A Comparative Analysis of Good Faith Purchase

Alan Schwartz[*] *and Robert E. Scott*[**]

Abstract

What follows is the substantive portion of a paper that analyzes the law of good faith purchase in a new way. Good faith purchase questions have occupied courts and commentators for centuries. We argue that prior treatments have misconceived the economic problem. An owner of goods will take optimal precautions to prevent theft if she is faced with the loss of her goods; and a purchaser will make an optimal investigation into his seller's title if the purchaser is faced with the loss of the goods. An owner and a buyer cannot both be faced with the full loss, however. The good faith purchase question thus presents a problem of "double marginalization"; and as with these problems generally, it cannot be solved in a first best efficient way. Current law, however, is less efficient than it could be. Under it, an owner always can recover stolen goods, which reduces her incentive to take optimal precautions but creates first best incentives to search for stolen goods. A buyer makes a suboptimal investigation into title because the owner may never find him. We propose that the owner should be permitted to retain goods only if she satisfies a negligence standard set at the socially optimal precaution level (which we argue is feasible). This would increase her incentive to take precautions while retaining her efficient incentive to search. Since owner search and buyer investigation are complements, our proposal retains the buyer's (suboptimal) incentive to investigate. Also under current law, an owner who voluntarily parts with her goods cannot recover them from a good faith purchaser. This rule reduces the owner's incentive to search and so reduces the buyer's incentive to investigate. Thus, we propose that a negligence standard should apply to owners generally. The remainder of the paper will analyze the law elsewhere in the hope of developing a generally applicable solution. This is an important issue since today many stolen goods cross national borders.

Part 1. Introduction.

The relative rights of an owner of stolen or misappropriated goods and a purchaser of them have occupied courts and commentators for centuries. The subject remains topical, with property theft apparently on the rise, and there is no widely accepted solution. Good faith purchase issues, as we show, raise a "double marginalization" problem: the owner will take

---

[*]Sterling Professor of Law, Yale Law School; Professor, Yale School of Management.

[**]Alfred McCormack Professor of law, Columbia Law School; Director, Center for Contract and Economic Organization, Columbia University.

optimal precautions against theft if she has no legal right to recover stolen or misappropriated goods, and the ultimate purchaser will take optimal precautions if he has no right to retain goods with a defective title. The owner and the ultimate purchaser cannot lose simultaneously, however. As has been shown in other contexts, there is no “first best” efficient solution to double marginalization problems.[1] We propose a solution with two features: the first is novel in this context; the second would modify U.S. law: a) The owner can recover her goods from the ultimate purchaser only if she chose an efficient – i.e., a non-negligent – precaution level. This reform, if it could be implemented, would improve the owner’s incentive to take precautions without worsening her incentive to search for stolen goods. b) Improving the ultimate purchaser’s incentives is more difficult. The current distinction in U.S. law [2] between a thief’s void title – the owner always recovers the goods – and the thief’s voidable title – the owner loses to a good faith purchaser – should be abandoned. The owner should win unless he is negligent.; We argue that the economically grounded reforms we propose are consistent with current notions of the rights of property owners and with a philosophical analysis of the issue. We test our proposal by undertaking a comparative evaluation of the good faith purchase rules adopted by other Western states. We conclude that our proposed reforms should work in these jurisdictions because the economies of these states are relevantly the same as the United States.

Part 2 sets out a model of the good faith purchase problem. Part 3 solves the model for stolen goods and Part 4 solves the model for misappropriated goods. Part 5 is a normative analysis of the various laws regarding good faith purchase, beginning with the Uniform Commercial Code that is United States law. Part 6 concludes.

[1]We later show the inefficiency of having stolen or misappropriated goods escheat to the state.

[2] See Uniform Commercial Code § 2-403.

