  $\beta$  goods for which A had not paid for, Y still had ownership rights, so Y's sale of them did not result in a violation of X's ownership rights.

X filed a petition for acceptance of appeal, primarily arguing that:

Even if under the terms of the contract Y and A agreed that ownership would be not transferred to A until the full amount of the price is paid (Clause (ii)), legal ownership was in fact transferred to A by the sale, and Y had only a kind of security interest. That is why A could resell the goods to a third party (Clause (iii)). Y acquired a security interest in the goods each time it supplied them to A. Y satisfied the requirements for perfection of the security interest over the Group  $\beta$  goods between 21 May 2014 and 18 June 2014. By contrast, the requirements for perfection of a mortgage in respect of movable objects that are replaced need not be superimposed each time an individual item of movable property joins the object of the mort-

gage.<sup>7</sup> Thus, X also satisfied the requirements for perfection on 11 March 2013 concerning acquisition of the ownership of the Group  $\beta$  goods. Y is liable for damages because Y's act of selling Group  $\beta$  goods to B constituted an infringement of X's ownership rights.

## 2. *Judgment of the Supreme Court*

The Supreme Court did not accept X's argument and upheld the position of the second trial court. Its reasoning was as follows: Clause (ii) provided for Y's retention of ownership of the goods until they were paid in full, in order to secure the payment of the purchase price by A. The ownership of the goods was retained by Y only for a certain period of time, namely until payment of the purchase price. Clause (iii) intended to allow A to set aside capital to pay Y the purchase price. It cannot be considered from that clause that ownership was transferred to A before the payment of the price.

## 3. *Discussion*

The Supreme Court recognized that retention of title has priority over mortgage on the grounds that the mortgage creditor cannot acquire title to property in which ownership is retained by the seller by virtue of a retention of title. However, this judgment is not broadly applicable to cases where there is a conflict between a retention of title and a mortgage. The decision was simply made according to the facts inherent in this particular case.

The Supreme Court notes that Clause (ii) limits the scope of the object of the retention of title and the secured claim. Behind such focus is the idea that there is a great need to protect the seller because of the relationship between the object of the retention of title and the secured claim as consideration. It is suggested that if the claims secured by the retention of title were extended to claims arising from contracts other than a contract of sale (e.g., loan claims), a conclusion different from the one in this judgment would be reached.<sup>8</sup>

Moreover, when an agreement such as Clause (ii) is made, it does not always mean that ownership is retained by the seller. The Supreme Court simply stated that the mere fact that Clause (iii) was agreed upon does not transfer ownership to A; rather, it gave A the power to resell the goods. Depending on the details of the agreement made between the seller and the buyer, such a clause does not exclude the possibility that, as X contended,

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<sup>7</sup> Supreme Court, 10 November 1987, 民集 *Minshū* 41, 1559.

<sup>8</sup> T. IWAKAWA [岩川隆嗣], 判例批評 [Case Study Review], *ジュリスト Jurisuto* 1544 (2020) 69. See also H. TADAKA [田高寛貴], 譲渡担保と所有権留保 [Mortgage and Retention of Title], *法学教室 Hōgaku Kyōshitsu* 424 (2016) 87.

ownership would be transferred to the buyer and only a kind of security interest would be granted to the seller.<sup>9</sup>

Thus, the decision indicates directly only that priority as between a retention of title and a mortgage will depend on what covenants were made by the parties to the sales contract. However, a more general theory can also be read from the text of the judgment. The Supreme Court pointed to the limited scope of the object of the retention of title and the secured claim as reasons for protecting the seller. From this we can see the Supreme Court's position that it will protect the seller if there is no significant deviation from the simplest case of retention of title, i.e., a case in which a covenant of retention of title is provided to secure payment only for the price of the sale of a specific good.<sup>10</sup> What is not clear is at which point a deviation would be deemed as rendering the seller unprotected.

This judgment does not determine priority as between a retention of title and a mortgage based on when the requirements for perfection are satisfied. Thus, according to this judgment, a seller would have priority over the creditor of the mortgage even if a sales agreement with a covenant of retention of title is entered into after the requirements for perfection concerning the mortgage have been satisfied.

