The Various Standards for the "Good Faith" of a Purchaser

*By Stephen L. Sepinuck**

Numerous legal rules allow a "good faith" purchaser of property to receive greater rights to the property than the transferor had to give by entitling the purchaser to take free of, or acquire priority over, a third party's claim to or interest in the purchased property. This article explains why the phrase "good faith" means something different in each of these rules and analyzes what the term means in a few specific examples. In so doing, the article provides a framework for determining what "good faith" means in the myriad other rules that protect purchasers.

INTRODUCTION

Commercial law is replete with references to "good faith." The Uniform Commercial Code ("U.C.C.") alone uses the phrase ninety-seven times in the official text, and uses the Latin equivalent—"bona fide"—an additional eleven times.[1] The terms "good faith" and "bona fide" appear, collectively, in forty-five places in the Bankruptcy Code.[2] They are used twice each in the National Labor Relations Act and the Comprehensive Environmental Response, Compensation, and Liability Act,[3] seven times in the Uniform Voidable Transactions Act,[4] pop up in

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1. *See infra* notes 7, 10, 12, & 14. Added to this are almost 200 references in the official comments. Those references are attached to 118 different sections, more than half of which do not refer to "good faith" or "bona fide" in the official text.

2. For provisions using the term "good faith," see 11 U.S.C. §§ 109(c)(5)(B), 362(c)(3)(B), (C), (4)(B), (D), (i), (k)(2), (n)(1)(D), 363(m), 364(e), 521(i)(e), 524(*l*)(2), (3), 542(c), (d), 548(c), 549(c), 550(b)(1), (2), (e)(1), 707(b)(4)(C)(i)(II), 727(a)(9)(B)(ii), 746(a), 1113(b)(2), 1114(f)(2), 1123(e), 1126(e), 1129(a)(3), 1144(1), 1225(a)(3), 1325(a)(3), (7) (All references to the United States Code in this article are to the version available on Westlaw as of April 1, 2018.). For provisions using the term "bona fide," see 11 U.S.C. §§ 101(32)(C)(i), 303(b)(1), (h)(1), 363(f)(4), 503(c)(1)(A), 504(c), 544(a)(3), 545(2), 547(c)(7), (e)(1)(A), 548(d)(1), 549(c), 1145(a)(4).

In addition, the Bankruptcy Code uses the term "bad faith" in 11 U.S.C. §§ 303(i)(2), 348(f)(2), 707(b)(3)(A).

3. *See* 29 U.S.C. § 158(a)(5), (d), 42 U.S.C. §§ 9601(40), 9607(r).

4. *See* UNIF. VOIDABLE TRANSACTIONS ACT §§ 6(1)(i), 8(a), (b)(1)(ii)(A), (B), (d), (f)(3) (UNIF. LAW COMM'N 2014) (each using the term "good faith"); *id.* § 2(b) (using the term "bona fide").

at least twenty-five state real property recording acts,[5] and appear in numerous Restatements.[6]

It would be surprising if, in all these different uses, the terms carried the same meaning. And, indeed, they do not.

The terms "good faith" and "bona fide" (henceforth referred to solely as "good faith") are used in several very different contexts. The first context, perhaps the most common, consists of references to a contracting party's duty to act in good faith. This obligation is codified in Article 1 of the U.C.C. and recognized by the Restatement (Second) of Contracts, each of which provides that every contract imposes an obligation of good faith in its performance and enforcement.[7] Note, although this is often referred to in the singular, as *the duty* of good faith, its application to both performance and enforcement arguably constitutes two distinct obligations. After all, the obligation to *perform* in good faith is a duty relating to a covenant, and it implicitly deals with the obligations owed by the person with the duty. In contrast, the obligation to *enforce* in good faith is a condition that limits contractual rights, and it deals implicitly with the obligations owed to the person with the duty.

Good faith is used in a second context in the legal rules that impose a duty to negotiate or bargain in good faith or that make negotiation in good faith a condition to some right.[8] To the extent that this duty applies at the pre-contract stage, as it often does, rather than to a modification of an existing contract, this duty is necessarily distinct from the general duty to perform or enforce a contract in good faith, which applies only to parties already in contract with each other.[9]

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5. *See* Alaska Stat. § 40.17.080(b); Cal. Civ. Code § 1107; D.C. Code § 42-401; Haw. Rev. Stat. § 502-83; Idaho Code § 55-812; Ind. Code § 32-21-4-1(b); Md. Code, Real Prop. § 3-203(1); Mich. Comp. Laws § 565.29; Minn. Stat. § 507.34; Mont. Code § 70-21-304; Neb. Rev. Stat. § 76-238(1); Nev. Rev. Stat. § 111.325; N.H. Rev. Stat. § 477:3-A; N.J. Stat. § 46:26A-12(c); N.M. Stat. § 14-9-3; N.Y. Real Prop. Law § 291; N.D. Cent. Code § 47-19-41; Ohio Rev. Code § 5301.25; Or. Rev. Stat. § 93.640; Pa. Stat. tit. 21, § 351; S.D. Cod. Laws § 43-28-17; Utah Code § 57-3-103(1); Wash. Rev. Code § 65.08.070; Wis. Stat. § 706.08(1)(a); Wyo. Stat. § 34-1-120.

6. *See, e.g.*, Restatement (Third) of Agency §§ 5.04(a), (b), 6.07(c)(3), 8.06(1)(a)(i), (2)(a), 8.15 (2006); Restatement (Second) of Contracts §§ 205, 241 (1981); Restatement (Third) of Restitution and Unjust Enrichment §§ 58(2), 60(1), 66, 67 (2011).

7. *See* U.C.C. § 1-304 (all citations to the Uniform Commercial Code in this article are to the official text as of 2013); Restatement (Second) of Contracts § 205. The U.C.C. uses "good faith" in this context in the following provisions: U.C.C. §§ 1-302(b), 1-304, 1-309, 2-305(2), 2-306(1), 2-311(1), 2-323(2), 2-603(3), 2-706(1), 2-712(1), 2A-109(1), (2), 2A-511(3), 2A-518(2), 2A-527(2), 3-311(a), 3-409(c), 4-103(a), 4-503(2), 4A-302(b), 5-109(a)(2), 7-206(b), 7-508, 7-601(b).

8. The Bankruptcy Code uses "good faith" in this context in 11 U.S.C. § 109(c)(5)(B). Although this usage deals with negotiating with existing creditors, not all creditors have a contractual relationship with the debtor. Tort creditors, for example, typically do not. Hence, this reference to negotiating in good faith does not necessarily relate to contractual performance or enforcement.

For other examples of a legal duty to negotiate or bargain in good faith, see 5 U.S.C. § 7114(a)(4), (b), 29 U.S.C. § 158(a)(5), (d).

Although not necessarily phrased in terms of "good faith," some common-law rules of contract constrain the behavior of parties negotiating agreements in ways similar to a duty of good faith. For example, a party that violates the forthright negotiator principle might find the agreement interpreted according to the meaning ascribed by the other party. *See, e.g.*, United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810 (Del. Ch. 2007). *see also* Restatement (Second) of Contracts § 20(b) (1981).

9. *See, e.g.*, Restatement (Second) of Contracts § 205 cmt. c; *In re* Off Dock USA, Inc., 2015 WL 3895538, at *4 (9th Cir. BAP June 24, 2015); McClain v. Octagon Plaza, LLC, 71 Cal. Rptr. 3d 885, 897 (Ct. App. 2008); Racine & Laramie, Ltd. v. Dep't of Parks & Recreation, 14 Cal. Rptr. 2d 335,

A third common context in which good faith is used is in defining the rights of a purchaser: that is, someone who acquires an interest in property through a voluntary transaction.[10] In this context, even though good faith usually relates to a contractual relationship—that is, the purchase[11]—the term is relevant not to the purchaser's rights or duties vis-à-vis the transferor, but to the purchaser's rights vis-à-vis some third party with an interest in or claim regarding the property transferred. In this context, a purchaser acting in good faith often takes free of the rights or claim of such a third party, whereas a purchaser not acting in good faith does not.

Commercial law refers to good faith in at least one additional context. Numerous commercial law statutes require good faith in the filing of a pleading or plan of reorganization, refer to a good faith effort or belief, or otherwise apply in a non-contractual setting.[12] Whether all of these references constitute a single context of the use of good faith or many different contexts is an issue that this article need not address. It is sufficient to point out that good faith in this non-contractual context is necessarily different from the three other contexts in which good faith is used: performance and enforcement, purchase, and negotiation.

Scholars and legal authorities have long recognized that the meaning of "good faith" varies with the context in which it is used.[13] Even solely within the U.C.C.,

338–41 (Ct. App. 1992); Robert S. Summers, *Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 220–21 (1968). *But cf.* U.C.C. § 2-314 cmt. 3 (suggesting that the general duty of good faith imposes a duty to disclose to a prospective buyer of goods known but hidden defects); Mkt. Street Assocs. Ltd. P'Ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (suggesting that the duty of good faith is "minimized" during pre-contractual negotiations).

10. *See, e.g.*, U.C.C. § 1-201(b)(29), (30) (defining "purchase" and "purchaser," respectively).

The U.C.C. uses "good faith" in this context in U.C.C. §§ 1-201(b)(9), 2-402(2), 2-403(1), 2-702(3), 2-706(5), 2A-103(1)(a), 2A-103(1)(o), 2A-304(1), 2A-305(1), 2A-308(1), 2A-308(2), 2A-511(4), 2A-527(4), 3-202(b), 3-302(a)(2), 3-403(a), 3-404(a), 3-404(b)(2), 3-405(b), 3-406(a), 3-416(b), 3-418(c), 4-207(b), 4-207(c), 4-209(c), 5-109(a)(1), 6-107(3)(a), 6-107(3)(b), 7-203, 7-208, 7-209(c), 7-210, 7-301(a), 7-304(c), 7-308(d), 7-501(a)(5), 7-504(b)(4), 9-321(a), 9-330(a)(1), 9-330(b), 9-330(d), 9-403(a), 9-405(a), 9-615(g), 9-617(b). The Bankruptcy Code uses the term in this context in 11 U.S.C. §§ 362(n)(1)(D), 363(m), 544(a)(3), 545(2), 547(e)(1)(A), 548(c), (d)(1), 549(c), 550(b)(1), (2), (e)(1), 746(a), 1144(1).

11. A purchaser, at least under the U.C.C. definition, can include a donee, who might not have a contractual relationship with the donor.

12. The U.C.C. uses "good faith" in this context in U.C.C. §§ 1-201(b)(23), 2-328, 2-615(a), 2A-405(a), 3-311(a), 3-420(c), 9-627(c)(2). The Bankruptcy Code uses the term in this context in 11 U.S.C. §§ 362(c)(3)(B), (C), (4)(B), (D), (i), (k)(2), 503(c)(1)(A), 504(c), 521(i)(e), 524(*l*)(2), (3), 542(c), (d), 707(b)(4)(C)(i)(II), 727(a)(9)(B)(ii), 1113(b)(2), 1114(f)(2), 1123(e), 1126(e), 1129(a)(3), 1145(a)(4), 1225(a)(3), 1325(a)(3), (7).

Some uses of the term are difficult to classify. For example, several provisions of the U.C.C. deal with a bank's or other payor's good faith in honoring or refusing to honor a draft. *See, e.g.*, U.C.C. §§ 2-506(2), 3-407(c), 3-417(a), (d)(1), 4-109(a), 4-208(a), (d), 4-401(d), 4-404, 4-406(d)(2), (e), 4A-202(b). Good faith in that context might deal with the payor's relationship to its customer (i.e., the duty to perform in good faith) or the payor's relationship to the payee, which is often non-contractual. *See also* U.C.C. § 7-404 (immunizing from liability to a third person a bailee that receives and disposes of goods in good faith); 11 U.S.C. §§ 101(32)(C)(i), 303(b)(1), (h)(1), 363(f)(4) (each referring to a "bona fide dispute" of a debt, claim, or interest, which might be about the relationship between the parties or about the disputing party's honesty with the court), 364(e) (dealing with an extension of credit in good faith), 547(c)(7) (referring to a "bona fide payment").

13. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a ("The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with that context."); *id.* cmts. b, c, d, e (referring to

which statutorily defines good faith,[14] the meaning of the term does—and must—vary with the context in which it is used.[15] Indeed, the official comments say as much.[16] More significant, the statutory definition, on its face, makes sense only with respect to good faith as used in the first and second contexts: (i) performance and enforcement and (ii) negotiation or bargaining.

Revised Article 1 defines "good faith" "honesty in fact and the observance of reasonable commercial standards of fair dealing."[17] Both aspects of this standard—the subjective requirement of honesty and the objective requirement of reasonable commercial standards of fair dealing—can undoubtedly apply to the performance or enforcement of a contract that falls within the scope of the U.C.C. A party can act honestly or dishonestly, and deal fairly or unfairly, when performing or enforcing a contract. However, neither standard seems directly applicable to the good faith of a purchaser.

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good faith purchase, good faith in negotiation, good faith performance, and good faith enforcement); Denise R. Boklach, *Commercial Transactions: U.C.C. Section 1-201(19) Good Faith—Is Now the Time to Abandon the Pure Heart/Empty Head Test?*, 45 OKLA. L. REV. 647, 656–63 (1992) (distinguishing good faith purchase from good faith performance); Steven J. Burton, *Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View*, 35 WM. & MARY L. REV. 1533, 1538–45 (1994) ("The meaning of 'good faith' varies with its functions in these different contexts," suggesting that even within the context of performance and enforcement, the term means different things because good faith performance is a duty and good faith in enforcement is a condition; and proposing different definitions for purchasing, performing, and enforcing in "good faith"); E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 668–69 (1963) (distinguishing between good faith performance and good faith purchase); Christina L. Kunz, *Frontispiece on Good Faith: A Functional Approach within the UCC*, 16 WM. MITCHELL L. REV. 1105, 1106 (1990) ("This essay proposes a functional approach to good faith, whereby the definition of good faith is determined by the function that good faith serves in each type of situation."). The point has also been made in contexts outside of commercial law. *See* Samuel W. Buell, *Good Faith and Law Evasion*, 58 UCLA L. REV. 611, 617 n.16, 627–36 (2011) (stating that "[t]he meaning of good faith varies with legal context" and then distinguishing between performing in good faith and negotiating in good faith). *Cf.* Summers, *supra* note 9, at 208, 215 (indicating first that in the U.C.C. "[g]ood faith is good faith," whether in the context of performance or purchase, but later suggesting that the U.C.C. be amended to confine the definition of "good faith"—which was then limited to "honesty in fact"—to good faith purchase).

14. *See* U.C.C. §§ 1-201(b)(20), 2-103(1)(b), 3-103(a)(6), 5-102(a)(7), 7-102(a)(6), 8-102(a)(10), 9-102(a)(43); *see also* U.C.C. §§ 2A-103(3), 4-104(c), 4A-105(a)(6) (each making one of the other definitions of "good faith" applicable to that Article).

15. *See* PEB COMMENTARY ON THE UNIFORM COMMERCIAL CODE: COMMENTARY NO. 10 (Feb. 10, 1994) ("The meaning of 'good faith' varies with the context. Sometimes the context is as a standard of performance or enforcement; other times the context is that of good faith purchase.").

16. *See* U.C.C. § 1-201 cmt. 20 (stating that "fair dealing," a phrase used in the definition of "good faith," "is a broad term that must be defined in context").