Part 2. A Model.[3]

There are four possible players: an owner of goods; a thief; sometimes a dealer; and an ultimate purchaser ("the buyer"). The owner can take precautions to prevent theft. The dealer and the buyer can take precautions to ensure that they are not buying stolen or misappropriated goods. We initially assume that U.S. law applies: The owner is entitle to recover stolen goods, but the owner cannot recover goods that he voluntarily transferred to a miscreant if the goods reach a buyer who purchased in good faith.[4]

Before reaching the analysis, we make two important assumptions. First, the owner takes the level of policing as given. When policing is extensive, she spends less on precaution, and conversely. The owner cannot affect society's choice of a police level, however. Second, we can focus largely on owners and buyers even when a solvent dealer exists in the chain of sales. If the owner recovers the goods from a buyer who is not a dealer, the buyer sues the dealer for breach of a title warranty. If the dealer had disclaimed this warranty, the price of his goods falls in the amount (approximately) of the risk. If the owner cannot recover from a buyer who is not a dealer, she sues the dealer for conversion. Hence, a dealer whom the owner finds will lose the goods' value to someone. The dealer, that is, either assumes the role of an owner, if the buyer loses, or the role of a buyer, if the owner loses.[5] Thus, we restrict our analysis primarily to owners and buyers.

---

[3]Our model is similar to the model in William Landes and Richard A. Posner, "The Economics of Legal Disputes Over the Ownership of Works of Art and Other Collectibles", in Essays in the Economics of the Arts (V.A. Ginsburgh and P.M Menger, Eds. 1996). Relevant differences are noted later.

[4]The theft rule is anapplication of the fundamental common law principle of *nemo dat quod non habet* -- one cannot convey greater rights in property than one has. It would apply to sales transactions via UCC §1-103. The rights of goof faith purchasers when the goods have been voluntarily transferred to a miscreant are embodied in UCC §2-403(1) & (2).

[5]Much prior analysis overlooks the possibility that owners can sue dealers for conversion. A notable exception is Hanoch Dagan, "The Market Overt as Insurance" (200-) (In Hebrew, English translation on request).

Turning to the model, the owner's precaution cost is c. The probability that the owner's precautions prevent theft is p(c). The owner values the goods in his possession at v_o. If there is a theft and the goods are found, the value of returned goods to him is v_r. We make no assumptions as to the relative magnitudes of v_o and v_r. Some goods may rise in value even given theft while others may fall in value due to later use or abuse. In actual cases, owners will attempt to recover valuable stolen goods so v_r should be nontrivial. An owner sometimes can increase the probability of recovering stolen goods, say by registering them if a registry exists, or tagging them electronically and the like.[6] Once goods are stolen, the owner can search, notify the authorities, put ads in the newspaper, etc. All of these costs of attempting to recover stolen goods are denoted z; the probability that the owner recovers the goods is x(z).

The buyer and dealer can investigate to ensure that their seller can convey a good title. We focus on the buyer initially, and let his investigation cost be w. The probability that the buyer gets good title is g(w). A buyer who lacks good title can retain the goods if the owner does not find him. Thus, the probability that the buyer keeps the goods is g(w) + (1 - g(w))(1 - x(z)). The first term is the probability that the buyer's precautions ensured a good title; the second term is probability that his title is bad times the probability that the owner never finds him. The buyer values the goods at v_b. When the buyer loses the goods to the owner, his payoff is assumed to be zero.

Regarding the relationships among these variables, the owner's incentive to invest in theft protection and the buyer's investment in getting good title are (weak) substitutes. The more the owner invests in precaution, the smaller is the pool of stolen goods in commerce, so the lower is the investigation level it is optimal for buyers to choose. Similarly, the more the buyer invests in precaution, the more difficult it is for thieves to sell stolen goods, so the lower is the

[6]Lojack is an electronic tag.

precaution level it is optimal for owners to choose. On the other hand, the owner's incentive to search once goods are stolen and the buyer's incentive to ensure good title, we argue, are complements. Since search increases the probability that stolen goods are found, buyer investments in ensuring good title become more productive as owner search increases.

