

An Inquiry into the Realization Path of the Seller's Right of Reclamation in Bankruptcy Proceedings

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Abstract

Article 388 of the Civil Code introduces the concept of 'other contracts with guarantee functions', placing retention of title sales contracts, financial leasing contracts, and recourse factoring contracts on par with typical guarantee contracts, thereby conferring the effects of guarantee rights on such contracts from the perspective of functionalist legislation. Regarding retention of title contracts, the Civil Code, through Articles 641 and 642, introduces registration against third parties rules and provisions for reference to the enforcement procedures of security interests, effectively treating the seller's retained ownership as a security interest, thereby diminishing the attributive nature of the ownership in the subject matter and substituting it with priority right of satisfaction from the value of the subject matter. The introduction of functionalist legislation has also prompted the Supreme People's Court to conduct certain cleanups and revisions to judicial interpretations during the implementation of the Civil Code. The Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Enterprise Bankruptcy Law of the People's Republic of China (II) (Judicial Interpretation No. 18 of 2020) (hereinafter referred to as the 'Bankruptcy Judicial Interpretation (II)') is also within the scope of modification, with Articles 34 to 38 specifically stipulating the specific rules regarding retention of title in bankruptcy proceedings. However, this modification has not made any substantive changes to retention of title, still regulating it based on the perspective of ownership formation under formalism. This has led to ambiguity in the nature of the seller's rights in bankruptcy proceedings. Furthermore, the uncertainty regarding the nature of the seller's right of reclaim has resulted in its realization path being inconsistent with the legislative stance of the current Civil Code. Specifically, when the seller is bankrupt, it may exercise the right of reclaim under Article 642 of the Civil Code; whereas when the buyer is bankrupt, the right enjoyed by the seller should be a separate right (priority claim).

Keywords

Retention of title; Right of reclamation; Bankruptcy proceedings.

1. Raising of the Question

Within the provisions of the Interpretation II of the Supreme People's Court on Several Issues Concerning the Application of the Enterprise Bankruptcy Law of the People's Republic of China (hereinafter referred to as the "Interpretation II of the Bankruptcy Law"), Article 2 designates property for which ownership has not been transferred as the property of the seller, and systematically establishes a framework for the seller to exercise the right of recovery in bankruptcy proceedings to safeguard its own interests through Articles 34 to 38. Specifically, from a formalist perspective, Interpretation II of the Bankruptcy Law regards a retention-of-title contract as a contract where neither party has fully performed its obligations. When either the buyer or the seller enters bankruptcy liquidation proceedings, the bankruptcy administrator has the discretion to choose whether to continue performing the contract or terminate it. In the event of the buyer's bankruptcy, if the bankruptcy administrator decides to

continue performing the contract, the seller has the right to reclaim the subject matter in accordance with Article 641 of the Civil Code and other relevant provisions when the buyer fails to make timely payment of the purchase price without justifiable cause. At this juncture, regardless of whether the seller's retained ownership has been registered, the seller may exercise the right of recovery to receive priority compensation as long as the buyer engages in specific breaches of contract. This provision inherits from Articles 35 and 36 of the Interpretation of the Supreme People's Court on Issues Concerning the Application of Law in the Trial of Sales Contract Disputes (2012) and affirms, under the formalist doctrine, the seller's ownership of the subject matter in a retention-of-title arrangement.

According to Article 54 of the Judicial Interpretation on Security Interests, if the mortgagee has not completed the registration procedures for the chattel mortgage and the mortgagor subsequently enters bankruptcy, the people's court shall not support the mortgagee's claim for priority repayment from the mortgaged property. Extending this principle to the retention-of-title system, when the buyer enters bankruptcy, only sellers who have registered the retention of title can assert priority over general creditors. In essence, the seller's retained ownership under the Judicial Interpretation on Security Interests constitutes a security interest in rem, which, in the event of the buyer's bankruptcy, precludes the bankruptcy administrator's right to choose whether to perform or terminate the contract, thereby mandating the continuation of the retention-of-title contract. If the bankruptcy administrator fails to perform the contract as agreed, only sellers who have registered the retention of title may exercise the right of recovery to obtain priority repayment from the subject matter. Conversely, sellers who have not registered cannot assert priority over general bankruptcy creditors and may only seek relief through the general bankruptcy claim process.