The conclusion adopted by this judgment itself is appropriate. Adopting the conclusion that a seller loses the title if a mortgage is later placed on goods in which the seller has retained ownership of the goods is equal to not allowing the seller the means to defend himself. In some cases, the seller may have no choice but to stop supplying goods to the buyer, and the object of the mortgage may be insignificant. Thus, a rule that did not protect the seller could also work against those who wish to secure their claims with a mortgage. The Supreme Court's attitude of trying, in principle, to protect the seller to avoid such a situation can be supported.<sup>11</sup> However, it would also be inappropriate to protect the seller without restriction. This judgment attempts to determine whether or not to protect the seller based on the details of the contract between the seller and the buyer. As already noted, this solution could cause unexpected harm to those who are about to enter into a transaction using a retention of title because it leaves it unclear under what conditions the seller would not be protected. However, since

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9 N. MATSUMOTO [松本展幸], 判例解説 [Case Commentary], 最高裁判所判例解説 民事篇 平成 30 年度 *Saikō Saiban-sho hanrei kaisetsu minji-hen heisei 30-nendo* (2021) 337–338.

10 IWAKAWA, *supra* note 8, 69.

11 K. WADA [和田勝行], 破産・民事再生手続における (第三者) 所有権留保の取り扱いに関する一考察 [A Study on the Handling of Retention of Title in Bankruptcy and Civil Rehabilitation Proceedings], 法学論叢 *Hōgaku Ronsō* 180 (2017) 699.

there are natural limits to solutions not based on statutory law, the solution in this judgment can be evaluated as an unavoidable one.

### III. OPTIONS FOR NEW LEGAL RULES

Movable security interests are currently the subject of discussion in the Ministry of Justice's Legislative Council.<sup>12</sup> There are two basic concepts for the introduction of mortgage and retention of title into the Civil Code. The first concept is that when a contract of mortgage or a contract of sale with a retention of title clause is entered into, it either transfers ownership to the creditor or retains the seller's ownership, while placing appropriate restrictions on the rights and obligations of the creditor or seller and the debtor or buyer (Option-1). The second concept is to realize the benefits of security aimed at by mortgages and retention of title by creating a new security interest (Option-2). According to this latter concept, even if a reservation of title is made, as is the case when a pledge of movable property is established, ownership of the goods is transferred from the seller to the buyer, and the seller acquires only a security interest in the goods.

Option-1 would basically codify the currently unwritten rules, with certain modifications. Option-2 would require a fundamental change in the Civil Code. Deciding whether to follow Option-1 or Option-2 is fundamental to the construction of the system, and this decision has been postponed. This is probably because a final decision need not be made before the time of codification. At present, the consequences of the individual regulations are being considered.

When there is a conflict between a retention of title and a mortgage as to the same movable, how is their ranking determined?

Assuming Option-1, the view of existing case law is basically maintained. It is proposed that the seller has priority over the creditors of the mortgage to the extent that they secured the payment for the goods without specifying satisfaction of any particular requirements for perfection concerning the retention of title (hereafter Option-1-1).

Even assuming Option-1, one could demand that the seller satisfy certain requirements for perfection concerning the retention of title by means of a constructive transfer with retention of possession or by registration (hereafter Option-1-2). This is because it is not impossible, as argued by X at trial, to hold that a reservation of title transfers ownership of the goods to the

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12 [https://www.moj.go.jp/shingi1/housei02\\_003008.html](https://www.moj.go.jp/shingi1/housei02_003008.html). The following descriptions are compiled primarily from the materials of the 4<sup>th</sup> meeting on 13 July 2021 (<https://www.moj.go.jp/content/001353134.pdf>) and the 15<sup>th</sup> meeting on 19 April 2022 (<https://www.moj.go.jp/content/001373103.pdf>).

buyer and establishes a security interest in the seller, and this can be confirmed by legislation. Assuming Option-2, the seller would still be required to satisfy certain elements for perfection by means of a constructive transfer with retention of possession or registration in the same manner as already provided for in the Civil Code for others who acquire a security interest (hereafter Option-2-1).