17. U.C.C. § 1-201(b)(20). Several states preserved the older definition of good faith when enacting revised Article 1. In those states, the general duty to perform and enforce in good faith is the purely subjective standard of "honesty in fact." *See* U.C.C. § 1-201(19) (2000). Even in those states, the heightened standard of good faith applies in Article 8, *see* § 8-102(a)(10), and is supposed to apply in Article 9, *see* § 9-102(a)(43) & cmt. 19. Unfortunately, it is not clear that the heightened standard does apply the duty to perform and enforce in good faith in connection with an Article 9 transaction. Technically, the definition of "good faith" in Article 9 applies only to the term when used in Article 9 itself (e.g., in § 9-330(a)(1), (b), (d)). *See* § 9-102(a). Although comment 19 indicates that the heightened standard of section 9-102 is to apply to the general Article 1 duty of good faith in an Article 9 transaction, that is simply not what the Code says. If that was what the drafters really wanted to accomplish, they should have written section 9-102(a)(43) the way section 8-102(a)(10) was written. The same point applies to the heightened standard of good faith in section 3-103(a)(6).

Certainly, one can inquire whether a purchaser has acted honestly and dealt fairly in its transaction *with the transferor*. However, the special protections in the U.C.C. for a good faith purchaser deal with the purchaser's rights against a third party with an interest in or claim to the purchased property. Consequently, good faith in this context is principally about the purchaser's relationship to that third party. It could be that purchaser who acts dishonestly toward or deals unfairly with the transferor is not deserving of such protections, but that proposition is far from obvious.[18] Instead, it seems more appropriate to focus on the relationship of the purchaser to the third party. For example, it might make sense to inquire if the purchaser is aware of the third party's rights or purposefully seeking to undermine them. However, it is something of a stretch to ask whether the purchaser has acted honestly and fairly with respect to the third party. Honesty is an attribute of communication, either in words or by conduct. But the purchaser does not typically communicate with the third party at the time of purchase. Similarly, it is difficult to assess whether a purchaser has acted fairly with respect to a third party with whom the purchaser has no direct dealings. Although a comment to one section of the U.C.C. does suggest that a particular type of purchaser can act unfairly with respect to a third party with an interest in the property involved,[19] the entire discussion is really about notice and due diligence, not fairness in the normal sense of the word. Consequently, despite the fact that the U.C.C. expressly defines the term "good faith," the term likely means something different or additional in the provisions delineating the rights of a good faith purchaser than what the definition indicates.[20]

This conclusion is supported by comments and commentary indicating that good faith in performance and enforcement is, like course of performance, course of dealing, and usage of trade, an aspect of the parties' agreement and an interpretive aid in ascertaining what that agreement is.[21] Consequently, while the obligation of good faith cannot be disclaimed, its meaning can be varied by the contracting parties' agreement.[22] In contrast, the requirements for good faith purchase are not something that the contracting parties can alter by their agreement,[23] because it deals with the purchaser's rights against a non-contracting party.

This article explores what "good faith" means in the various legal rules dealing with the rights of a good faith purchaser. It begins by identifying the one requirement for good faith purchase that applies in every setting: genuineness. The

18. A strong argument can be made that a purchaser's *dishonesty* in the transaction with the transferor is a basis for denying the purchaser the protections of a good faith purchaser. *See infra* notes 49–59 and accompanying text. It is far less clear that *dealing unfairly* with the transferor is a basis for doing so.

19. *See* U.C.C. § 9-331 cmt. 5; *see also id.* § 9-330 cmt. 6 (distinguishing U.C.C. § 9-331 cmt. 5 and stating that "a purchaser of chattel paper under this section is not required as a matter of good faith to make a search in order to determine the existence of prior security interests").

20. The definition makes even less sense with respect to the U.C.C.'s provisions dealing with good faith in a non-contractual situation. *See, e.g.*, *id.* §§ 2-615(a), 2A-405(a) (each referring to "compliance in good faith with any applicable foreign or domestic governmental regulation").

21. *See* PEB Commentary on the Uniform Commercial Code: Commentary No. 10 (Feb. 10, 1994).

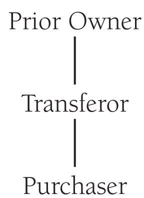
22. *See* U.C.C. § 1-302(b).

23. *See id.* § 9-331 cmt. 5; *cf. id.* § 9-330 cmts. 5–7.

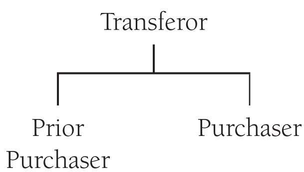
article then discusses several different legal rules protecting good faith purchasers to demonstrate that the meaning of the law's myriad references to "good faith purchase" and "good faith purchaser" differ in meaning. That is, what it takes for a purchaser to be acting in good faith varies, and its meaning in any particular context is based on a variety of competing values and principles. The article then proposes a framework for determining what good faith purchase means in each individual setting.

The Big Picture

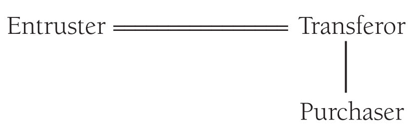
Many of the rules dealing with a good faith purchase involve the competing rights or claim of a third party, whose interest in or claim to the purchased property predated the purchase. The third party might be a prior owner with a right of rescission seeking to reclaim the property from a purchaser further down the chain of title:



It might be a prior purchaser—either a buyer or secured party—that claims superior rights to the property:



Or it might be an owner that entrusted possession of the property to a merchant that purported to sell the property:



In each of these situations,[24] a rule protecting a good faith purchaser is in tension with two fundamental principles of property and property law. The first of

24. The issue can arise in other contexts as well. For example, a purchaser might buy goods from a merchant, who acquired them directly or indirectly from a thief. When the statute of limitations begins to run on a claim by the original owner to recover the goods might depend on what actions the owner took to publicize the theft or to discover who has possession. Such actions could be viewed as an aspect of good faith. *See* Alan Schwartz & Robert E. Scott, *Rethinking the Laws of Good Faith Purchase*, 111 Colum. L. Rev. 1332 (2011).

these principles—sometimes referred to as the "derivation principle" or by the Latin phrase *nemo dat quod non habet* (one cannot give what one does not have)—is that a person can transfer only those rights in property that the person has. In other words, a transferee's rights are derived from, and therefore limited by, the rights of the transferor. The second principle, based in part upon the first, is that the sequence of multiple transfers matters: a person who acquires an interest in property should prevail over anyone who later acquires an interest in the same property from the same transferor. This "first in time, first in right" principle flows from the derivation principle because an initial transfer of property rights will necessarily deplete the transferor's rights in the property, leaving the transferor with few or no rights to transfer to anyone else.

Good faith purchasers—by taking property free of the existing interest or claim of a third person—acquire better rights than the transferor had. This is not to say that the rules protecting good faith purchasers are wrong or should be narrowly construed. It merely means that the rules must necessarily be designed to promote other policies or values. In many of the situations, the good faith purchaser and the prior claimant are both innocent parties, and the law can protect only one of them. It often sides with the good faith purchaser based on the judgment that the prior claimant was better able avoid the loss. Even when that is not the case, the law is necessarily elevating some policy or value above the derivation and first-in-time principles. Identifying that policy or value is critical to understanding what "good faith" means in that context.

The same is true with respect to the good faith purchase rules that do more than cut off the rights of a competing claimant to the property. For example, the rules protecting a holder in due course of a negotiable instrument—a particular type of good faith purchaser[25]—allow the holder to take free not only of most *claims* to the instrument,[26] but also most *defenses to payment*[27]:

25. *See* U.C.C. § 3-302(2).

26. *See id.* § 3-306.

27. *See id.* § 3-305(b). Almost forty years ago, Grant Gilmore suggested that this right of a holder in due course had long outlived its original purpose. *See* Grant Gilmore, *The Good Faith Purchase Idea and The Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 612–16 (1980). Serious consideration should therefore be given to eliminating it. That is, to allow a holder in due course to take free of *claims* but not of *defenses*. The FTC Holder in Due Course Regulation, 16 C.F.R. § 433.2 (2017), has already done this in some consumer transactions, due largely to the fact that depriving the maker of defenses can be unfair. Indeed, the potential unfairness of allowing a holder in due course to take free of defenses seems to underlie the highly questionable assumption in cases involving duplicate original notes: that the maker is not liable to pay both. *See, e.g.*, Provident Bank v. Cmty. Home Mortg. Corp., 498 F. Supp. 2d 558 (E.D.N.Y. 2007); DLJ Mortg. Capital, Inc. v. Homeloan Mortg. Corp., 2008 WL 376941 (Cal. Ct. App. Feb. 13, 2008); HSBC Bank USA v. Perez, 165 So. 3d 696 (Fla. Ct. App. 2015). For other rules allowing a good faith purchaser to take free of defenses, see RESTATEMENT (SECOND) OF CONTRACTS §§ 155, 164(2), 166(b), 175(2), 177(3) (1981). Consider also U.C.C. section 2A-407, which allows a lessor of goods and the lessor's assignees to take free of the lessee's defenses if the lease is a finance lease that is not a consumer lease. Although that rule does not expressly require that the lessor or its assignee act in good faith, the official comment makes it clear that good faith is required. *See* U.C.C. § 2A-407 cmt. 1.

Maker ——— Transferor

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Holder in Due Course

As such, the rules give the holder in due course better rights against the person obligated on the instrument than the transferor had. Again, these enhanced rights of a good faith purchaser are not necessarily bad, but understanding what policies or values the law is trying to serve by providing these enhanced rights is critical to determining what it takes for the purchaser to be acting in good faith.[28]

One of the most common requirements for a purchase to be in good faith is that the purchaser must not have notice of the third-party claimant's pre-existing interest in or claim to the purchased property. This is seen most clearly in the rules relating to the real property recording system. In twenty-five U.S. states, the law allows a good faith purchaser of real property to take free of a prior unrecorded interest in the property.[29] In most of the remaining states, the law allows a purchaser "without notice" of the prior interest to do the same.[30] The clear implication of the fact that some states refer to "good faith" in their real property recording statutes while others refer to lack of notice is that the phrase "good faith" in recording statutes is merely a synonym for lack of notice.[31] The case law bears this out. Courts interpreting the statutes that require good faith regularly equate that term to lack of notice.[32] Even in the five states that have

28. The equitable and policy considerations implicated by the rule that cuts off defenses to payment might be different from those implicated by the rule cutting off competing claims to the instrument. For that reason, this article does not focus on the good faith needed to qualify as a holder in due course, and leaves that issue for another time.

29. *See supra* note 5.

30. *See* Ala. Code § 35-4-90(a); Ariz. Rev. Stat. § 33-411(A); Ark. Code § 14-15-404(b); Fla. Stat. § 695.01(1); 765 Ill. Comp. Stat. 5/30; Iowa Code § 558.41(1); Ky. Rev. Stat. 382.270; Miss. Code § 89-5-5; R.I. Gen. Laws § 34-11-1; S.C. Code § 30-7-10; Tex. Prop. Code § 13.001(a); Va. Code § 55-96(A)(1); W. Va. Code § 40-1-9.

31. *See* 11 Thompson on Real Property § 92.09(c)(1), at 179–80 (David A. Thomas ed., Lexis/Nexis 2015).

32. *See, e.g.*, *California*: United States v. Certain Parcels of Land Situated in San Bernardino Cty., 85 F. Supp. 986, 1004–05 (S.D. Cal. 1949); First Fidelity Thrift & Loan Ass'n v. Alliance Bank, 71 Cal. Rptr. 2d 295, 300 (Ct. App. 1998); Brock v. First S. Sav. Ass'n, 10 Cal. Rptr. 2d 700, 702–03 (Ct. App. 1992) (each apparently equating "good faith" with a lack of knowledge or notice of the competing interest in the property). *Idaho*: Sun Valley Hot Springs Ranch, Inc. v. Kelsey, 962 P.2d 1041, 1045 (Idaho 1998) ("Good faith means a party purchased the property without knowing of any adverse claims to the property."). *Michigan*: Wells Fargo Bank v. SBC IV REO, LLC, 896 N.W.2d 821, 842–43 (Mich. Ct. App. 2016); Penrose v. McCullough, 862 N.W.2d 674, 679–80 (Mich. Ct. App. 2014); Coventry Parkhomes Condo. Ass'n. v. FNMA, 827 N.W.2d 379, 383 (Mich. Ct. App. 2012); Richards v. Tibaldi, 726 N.W.2d 770, 781 (Mich. Ct. App. 2006); Mich. Nat'l Bank & Trust Co. v. Morren, 487 N.W.2d 784, 786 (Mich. Ct. App. 1992) ("A good-faith purchaser is one who purchases without notice of a defect in the vendor's title."). *Minnesota*: Citizens State Bank v. Raven Trading Partners, Inc., 786 N.W.2d 274, 278 (Minn. 2010); Anderson v. Graham Inv. Co., 263 N.W.2d 382, 383 (Minn. 1978) ("Such a purchaser is defined as one who gives consideration in good faith without actual, implied, or constructive notice of inconsistent outstanding

statutes requiring both "good faith" and lack of notice,[33]—which might suggest that the terms are not completely synonymous—courts focus exclusively on lack of notice.[34] Only one rather old case, discussed below,[35] suggests that purchasing in good faith requires anything more or other than a lack of notice.

Other legal protections for good faith purchasers equate good faith with—or at least treat good faith as including—lack of notice of the interest or competing claim. For example, the Uniform Voidable Transactions Act (the successor to the Uniform Fraudulent Transfer Act) protects good faith purchasers in two ways: (i) it gives the initial purchaser, if acting in good faith, a lien for the value of what the purchaser provided to the debtor;[36] and (ii) it insulates a subsequent good faith purchaser from liability entirely.[37] For each of these purposes, "[k]nowledge of the facts rendering the transfer voidable would be inconsistent with the good faith that is required of a protected transferee."[38] In other words, the requirement of good faith implies a lack of knowledge. Similarly, according to the Restatement (Third) of Restitution and Unjust Enrichment, a good faith purchaser of property takes free of a restitution claim of a prior owner.[39] For this purpose, the comments make

rights of others."). *Nevada*: Berge v. Fredericks, 591 P.2d 246, 248 (Nev. 1979) ("In order to be entitled to the status of a bona fide purchaser without notice under NRS 111.325, respondent . . . was required to show that legal title had been transferred to her before she had notice of the prior conveyance to appellant."); Allison Steel Mfg. Co. v. Bentonite, Inc., 471 P.2d 666, 679 (Nev. 1970) ("A subsequent purchaser with notice, actual or constructive, of an interest in the land superior to that which he is purchasing is not a purchaser in good faith, and not entitled to the protection of the recording act."). *New Hampshire*: C F Inv., Inc. v. Option One Mortg. Corp., 42 A.3d 847, 849–50 (N.H. 2012) ("in order for the defendants to claim the protection of the recording statute as bona fide purchasers, they must have lacked notice—actual, record, or inquiry—of the plaintiff's prior interest"); Hawthorne Trust v. Maine Sav. Bank, 618 A.2d 828, 831 (N.H. 1992) ("A bona fide purchaser for value is one who acquires title to property for value, in good faith, and without notice of competing claims or interests in the property."). *Utah*: Pioneer Builders Co. of Nev., Inc. v. K D A Corp., 292 P.3d 672 (Utah 2014); Morris v. Off-Piste Capital, LLC, 2018 WL 312800 (Utah Ct. App. Jan. 5, 2018) (each indicating that to take real property in good faith, a purchaser must lack notice of the prior unrecorded interest and not suggesting that anything additional is required).

The Ohio statute protects a "bona fide purchaser having, at the time of purchase, no knowledge of the existence of" the prior unrecorded interest. Ohio Rev. Stat. § 5301.25(A). The reference to "knowledge" has promoted courts to not deny "bona fide" status to purchasers who merely had inquiry notice of the prior interest. *See* Emrick v. Multicon Builders, Inc., 566 N.E.2d 1189 (Ohio 1991).