Part 3. Stolen Goods.

3.1 Social Welfare

Society, we assume, prefers to deter theft. Beginning with the owner, suppose the probability that she can recover stolen goods is zero. Then, she can only attempt to prevent theft. Her gain from ownership is the expected value of retaining the goods less the cost of precaution. Her problem is to choose a precaution level that maximizes this gain.

$$\text{Max}_c\,(p(c))v_o - c$$

Her first order condition is

$$(1)\quad p'(c)v_o = 1$$

The left hand side of (1) is the marginal gain from precaution and the right hand side is the marginal cost. As these equate, the owner chooses the first best precaution level.

Turning to the buyer, let the probability that the owner recovers stolen goods be one. Then the buyer can only attempt to acquire good title initially. His gain from possession becomes the expected value of retaining the goods less his investigation cost. His problem is to choose an investigation level that maximizes this gain.

$$\text{Max}_w\, g(w)v_b - w$$

His first order condition is

$$(2)\; g'(w)v_b = 1$$

The left hand side of two is the buyer's marginal gain from keeping the goods and the right hand side is the marginal cost. Since these equate, the buyer chooses the first best investigation level.

There is a legal problem because global first best efficiency is impossible: the probability that the owner recovers stolen goods cannot be both zero and one. As the probability that the owner can recover the goods increases above zero, her incentive to prevent theft falls. On the other hand, as the owner's probability of recovery increases, the buyer's probability of retaining the goods falls, so his incentive to take precautions increases.[7]

*3.2 The parties' actual optimization problem*s

When goods are stolen, the owner can recover them from a good faith purchaser. As a consequence, the owner has two goals: to reduce the probability of theft and to increase the probability that she can recover stolen goods. Her gain from ownership now is the expected value of retaining the goods less her precaution cost plus the expected value of recovering goods that are stolen less the cost of searching for them. She therefore must choose both a precaution level and a search level. Since she does not search unless goods are stolen, she maximizes

$$\text{Max}_{c,z}\ p(c)v_o + (1 - p(c))[x(z)v_r - z] - c$$

The first term is the expected value to the owner of foiling theft (the probability of keeping the goods times their value). The second term is the expected value of recovering stolen goods, valued at v_r, less the cost of searching. The last term is the owner's precaution cost.

The owner has two first order conditions:

$$(3)\ p'(c)\{v_o - [(x(z)v_r + z]\} = 1$$

$$(4)\quad x'(z)v_r = 1$$

Because the bracketed term in Expression (3) is positive, the left hand side of (3) is smaller than the left hand side of Expression 1. The owner chooses a suboptimal precaution level because she

[7]3.Landes and Posner's excellent analysis of the art market omits dealers, and assumes that the owner can recover stolen art with certainty, the owner and the buyer place the same value on stolen goods, the buyer attempts to conceal his possession, and parties function under some legal uncertainty. These assumptions are plausible for the art market but not generally so we do not make them. Also, because Landes and Posner focus on this market, they do not attempt to derive generally applicable legal reforms nor do they make a comparative law analysis.

may recover the goods. Expression (4) shows that after theft occurs, the owner invests optimally in recovering stolen goods. This is because she keeps any goods she finds.

The buyer's gain from ownership now is the expected value of the goods to him if he gets a good title or if he does not but the owner never locates the goods. He maximizes

$$v_b[g(w) + (1 - g(w))(1 - x(z)] - w$$

The first probability term in brackets is the probability that the buyer purchases a good title; the second term is the probability that he did not but is never found. The buyer's first order condition is

$$(5) \quad g'(w)v_b(x(z)) = 1$$

When x(z), the probability that the owner finds the buyer, equals one, Expression (5) reduces to Expression (2): the buyer takes optimal precautions. As x(z) falls, the buyer reduces his precaution level below the social optimum. The buyer tempers his precautions because the owner may never find him. We summarize this reasoning in

<u>Proposition One: When the owner can recover stolen goods, she takes suboptimal precautions to prevent theft but searches optimally for stolen goods; the buyer take suboptimal precautions to ensure that he receives a good title.</u>

Remark 1: The buyer's precaution level is increasing in x(z) – the probability that the owner finds the goods.[8] Hence, owner search and buyer precaution are complements: as the owner increases search, buyer precautions to ensure good title become more productive.