According to the current framework of the Civil Code, the ranking of competing security interests would, in principle, be determined based on the time when the requirements for perfection were satisfied, regardless of whether Option-1-2 or Option-2-1 is adopted (hereafter Option-1-2-1 and Option-2-1-1 respectively).

On the other hand, the current framework of the Civil Code is not without its problems. Even if delivery is made by a constructive transfer with retention of possession, it is difficult for a third party to recognize this fact, and registration would add to the cost and effort. Therefore, a proposal was made to introduce a new system based on the filing system of Art. 9 of the Uniform Commercial Code and to adopt the principle of determining priority between competing security interests based on the time when the filing is made (hereafter Option-1-2-2 and Option-2-1-2 respectively).<sup>13</sup>

Thus, there are multiple options. It is, however, proposed that an exception with respect to priority between retention of title and mortgage be equally valid as among Option-1-2-1, Option-2-1-1, Option-1-2-2, and Option-2-1-2. The exception is that the seller has priority over the mortgage creditor if the price is secured, if requirements for perfection are satisfied, or if the filing is made before a certain period of time has expired after the delivery of the object of the retention of title. According to this proposal, when a claim other than a claim for payment is also secured by a retention of title, priority as between a retention of title and a mortgage will be determined by the above principle, that is, Option-1-2-1, Option-2-1-1, Option-1-2-2, or Option-2-1-2.<sup>14</sup>

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13 The filing is supposed to be the first step in determining whether there is a third party with an interest in the item that is about to be the object of transaction. Based on the idea that a detailed investigation can be done by means of interviewing the person in possession of the object, only limited matters are to be recorded, such as the name of the person or persons who have acquired the security interest and the person who is subject to the security interest, and the object in question.

14 Revising the content and effect of registration is also being considered. Currently, there are two ways to satisfy the requirement for perfecting the acquisition of a security interest: constructive transfer with retention of possession and registration. There was a proposal to concentrate the solution onto a use of the registry, but this drew opposition. By contrast, still favoured is the proposal that the two methods be allowed to coexist, with a person who has registered his security interest being giv-

#### IV. CONCLUDING REMARKS

Although there are a variety of options for revision, it is expected that each of the options will answer the question regarding a conflict between a retention of title and a mortgage in a manner generally the same as in the case law discussed in this paper. The focus of the discussion is not on the conclusion that should be reached, but on how to reach it. Which option should be adopted? The answer may be determined by reference to peripheral systems not presented in this paper. The chosen proposal may not be theoretically correct or even convenient for the user (a cautious approach is often favoured). Statutes are sometimes the product of compromise. Nevertheless, it can be assumed that there will be reasons underlying the choice that is made. Needless to say, it is important for the future of the Japanese Civil Code, as well as for interested legal professionals in other countries, that the reasons for the choices made be clarified.

Finally, let me briefly indicate my prediction.

Will Option-1 or Option-2 be chosen? Option-2 would not be favoured by those familiar with the current rules on mortgage and retention of title because it would significantly change the current trading order. It is also possible that even if a new security interest is created, it will not be used, and mortgages or agreements on retention of title will be concluded as before. Rather than preparing a provision for such a case, it would be simpler to adopt Option-1, which would make the entire Civil Code more concise. Thus, perhaps Option-1 will be adopted.

The creation of a filing system is an attractive idea because it is expected that it would expand the methods for financial transactions. For example, the seller of a sales contract and the creditor of a mortgage would be able to change their ranking by agreement. However, the structure planned for the filing system has not been fully clarified at this time. Option-1-2-2, which assumes the introduction of a filing system, seems to be the best solution, provided that it is convenient enough for users to accept.

#### SUMMARY

*Japanese business practice has developed two methods to create security interests in movable property without transferring possession. One is a mortgage*

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en priority over a creditor who has merely satisfied the requirement for perfection through a constructive transfer with retention of possession, regardless of when the registration was made. If this proposal is pushed forward and a filing system is introduced, the relationship between filing and registration will also need to be considered.