33. *See* D.C. Code § 42-401 ("bona fide purchasers and mortgagees without notice"); Md. Code, Real Prop. § 3-203(1) ("[a]ccepted delivery . . . in good faith; [w]ithout constructive notice"); Neb. Rev. Stat. § 76-238(1) ("purchasers in good faith without notice"); N.J. Stat. § 46:26A-12(c) ("bona fide purchasers and mortgagees . . . without notice"); Ohio Rev. Code § 5301.25 ("subsequent bona fide purchaser having . . . no knowledge").

34. *See, e.g.*, *District of Columbia*: Osin v. Johnson 243 F.2d 653 (D.C. Cir. 1957); Kayfirst Corp. v. Wash. Terminal Co., 813 F. Supp. 67 (D.D.C. 1993); *In re* Aumiller, 168 B.R. 811 (Bankr. D.D.C. 1994). *Maryland*: Lewis v. Rippons, 383 A.2d 676, 680 (Md. Ct. App. 1978). *New Jersey*: Sonderman v. Remington Constr. Co., 583 A.2d 367 (N.J. Super. Ct. 1990); Scult v. Bergen Valley Builders, Inc., 183 A.2d 865 (N.J. Super. Ct. 1962).

35. *See infra* notes 60–61 and accompanying text.

36. Unif. Voidable Transactions Act § 8(d) (Unif. Law Comm'n 2014).

37. *Id.* § 8(b)(1)(ii).

38. *Id.* § 8 cmt. 2.

39. *See* Restatement (Third) of Restitution and Unjust Enrichment §§ 58(2), 66 (2011).

clear, "good faith" means nothing more than lack of notice of the facts giving rise to the restitution claim.[40]

The prominent role notice normally plays in good faith purchase should not be surprising. After all, there would rarely be adequate justification to allow a purchaser of property to take free of a prior interest in or claim to the property—that is, to deviate from both the derivation principle and the first-in-time principle—if the purchaser had notice of the prior interest or claim.[41] In most such cases, the purchaser could adequately protect itself by simply declining to purchase.

It is imperative to note, however, that notice in these settings is usually different from and broader than knowledge. A purchaser typically has notice of the prior interest in or claim to the property when the purchaser *knows* of the interest or claim or *has reason to know* of it. Reason to know is not only heavily dependent on the facts, but also on the nature of the transaction and the type of due diligence that the law expects purchasers to perform. Its meaning therefore varies significantly in the various legal rules protecting good faith purchasers, a proposition to which this article will return.

In contrast, in several statutory protections for good faith purchasers, "good faith" means something different from lack of notice. For example, the U.C.C. definition of "holder in due course" expressly requires the holder to take the instrument both "in good faith" and "without notice of any claim to the instrument" or any defense to payment.[42] Similarly, section 550 of the Bankruptcy Code[43] insulates from liability some subsequent purchasers of property if an earlier transfer of the property is avoidable under any of several provisions of the Bankruptcy Code. To qualify for this protection, the subsequent purchaser must take the property both "in good faith" and "without knowledge of the voidability of the [prior] transfer." By differentiating good faith from notice or knowledge, each of these statutes implies that good faith has a different meaning.

This point is even more clear in the U.C.C. definition of "buyer in ordinary course of business" (known as a BIOCOB). A BIOCOB can acquire goods free of a prior, perfected security interest.[44] To qualify as a BIOCOB, a buyer must, among other things, purchase goods in good faith.[45] However, a person who has notice or even knowledge of the prior perfected security interest can qualify as a BIOCOB, provided the person does not know that the sale violates the rights of another person.[46] Consequently, whatever "good faith" means in this context, it is not mere notice of a third party's interest in the goods.

40. *Id.* § 66 cmt. d.

41. This is evidenced by the fact that so few states have enacted pure race recording statutes. One of the very few exceptions is N.C. Gen. Stat. § 47-18(a).

42. *See* U.C.C. § 3-302(a)(2)(ii), (v), (vi).

43. 11 U.S.C. § 550(b)(1).

44. *See* U.C.C. § 9-320(a). A BIOCOB can also obtain the rights of an entruster of goods. *See infra* note 87 and accompanying text.

45. *See* U.C.C. § 1-201(b)(9).

46. *Id.* The same is true of a "licensee in ordinary course of business." *See id.* § 9-321(a).

The Baseline—Genuineness

Numerous dictionaries list "genuine" as one of the definitions of "bona fide."[47] Several courts, relying on those dictionaries, have interpreted the phrase "bona fide" to require or mean genuineness in various contexts.[48] Consequently, it is hardly a leap in logic to assert that, to be a *bona fide* or good faith purchaser, a person must be a *genuine* purchaser.

To be genuine, a person must possess the attribute or character claimed.[49] In short, a genuine purchaser must be a true or real purchaser. In connection with this, recall that a purchaser is someone who acquires an interest in property through a voluntary transaction.[50] A thief, in contrast, acquires property involuntarily (from the owner's point of view), and thus is not a purchaser. A person who enters into a voluntary transaction to acquire property but who does so in a manner that is analogous to theft is really a purchaser in name only. Such a person is not a genuine purchaser and hence not a good faith purchaser.

For example, consider a purchaser who never intends to pay the agreed-upon price.[51] A person who buys on credit can be a good faith purchaser.[52] However, it is one thing for a credit buyer to fail to pay and quite another for a cash buyer to provide the seller with a fraudulent payment.[53] In the latter case, the seller was not willingly accepting a credit risk. The following hypothetical illustrates the point.

Illustration One

Deceitful visits Jeweler's store and selects a diamond ring for purchase. Deceitful pays with a personal check. The check is drawn on an account that is

47. *See, e.g.*, American Heritage Dictionary of the English Language 149 (1971); Black's Law Dictionary 223 (rev. 4th ed. 1968); The New Shorter Oxford English Dictionary 257 (1993).

48. *See, e.g.*, Brennan v. Taft Broad. Co., 500 F.2d 212, 217 (5th Cir. 1974); Fort Des Moines Church of Christ v. Jackson, 215 F. Supp. 3d 776, 798 (S.D. Iowa 2016); Abreu v. N.M. Children, Youth & Families Dep't, 797 F. Supp. 2d 1199, 1224 (D.N.M. 2011); Knoll Pharm. Co. v. Auto. Ins. Co. of Hartford, 210 F. Supp. 2d 1017, 1030 (N.D. Ill. 2002); Martin v. W. Elec. Co., 1978 WL 100 (N.D. Ill. Aug. 11, 1978); Ablen-Samed v. Dailey, 755 S.E.2d 805, 810–11 (Ga. 2014); People v. Butler-Jackson, 862 N.W.2d 423, 427 (Mich. Ct. App. 2014).

49. *See* American Heritage Dictionary of the English Language 550 (1971); The New Shorter Oxford English Dictionary 1078 (1993).

50. *See supra* note 10.

51. In many contexts, a donee can qualify as a purchaser. *See, e.g.*, U.C.C. § 1-201(b)(28), (29) (defining a "purchaser" to include a person who takes by gift). However, most of the rules that protect good faith purchasers are limited to those who take for value. *See, e.g.*, U.C.C. §§ 2-403(1), 2A-304(1), 3-302(a); statutes cited *supra* notes 5 & 30. Consequently, while a donee can be a good faith purchaser in some contexts, a donee cannot normally be a good faith purchaser that takes free of a third party's interest in or claim to the property acquired.

52. *See* U.C.C. § 1-201(b)(9).

53. The difference is evidenced by the seller's different rights in such a situation. Under section 2-507 of the U.C.C., a seller of goods has a right to reclaim the goods if the buyer tendered payment at the time of delivery but the payment mechanism has failed. But this right applies only if the sale was a cash sale: that is, the buyer was supposed to make payment on delivery. *See* U.C.C. § 2-511 cmts. 4–6. If, in contrast, the buyer purchased on credit (i.e., delivery now, payment later) and the buyer's subsequent check for the purchase price bounced, the seller does not have a right to reclaim the goods under section 2-507.

either nonexistent or, as Deceitful knows, does not and will not have sufficient funds to over the check.

Deceitful's conduct in this example is fraudulent as to Jeweler and has essentially converted a voluntary purchase into a theft. More to the point, Deceitful's fraudulent conduct has a direct impact on any third party that has a claim to or interest in the diamond ring. Any creditor that had a security interest in Jeweler's inventory would normally be entitled to a security interest in whatever consideration each buyer provides.[54] Because Deceitful paid with a fraudulent check, there are, effectively, no proceeds of the diamond ring to which the security interest can attach. Similarly, if a rightful owner had entrusted the ring to Jeweler, Jeweler would likely hold the sale proceeds in trust for the owner or otherwise be liable to the owner for the amount received.[55] Because there are no proceeds, the owner is defrauded to the same extent that Jeweler was. For these reasons, it makes sense to conclude that Deceitful is not purchasing in good faith.[56] Deceitful therefore does not qualify as a buyer in ordinary course of business,[57] and thus cannot take the diamond ring free of either a perfected security interest granted by Jeweler[58] or the rights of an owner who had entrusted the ring to Jeweler for repair.[59]

Genuineness can come into play in at least one additional and important way. A purchaser in a transaction that has no *raison d'être* or independent economic purpose, and which is instead conducted solely to defeat the rights of a third person with an interest in or claim to the property transferred, is not a genuine purchaser. *Pancoast v. Duval*,[60] a property case alluded to above, provides an example.

The relevant facts can be distilled as follows. Stephen Duval acquired twelve acres of real property in 1871. He and his wife granted Dr. Shreve a mortgage on 6.7 acres to secure a debt of $3,000. They granted a mortgage on the other portion of the property to Lydia and Emma Shreve, who did not record their mortgage. Several months later, Duval transferred the entire property to his father, who swore that he had no knowledge or notice of the unrecorded mortgage. Despite the lack of notice, the court concluded that the father was not a bona fide purchaser within the meaning of the state's real property recording statute, and thus did not take free of the unrecorded mortgage. The court based its conclusion on the fact that Dr. Shreve was indebted to the father and the transfer was intended to "secure" Dr. Shreve's obligation. As the father stated, "I intended to take the deed and hold it until Dr. Shreve paid the debt due to me."[61]

54. *See* U.C.C. §§ 9-203(f), 9-315(a)(2).

55. *See* Restatement (Third) of Restitution and Unjust Enrichment § 47, ill. 20 (2011).

56. *See* Emrick v. Multicon Builders, Inc., 566 N.E.2d 1189, 1193 (Ohio 1991) (indicating that all the state's real property recording statute "requires of the subsequent purchaser is honesty of purpose at the time of making the purchase").

57. *See* U.C.C. § 1-102(b)(9) (requiring good faith for a buyer to qualify as a biocob).

58. *See id.* § 9-320(a).

59. *See id.* § 2-403(2), (3).

60. 26 N.J. Eq. 445 (Ch. Ct. 1875).

61. *Id.* at 448.

Although the court's conclusion might have been based somewhat on the fact that the transferor and transferee were related (son and father, respectively)—courts do appear to give closer scrutiny when the parties are related[62]—it seems to be grounded more on the court's judgment that, even if there was nothing fraudulent in the father's actions, there was nothing real about the transaction. The only purpose was to defeat the rights of Dr. Shreve.[63]

Somewhat similarly, several courts have ruled that a negotiable instrument purchaser that is closely aligned or connected with the transferor, such as by dictating the terms of the transaction in connection with which the instrument was issued, is not a good faith purchaser of the instrument and thus cannot be a holder in due course.[64]

Now consider this second illustration:

Illustration Two

> Contractor is the sole owner of Alpha Construction, LLC. All of Alpha's assets secure a sizeable loan from Bank. Nevertheless, until recently, Alpha has been profitable and has no difficulty making debt service payments on the loan while also providing income to Contractor. Nine months ago, some lengthy litigation ended in a $1 million judgment against Alpha. In response, and in an effort to effectively free the business of liability on the judgment, Contractor: (i) formed Beta Construction, LLC; (ii) caused Alpha to transfer all of its assets (which were still encumbered by Bank's security interest) to Beta for $10; (iii) dissolved Alpha; and (iv) operated the construction business through Beta, using the same office and employees.

These facts present a classic case of successor liability.

62. *See In re* Palmer, 103 B.R. 348 (Bankr. M.D. Fla. 1989); Merchants & Planters Bank & Trust Co. v. Phoenix Hous. Sys., Inc., 729 S.W.2d 433 (Ark. Ct. App. 1987); Cent. Fin. Loan Corp. v. Bank of Illinois, 500 N.E.2d 1066 (Ill. App. Ct. 1986); Taylor Motor Rental, Inc. v. Assocs. Disc. Corp., 173 A.2d 688 (Pa. Super. Ct. 1961) (each concluding that a buyer related to or associated with the seller was not a BIOCOB, although basing that conclusion on the ordinariness of the transaction rather than on the good faith of the buyer); *see also* Ford Motor Credit Co. v. First Nat'l Bank of Crossett, 500 S.W.3d 188 (Ark. Ct. App. 2016) (reversing a summary judgment on the question).

63. Oddly, however, it was not the mortgage to Dr. Shreve that the father claimed to take free of, it was the mortgage to Lydia and Emma Shreve. Nothing in the court's brief decision focuses on this distinction.

64. *See, e.g.*, Rehurek v. Chrysler Credit Corp., 262 So. 2d 452, 453–54 (Fla. Ct. App. 1972); Kaw Valley State Bank & Trust Co. v. Riddle, 549 P.2d 927, 934 (Kan. 1976); Unico v. Owen, 232 A.2d 405 (N.J. 1967); Advanta Bus. Servs. Corp. v. Five C's Hardware & Paint Store, Inc., 681 N.Y.S.2d 569, 370–71 (Sup. Ct. App. Div. 1998); Arcanum Nat'l Bank v. Hessler, 433 N.E.2d 204, 210 (Ohio 1982), *But cf.* Fidelity Bank v. Avrutick, 740 F. Supp. 222, 237 (S.D.N.Y. 1990) (a close relationship with the transferor might facilitate notice of fraud in a transaction but alone cannot create an issue of the purchaser's good faith); Deutsche Bank Trust Co. Ams. v. Samora, 321 P.3d 590, 600–01 (Colo. Ct. App. 2013) (refusing to treat entities owned by a common parent company as sufficient to apply the closely connectedness doctrine); First Nat'l Acceptance Corp. v. Bishop, 187 S.W.3d 710, 716 (Tex. App. 2006) (refusing to adopt *Unico*'s close connectedness doctrine but nevertheless refusing to treat as a holder in due course a purchaser that had exercised a "substantial voice" in the transferor's business).

The close connectedness doctrine prompted the Federal Trade Commission to issue its Holder in Due Course Regulation, 16 C.F.R. § 433.2, which insulates a consumer who issues negotiable instrument in a consumer transaction from the rights of a holder in due course. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 15-9 (6th ed. 2010).

In general, a purchaser of assets, even a purchaser acquiring substantially all of the assets of a business, is generally not liable for the seller's debts. However, most jurisdictions in the United States recognize the following four equitable exceptions to this basic rule:

(1) if the purchaser expressly or impliedly agrees to assume the seller's liabilities;

(2) if the transaction amounts to a *de facto* merger or consolidation of the two parties;

(3) if the purchaser is merely a continuation of the seller; or

(4) if the transaction is entered into fraudulently to escape liability for debts.[65]

If any of these four exceptions applies, the purchaser will be deemed to be a "successor" of the seller, and will be liable for the seller's debts. The facts of Illustration Two present a strong case for successor liability under both the second and third exceptions: *de facto* merger and mere continuation.[66] Assuming one or both of those exceptions applies, Beta is not a genuine purchaser of Alpha's assets.