Based on the aforementioned analysis, under circumstances where the buyer enters bankruptcy, Interpretation II of the Bankruptcy Law still grants the bankruptcy administrator the right to choose whether to perform the contract. However, when the bankruptcy administrator commits specific breaches, such as failing to pay the purchase price as agreed, the seller is entitled to exercise the right of recovery over the subject matter, regardless of whether the retention of title has been registered. In contrast, the Judicial Interpretation on Security Interests stipulates that only sellers who have registered the retention of title may obtain priority repayment through the process of exclusion rights. Under the same circumstances, different judicial interpretations provide entirely distinct remedial paths. The core conflict between these two remedial approaches lies in the fact that both Article 37 of the Judicial Interpretation on Sales Contracts (2012) and Article 643 of the Civil Code provide for the buyer's right of redemption, and the seller's recovery of the subject matter does not constitute a final and absolute entitlement to ownership. Instead, the seller must liquidate the subject matter and distribute the proceeds, with any surplus refunded to the buyer and any deficiency compensated by the seller. However, Interpretation II of the Bankruptcy Law contains no such provisions, implying that once the seller recovers the subject matter, they acquire final and absolute ownership of it, which contradicts the procedural recovery stipulated in civil law. In essence, the seller's retained ownership under civil law does not guarantee the seller's true entitlement to the subject matter but rather serves as a procedural means of realizing security rights or preserving (security value). The buyer retains the right of redemption to regain possession of the subject matter and may claim any residual value after the seller's liquidation. In contrast, under bankruptcy law, once the seller exercises the right of recovery over the subject matter, their ownership becomes final and absolute, and the buyer can no longer exercise any rights over the subject matter. Any payments already made by the buyer for the subject matter can only be redressed through contractual remedies. The two systems diverge in their characterization of the seller's retained ownership: bankruptcy law treats it as a true ownership right, while civil law defines it as a security interest in rem. The

differing nature of these recovery rights offers varying levels of protection to buyers and sellers, necessitating a discussion on the rightful attributes of the seller's retained ownership in bankruptcy proceedings to clarify the appropriate path for exercising the right of recovery under the current legal framework.

2. Clarify the prerequisites for the realization of the seller's right of repossession in bankruptcy proceedings

Article 18 of China's Enterprise Bankruptcy Law stipulates that "After the people's court accepts a bankruptcy application, the administrator has the right to decide whether to terminate or continue to perform a contract that was established before the acceptance of the bankruptcy application and has not been fully performed by both the debtor and the other party, and shall notify the other party." This clause provides rules for the handling of executory contracts in bankruptcy, and the exercise of the administrator's option right is targeted at executory contracts. Therefore, it is necessary to clarify what an executory contract is. China's bankruptcy law does not use the term "executory contract" but instead describes it as "both parties have not fully performed their obligations," which is the same as the provisions in German and Japanese laws.

American scholar Countryman believes that an executory contract refers to a contract in which neither the bankrupt party nor the other party has fully performed their contractual obligations and, on this basis, can constitute a material breach of contract. This standard of material breach is widely cited, and contracts that have been fully performed or almost fully performed do not fall within the scope of "executory contracts." However, this does not exclude the possibility that in practice, some courts use a result-oriented criterion for judgment. If treating a contract as an executory contract would produce the results presupposed by the legislature, then the contract is considered an executory contract; otherwise, it is not. From the perspective of China's Enterprise Bankruptcy Law, the "not fully performed" standard is adopted.

Specifically, in the context of retention of title, both the buyer and the seller have not fully performed their contractual obligations during the retention of title period. The buyer has not fully paid the contract price during this period. Although the seller has actually delivered the subject matter to the buyer, before the buyer pays off the price of the subject matter, the buyer only acquires the rights of possession, use, and benefit of the subject matter, and the occurrence of property rights transfer is subject to the buyer's payment being deferred. Therefore, at this time, the seller has the obligation under the sales contract to enable the buyer to fully acquire complete ownership, and thus the obligation of property rights transfer has not been fully performed. The Supreme People's Court holds this view, believing that when the buyer's price has not been fully paid or other conditions agreed upon between the two parties have not been met in a retention of title contract, ownership has not been transferred, so it belongs to a contract where both parties have not fully performed their obligations. On this basis, when either the buyer or the seller enters bankruptcy proceedings, the bankruptcy administrator of that party has the right to choose to terminate the contract or continue to perform it. It is not difficult to see that this is based on a formalist stance to determine that ownership has not been transferred before the conditions are met, and thus the seller's obligations have naturally not been fully performed.