(譲渡担保 *jōto tanpo*) and the other is a retention of title (所有権留保 *shoyū-ken ryūho*). There is no statutory provision for either mortgage or retention of title. For this reason, the rights and obligations of creditors and debtors have been clarified by case law. An important question is which has priority over the other when a retention of title and a mortgage are set up on the same movable. The author discusses this question by first analysing the decision of Japan's Supreme Court of 7 December 2018. In its decision the Supreme Court recognized that a retention of title has priority over a mortgage. However, the author qualifies the judgment as being not broadly applicable to all cases where there is a conflict between a retention of title and a mortgage because the decision's outcome was shaped by the very specific circumstances of the case.

The second half of the article provides an overview on the current discussion at the Ministry of Justice's Legislative Council regarding security interests in movable property. Two basic concepts for the introduction of mortgage and retention of title into the Civil Code are under consideration. The first concept holds that entering into a contract of mortgage or a contract of sale with a retention of title clause serves to transfer ownership to the creditor or retain the ownership of the seller, while placing appropriate restrictions on the rights and obligations of the creditor or seller and the debtor or buyer. This option would basically codify the current unwritten rules, with certain modifications. The second concept is to realize the benefits of security aimed at by mortgages and retention of title by creating a new security interest by setting up a filing system. This option would require a fundamental change of the Civil Code.

(The editors)

#### ZUSAMMENFASSUNG

Die Praxis hat in Japan zwei Methoden entwickelt, um besitzlose Sicherungsrechte an beweglichen Sachen zu schaffen. Das eine ist die Sicherungsübereignung (譲渡担保 *jōto tanpo*) und das andere ein Zurückbehaltungsrecht (所有権留保 *shoyū-ken ryūho*). Für beide fehlt eine gesetzliche Grundlage. Aus diesem Grund sind die diesbezüglichen Rechte und Pflichten der Gläubiger und der Schuldner von der Rechtsprechung ausgeformt worden. Eine zentrale Frage ist, welches der beiden Sicherungsmittel Vorrang hat, wenn beide bezüglich ein und derselben Sache vereinbart wurden. Der Verfasser diskutiert diese Frage zunächst anhand der Leitentscheidung des Obersten Gerichtshofes vom 7. Dezember 2018. In der Entscheidung hat der Oberste Gerichtshof anerkannt, dass das Zurückbehaltungsrecht Vorrang gegenüber einer Sicherungsübereignung besitzt. Der Autor weist jedoch einschränkend darauf hin, dass diese Entscheidung auf einer besonderen Gestaltung des zugrundeliegenden Sachverhalts beruht.

*Die zweite Hälfte des Beitrages gibt einen Überblick über die aktuelle Diskussion im Legislativausschuss des japanischen Justizministeriums über die Gestaltung von Sicherungsrechten an beweglichen Sachen. Bezüglich der Einführung der Sicherungsübereignung und des Zurückbehaltungsrechts in das Zivilgesetz werden derzeit zwei unterschiedliche Konzepte diskutiert. Das eine Konzept sieht vor, dass ein Vertrag über die Schaffung einer Sicherungsübereignung eine Übertragung des Eigentums auf den Gläubiger bewirkt, während ein Kaufvertrag unter Vereinbarung eines Zurückbehaltungsrechts demgegenüber das Eigentum beim Verkäufer belässt. Für beide Konstellationen werden jeweils entsprechende Beschränkungen hinsichtlich der Ausübung der dadurch geschaffenen Rechtspositionen des Gläubigers oder Verkäufers bzw. Schuldners oder des Schuldners oder Käufers vorgesehen. Dieser Vorschlag würde im Wesentlichen die geltende ungeschriebene Rechtslage mit gewissen Modifikationen kodifizieren. Das andere Konzept stellt die Vorteile in den Vordergrund, die mit der Sicherungsübereignung und dem Zurückbehaltungsrecht verbunden sind, und will auf dieser Grundlage ein neues registrierungsbasiertes Kreditsicherungsinstrument schaffen. Dieser Vorschlag würde eine grundlegende Änderung des Zivilgesetzes voraussetzen.*

*(Die Redaktion)*