In short, a purchaser of assets that, under one of these principles, is a "successor" to the seller is not a genuine purchaser and hence not a good faith purchaser. This conclusion is evidenced by the fact that courts often refer to

65. *See, e.g.*, Daewoo Elecs. Am. Inc. v. Opta Corp., 2017 WL 5662383, at *6 (9th Cir. Nov. 27, 2017) (applying California law); Lehman Bros. Holdings, Inc. v. Gateway Funding Diversified Mortg. Servs., L.P., 785 F.3d 96, 102 (3d Cir. 2015) (applying Pennsylvania law); C.T. Charlton & Assocs., Inc. v. Thule, Inc., 541 F. App'x 549, 551 (6th Cir. 2013) (applying Michigan law); Flake v. Schrader-Bridgeport Int'l, Inc., 538 F. App'x 604, 620 (6th Cir. 2013) (applying Tennessee law); DeJesus v. Park Corp., 530 F. App'x 3, 6 (1st Cir. 2013) (applying Massachusetts law); Douglas v. Stamco, 363 F. App'x 100, 101–02 (2d Cir. 2010) (applying New York law); Milliken & Co. v. Duro Textiles, LLC, 887 N.E.2d 244, 254–55 (Mass. 2008); Tabor v. Metal Ware Corp., 168 P.3d 814, 816–17 (Utah 2007); La Bella Dona Skin Care, Inc. v. Belle Femme Enters., LLC, 805 S.E.2d 399, 407 (Va. 2017); *see also* John H. Matheson, *Successor Liability*, 96 Minn. L. Rev. 371, 383–94 (2011); Restatement (Third) of Torts: Products Liability § 12 (1998) (restating this rule with respect to liability for defective products).

Although the rule is phrased consistently across jurisdictions, application of the rule does vary somewhat, with the result that courts must occasionally determine which state's law governs the successor liability issue. *See, e.g.*, Berg Chilling Sys., Inc. v. Hull Corp., 435 F.3d 455, 462–68 (3d Cir. 2006) (choosing between Pennsylvania and New Jersey law with respect to a claim that the transaction was a *de facto* merger). Moreover, the rules for successor liability can be different with respect to claims under federal law for employment discrimination, for nonpayment of wages, or for the cost of cleaning up environmental contamination.

66. The *de facto* merger and mere continuation bases for successor liability are similar, and courts look to many of the same facts in applying them. *See* Berg Chilling Sys., Inc. v. Hull Corp., 435 F.3d 455, 464–65 (3d Cir. 2006); Ruiz v. Blentech Corp., 89 F.3d 320, 325 (7th Cir. 1996); Luxliner P.L. Export Co. v. RDI/Luxliner, Inc., 13 F.3d 69, 73 (3d Cir. 1993); Nat'l Gypsum Co. v. Cont'l Brands Corp., 895 F. Supp. 328, 336 (D. Mass. 1995); Glynwed, Inc. v. Plastimatic, Inc., 869 F. Supp. 265, 275 (D.N.J. 1994); Lumbard v. Maglia, Inc., 621 F. Supp. 1529, 1535 (S.D.N.Y. 1985). *But cf.* Bud Antle, Inc. v. E. Foods, Inc., 758 F.2d 1451, 1457 (11th Cir. 1985) ("Although the de facto merger and mere continuation exceptions are related and have similar characteristics, most courts have treated them as separate theories.").

"good faith" when analyzing whether an asset purchaser has successor liability under one of these principles, occasionally going so far as to equate the concepts.[67] But the conclusion also follows at a more conceptual level. As a successor to the seller, the purchaser stands in the shoes of the seller, and hence is not really a purchaser at all and cannot be entitled to greater rights of a good faith purchaser.[68]

Of course, nothing in the facts of Illustration Two indicated that the judgment creditor had an interest in or claim to any of the assets that Alpha transferred to Beta. And without such an interest or claim, there might be no need to determine whether Beta is a good faith purchaser of those assets. So let us tweak the facts a bit with the following illustration:

Illustration Three

> Same initial facts as in Illustration Two. After obtaining the judgment, the judgment creditor acquired a judgment lien on Alpha's equipment.[69] The judgment lien is subordinate to Bank's prior perfected security interest.[70] In response, and in an effort to effectively free both the business and the equipment of liability on the judgment, Contractor: (i) formed Beta Construction, LLC; (ii) caused Alpha to transfer all of its assets other than the equipment to Beta for $10; (iii) got Bank to foreclose its security interest in the equipment by selling the equipment to Beta on credit, taking back a security interest in the equipment to secure payment of the purchase price;

67. *See, e.g.*, Yanez v. Graco Inc., 45 F. Supp. 3d 1016, 1031 (D. Minn. 2014); DeMauro v. MTH Enters. LLC, 2014 WL 1312068, at *4 (Ill. App. Ct. Mar. 31, 2014); Mamacita, Inc. v. Colborne Acquisition Co., 2011 WL 881654, at *3 (N.D. Ill. Mar. 11, 2011); Call Ctr. Techs., Inc. v. Grand Adventures Tour & Travel Pub. Corp., 635 F.3d 48, 52 (2d Cir. 2011); Walton v. Mazda of Rock Hill, 657 S.E.2d 67, 70 (S.C. Ct. App. 2008).

The relationship of good faith to successor liability might be different when successor liability is established under a broader, federal-law doctrine. *Cf.* K.C. 1986 Ltd. P'ship v. Reade Mfg., 472 F.3d 1009, 1021 (8th Cir. 2007) (suggesting that CERCLA liability can be imposed on a successor even though it is a bona fide purchaser); Major v. Chons Bros., Inc., 53 P.3d 781, 785 (Colo. Ct. App. 2002) (suggesting successor liability under the FLSA is imposed on bona fide purchasers); First Judicial Dist. Dep't of Correctional Servs. v. Iowa Civil Rights Comm'n, 315 N.W.2d 83, 92 (Iowa 1982) (similar). *But cf.* Flores v. Velocity Express, LLC, 2015 WL 3902006 (N.D. Cal. June 23, 2015) (treating bone fide purchase as one element of successor liability under the FLSA); EEOC v. SWP, Inc., 153 F. Supp. 2d 911, 924 (N.D. Ind. 2001) (largely equating successor liability for the purposes of federal employment discrimination liability with the failure to qualify as a good faith purchaser).

68. U.C.C. section 3-302(c)(iii) prevents a person from qualifying as a holder in due course—that is, a good faith purchaser for value of a negotiable instrument—if the person is a "successor in interest" to the transferor. Although that rule is independent of the requirement of good faith, it is certainly consistent with the broader principle that a successor is not a good faith purchaser.

Purchasers in bulk also often do not qualify as a protected purchaser, *see* U.C.C. §§ 1-201(b)(9) (defining buyer in ordinary course of business to exclude a buyer in bulk of the seller's goods); *id.* § 3-302(c)(ii) (providing that a buyer in bulk of the transferor's negotiable instruments cannot be a holder in due course), but that rule too is independent of the requirement of good faith.

69. In most jurisdictions, a judgment lien would not arise unless the sheriff levied on the equipment pursuant to a writ of execution. In some states, however, a judgment creditor may obtain a judgment lien on some types of personal property, including the equipment of a business, by filing a notice of the judgment with the Secretary of State or by recording the judgment in the appropriate county office. *E.g.*, Cal. Civ. Proc. Code §§ 697.510, 697.530; Nev. Rev. Stat. § 353C.170(2).

70. *See* U.C.C. §§ 9-201(a), 9-317(a).

(iv) dissolved Alpha; and (v) operated the construction business through Beta, using the same office and employees.

The mere fact that the transfer of the equipment was effected as a foreclosure sale by Bank, rather than as a direct transfer by Alpha, will not insulate Beta from successor liability.[71] Assuming Beta is a successor to Alpha, Beta is not a good faith purchaser and thus does not take the equipment (or other assets) free of the judgment lien.[72]

So, to summarize so far, a good faith purchaser must, in all contexts, be a genuine purchaser. This means that a purchaser with successor liability does not qualify as a good faith purchaser. More broadly, it means that the purchaser must not be engaged in fraud and the transaction must have a real economic purpose other than to defeat the rights of a third party.

The remainder of this article explores what additional requirements apply for good-faith-purchaser status in selected settings.

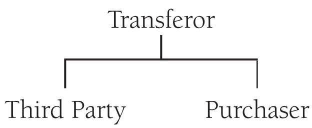
Good Faith Purchaser of Real Property Under Recording Statutes

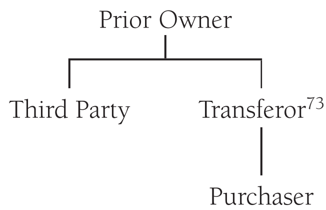
As discussed above, the state real property recording statutes that require good faith for a purchaser to take free of an unrecorded interest use "good faith" primarily as a synonym for "without notice." The cases on what constitutes notice—and therefore an absence of good faith—are legion and not entirely consistent from jurisdiction to jurisdiction. Yet despite occasional differences in results, the basic issue remains the same: did the purchaser know or have reason to know of the prior unrecorded interest.

71. *See, e.g.*, Call Ctr. Techs., Inc. v. Grand Adventures Tour & Travel Pub. Corp., 635 F.3d 48 (2d Cir. 2011); NLRB v. Leiferman Enters., LLC, 649 F.3d 873 (8th Cir. 2011); Elvis Presley Enters., Inc. v. Passport Video, 334 F. App'x 810 (9th Cir. 2009); Murphy v. Blackjet, Inc., 2016 WL 3017224 (S.D. Fla. May 26, 2016); Sourcing Mgmt., Inc. v. Simclar, Inc., 118 F. Supp. 3d 899 (N.D. Tex. 2015); Opportunity Fund, LLC v. Savana, Inc., 2014 WL 4079974 (S.D. Ohio Aug. 19, 2014); Agit Global, Inc. v. Wham-O, Inc., 2014 WL 1365200 (S.D. Cal. Apr. 7, 2014); Security Alarm Fin. Enters., Inc. v. Parmer, 2013 WL 593767 (N.D. W. Va. Feb. 15, 2013); Ortiz v. Green Bull, Inc., 2011 WL 5554522 (E.D.N.Y. Nov. 14, 2011); Perceptron, Inc. v. Silicon Video, Inc., 2010 WL 3463098 (N.D.N.Y. Aug. 27, 2010); Miller v. Forge Mench P'ship Ltd., 2005 WL 267551 (S.D.N.Y. Jan. 31, 2005); *In re* Comprehensive Power, Inc., 2017 WL 6327192 (Bankr. D. Mass. Dec. 8, 2017); United States v. Adaptive Micro-Systems, LLC, 914 F. Supp. 2d 1331 (Ct. Int'l Trade 2013); BRS-Tustin Safeguard Assocs. II, LLC v. iTherX Pharma, Inc., 2014 WL 2621117 (Cal. Ct. App. June 13, 2014); Millbrook IV, LLC v. Production Servs. Assocs., LLC, 2015 WL 1516531 (Ill. App. Ct. Apr. 1, 2015); Milliken & Co. v. Duro Textiles, LLC, 887 N.E.2d 244 (Mass. 2008); Auto. Innovations, Inc. v. J.P. Morgan Chase Bank, 2014 WL 7745773 (N.J. Super. Ct. Feb. 5, 2015); Florence St. Corp. v. Armenia Coffee Corp., 2013 WL 3466540 (N.J. Super. Ct. July 11, 2013); Tap Holdings, LLC v. Orix Fin. Corp., 970 N.Y.S.2d 178 (App. Div. 2013); Fourteen Florence St. Corp. v. Armenia Coffee Corp., 2013 WL 3466540 (N.J. Super. Ct. July 26, 2013); Cont'l Ins. Co. v. Schneider, Inc., 873 A.2d 1286 (Pa. 2005); *see also* La Bella Dona Skin Care, Inc. v. Belle Femme Enters., LLC, 805 S.E.2d 399 (Va. 2017) (unlike successor liability based on fraud, which must be proven by clear and convincing evidence, successor liability based on mere continuation need be proven only by a preponderance of the evidence; the lower court erred in applying the higher standard and then concluding that the newly formed entity that purchased the assets of a business from a secured party at a foreclosure sale was not a mere continuation of the debtor).

72. *See* U.C.C. § 9-617(a)(3), (b), (c)(3) (providing, collectively, that a transferee that does not act in good faith takes collateral subject to any subordinate lien); *see also id.* § 9-617 cmt. 4.

In a broad sense, the decisions on what constitutes reason to know—and therefore notice—are an effort by courts to assess comparative fault. The third party claimant acquired an interest in the property before the purchaser—either from the transferor or from someone further up the chain of title:





But the third party failed to properly record the instrument of transfer through which the third party acquired its interest. Accordingly, the third party bears a substantial portion of the responsibility for the fact that there are now multiple claimants to the property and a dispute between them about whose interest takes priority. But this responsibility of the third party is counterbalanced by the rather substantial due diligence that the law expects of those who purchase real property.[74]

The reasons for this expectation are not difficult to discern. Real property tends to be one of the most expensive assets that individuals or businesses acquire and one of the most valuable assets they own. Given the high cost, prudence alone should impel purchasers of real property to engage in significant due diligence. Given the high value, which implies that the third party is likely to suffer a substantial loss if the purchaser is granted priority, the law wants to encourage purchasers to take steps to avoid the loss. Moreover, for most purchasers of real property—individuals and businesses—such purchases are relatively infrequent. Even real estate developers, who *as sellers* might transfer dozens or even hundreds of parcels after subdividing the developed property, tend to be infrequent buyers of real property. Given the low frequency and high price, the costs of extensive due diligence are usually not excessive in relation to the purchase price. For all of these reasons, courts treat a rather wide array of facts as providing notice to the purchaser of the prior unrecorded interest.

In general, notice sufficient to defeat good faith consists of any of the following:

- Actual knowledge, which arises from information communicated to the purchaser.

73. There could, of course, be more than one intermediate owner between the grantor to the third party and the grantor to the purchaser.

74. As some scholars have noted, the due diligence that the law requires of a good faith purchaser is somewhat inversely proportional to the precautions that the law could demand from the other claimant. *See* Alan Schwartz & Robert E. Scott, *Rethinking the Laws of Good Faith Purchase*, 111 Colum. L. Rev. 1332, 1339 (2011).

- Constructive notice, which arises from facts evident from a physical inspection of the property and a reasonable search of the recorded real estate records.
- Inquiry notice, which rises from whatever information should have been discovered during a reasonable investigation of the facts of which the purchaser has acknowledge or constructive notice.[75]

Under this approach, a purchaser has constructive notice not only of every properly recorded conveyance in the chain of title, but also of documents associated with one of them[76] and information referenced or recited in any of them.[77]

This is not to say that every recorded document provides constructive notice. A recorded conveyance by someone outside the chain of title does provide constructive notice.[78] For example, if a conveyance *to* a grantor is recorded after conveyance *by* the grantor, so that the latter would not normally be discovered in a search of the real property records, it is considered a "wild deed" and most jurisdictions will not treat it as providing notice.[79] Similarly, a restriction in the chain of title to the dominant estate, rather than in the chain of title to the subservient estate, might also fail to provide constructive notice.[80] Aside from these rather rare exceptions, the doctrine of constructive notice charges a purchaser with notice of pretty much everything recorded in the chain of title. Indeed, that is the purpose of having a recording system.

Inquiry notice can be extensive. One court held that it includes information in an unrecorded and apparently lost deed that was referenced in a replacement deed that was recorded.[81] Inquiry notice often also includes information that could be obtained from anyone in possession, if that person is someone other than the prospective grantor. For example, in many jurisdictions, a purchaser is expected to inspect the property and inquire of anyone in possession if that person claims an interest in the property.[82] This is true even if the property con-

75. *See, e.g.*, 11 Thompson, *supra* note 31, § 92.09(c).

76. *See, e.g.*, Gorzeman v. Thompson, 986 P.2d 29 (Or. Ct. App. 1999) (a grantee of an interest in real property was not a good faith purchaser and was on notice of the full amount of the $42,000 mortgage debt even though the recorded mortgage described the debt as only $400.26 because a reasonable person would question the correctness of a twenty-two-year mortgage for a $400 debt and the promissory note, which indicated the correct amount, was recorded with the mortgage).