The core view of this article is to regulate retention of title sales contracts from a functionalist perspective and treat the retention of title system under the theory of the constitution of security interests. On this basis, by referring to the provisions of Articles 641, 642, and 414 of the Civil Code, the mode of property rights transfer in retention of title sales is reconstructed. That is, in a retention of title transaction, the right retained by the seller is not strictly ownership but a downgraded security interest. When the seller delivers the subject matter to

the buyer, ownership of the subject matter has been transferred, and the seller has fully performed the main performance obligation under the sales contract. At the same time, the retention clause uses the subject matter to secure the realization of the seller's price claim, so the buyer has the obligation to perform the security agreement and return the subject matter to the seller. Under this mode, the mode of property rights transfer in retention of title has actually become a structure of "sales contract + security agreement." Since the seller retains a security interest rather than ownership, the seller has fully performed the main performance obligation under the sales contract after delivering the subject matter, and the retention of title contract between the buyer and the seller naturally does not belong to a "contract where both parties have not fully performed their obligations." According to China's laws, a security contract refers to an agreement reached among the creditor, the debtor, and a third party that the guarantor shall perform the debt to the secured creditor, i.e., the creditor, when the debtor fails or is unable to perform the debt to ensure the realization of the creditor's rights. In this contract, only the guarantor has performance obligations, while the creditor has no performance obligations. Therefore, a security contract is a unilateral contract and naturally does not constitute an "executory contract" based on a bilateral contract as stipulated in Article 18 of the Enterprise Bankruptcy Law. Thus, the retention of title contract itself does not belong to a contract where both parties have not fully performed their obligations, and the seller does not need to undertake other performance obligations due to the security interest it retains. Therefore, under the theory of the constitution of security interests, a retention of title contract does not belong to an "executory contract" under bankruptcy law.

Of course, regarding the mode of property rights transfer in a retention of title contract under the theory of the constitution of security interests as a structure of "sales contract + security agreement," some scholars have raised doubts. They argue that although Article 388 of the Civil Code includes retention of title contracts within the scope of "other contracts with security functions," this does not mean that retention of title contracts have already become a type of security contract. Because according to the provisions of Article 388, Paragraph 1, there should be a principal contract in addition to the security contract, and the security contract is a subordinate contract to the principal contract. However, in a retention of title contract, the buyer and the seller only sign one sales contract, and the ownership retained by the seller is merely a transaction structure "embedded" in the secured creditor's rights and does not have subordination, so it does not conform to the external form of a principal contract and a subordinate contract. When brought into bankruptcy proceedings, the retention of title contract cannot be characterized as a security contract and thus cannot exclude the application of the rules regarding executory contracts in bankruptcy law.

The above-mentioned doubts have their rationality, but when understanding security contracts, one should focus on their essential connotations rather than their external forms. In the context of property security, compared with the principal contract, what is more normatively significant is the creditor's rights generated by the principal contract rather than the principal contract itself. The object of security is the creditor's rights of the creditor, not the principal contract. Therefore, what truly plays a security role is not the principal contract but the security right. The reason why the security interest holder can have priority over other general creditors in repayment is due to the real right effect of the security interest, not the contractual effect of the security contract. The subordination of a security contract is subordination to the principal creditor's rights, not to the security contract itself. Although a retention of title sales contract only has a sales contract and no subordinate security contract, its substantive security function meets the core characteristic of a security contract being subordinate to the principal creditor's rights. The seller's price claim is the principal creditor's rights, and the ownership it retains is (substantially) a security interest. Thus, the view that a retention of title contract cannot exclude the application of the rules regarding executory contracts in bankruptcy law due to its

lack of the form of a security contract cannot hold water, and it can be concluded that a retention of title sales contract does not belong to an "executory contract" under bankruptcy law.