Remark 2: The owner's incentive to take precautions can be increased to first best if stolen goods escheat to the state when they are found. This possible reform is questionable on two grounds. First, the reform eliminates the owner's incentive to search for stolen goods, and

[8] See Expression (5).

thereby reduces the buyer's incentive to take precautions. Second, strongly held intuitions regarding property rights hold that an owner should not lose his goods when he was not at fault.

Remark 3: When the possessor of stolen goods is not a dealer, the presence of a solvent dealer in the chain of sales may worsen the owner's incentive to take precautions. To see why, assume that the value of returned goods to the owner exceeds their original value ($v_r > v_o$). Then the owner will recover the goods from the possessor. When the value of returned goods is less than their original value to the owner, she will sue the dealer for the original value. Unless the dealer could show that the goods he sold were worth materially less than their original value, the dealer's presence puts a floor under the owner's loss from theft. This reduces her incentive to take precautions.[9] A solution to this concern would be to bar suits against dealers when owners can locate the goods.

Part 4. Voidable Title.

A transferee receives a voidable title if the owner "delivered [the goods] under a transaction of purchase."[10] A party with voidable title can convey a good title to a good faith purchaser for value.[11] The owner thus may be unable to recover goods that her initial transferee misappropriated.

4.1 The owner

The voidable title rule increases the owner's incentive to take precautions, because he is less likely to recover the goods, but decreases the owner's incentive to search for the same

[9]Formally, if v_o is substituted for v_r in Expression (3), the left hand side falls; it becomes privately optimal for the owner to choose a lower precaution level.

[10]UCC §2-403(1).

[11]Id.

reason. Formally, the probability that the owner can recover the goods is the product of the probability that he finds them times the probability that the buyer lacked good faith in purchasing them. We let g(e) be the probability that the buyer, at cost e, purchased in good faith. Then the probability that the owner can recover the goods is $x_r = x(z)(1 - g(e))$. The owner cannot take goods back if he does not find them, so the return probability continues to increase in z, the owner's search expenditure. On the other hand, as g(e) – the probability that the buyer was a good faith purchaser – increases, the return probability falls. Since this probability is unlikely to be zero, $x_r < x(z)$.

When x_r is substituted for x(z) in Expression (3), the left hand side increases, showing that the owner's precaution level increases. When x_r is substituted for x(z) in Expression (4), the left hand side falls, showing that the owner searches less for stolen goods. Since the owner searches optimally when he can recover any goods he finds, it is inefficient to reduce his search intensity. In sum, the voidable title rule reduces the owner's precaution inefficiency but creates a search inefficiency.

4.2 The buyer

The buyer now keeps the goods if he is found to be in good faith, with probability g(e), or if he is not but the owner does not find him. Thus, the buyer chooses his good faith precaution level to maximize

$$v_b[g(e) + (1 - g(e)(1 - x_r\ ] - e.$$

The first term in brackets is the probability that the buyer's efforts resulted in his receiving a good title; the second term is the probability that his title is bad but the owner does not find him.