77. *See, e.g.*, Miller v. Romanauski, 2014 WL 1408215 (Ohio Ct. App. Apr. 10, 2014) (purchasers had constructive notice of a restriction contained in recorded deeds to owners up the chain of title to their grantor).

78. *See, e.g.*, Esterholdt v. PacifiCorp, 301 P.3d 1086 (Wyo. 2013).

79. *See, e.g.*, *In re* Nowlin, 558 B.R. 907 (Bankr. C.D. Cal. 2016); Sabo v. Horvath, 559 P.2d 1038 (Alaska 1976); *see also* Salt Lake City v. Metro W. Ready Mix, Inc., 89 P.3d 155 (Utah 2004) (a purchaser whose own title is based on a wild deed cannot be a good faith purchaser).

80. *See, e.g.*, Oliver v. Schultz, 885 S.W.2d 699 (Ky. 1994); Witter v. Taggart, 577 N.E.2d 338 (N.Y. 1991); *cf.* Huntington Nat'l Bank v. R Kids Count Learning Ctr., LLC, 2017 WL 4265919 (Ohio Ct. App. Sept. 26, 2017) (a purchaser had no notice of a recorded mortgage granted by a ground lessee of .6 acres of a 1.5-acre lot because the mortgage was outside the chain of title of the whole).

81. Harper v. Paradise, 210 S.E.2d 710 (Ga. 1974).

82. *See, e.g.*, *In re* Blanchard, 520 B.R. 740 (Bankr. E.D. Wis. 2014); Bohensky v. 3912 NU Rainspring, LLC, 48 N.Y.S.3d 481 (Sup. Ct. 2017); 11 Thompson, *supra* note 31, § 92.09(c)(3)(a). *Contra* Grose v. Sauvageau, 942 P.2d 398 (Wyo. 1997); N.M. Stat. § 14-9-3; Va. Code § 55-96(A)(1).

tains numerous units, each of which is in the possession of a different person.[83] The expectation also applies even if the purchaser has entered into with the transferor an agreement that restricts the purchaser's freedom to make inquiry of tenants or others in possession.[84] In other words, a purchaser cannot though its contract with the transferor limit the scope of its due diligence in a way that will affect the rights of third parties.

The doctrine of inquiry notice has been criticized as running counter to one of the underlying goals of the recording system: to facilitate real estate transaction.[85] Nevertheless, it survives and limits who qualifies as a good faith purchaser of real property.

Good Faith Purchaser of Goods under the U.C.C.

The U.C.C. has rules that protect two different types of purchasers of goods: (i) buyers in ordinary course of business and (ii) good faith purchasers for value. The former is a subset of the latter. The rules protecting each type are grounded, to a large extent, in an assessment of comparative responsibility.

Buyer in Ordinary Course of Business

To be a BIOCOB, a person must do all of the following:

- Be a buyer (not merely a purchaser).
- Be in good faith.
- Act without knowledge that the sale violates the rights of another person in the goods.
- Buy in the ordinary course of business.
- Transact with a person in the business of selling goods of that kind.
- Not purchase in bulk.
- Take possession of the goods or have the right to recover the goods from the seller.[86]

A person who qualifies as a BIOCOB is protected by two rules. First, the buyer acquires all of an entruster's rights to the goods.[87] Thus, for example, if the owner of an emerald brooch brings it to a jeweler for repair, and the jeweler mistakenly or maliciously sells the brooch to a BIOCOB, the BIOCOB acquires all of the

83. *See, e.g.*, Waldorff Ins. & Bonding, Inc. v. Eglin Nat'l Bank, 453 So. 2d 1383 (Fla. Ct. App. 1984); Phelan v. Brady, 23 N.E. 1109 (N.Y. 1890).

84. *See, e.g.*, 116 Madison St., LLC v. Seid, 901 N.Y.S.2d 900 (Civ. Ct. 2009).

85. *See* 11 THOMPSON, *supra* note 31, § 92.09(c)(3).

86. U.C.C. § 1-201(b)(9). In addition, the seller must not be a pawnbroker and, while the buyer may purchase on credit, the transaction cannot be in total or partial satisfaction of a money debt. *Id.*

87. *See id.* § 2-403(2).

owner's rights to the brooch. Second, a BIOCOB takes free of a security interest created by the seller.[88]

Assessing the good faith needed to be a BIOCOB begins with an analysis of the comparative responsibility of the buyer and the third party claimant. However, the calculus is quite different than it is with respect to purchasers of real property. As with the third party claimant to real estate, the third party claimant to the goods—an entruster or secured party—bears some responsibility for creating the situation that results in the priority dispute.

An entruster has delivered goods to a person who is in the business of selling goods of that kind.[89] Doing so is not negligent and certainly is not malicious, but merchants who are in the business of selling a kind of good are commonly supposed to be the owner of those goods, or at least authorized to sell them. Consequently, even though the entruster has not authorized the merchant to sell the entrusted goods, the entruster at least enabled such a sale to occur.[90]

A creditor with a security interest in a merchant's inventory is likely to have done something similar. Such a creditor may perfect the security interest by filing in the appropriate office a financing statement that identifies the debtor and describes the collateral in general terms.[91] Such a financing statement gives notice to the world of the secured party's rights in the goods, much like recording a deed or mortgage in the appropriate county office gives notice to the world of the grantee's interest. The secured creditor could alternatively perfect the security interest by taking possession of the goods,[92] but few creditors with a security interest in inventory do that or wish to do that. After all, their purpose is generally not to finance the *inventory*, but to finance the debtor's *business*, and the debtor needs possession of the inventory so as to be able to sell the inventory and otherwise operate the business.

A perfected security interest normally continues in collateral that the debtor sells,[93] and the secured party's rights are presumptively superior to the rights of the buyer.[94] However, a secured party may authorize the debtor to sell collateral—any type of collateral—free and clear of the security interest.[95] Such authorization might be given expressly, either in the security agreement or by a subsequent written or

88. *See id.* § 9-320(a).

89. If the person to whom the goods are entrusted is not in the business of selling goods of that kind, no purchaser from the person in possession can qualify as a BIOCOB. *See id.* § 1-201(b)(9).

90. *See* Graffman v. Espel, 1998 WL 55371, at *3 (S.D.N.Y. Feb. 11, 1998) ("When a person knowingly delivers his property into the possession of a merchant dealing in goods of that kind, that person assumes the risk of the merchant's acting unscrupulously by selling the property to an innocent purchaser. The entrustment provision places the loss upon the party who vested the merchant with the ability to transfer the property with apparent good title."), *aff'd*, 201 F.3d 431 (2d Cir. 1999).

91. *See* U.C.C. §§ 9-108(a)–(c), 9-310(a), 9-502(a), 9-504.

92. *See id.* § 9-313(a).

93. *See id.* § 9-315(a)(1). *But cf. id.* § 9-317(b)–(d) (allowing buyers, lessees, and licensees to take their interests free of an unperfected security interest).

94. *See id.* § 9-201(a).

95. *See id.* § 9-315(a)(1).

oral statement.[96] Alternatively, such authorization might be implied from the parties' course of dealing or course of performance.[97]

The law that allows a BIOCOB to take free of a perfected security interest[98] is not so much as an exception to the rules that generally allow a creditor with a perfected security interest to defeat the rights of a buyer, as it is a corollary to the rule that a secured party may authorize the debtor to sell collateral free and clear of the security interest.[99] In essence, it creates a conclusive presumption that the secured party has authorized the sale free and clear.

If, however, the secured party perfects its security interest in inventory by taking possession of the collateral, the debtor will be unlikely able to sell the collateral. More important, the buyer is unlikely to qualify as a BIOCOB because to do so the buyer must take possession or have the right to take possession.[100] If instead the secured party perfects by filing a financing statement, but leaves the debtor with possession, the secured party is facilitating the debtor's sale of the inventory much like an entruster does, and perhaps more so. This is the case even though the secured party's filed financing statement gives notice to the world of the security interest.

It is unclear precisely how the responsibility of an entruster or of a secured party that perfects a security interest in inventory by filing compares to the responsibility of a real estate grantee that fails to properly record its interest. What is clear, however, is that the good faith of a purchaser of goods from a merchant is treated very differently from the good faith of a purchaser of real property. A brief exploration of those differences is in order.

To qualify as a good faith purchaser of goods from a seller engaged in the business of selling goods of that kind, little or no due diligence is required.[101] That is

96. *See, e.g.*, Peoples Nat'l Bank & Trust v. Excel Corp., 695 P.2d 444 (Kan. 1985) (bank officer's oral instruction to debtor when loan was made that debtor was free to sell the cattle at any time trumped provision of written security agreement prohibiting debtor from selling livestock); Citizens Nat'l Bank of Madelia v. Mankato Implement, Inc., 441 N.W.2d 483 (Minn. 1989) (bank's oral consent to debtor's trade-in of collateral was effective to extinguish its security interest in collateral despite a written provision in security agreement that such consent must be in writing).

97. *See, e.g.*, Neu Cheese Co. v. FDIC, 825 F.2d 1270 (8th Cir. 1987) (creditor consented to sales of milk free and clear by failing to object to more than 700 prior sales); Gretna State Bank v. Cornbelt Livestock Co., 463 N.W.2d 795 (Neb. 1990) (debtor's sale of cattle was impliedly authorized by years of bank's failure to object to such sales as long as debtor retained sixty head); Farmers State Bank v. Farmland Foods, Inc., 402 N.W.2d 277 (Neb. 1987) (secured party authorized sales of hogs free and clear by failing to object to more than 130 previous sales).

98. *See* U.C.C. § 9-320(a).

99. *See* Valley Bank & Trust Co. v. Holyoke Cmty. Fed. Credit Union, 121 P.3d 358 (Colo. Ct. App. 2005) (buyers of automobiles took free of security interest held by seller's secured lender because the lender was deemed to have authorized the sales free and clear and because the buyers qualified as buyers in ordinary course of business); W. Idaho Prod. Credit Ass'n v. Simplot Feed Lots, Inc., 678 P.2d 52 (Idaho 1984) (buyer of crops, who could not take free under the predecessor of section 9-320(a), took free of a perfected security interest because the secured party had by its conduct authorized the sale).

100. *See* U.C.C. § 1-201(b)(9).

101. This is true even with respect to expensive goods, such as aircraft. *See, e.g.*, *In re* Gary Aircraft Corp., 681 F.2d 365, 375–76 (5th Cir. 1982).

Note, however, that the protection accorded to BIOCOBS is not absolute. They do take subject to a perfected security interest granted by someone other than the seller, presumably further up the chain of because these transactions are ubiquitous and often in exchange for small amounts of consideration. To require extensive due diligence before the purchaser can take free of third party claims and interests would disrupt the free flow of commerce. Even a standard based on actual knowledge of the competing property rights—which might not impose any measure of due diligence—would be undesirable because it would create a factual issue in each case: what did the buyer know. The law instead wants to preserve the finality of these common transactions. In this respect, it is perhaps fair to suggest that the law is protecting the transaction more than it is protecting the buyer.

The cases dealing with the qualifications to be a BIOCOB bear this out. Most deal with one or more of the other requirements rather than with good faith.[102] Moreover, the few that do refer to good faith might really be relying on one of the requirements. For example, in *Chen v. New Trend Apparel, Inc.*,[103] the court adopted a magistrate's conclusion that, because the buyer of textiles viewed the seller's purported desire to be paid large sums exclusively in cash as a red flag that something was amiss, the buyer was obliged to investigate further into the ownership interests of the merchandise being purchased.[104] However, it was unclear whether this conclusion, which did not resolve the case but merely led to a denial of a motion for summary judgment, was based on the requirement of good faith or the requirement that the sale be made in the ordinary course of business.[105] In *Porter v. Wertz*,[106] the court held that a purchaser of a painting was not a buyer in ordinary course of business in part because of his "indifference" as to the seller's provenance to the painting.[107] However, the decision was equally based on the fact that the seller was a delicatessen employee, and thus not in the business of selling art.[108]

Perhaps the most informative case about the good faith needed to be a BIOCOB is *Davis v. Carroll*,[109] although even in that case there was evidence that the sales

title. *See* U.C.C. § 9-302(a) (limiting the take-free rule to security interests "created by the buyer's seller"); *In re* Sunrise R.V. Inc., 105 B.R. 587 (Bankr. E.D. Cal. 1989) (a BIOCOB does not take free of security interest granted by a prior owner). Although that limitation has been criticized, *see* Richard H. Nowka, *Section 9-320(a) of Revised Article 9 and the Buyer in Ordinary Course of Pre-encumbered Goods: Something Old and Something New*, 38 BRANDEIS L.J. 9 (2000), it is there to protect secured parties that finance equipment, rather than inventory. It also means that a buyer of expensive goods, particularly used goods, might wish to conduct some due diligence by investigating the source of the seller's title and the extent of the seller's ownership.

102. *See, e.g.*, Zaretsky v. William Goldberg Diamond Corp., 820 F.3d 513 (2d Cir. 2016); Aircraft Trading & Servs. Inc. v. Braniff, Inc., 819 F.2d 1227 (2d Cir. 1987); *In re* Ayres Aviation Holdings, Inc., 342 B.R. 104 (Bankr. M.D. Ga. 2006) (dealing with whether the buyer acquired the goods in satisfaction of preexisting debt); Tanbro Fabrics Corp. v. Deering Milliken, Inc., 385 N.Y.S.2d 260 (1976); Nat'l Bank of Commerce v. First Nat'l Bank & Trust Co. of Tulsa, 446 P.2d 277 (Okla. 1968) (each dealing with whether the seller was in the business of selling goods of the kind involved); Wells Fargo Bank, NW v. RPK Cap. XVI, LLC, 360 S.W.3d 691 (Tex. App. 2012).

103. 8 F. Supp. 3d 406 (S.D.N.Y. 2014).

104. *Id.* at 454.

105. *See id.* at 453 (noting both requirements when beginning this portion of the analysis).

106. 416 N.Y.S.2d 254 (Sup. Ct. 1979).

107. *Id.* at 257, 259.

108. *Id.* at 257.

109. 937 F. Supp. 2d 390 (S.D.N.Y. 2013).

were not in the ordinary course of the seller's business, providing an alternative basis for concluding that the buyer was not a BIOCOB.[110] The case involved an art collector who purchased from a dealer several consigned paintings that the rightful owner had previously asked the dealer to return. In deciding whether the buyer acted in good faith, and thus qualified as a BIOCOB, the court noted that a merchant buyer of artwork is expected to take additional steps to verify the true owner when "there are warning signs about problems in a sale."[111] This heightened duty of merchant buyers of artwork rests in part on the high price artwork can command and the relative ease with which stolen art can be conveyed to innocent purchasers, who then must relinquish the art to the rightful owner.[112] The court went on to identify each of the following as possible red flags:

- a sale price obviously below market;
- a negotiation or sales procedure that differed from previous transactions between buyer and seller;
- the buyer's awareness of the seller's financial difficulties; and
- the buyer has reason to doubt the seller's ownership of the artwork.[113]

The court then concluded that the collector had not acted in good faith because the collector had not responded reasonably to two red flags. First, the provenance documents provided by the dealer—some of which the collector had created—were ambiguous as to whether the dealer owned the artworks or was selling them on consignment on behalf of the artist's estate.[114] Those that clearly identified the dealer as the owner were not supported by evidence indicating how the dealer became the owner.[115] Second, the sales price represented a 68.55 percent discount from fair market value.[116] While there was evidence that a discount as high as 40 percent might be appropriate for transactions involving large volumes, atypical works, and galleries keen to shift their focus, there was no evidence suggesting that higher discounts were ever customary.[117] Other New York cases support the conclusion that an offer to sell artwork to a merchant at a bargain price is a red flag that requires investigation into the work's ownership if the buyer is to be in good faith.[118]

110. *See id.* at 434–35.
111. *Id.* at 423 (quoting Joseph P. Carroll Ltd. v. Baker, 889 F. Supp. 2d 593, 604 (S.D.N.Y. 2012)).
112. *See id.*
113. *Id.* at 426 (quoting *Baker*, 889 F. Supp. 2d at 604).
114. *Id.* at 429.
115. *Id.*
116. *Id.* at 404, 432–34.
117. *Id.* at 407–08, 434.
118. *E.g.*, Kozar v. Christie's, Inc., 2011 WL 1886585, at *9 (N.Y. Sup. Ct. May 18, 2011). Of course, not every discount or reduction in price creates a red flag. *See* Morgold, Inc. v. Keeler, 891 F. Supp. 1361, 1368–69 (N.D. Cal. 1995) (the drop in the seller's asking price for a painting

But while *Davis v. Carroll* and the cases it relies on do impose a measure of due diligence on some buyers, it is important to note that courts have been careful to restrict this duty to buyers who are merchants,[119] although that might be due to the fact that New York continues to define "good faith" differently for merchants and non-merchants.[120] More significant, the courts are clear that such due diligence applies only when there are warning signs of an impropriety. As to what warning signs really should matter, however, some further discussion is warranted.