3. The Normative Path for the Realization of the Seller's Right of Reclamation When the Seller is Bankrupt

Based on the above analysis, in bankruptcy proceedings, the seller's right of retrieval can be exercised in accordance with the Civil Code and the Judicial Interpretation on Security Systems, or in accordance with the Judicial Interpretation (II) of the Bankruptcy Law. The legal effects of exercising the right of retrieval under different legal bases vary. However, this paper argues for constructing the system of retention of title based on the theory of security interests. Under this theory, a retention of title contract does not fall within the category of executory contracts under bankruptcy law. Consequently, the relevant provisions of the Judicial Interpretation (II) of the Bankruptcy Law, which are predicated on the theory of ownership constitution, are no longer applicable. The nature of the power retained by the seller should be recognized as a security interest. Therefore, in bankruptcy proceedings, the nature of the seller's exercise of the right of retrieval should also be recognized as a separate right (priority claim), and on this basis, a system of rules for the realization of the seller's right of retrieval in retention of title contracts within bankruptcy proceedings should be established.

3.1. When the seller is bankrupt, the right of reclamation may be exercised in accordance with Article 642 of the Civil Code

After the seller enters bankruptcy proceedings, the retention of title contract at this time no longer qualifies as an executory contract. Correspondingly, the bankruptcy administrator of the seller no longer has the option right and cannot choose to terminate the contract but can only continue to perform the sales contract.

Firstly, upon the seller's entry into bankruptcy proceedings, the acceleration of debt maturity system does not apply, and both the buyer and the seller should continue to perform the retention of title sales contract. However, if, during the performance process, the buyer fails to pay the contract price as agreed or engages in other actions that harm the seller's interests, the bankruptcy administrator may exercise the right of retrieval of the subject matter in accordance with Article 642 of the Civil Code, which is also the optimal means to safeguard the seller's interests. If the seller is unable to retrieve the subject matter, it may request the buyer to continue fulfilling obligations such as the payment of the contract price as stipulated in the contract. The provisions of Article 35, Paragraph 3, of the Judicial Interpretation (II) of the Bankruptcy Law can still be applied accordingly.

Secondly, regarding the legal consequences after the seller's bankruptcy administrator retrieves the subject matter, the buyer may exercise the right of redemption within a reasonable redemption period in accordance with Article 643 of the Civil Code. In other words, the seller's right of retrieval is procedural rather than final. If the buyer clearly indicates that it will not redeem within the redemption period or fails to redeem after the expiration of the redemption period, the seller has the right of resale and shall, after liquidating the proceeds from the resale, "refund the excess or demand payment of the deficiency."

3.2. The Impact of Unregistered Retention of Ownership on the Seller's Right of Reclaiming Goods

Subsequently, the issue that needs to be addressed is whether the exercise of the seller's right of retrieval is contingent upon the registration of the retention of title. This paper posits that the retained ownership by the seller essentially constitutes a security interest. Even if such retained ownership is not registered, it still qualifies as a real right, albeit with certain limitations in its effectiveness. Therefore, in scenarios involving only the seller and the buyer,

if the buyer defaults by failing to pay the price or fulfill specific conditions stipulated in the contract, it is reasonable to acknowledge that the seller can liquidate the subject matter to receive compensation, which is inherent in the real right of control. The effective exercise of the seller's right of retrieval serves as a means to exercise this right of liquidation and should not be precluded due to the non-registration of the retention of title, thereby denying the seller a legitimate means of safeguarding its rights.

When, in addition to the buyer and seller, there exist general creditors of the buyer, since these creditors, as general creditors, possess a claim right that cannot dominate the subject matter serving as security property, their claim right does not operate on the same level as the seller's priority right to be compensated from the security property, which is a real right of control over the subject matter. Consequently, prior to the initiation of compulsory enforcement proceedings, other general creditors cannot exercise rights over the subject matter and thus cannot engage in a dispute over real rights with the seller. Conversely, if the buyer's other creditors have already subjected the subject matter to seizure or attachment through compulsory enforcement proceedings, these other general creditors of the buyer also gain the right to exercise rights over the subject matter, creating a conflict with the seller's right of retrieval. In such cases, the unregistered ownership cannot prevail against them. The specific order of repayment should be determined in accordance with the relevant provisions of Article 54 of the Judicial Interpretation on Security Interests.