The buyer's first order condition is

$$(6)\ g'(e)v_b x_r = 1$$

Comparing Expressions (5) and (6), the buyer takes fewer precautions under the voidable title rule than under the theft rule because x_r, the probability that the owner finds him, is lower under the voidable title rule than under the theft rule. The buyer also takes fewer precautions if $g'(e) < g(w)$. Regarding the second factor, the voidable title rule worsens the buyer's incentives if it costs the buyer less to appear to be acting in good faith than actually to ensure himself a good title. Section 1-201(20) of the UCC defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing." The comment to this section suggests that good faith requires less of the buyer than a good care standard: "'fair dealing' ... is concerned with the fairness of conduct rather than the care with which an act is performed. This is an entirely different concept than whether a person exercised ordinary care in conducting a transaction."[12] On this view of the good faith requirement, the voidable title rule worsens the buyer's incentives for two reasons: the owner is less likely to find him and it costs him less to appear in good faith than to ensure good title. We summarize this reasoning in

<u>Proposition Two: The voidable title rule increases an owner's incentive to invest optimally in precautions to prevent theft but worsens the owner's incentive to search for stolen goods. The rule worsens the buyer's incentive to ensure that he has good title.</u>

Remark 4: The question is whether the gain in increasing the owner's precaution level overcomes the two inefficiencies the rule creates. This question cannot be answered a priori. Plausible speculation suggests that the answer is negative. The owner, in the circumstances we analyze, has "delivered the goods under a transaction of purchase." This suggests that her transferee appeared to be commercially above board, so the voidable title rule is unlikely to cause her to increase her precaution level materially. The transferee misappropriated the goods, however. As a consequence, the chance that the buyer purchased them in an outlet from which such goods are normally sold is substantially less than one. On this view, it is important not to

[12] UCC §1-201(20) Comment.

reduce the owner's incentive to search and the buyer's incentive to check his seller's title or to get a warranty.

4.3 Entrusting

An owner who entrusts his goods "to a merchant who deals in goods of that kind" cannot recover the goods from a buyer who purchased them "in the ordinary course of business."[13] An "ordinary course" purchase is from a "merchant who deals in goods of that kind."[14] The principal efficient precaution open to many buyers is to purchase from apparently reputable merchants. Thus, the entrusting rule protects buyers who have behaved almost optimally and (perhaps slightly) increases the owner's incentive to take precautions. The rule seems efficient all in all.

Part 5: Law Reform and Comparative Law

5.1 The United States

Under U.S. law concerning stolen goods the owner chooses an inefficiently low precaution level to protect against theft, because she may recover stolen goods, and the buyer chooses an inefficiently low investigation level to ensure that he has good title because the owner may never find him. The owner searches optimally for stolen goods because she can keep whatever she finds. We suggest that the owner's incentives can be improved under a negligence rule, that permits her to recover the goods only if she invested efficiently in care. This standard would require the owner to choose the precaution level that she would have chosen if she could not recover the goods. An owner would retain her property right only if she satisfied the negligence standard. Hence, the standard increases the owner's precaution level to first best

[13]UCC §2-403(2).

[14]UCC §1-201(9).

without worsening her incentive to search for stolen goods.[15]

An objection to this proposal is that negligence standards are difficult for courts to set and for juries to apply. We agree, but suggest that, while implementation problems plague negligence standards generally, they may be less severe here. To apply a negligence standard requires a knowledge of the probability of harm, its cost and the productivity of precautions. As regards theft, its probability in various locations often is known, the value of the goods – i.e., the harm – is easy to value relative to valuing personal injury costs and pain and suffering losses, and the set of effective precautions against theft is small and well known. Hence, a negligence standard should work at least as well in the area of good faith purchase area as in other domains, and perhaps would work even better.[16]

We also urge abandoning the distinction between void and voidable title. The negligence standard should apply to owner actions generally. An owner should be permitted to recover the goods if she satisfies the negligence standard regardless of the buyer's good faith. This argument rests on economic grounds. It remains valid when other justifications are considered.