Recall that a BIOCOB takes free of a security interest created by the seller even if the security interest is perfected and even if the BIOCOB knows of its existence.[121] However, a buyer of goods that knows the sale violates the rights of rights of another person cannot be a BIOCOB.[122] The good faith required of a BIOCOB must be consistent with these rules. If *knowledge* of a security interest does not prevent a buyer from qualifying as a BIOCOB, then mere *reason to know* of a security interest cannot either. Thus, reason to know of a security interest is not enough to create, under the guise of good faith, a duty to investigate further. The predicate to such a duty to investigate is whether the buyer has reason to know that the sale would violate the rights of someone else.

The mere fact that the buyer knows or has reason to know that the goods are on consignment should be treated similarly. After all, a consignment sale does not necessarily—or even normally—violate the rights of the consignor. If, however, the buyer has reason to know that the sale violates the consignor's rights, it would be appropriate to expect the buyer to investigate further and to regard a buyer who does not as not acting in good faith.[123]

The warning signs the court actually relied on in *Davis v. Caroll* arguably did suggest that the sale might violate someone else's rights in the paintings. Consider first the problems with the dealer's provenance, which gave the collector reason to doubt the dealer's ownership. If the documents had clearly indicated that the goods were being sold on consignment and that the seller did not claim ownership, the documents would not have constituted a red flag. They would

was not a warning signal because the original asking price was far above what was then reasonable and the ultimate sales price was within a reasonable price range for such a painting).

119. *See id.* at *8; Brown v. Mitchell-Innes & Nash, Inc., 2009 WL 1108526, at *6–7 (S.D.N.Y. Apr. 24, 2009); Graffman v. Espel, 1998 WL 55371, at *6 (S.D.N.Y. Feb. 11, 1998).

120. The heightened standard for merchants was based on the fact that Article 2 imposed a heightened standard of good faith on merchants: not merely honesty in fact but also observance of reasonable commercial standards of fair dealing. *See* U.C.C. § 2-103(1)(b); *see also Graffman*, 1998 WL 55371, at *5; Porter v. Wertz, 416 N.Y.S.2d 254, 257 (Sup. Ct. 1979). The official text of revised Article 1 removed this dichotomy by redefining good faith as requiring observance of reasonable commercial standards of fair dealing for all U.C.C. purposes (except Article 5). *See* U.C.C. § 1-201(b)(20). Consequently, in most states, merchants and non-merchants seeking to qualify as a BIOCOB would presumably be judged the same. However, New York did not adopt the heightened standard of good faith when it enacted revised Article 1. *See* N.Y. U.C.C. § 1-201(b)(20).

121. *See* U.C.C. § 9-320(a).

122. *See id.* § 1-201(b)(9).

123. *But cf.* Nordhues v. Maulsby, 815 N.W.2d 175, 190 (Neb. Ct. App. 2012) (quoting J.C. Equip., Inc. v. Sky Aviation, Inc., 498 S.W.2d 73, 76 (Mo. Ct. App. 1973), for the proposition that good faith requires that the buyer not have notice "of outstanding rights of others" or "of facts which would place a reasonably prudent person upon inquiry as to the title he is about to purchase").

have merely indicated that the sale was a consignment sale, not that the transaction violated the rights of the consignor. But by providing conflicting indications of ownership, the documents left it unclear who the owner was. A dealer who does not clearly distinguish between artwork owned and artwork consigned is not keeping very accurate records. It would be a jump to conclude that the dealer might therefore be selling goods the dealer is not authorized to sell, but only a small jump.

The heavily discounted price is somewhat similar. While merchants commonly discount goods, and even sell some goods below cost either as loss leaders or when going out of business, a discount approaching 70 percent of goods worth six or seven figures is not normal. Such a sale might be legitimate, but it does not strain one's imagination to suspect that the seller is seeking to unload goods in haste before the rightful owner comes calling. Moreover, it is appropriate to consider the two warning signs together. While ambiguous provenance documents and a heavily discounted price for expensive items might, individually, be only orange flags, collectively they appear bright red.

In contrast, it is far from clear that the other things identified but not relied on by the court as red flags really do suggest that the sale might violate the rights of the third person. A negotiation or sales procedure that differs from previous transactions suggests an unusual transaction but by itself does not suggest that a third party's rights are being infringed upon. The unusualness of a transaction might be sufficient to prevent the buyer from qualifying as a BIOCOB, but not due to a lack of good faith. Similarly, a buyer's awareness that the seller is having financial difficulties does not imply violation of a third party's rights. Hundreds of thousands of individuals and businesses go bankrupt each year and most do not steal from others as they circle the drain of insolvency.

In sum, purchases of goods from merchants in the business of selling goods of that kind can result in a priority dispute between the buyer and the rights of a third party. However, that third party—an entruster or secured party—bears some responsibility for enabling the dispute to arise by allowing the merchant to have possession of the goods. Because such purchases are common transactions, often in exchange for small amounts of consideration, the law is wisely loathe to impose on the buyers a substantial degree of due diligence, or indeed any requirement of due diligence absent some red flag. Doing so runs the risk of seriously impeding commerce. Finally, given the numerous other requirements for BIOCOB status, there is not much that the requirement of good faith itself needs to do. Accordingly, only if the buyer is not a genuine buyer,[124] or is presented with and fails to follow up on facts suggesting that the sale will violate the rights of a third party, should the buyer be deemed not to have purchased in good faith.

124. *See supra* notes 47–72 and accompanying text.

Good Faith Purchaser for Value

Section 2-403(1) provides protection for good faith purchasers of goods for value. Specifically, it provides that a person with "voidable title" to goods has the "power to transfer good title to a good faith purchaser for value."[125] The provision goes on to provide examples of when a person acquires voidable title. Before exploring what "good faith" means in this context, it is worth noting what this rule does not do.

By protecting good faith purchasers from someone with *voidable* title, the provision implicitly leaves unprotected all purchasers, whether in good faith or not, from someone with *void* title. "Void title" is a somewhat oxymoronic phrase for a person with no claim of ownership at all: a thief. In short, a thief cannot transfer good title to a good faith purchaser.[126] This rule—or non-rule, given that it is unexpressed in the Code—is premised in part on an assessment of comparative responsibility. Certainly, the victim of the theft and a good faith purchaser from the thief might both be innocent of any wrongdoing. Neither bears any responsibility for the thief's criminal act and only one of them can have superior rights to the goods. The law sides with the owner partly out of respect for the fundamental principles of property—*nemo dat quod non habet* and first in time, first in right. But there is another underlying reason for this rule. The purchaser entered into a voluntary transaction with the thief,[127] whereas the owner did not. The purchaser is therefore deemed to bear greater responsibility for creating the situation in which two innocent parties claim the goods.[128]

Voidable title, in contrast, is created through a voluntary transaction with the rightful owner.[129] For example, a buyer that pays with a check that is later dishonored, or who otherwise defrauds the seller in some way, acquires voidable title.[130] This is true even if the fraud constitutes theft under applicable criminal law.[131] Indeed, a buyer acquires voidable title almost any time the seller would

125. U.C.C. § 2-403(1).

126. *See, e.g.*, Textile Supplies, Inc. v. Garrett, 687 F.2d 123 (5th Cir. 1983); Suburban Motors, Inc. v. State Farm Mut. Auto. Ins. Co., 268 Cal. Rptr. 16 (Ct. App. 1990); Allstate Ins. Co. v. Estes, 345 So. 2d 265 (Miss. 1977); Welch v. Cayton, 395 S.E.2d 496 (W. Va. 1990); *see also* DeWeerth v. Baldinger, 836 F.2d 103 (2d Cir. 1987); O'Keeffe v. Snyder, 416 A.2d 862 (N.J. 1980); Solomon R. Guggenheim Found. v. Lubell, 567 N.Y.S.2d 623 (1991) (each dealing with when the statute of limitations begins to run on the owner's claim against someone who purchased stolen goods from a thief).

127. Recall that a purchaser is defined as a person that takes by a voluntary transaction creating an interest in property. U.C.C. § 1-201(b)(29), (30).

128. If the dispute is between the purchaser and a subrogee of the owner, such as an insurer that compensated the owner for the theft loss, the analysis might be different. Some courts look to apply the "superior equities doctrine" to such a situation. *See, e.g.*, Schrier v. Home Indem. Co., 273 A.2d 248 (D.C. 1971).

129. *See, e.g.*, Inmi-Etti v. Aluisi, 492 A.2d 917, 921–22 (Md. Ct. App. 1985).

130. *See* U.C.C. § 2-403(1)(b).

131. *See, e.g.*, West v. Roberts, 143 P.3d 1037, 1042–44 (Colo. 2006); Charles Evans BMW, Inc. v. Williams, 395 S.E.2d 650, 651–52 (Ga. Ct. App. 1990). *But cf.* Moore Equip. Co. v. Halferty, 980 S.W.2d 578 (Mo. Ct. App. 1998) (the individual who forged the signature of the person he claimed to represent on the documents used to purchase a combine did not qualify as purchaser with voidable title).

have restitution claim against the buyer,[132] including claims based on incapacity, mistake, or unconscionability. Section 2-403(1) protects the good faith purchaser who acquires the goods from someone with voidable title presumably because the prior owner with the restitution claim generally bears responsibility for putting the seller in the position of apparently having ownership and the ability to convey ownership.[133]

However, to qualify for this protection—that is, to be in good faith for the purposes of section 2-403—the purchaser must have no reasonable basis to believe that the seller lacks good title to the goods. Notice that this statement of the rule is phrased in the negative. That is quite intentional. The purchaser need not have reason to believe that the seller has good title; merely no reasonable basis for believing that the seller lacks it.

Determining what constitutes a reasonable basis to question the seller's ownership can be difficult because section 2-403(1) can apply to a variety of transactions. Unlike the rules protecting a BIOCOB, section 2-403(1) applies to both transactions in the ordinary course of business and transactions outside the ordinary course. It applies to purchases from merchants engaged in selling goods of that kind, merchants engaged principally in some other business and involved in only one transaction in this type of goods, and to purchases from non-merchants.[134] Similarly, the protected purchaser could be a merchant or non-merchant; and it could be a buyer or a secured party.[135] Moreover, although section 2-403(1) is limited to purchases of goods, it can apply to any type of goods—new or used, expensive or inexpensive, covered by a certificate of title or untitled.[136] It is questionable

132. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §§ 13(2), 14(3), 16(2) (2011); *see also* U.C.C. § 2-702(3) (subordinating a seller's reclamation rights to the rights of a good faith purchaser).

133. *Cf.* Sale Chevrolet, Buick, BMW, Inc. v. Peterbilt of Florence, Inc., 514 S.E.2d 747, 750 (N.C. Ct. App. 1999) (noting in its analysis of the facts involved that the prior owner was in the better position to have avoided the problem and that the purchaser was the closer of the two in observing reasonable commercial standards of fair dealing in the trade); MBank-Waco v. L. & J., Inc., 754 S.W.2d 245 (Tex. App. 1988) (by voluntarily entrusting an individual with possession of cattle and allowing him to place his brand on the cattle, the owners of the cattle "clothed him with indicia of ownership" and were estopped from asserting legal title to the cattle over the individual's secured party).

The same rationale underlies U.C.C. section 9-317(b), which allows a buyer of most types of personal property, including goods, to take free of an unperfected security interest if the buyer acts without knowledge of the security interest. The secured party in such a situation bears some responsibility for creating the conflict because it failed to take the actions needed to perfect, such as by filing a financing statement or taking possession of the collateral, which would provide a form of constructive or inquiry notice of a security interest. It is not clear why section 9-317(b) is based on lack of knowledge while section 2-403(1) is based on good faith.

134. *See West*, 143 P.3d at 1041 (subsection 2-403(1), unlike subsections (2)–(4), applies to non-merchant transactions).

135. *See, e.g.*, Shell Oil Co. v. Mills Oil Co., 717 F.2d 208 (5th Cir. 1983); *In re* Affiliated of Fla., Inc., 237 B.R. 495 (Bankr. M.D. Fla. 1998); *In re* Rea Keech Buick, Inc., 139 B.R. 625 (Bankr. D. Md. 1992); *In re* Wathen's Elevators, Inc., 32 B.R. 912 (Bankr. W.D. Ky. 1983); Maryott v. Oconto Cattle Co., 607 N.W.2d 820 (Neb. 2000); *MBank-Waco*, 754 S.W.2d 245 (each ruling that a secured party can be a good faith purchaser under section 2-403(1)).

136. Nevertheless, the vast majority of cases applying section 2-403(1) involve vehicles, livestock, or artwork.

whether the same degree of due diligence is expected by the purchaser in all of these different transactions. What is clear from the cases, however, is that the due diligence expected of a good faith purchaser of goods is somewhat less than what is expected of a good faith purchaser of real estate (which as discussed above is a lot) and somewhat more than what is expected of a BIOCOB (which is little).

Perhaps the most revealing judicial opinion on what good faith means in this context is another decision by the U.S. Court of Appeals for the Third Circuit, this one in *Johnson & Johnson Products, Inc. v. Dal International Trading Co.*[137] The case involved gray market goods: goods imported and sold in the United States outside the manufacturer's distribution system, often contrary to the wishes of the manufacturer. The manufacturer in Great Britain had sold the goods to a buyer that allegedly fraudulently misrepresented its intention to distribute the goods in Poland. The goods were nevertheless resold to a distributor in the United States. The trial court enjoined the distributor from reselling the goods after concluding that it was likely that the distributor had not purchased in good faith.[138] This conclusion was based on two principal facts. First, the distributor's entire business was conducted in a manner designed to insulate it from knowledge of potential illegality. Specifically, the shipping labels showing where the goods had originated were removed before the goods arrived in the distributor's warehouse, apparently so as to obscure the chain of title and prevent the transmission of knowledge of fraud in prior transactions. Second, the price of the goods was so low that the distributor must have known that the manufacturer would not have knowingly sold its products for resale in the United States.[139]

The Third Circuit vacated the injunction. It agreed that the trial court was justified in concluding that the manufacturer would not approve of a sale of the goods to a U.S. distributor, and that the distributor probably suspected that.[140] However, the court ruled that the relevant inquiry was different: whether the distributor knew that the goods had been obtained by fraud, or suspected as much and closed its eyes to the truth.[141] This required evidence that the distributor knew or had some reason to know that the original buyer had misrepresented to the manufacturer at the time of sale that it would distribute only in Poland. In short, there is a difference between having reason to know that the manufacturer would disapprove and having reason to know that the manufacturer had been defrauded. Put simply, the legally relevant question was whether the distributor "knew or suspected that there was a flaw in the title of one of its predecessors."[142] The court then went on to rule that the distributor had no duty to investigate.