Finally, regarding the restrictive conditions for the exercise of the seller's right of retrieval as stipulated in Article 35, Paragraph 2, of the Judicial Interpretation (II) of the Bankruptcy Law—namely, that the buyer has paid more than 75% of the price of the subject matter and that a third party has acquired the subject matter in good faith—these restrictive conditions are consistent with those discussed above concerning the exercise of the seller's right of retrieval. As the analysis above has demonstrated that these restrictive conditions lack legitimacy, they should consistently be excluded in bankruptcy proceedings.

4. The Prescriptive Path for the Seller's Right of Reclamation When the Buyer Bankrupts

4.1. Acceleration of Claims and Non-Individual Satisfaction

Upon the buyer's bankruptcy, in accordance with Article 46 of the Enterprise Bankruptcy Law (which stipulates that unmaturing claims shall be deemed due upon the acceptance of the bankruptcy application), the buyer's term interests are extinguished. Even if the debtor's performance period has not yet expired, its debts accelerate to maturity, and its bankruptcy administrator should promptly fulfill obligations such as price payment to the seller. However, when the bankruptcy administrator fulfills the price payment, based on the principle of equality of bankruptcy claims, it should be premised on not constituting individual debt repayment.

Article 16 of the Enterprise Bankruptcy Law provides that any debt repayment by the debtor to individual creditors after the acceptance of a bankruptcy application is invalid. The purpose of converting individual repayments into collective repayments and then conducting fair repayment according to the nature and proportion of claims is to ensure that creditors receive fair compensation when the debtor is insolvent. Nevertheless, Article 14 of the Judicial Interpretation (II) of the Bankruptcy Law also stipulates an exception to the principle of prohibiting individual repayments. Specifically, if the debtor has established a security interest in its own property for the benefit of a creditor, then as long as the repayment is made to the creditor within the value range of the collateral at the time of repayment, such individual repayment by the debtor is not subject to the constraints of Article 16 of the Enterprise Bankruptcy Law, except when the value of the collateral at the time of debt repayment is lower than the amount of the claim.

When applied to retention of title transactions, since the seller retains a security interest in the subject matter, if the value of the subject matter can secure the claim at the time of the buyer's bankruptcy (i.e., the value of the subject matter is not lower than the amount of the creditor's claim), the buyer's bankruptcy administrator may fulfill the obligation to repay the debt to the seller. This is because, in bankruptcy proceedings, creditors with real rights in security interests inherently possess the right to priority repayment. In the context of retention of title under the theory of security interests, the ownership retained by the seller is essentially a security interest, and the seller's position is equivalent to that of a secured creditor. Therefore, once the buyer has fulfilled its obligation to repay the price to the seller, it can acquire ownership of the subject matter free from any encumbrances. Consequently, the subject matter, as the buyer's property, can naturally be used to repay the claims of other general creditors based on its value. From this perspective, this arrangement does not conflict with the principle of fair repayment.

4.2. When the buyer is bankrupt, the seller only has the right of separate enforcement

In the event of the buyer's bankruptcy, the most crucial issue lies in whether the seller can retrieve the subject matter if the buyer's bankruptcy administrator fails to fulfill obligations such as price payment, thereby damaging the seller's interests. From the aforementioned analysis of the nature of the seller's rights in bankruptcy proceedings, under the overarching functionalist approach adopted by the Civil Code, the seller's rights essentially constitute a security interest, and thus should also be characterized as a right of exclusion in bankruptcy proceedings. However, Article 37 of the Judicial Interpretation (II) of the Bankruptcy Law stipulates that when the buyer defaults, the seller may retrieve the subject matter in accordance with Article 642 of the Civil Code to safeguard its own interests. At this juncture, it is necessary to reasonably explain the relationship between the two and the interplay between the right of retrieval under civil law and the right of exclusion under bankruptcy law.