There are noneconomic reasons to permit owners to recover stolen goods. An owner may have a particular relation to property, either because its possession permits the owner the better to exercise her autonomy or because she is personally invested in particular goods. These justifications for ownership raise two issues. First, do they outweigh the efficiency of a

[15]Formally, a negligence rule, if effective, changes the owner's maximization problem to the problem that Expression (1) solves rather than the problem that Expression (3) solves. The owner, that is, is induced to take first best precautions. The standard does not affect the problem that Expression (4) solves because the owner does not search for goods unless she loses them.

[16]A negligence standard cannot be applied to owners and buyers simultaneously. If both parties take care, only one of them can have the goods and if both parties fail to take care, neither should have them. Double marginalization problems cannot be solved in a globally efficient way. We have argued that it is more productive to influence owners.

negligence standard, which cuts off the owner's rights when she behaved negligently? Second, do these property rights justifications apply to the voidable title case? The second question must be answered no. An owner's voluntary transfer enables her transferee to convey good title to a good faith purchaser only if the "goods have been delivered [to the transferee] under a transaction of purchase."[17] The owner's loss in these case is primarily pecuniary. She has voluntarily parted with goods in exchange for the promise of money, but she has not been paid. She wants the goods back as a substitute for money, but she no longer has a particular connection to them.

The answer to the first question also should be no. Property as liberty or as personhood can justify only part of the law. A business can recover stolen property and a person has the same right to recover a plasma TV as an engagement ring. A deterring theft rationale, in contrast, applies broadly. A negligence standard better deters theft than the law we have. Further, under a negligence standard, an owner's right is cut off only if she materially contributed to her own loss. Thus, owners would have the power to protect their intrinsically valuable property interests.

A response to our view follows from the act/omission distinction. Under this distinction, actions are more blameworthy than omissions. An owner thus acts when she transfers goods to a transferee but only omits precautions when she is negligent.[18] The act/omission distinction is an application of the doctrine of "double effect." This doctrine, commonly applied to noncommercial problems, distinguishes between consequences of actions that were intended, as ends or as means, and consequences that were only foreseen. On this view, intentionally killing a person is more blameworthy than failing to take an action that would prevent the death of other persons. In the former case, the actor intended to cause a death; in the latter case, the actor did

[17]UCC §2-403(1)

[18]In *West v. Roberts*, 143 P.2d 1037 (Colo. 2006), the court distinguished the voidable from the void title cases because in the former the owner made a voluntary transfer of his property.

not, though he could foresee that his failure to act would result in death. As applied here, in the voidable title cases, the owner intends to part with her property as the means to maximize utility. In the void title cases, the owner could merely foresee that her failure to take precautions would result in the loss of her property, and in harm to buyers if she could get the property back. But she did not intend to incur a loss or to harm others.

We argue, however, that the doctrine of double effect should be rejected.[19] This doctrine confuses two questions. The first is whether an act is morally permissible. The second is whether an agent acted in a morally permissible way. The former question must be answered by weighing the considerations for and against the act. To illustrate, a person may give money to a charity from base motives, such as a desire for recognition or to spite relatives who wished to inherit. If the money is to be well spent, however, the giving of it is morally praiseworthy though the giver is not. Similarly, a person may drive too quickly in order to visit a sick friend, but her speeding injured another. The person committed a blameworthy act, though she intended to do good, not harm.

Applying this analysis here, an owner who fails to take effective precautions against theft encourages it and may cause harm to later purchasers. Her failure thus is culpable, though she probably did not intend harm to anyone. Losing her property is an appropriate sanction. In the same vein, though, an owner who voluntarily transfers property, after making the right inquiries, has acted in a blameless fashion, whatever her intent may have been. Therefore, no ground exists to deprive her of her goods. To summarize, there seems not to be a moral objection to applying a negligence standard to owners generally, and thus permitting them to recover goods that either were stolen or misappropriated after transfer.

[19]The following discussion owes much to Thomas Scanlon, Moral Dimensions, Chapter One (2009).

5.2 The United Kingdom, and etc.

6. Conclusion

February 1, 2010.