In reaching this conclusion, the court observed that the reason section 2-403(1) protects good faith purchasers "is to promote commerce by reducing transaction costs; it allows people safely to engage in the purchase and sale of goods without

137. 798 F.2d 100 (3d Cir. 1986).
138. *Id.* at 102–03.
139. *Id.* at 103.
140. *Id.*
141. *Id.*
142. *Id.* at 104.

conducting a costly investigation of the conduct and rights of all previous possessors in the chain of distribution."[143] Consequently, the court was unwilling to impose a duty to investigate unless the distributor suspects that the seller's title is flawed.[144]

The court's language and reasoning strongly suggest that the court would not have recognized a duty to investigate even if the distributor had reason to suspect that the seller's title was defective, as long as it did not actually suspect.[145] In other words, the court was using a subjective, rather than objective, standard. On this point, the court appears to be in the minority. Most courts treat good faith as requiring a duty to investigate if facts known to the purchaser create a reasonable basis for doubting the seller's ownership of the goods.[146]

Even under this standard, however, a purchaser has no duty to proactively search public records of pending litigation and hence is not charged with knowledge of what those records might reveal about claims to the goods.[147] Similarly, a vehicle purchaser does not lose good faith status by failing to examine or receive a certificate of title or manufacturer's statement of origin at the time of purchase, at least if the seller is a dealer.[148] This is so even if by doing so the purchaser failed to comply with its own internal guidelines or processes.[149] In contrast, there is some authority indicating that a buyer of an aircraft might have a duty to examine the records of ownership maintained by the FAA in order to purchase in good faith,[150] and a purchaser of a vehicle from a non-merchant might be expected to examine the seller's certificate of title.[151] After all, those records are created and maintained by government agencies precisely so that purchasers can readily ascertain information about the ownership of the goods to which the records relate.

Consistent with the Third Circuit's decision in *Dal International Trading*, a purchaser's knowledge that the seller has unpaid suppliers will not prevent the purchaser from being in good faith,[152] nor will knowledge that the seller

143. *Id.*; *see also* Welch v. Cayton, 395 S.E.2d 496, 501 (W. Va. 1990) (the rule "rests on the premise that it is cheaper for an owner to take precautions against giving title to a defrauder than it is for a purchaser to research the chain of title to every good he purchases").

144. 798 F.2d at 106.

145. *See id.* at 105. In so doing, the court analogized to the good faith needed to qualify as a holder in due course. A principal theme of this article is that "good faith" does—or least might—mean something different in each of the numerous rules that protects a good faith purchaser, and thus it is unwise to borrow authority under one rule and apply it to another without careful thought.

146. *See, e.g.*, Kotis v. Nowlin Jewelry, Inc., 844 S.W.2d 920, 924 (Tex. App. 1992) ("willful disregard of suspicious facts that would lead a reasonable person to believe the transaction was unlawful" prevents a purchaser from being in good faith).

147. *See* Brinkley v. Haluska, 982 N.E.2d 1019 (Ind. Ct. App. 2012).

148. *See, e.g.*, Cherry Creek Dodge, Inc. v. Carter, 733 P.2d 1024, 1028 (Wyo. 1987) (quoting Richard L. Epling, *Priority Disputes in Motor Vehicles and in Other Certificated Goods*, 41 Bus. Law. 361 368 (1983)).

149. *See* Libertyville Toyota v. U.S. Bank, 864 N.E.2d 850, 856 (Ill. App. Ct. 2007).

150. *See* J.C. Equip., Inc. v. Sky Aviation, Inc., 498 S.W.2d 73, 76–78 (Mo. Ct. App. 1973).

151. *Cf.* Kaminsky v. Karmin, 589 N.Y.S.2d 588 (Sup. Ct. 1992) (a buyer of a used vehicle might have to inspect record title, at least if vehicle has private plates, rather than dealer plates). If the purchaser were a secured party, compliance with the certificate of title statute would be necessary to perfect the security interest. *See* U.C.C. § 9-311(a)(2), (d).

152. *See* Shell Oil Co. v. Mills Oil Co., 717 F.2d 208 (5th Cir. 1983).

has not yet paid for the goods the purchaser is acquiring.[153] However, if the purchaser knew or had reason to know that the seller had acquired the goods without the ability or intention to pay, the purchaser would not be in good faith.[154]

It is impossible to catalogue all the facts that might raise a flag that is red enough to prompt a purchaser of goods to suspect the seller's ownership. Three factors, however, tend to stand out: the price paid for the goods, the location of the transaction, and the time between the seller's acquisition of the goods and the sale to the purchaser. When the circumstances of a transaction implicate all three factors, it will be difficult for the purchaser to ignore them and yet remain in good faith. For example, in one case an individual bought a car at a bar on a weekend night for $5,000 in cash, after learning that the seller acquired the car the day before for $8,100. The seller claimed he needed to sell after incurring gambling losses. The trial court concluded that purchaser was not in good faith, and hence did not take the car free of the claim of the prior owner to whom the seller had given a bad check. Unsurprisingly, the appellate court held that substantial evidence supported that conclusion.[155]

Even individually these three factors can raise a red flag. A seller who is willing to sell goods for far less than their known value might simply be in need of quick cash, but it is perhaps equally likely that the seller is trying to get anything of value for goods to which someone else has an actionable claim. Thus, for example, one court ruled that an individual who paid $3,500 for a mint-condition Rolex watch worth $7,000–$8,000, and who was familiar with the prices of such watches, was not a good faith purchaser.[156] Other decisions are in accord.[157]

Similarly, selling new consumer electronics out of the back of an unmarked van or anything of substantial value in the men's room of the local bus station is, to put it mildly, atypical. The purchaser is such a transaction should be on notice that there might be a defect in the seller's claim of ownership to the goods.[158] Even

153. *See* Brumley Estate v. Iowa Beef Processors, Inc., 704 F.2d 1352 (5th Cir. 1983); Genesee Merchants Bank & Trust Co. v. Tucker Motor Sales, 372 N.W.2d 546 (Mich. Ct. App. 1985); Maryott v. Oconto Cattle Co., 607 N.W.2d 820 (Neb. 2000); *see also* Libertyville Toyota v. U.S. Bank, 864 N.E.2d 850, 856 (Ill. App. Ct. 2007) (bank that purchased vehicles acted in good faith even though it was unaware of whether the seller's supplier had been paid for the vehicles).

154. *See* Blackhawk Pontiac Sales, Inc. v. Orr, 405 N.E.2d 499 (Ill. App. Ct. 1980); *see also* Burk v. Emmick, 637 F.2d 1172 (8th Cir. 1980) (purchaser that promised the prior owner that there were sufficient funds to cover the seller's payment for the goods, when in fact there were not, was not in good faith).

155. Cooper v. Pac. Auto. Ins. Co., 603 P.2d 281 (Nev. 1979).

156. Kotis v. Nowlin Jewelry, Inc., 844 S.W.2d 920, 924 (Tex. App. 1992).

157. *See* Graves Motor, Inc. v. Docar Sales, Inc., 414 F. Supp. 717 (E.D. La. 1976) (a purchaser that accepted a car worth $14,500 to satisfy as debt for $9,100—incurred from bad checks—and that allowed the seller to retain possession was not in good faith); Hollis v. Chamberlin, 419 S.W.2d 116 (Ark. 1967) (an individual who purchased for $500 what appeared to be a new $1,000 camper unit for a truck did not act in good faith); *see also* Cosid, Inc. v. Bay Steel Prods. Co., 252 So. 2d 274 (Fla. Ct. App. 1971) (there was factual issue about whether a buyer of steel acted in good faith so as to be a BIOCOB in part because the price was low); Karibian v. Paletta, 332 N.W.2d 484, 487 (Mich. Ct. App. 1983) (a fact finder may infer a lack of good faith from a low price).

158. A relative of mine used to sell new stereo components out of a van in a large U.S. city. He worked on commission. Purchasers thought that they were getting a steal—both literally and figuratively—and my relative did nothing to counter that perception. In fact, the goods were not stolen. But by exploiting

the mere fact that a third party has possession of the goods might, if known by the purchaser, be sufficient to raise a duty to inquire further.[159]

Collectively, these cases suggest that section 2-403(1) is an anti-ostrich rule, not a pro-ferret rule.[160] To be in good faith, a purchaser must not put its head in the sand, wilfully ignoring disturbing circumstances or information, but it need not dig up the dirt in a proactive search. Moreover, the Third Circuit was absolutely correct that no duty to investigate arises merely because the transaction is unusual or the facts known to the purchaser provide a reasonable basis for suspecting that the seller is engaged in some improper conduct (e.g., doing something that a prior owner would not approve of). The purchaser must have a reasonable basis for suspecting a defect in the seller's title to the goods, and thus that the rights of a third person are at stake, before the purchaser has any duty to investigate.[161]

The discussion of section 2-403(1) so far has focused on purchasers who are buyers. But it is important to remember that a secured party is also a "purchaser" that can take goods free of the claim of a prior owner.[162] If the debtor entered into the security agreement and the secured party gave value after the debtor acquired voidable title to the goods, the analysis of good faith should be the same as for a buyer. But if the security agreement and value predate the debtor's acquisition of the goods, the analysis of good faith must take this different sequence of events into account.

The most common scenario in which this sequence of events is likely to arise is if the secured party is financing the debtor's inventory and has a security agreement covering existing and after-acquired inventory, although a creditor that is financing the debtor's entire business might have a security interest in all existing and after-acquired personal property, including both equipment and inventory. The first question to deal with is at what time is the secured party's good faith to be determined. It could be:

(i) when the secured party first gave value and the debtor signed the security agreement;

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the purchasers' perception, he was able to sell inferior products at inflated prices. By all accounts, it was a very lucrative business model.

159. *See* W. States Collection Co. v. Marable, 437 P.2d 1000 (N.M. 1968).

160. I have used this metaphor before. *See* Stephen L. Sepinuck & Kristen Adams, *Spotlight*, COM. L. NEWSL. (ABA Bus. Law Section, Summer 2011) 7, 8 (discussing U.C.C. § 9-331 cmt. 5; Pascack Cmty. Bank v. Universal Funding, LLP, 16 A.3d 1097 (N.J. Super. Ct. App. Div. 2011)).

161. This is consistent with the approach recognized in the Restatement of Restitution. Section 66, titled "Bona Fide Purchaser," provides that a "purchaser for value and without notice" takes free of equitable interests that a restitution claimant might have. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 66 (2011). Although the text of the section fails to indicate what fact the purchaser must lack notice of, comment *a* specifies that it is notice "of competing claims." Thus, under the Restatement, it is not notice of *an irregularity* in the purchase transaction that prevents bona fide purchaser status, it is notice of *a competing claim*. *See also id.* § 66 cmt. d (explaining that the "elusive requirement of 'good faith' is not a separate requirement," but merely a synonym of "for value [and] without notice").

162. *See supra* note 135.

(ii) on each occasion that the secured party gave value (which might be frequently in the case of inventory financing);

(iii) on each occasion when the security interest attached to after-acquired goods, which could not be until when the debtor acquired rights in them and thus is likely to be on different dates for different goods;[163] or

(iv) on each occasion that the secured party took some affirmative action relating to the transaction.

There is one, somewhat old case suggesting that the good faith of the secured party should be analyzed only as of the time the security agreement was entered into.[164] However, this would not be consistent with other law protecting the rights of good faith purchasers, which focuses mostly on when the purchaser gave value.[165] More important, it fails to account for the circumstances that are most likely to call the secured party's good faith into question.

Consider a debtor that is having financial difficulties and has defaulted on its secured obligations. The collateral is worth substantially less than the secured obligation. Consequently, the secured party is undersecured and poised to suffer a significant loss. Shortly before the secured party exercises its default remedies, the debtor purchases goods on credit from one or more suppliers. Because the debtor is insolvent,[166] the suppliers have a right to reclaim the goods.[167] The suppliers might also have a restitution claim based on fraud, if the debtor misrepresented its ability or intent to pay for the goods. However, section 2-403(1) subordinates each of these claims to the rights of a good faith purchaser for value.[168]

The mere fact that the secured party's position improved as a result of the debtor's acquisition of the goods does not mean that the secured party failed to act in good faith.[169] Moreover, given the discussion above, the secured party's knowledge or reason to know that the debtor was insolvent would not negate good faith.[170] Even if the secured party knew or had reason to know that the debtor lacked the intention to pay for the goods, and thus knew or had reason to know that the debtor was acting with fraudulent intent, the secured party should still qualify as a good faith purchaser if the secured party took no action

163. *See* U.C.C. § 9-203(b)(2).

164. *See In re* Wathen's Elevators, Inc., 32 B.R. 912, 920 (Bankr. W.D. Ky. 1983).

165. *See, e.g.*, Garmo v. Clanton, 551 P.2d 1332 (Idaho 1976) (buyer of real property who acquires notice of an unrecorded interest after entering into the purchase contract but before making any payment is not a good faith purchaser); Daniels v. Andserson, 642 N.E.2d 128 (Ill. 1994) (same); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 66 cmt. f (2011) (indicating the purchase must be completed for the purchaser to be fully protected and that a purchaser who has paid only part of the price receives protection only for the amount paid).

166. *See* U.C.C. § 1-201(b)(23) (defining "insolvent").

167. *See id.* § 2-702(2).

168. *See id.* § 2-702(3) (referencing section 2-403 in connection with the reclamation right).

169. *See, e.g.*, *In re* Samuels & Co., 526 F.2d 1238 (5th Cir. 1976) (en banc, reversing an earlier panel decision to the contrary).

170. *See supra* notes 152–53 and accompanying text; *see also* Bank of Beaver City v. Barretts' Livestock, Inc., 295 P.3d 1088 (Okla. 2012) (the good faith requirement of section 2-403(1) does not require lender to notify the debtor's suppliers of the debtor's deteriorating financing condition).

to encourage the purchase after acquiring that knowledge or notice.[171] That is because the good faith of a purchaser relates to its knowledge or notice of facts at the time the purchaser acts. If all of the secured party's actions predate the debtor's fraudulent purchase of goods, and the secured party is simply relying on the automatic attachment of its security interest to after-acquired property as provided in the security agreement, there is no basis for denying the secured party the status of a good faith purchaser.

However, the result is and should be different if, after the secured party learns that the debtor will not pay or is unlikely to pay its suppliers, the secured party facilitates the debtor's acquisition of goods on credit in the hope of increasing the total value of the collateral.[172] Similarly, if the secured party has taken effective control of the debtor and orchestrated the debtor's purchase of goods without intending to pay for them, so as to increase the amount and value of the collateral, the secured party would not be acting in good faith and would not take free of the suppliers' reclamation rights.[173] Consequently, the secured party's good faith should be assessed not merely at the inception of the secured transaction, but also at later times, such as when the secured party takes some action relating to the transaction.

That said, not every action of the secured party negates good faith. Merely cutting off credit to the debtor is not bad faith, even if done without notifying the

171. *Cf. supra* note 154 and accompanying text.

172. *See, e.g.*, Dick Hatfield Chevrolet, Inc. v. Bob Watson Motors, Inc., 708 P.2d 494 (Kan. 1985) (the bank that facilitated the debtor's trade of vehicles with another dealer by releasing its security interest but which deposited the other dealer's check to the debtor and retained the funds while refusing to honor the debtor's check to the other dealer did not act in good faith).

If a secured party does not act in good faith, and therefore cannot defeat the reclamation rights of an unpaid seller of goods under section 2-403(1), the secured party presumably also does not gain priority under section 9-201(a), which provides that a security interest is effective against creditors of the debtor except as otherwise provided in the U.C.C. The language of exception covers the entire U.C.C., not merely Article 9.