Regarding this relationship, some argue that Article 642 of the Civil Code serves as the basis for the seller's right of retrieval in bankruptcy, while the formal basis for exercising this right lies in Article 38 of the Enterprise Bankruptcy Law. This perspective clearly addresses the seller's right of retrieval in the context of the buyer's bankruptcy under the theory of ownership constitution. However, as this paper has already elucidated its stance above, under the theory of security interest constitution, Article 642 of the Civil Code should serve as the basis for the seller to exercise its right of exclusion rather than its right of retrieval. Article 109 of the Enterprise Bankruptcy Law defines the right of exclusion, which refers to the creditor's right to prior repayment from the specific property on which a security interest has been established in the debtor's property before the commencement of bankruptcy proceedings. Fundamentally, it pertains to the application of security interests and other statutory priority rights in bankruptcy law. The retained ownership by the seller essentially constitutes a security interest and can form the underlying right for the right of exclusion. Therefore, the seller's right of retrieval stipulated in Article 642 of the Civil Code and the seller's right of exclusion in bankruptcy proceedings are essentially the same. When the buyer exhibits the default scenarios outlined in Article 642 of the Civil Code, if the buyer has not entered bankruptcy proceedings, the seller can safeguard its interests by retrieving the subject matter. Furthermore, if the buyer redeems the subject matter within a reasonable redemption period, the seller can resell the subject matter and conduct a (liquidation) to "refund the excess or demand payment of the deficiency" based on the proceeds from the resale. Conversely, when the buyer enters bankruptcy proceedings, the seller can seek redress for its interests by exercising its right of exclusion, thereby effectively realizing its claim for the price. Thus, concerning the seller's retained ownership, the right of retrieval and the right of exclusion merely represent different avenues for exercise in distinct proceedings.

4.3. Unregistered retention of ownership shall not be opposed to other general creditors in bankruptcy

In the context of bankruptcy proceedings, if ownership retention is not registered, the seller's claim for the purchase price can no longer take precedence over other general creditors. According to Article 54 of the Judicial Interpretation on Security Interests, if the mortgagor goes bankrupt, the court shall not support the claim of an unregistered mortgagee for priority repayment from the mortgaged property. Unregistered chattel mortgages also cannot take precedence over bankruptcy creditors. Based on the discussion in this paper, unregistered ownership retention similarly cannot take precedence over general bankruptcy creditors. The right of exclusion, as a preferential right of repayment for the seller, inherently signifies the ability to take precedence over general bankruptcy creditors. Therefore, only when ownership retention is registered can the seller's retained ownership take precedence over general bankruptcy creditors, enabling the seller to exercise the right of exclusion for preferential repayment. If ownership retention is not registered, it cannot take precedence over general bankruptcy creditors, and the seller's claim for the purchase price must be treated as a general claim and settled equally with other ordinary bankruptcy creditors in proportion to their claims. In substantive law, if the seller and the buyer reach a mutual agreement, the seller may retrieve the subject matter and then resell or discount it at a reasonable price, with the proceeds being settled through a "refund the excess or demand payment of the deficiency" mechanism. If no agreement is reached, the seller may request that the procedures for realizing security interests be followed to safeguard its rights. In this case, the seller's retrieval and subsequent sale or discounting of the subject matter have the same legal effect as the auction or sale procedures under security interest realization. Given the principle that bankruptcy law respects substantive law, the same logic should be applied in procedural rules under bankruptcy law: a seller who has registered ownership retention can naturally exercise the right of exclusion for preferential repayment from the subject matter. However, if the seller and the buyer's bankruptcy administrator reach a mutual agreement, the seller may retrieve the subject matter and resell it at a reasonable price, with the proceeds being disposed of and settled to enhance the efficiency of bankruptcy proceedings.

In summary, if the seller goes bankrupt and the ownership retention contract does not fall under the category of an executory contract, the acceleration of debt maturity does not apply, and both parties should continue to perform the ownership retention contract. However, if, during performance, the buyer fails to pay the contract price as agreed or engages in other actions that harm the seller's interests, the bankruptcy administrator may exercise the right of retrieval over the subject matter in accordance with Article 642 of the Civil Code. In the event of the buyer's bankruptcy, the seller's rights under bankruptcy law should be characterized as the right of exclusion. Firstly, because respecting non-bankruptcy law norms is a fundamental principle of bankruptcy law. Secondly, in substantive law, the seller under ownership retention actually holds a security interest, and thus, the seller's rights under bankruptcy law should be the right of exclusion. Furthermore, Article 109 of the Enterprise Bankruptcy Law stipulates that the basis for the right of exclusion in bankruptcy is the creditor's security interest in the debtor's specific property. This provision only excludes guarantees from the basis of the right of exclusion but does not exclude other rights with security functions. Therefore, since the seller holds a security interest in the subject matter under ownership retention, this naturally serves as the basis for the seller to exercise the right of exclusion.

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