173. *See, e.g.*, Monsanto Co. v. Walter E. Heller & Co., 449 N.E.2d 993, 1000 (Ill. App. Ct. 1983) (the trial court did not err in concluding that the secured party did not act in good faith given its considerable control over the debtor's operations and the debtor's transactions with its suppliers). In reaching its conclusion, the court did not specify precisely what the secured party did. Instead, it referred generally to its "direct involvement with the operation of [the debtor] and with [the debtor's] transactions with its suppliers." *Id.* at 1000. The secured party did closely monitor the debtor's books and records, had established a lock box for proceeds of collateral, and calculated how much of those proceeds would be released to the debtor pursuant to the parties' loan agreement. *Id.* at 995. It also cut off credit on short notice. *Id.* at 996. But these facts do not support a conclusion that the secured party acted in bad faith. Perhaps the decision is best explained by the fact that the court relied on the original decision of the Fifth Circuit in *In re Samuels*, before that decision was reversed en banc. *See id.* at 999–1000.

Numerous courts have suggested—but not ruled—that a secured party's control over the debtor can prevent the secured party from being a good faith purchaser. *See, e.g.*, *In re* Samuels, 526 F.3d at 1243 (ruling that there was no evidence that the secured party acted in bad faith in part because there was no claim that the secured party had exercised control over the debtor's business operations); MBank-Waco v. L. & J., Inc., 754 S.W.2d 245, 250–51 (Tex. App. 1988) (concluding that a bank, as a secured party, was a good faith purchaser of cattle in part because the bank never exercised any control over the debtor's cattle business or suggested that he defraud or deceive the cattle suppliers).

debtor's suppliers.[174] After all, the supplier has taken the risk of nonpayment by transferring the goods to the debtor in a voluntary transaction, and thus bears a significant portion of the responsibility for the fact that a priority dispute now exists. A secured party or other purchaser generally should not be charged with a duty to investigate the debtor's source of title, let alone a duty to protect the debtor's suppliers, because such a duty would impede the flow of commerce by slowing up and increasing the cost of numerous common and perfectly legitimate transactions.

Good Faith Recipient of a Fraudulent Transfer

There are two primary sources of law that provide for the avoidance of fraudulent transfers: (i) the Uniform Voidable Transactions Act, ("UVTA"),[175] formerly known as the Uniform Fraudulent Transfer Act; and (ii) section 548 of the Bankruptcy Code.[176] The UVTA gives creditors of the transferor the right to avoid a fraudulent transfer made by the transferor; the Bankruptcy Code gives the trustee in bankruptcy the power to avoid fraudulent transfers made by the debtor.[177] Each covers both actually fraudulent transfers and three types of constructively fraudulent transfers:

Actually Fraudulent Transfers:

- A transfer made "with actual intent to hinder, delay, or defraud";[178]

Constructively Fraudulent Transfers:

- A transfer for which the debtor received less than reasonably equivalent value and:
  - was insolvent or became insolvent as a result of the transfer;[179]

174. *See, e.g.*, Coop. Fin. Ass'n v. B & J Cattle Co., 937 P.2d 915, 921 (Colo. Ct. App. 1997); Maryott v. Oconto Cattle Co., 607 N.W.2d 820, 828 (Neb. 2000).

175. In 1918, the Uniform Law Commission promulgated the Uniform Fraudulent Conveyance Act ("UFCA"), which was later adopted by half of the states, to provide uniform rules on what constitutes a fraudulent transaction. *See* Uniform Voidable Transactions Act, Prefatory Note (2014). In 1984, the Commission replaced the UFCA with the Uniform Fraudulent Transfer Act ("UFTA"). *Id.* In 2014, the Commission made some minor amendments to the UFTA and re-titled it the Uniform Voidable Transactions Act ("UVTA"). Already, at least fifteen states have enacted the UVTA. Most of the remainder have the UFTA. The remaining few have either the UFCA, a nonuniform statute, or common law that governs fraudulent transfers.

176. Each also allows a creditor to avoid the debtor's incurrence of an obligation. *See* UVTA §§ 4(a), (5); 11 U.S.C. § 548(a)(1), (b). This article does not discuss avoidance of obligations.

177. If a debtor that has made an avoidable fraudulent transfer thereafter becomes the subject of a bankruptcy proceeding, the bankruptcy trustee may use either the applicable nonbankruptcy law—such as the UVTA—or section 548 to avoid the transfer. *See* 11 U.S.C. § 544(b)(1). However, the trustee may not use applicable nonbankruptcy law to avoid specified charitable contributions. *See* 11 U.S.C. § 548(b)(2).

In a Chapter 11 bankruptcy, the debtor in possession has the trustee's power to avoid fraudulent transfers. *See* 11 U.S.C. § 1107(a).

178. *See* UVTA § 4(a)(1); 11 U.S.C. § 548(a)(1)(A); *see also* UVTA § 1(2), (16) (defining "asset" and "transfer," respectively).

179. *See* UVTA § 5(a); 11 U.S.C. § 548(a)(1)(B)(i), (ii)(I); *see also* 11 U.S.C. § 548(a)(2), (d)(3), (4) (limiting the trustee's power to avoid charitable contributions). Under UVTA section 5(a), this type of

- was engaged in business while undercapitalized; or
- intended to incur debts beyond the debtor's ability to pay when due.[180]

There are some important differences between the avoidance rules of the UVTA and Bankruptcy Code section 548. Perhaps the most critical is that section 548 covers only those transfers made within two years before the filing of the bankruptcy petition.[181] In contrast, the UVTA generally reaches back longer, usually four years.[182] More relevant to this article, however, are the different protections each provides to a good faith transferee. Each protects a good faith transferee to the extent of the value the transferee provided to the debtor,[183] and for improvements made to the property after the transfer.[184] However, the UVTA goes further with respect to a good faith transferee of an actually fraudulent transfer by insulating the transfer from avoidance entirely (provided the transferee gave reasonably equivalent value). The following chart illustrates the variation in the protections available to a good faith transferee.

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transfer is avoidable only by a creditor whose claim arose before the transfer was made. In contrast, a bankruptcy trustee's power under 11 U.S.C. § 548 does not require that the debtor still have a creditor whose claim arose before the transfer, and the avoidance of a transfer under it is for the benefit of all creditors with prepetition, unsecured claims, regardless of whether their claims arose before or after the transfer. *See* Moore v. Bay, 284 U.S. 4 (1931); 11 U.S.C. §§ 550(a), 551.

180. *See* UVTA § 4(a)(2); 11 U.S.C. § 548(a)(1)(B)(i), (ii)(III); *see also* 11 U.S.C. § 548(a)(2), (d)(3), (4) (limiting the trustee's power to avoid charitable contributions).

181. *See* 11 U.S.C. § 548(a)(1). Certain transfers to a self-settled trust are avoidable if made within ten years before the petition regardless of the fraudulent transfer criteria set forth in section 548(a). 11 U.S.C. § 548(e)(1).

182. *See* UVTA § 9(a), (b). For intentionally fraudulent transfers, the limitations period is the latter of four years or one year after the transfer was or reasonably could have been discovered.

Note, these two limitations periods measure different timeframes. Section 548 deals with transfers made within two years before the filing of the bankruptcy petition. In contrast, section 544(b) and the UVTA deal with the time between when the transfer was made and when suit is brought to rescind it. UVTA § 9(a), (b) (four-year limitations period). Some states, however, have enacted longer or shorter time periods. *See, e.g.*, Cal. Civ. Code § 3439.09(c) (putting a limit of seven years on claims that might have taken longer to discover). On top of that, most courts to rule on the issue have concluded that section 546(a) of the Bankruptcy Code tolls the expiration of a statute of limitations under state law when a debtor files for bankruptcy. *See, e.g.*, *In re* Acequia, Inc., 34 F.3d 800, 807 (9th Cir. 1994); *In re* EPD Inv. Co., 523 B.R. 680 (9th Cir. BAP 2015); *In re* Antex, Inc., 397 B.R. 168, 174 (1st Cir. BAP 2008). In other words, as long as a state-law fraudulent transfer claim exists on the petition date, the only relevant limitations period is in 11 U.S.C. § 546(a), which normally gives the bankruptcy trustee two years to file the complaint from when the bankruptcy petition is filed. As a result, a trustee may bring an action under section 544 and the UVTA up to six years after the transfer was made (four years under the UVTA plus two additional years under section 546(a)).

If the IRS holds an unsecured claim, the limitations period is apparently even longer. *See In re* Kipnis, 555 B.R. 877 (Bankr. S.D. Fla. 2016) (section 544(b) gives the bankruptcy trustee the rights of unsecured creditors to avoid prepetition transfers, these rights are subject to non-bankruptcy statutes of limitation, and, under federal law, the IRS has ten years to collect taxes, during which period it may avoid transfers under state law without being bound by state statutes of limitation; therefore the trustee may avoid transfers as far back as ten years if the IRS holds an unsecured claim).

183. *See* UVTA § 8(d); 11 U.S.C. § 548(c).

184. *See* UVTA § 8(c); 11 U.S.C. § 550(e).

<table>
<tr><th></th><th>UVTA</th><th>Bankruptcy Code</th></tr>
<tr><td>Good faith transferee of an intentionally fraudulent transfer</td><td>Transfer unavoidable if reasonably equivalent value given, § 8(a).</td><td rowspan="2">Transferee protected to extent of value given, § 548(c), and for the lesser of the cost or value of any improvement, § 550(e).</td></tr>
<tr><td>Good faith transferee of either an intentionally or constructively fraudulent transfer</td><td>Liability adjusted as equities require, § 8(c), and transferee protected to extent of value given, § 8(d).</td></tr>
</table>

Despite these differences, it appears that "good faith" means the same thing under the UVTA and section 548 because they have essentially the same purpose. Each is designed to achieve a measure of distributive justice by unwinding a completed transaction that injured creditors of the transferor.[185]

But the mere fact that the phrase "good faith" means the same thing in these two statutory schemes for dealing with fraudulent transfers does not provide much guidance on what "good faith" means or on when a transferee has or has not acted in good faith. To analyze that, it is vital to appreciate how the issue differs from what it means for either a purchaser of real property to be in good faith under state recording statutes or a purchaser of goods to be in good faith under the U.C.C. There are three principal differences.

First, unlike the protections for good faith purchasers discussed above, the protections for good faith transferees of a fraudulent transfer are not in tension with fundamental principles of property law. Each of the good faith purchaser rules discussed above involves a competing claimant with an earlier interest in or claim to the purchased property, and the rule itself creates an exception to both *nemo dat quod non habet* and its corollary, first in-time, first-in-right. In contrast, fraudulent transfer laws are designed, for the most part, to protect the transferor's unsecured creditors. Such creditors could be almost anyone to whom the transferor owes a debt, including tort victims, trade creditors, or taxing authorities. The one thing they have in common is that they have no interest in or claim to any property of the transferor, and specifically no rights in the property transferred.[186] Instead, the transferee, by acquiring the property for

185. *See, e.g.*, *In re* Bayou Grp., LLC, 396 B.R. 810, 827 (Bankr. S.D.N.Y. 2008) ("Section 548 is not a punitive provision designed to punish the transferee, but is instead an equitable provision that places the transferee in the same position as other similarly situated creditors who did not receive fraudulent conveyances."), *aff'd in part & rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010).

186. In most cases, a secured party does not need to use fraudulent transfer law to recover collateral that the debtor has fraudulently transferred because the secured party will usually have superior rights to the collateral than does the transferee. *See* U.C.C. § 9-201(a). Moreover, it is doubtful that a secured party could use the UVTA to recover collateral that the debtor has fraudulently trans-

value, is a purchaser and the first to acquire an interest in the property. Accordingly, if *nemo dat* and first-in-time are relevant at all, they would seem to support the transferee, not the fraudulent transfer plaintiff. Indeed, because fraudulent transfer law unwinds completed transactions, sometimes transactions completed many years in the past, it runs counter to the finality principle that the law otherwise endeavors to protect.[187]

Second, there is little or no basis for assessing comparative responsibility. The fraudulent transfer plaintiff has done nothing to create the situation giving rise to the litigation, such as by failing to record a conveyance of an interest in real property or by delivering possession of goods to a buyer that has not yet paid. Thus, the plaintiff bears no responsibility at all.[188] But the same might also be true of the transferee. Moreover, because the transfer could involve any type of property and occur in any type of transaction,[189] even the payment of an antecedent debt,[190] it is nearly impossible to settle on the degree of due diligence that should be expected of the transferee.

Third, the consequence of being deemed to lack good faith is somewhat draconian. A buyer of goods who fails to qualify as a BIOCOB, and therefore takes subject to the rights of a secured party or entruster, or who fails to qualify as a good faith purchaser and therefore takes subject to the restitution claim of a prior owner, will almost always have a claim against the seller for breach of the warranty of title.[191] A purchaser for value of an interest in real estate who lacks good

ferred because the Act does not apply to property to the extent it is encumbered by a valid lien. *See* UVTA § 1(2), (12) (defining "asset" and "transfer," respectively).

187. The law seeks to respect finality of commercial transactions in numerous ways. For example, a majority of courts refuse to apply the discovery rule to a claim for theft of a negotiable instrument because of the policy favoring finality of commercial transactions. *See, e.g.*, John Hancock Fin. Servs., Inc. v. Old Kent Bank, 346 F.3d 727, 733–34 (6th Cir. 2003); Husker News Co. v. Mahaska State Bank, 460 N.W.2d 476, 477–78 (Iowa 1990); Brennan v. Edward D. Jones & Co., 626 N.W.2d 919 (Mich. Ct. App. 2001). For other examples, see the following: United States v. Lavin, 942 F.2d 177, 186 (3d Cir. 1991) ("The good-faith purchaser exception [in U.C.C. § 2-403(1)] developed over time in order to promote finality in commercial transactions and thus to encourage purchases and to foster commerce."); Bradford Trust Co. of Boston v. Tex. Am. Bank-Houston, 790 F.2d 407, 409 (5th Cir. 1986) (referencing the policy favoring finality in commercial transactions and using that policy to resolve a dispute between a bank that honored a forged wire transfer order of its customer and the bank to which the funds were wired but did not credit the account directed).

188. This is even more clear if the plaintiff were the bankruptcy trustee, who effectively represents all the unsecured claimants. Even if some unsecured claimants bore some responsibility for the situation—for example, by entering into transactions that precipitated the debtor's insolvency and bankruptcy filing—it would be inappropriate to burden other claimants for that. *Cf.* 11 U.S.C. § 544(a) (granting the trustee the rights to avoid any otherwise transfer that a creditor could avoid under nonbankruptcy law "without regard to any knowledge of the trustee").

189. *See* UVTA § 1(16); 11 U.S.C. § 101(54) (each defining "transfer" to include any "mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with" an interest in property).

190. *See* UVTA § 3(a); 11 U.S.C. § 548(d)(2) (each defining "value" to include satisfaction of an antecedent debt).

191. *See* U.C.C. § 2-312(1). The exception would be in the rare transaction in which the seller effectively disclaimed the warranty of title. *See id.* § 2-312(2).

faith and therefore does not take free of an unrecorded interest would also have a claim against the transferor if the transferor provided a general warranty deed.[192] In contrast, a recipient of a fraudulent transfer who lacks good faith loses any protection for the value of what the transferee provided in return.[193] For example, consider the following illustration.

Illustration Four

> Transferor, which is insolvent, sold Blackacre to Transferee for $400,000. Blackacre was worth $1 million at the time. A court later determines that the amount Transferee paid was not reasonably equivalent value for Blackacre, and avoids the Transfer. Transferee is therefore liable either to return Blackacre[194] or to pay $1 million value of Blackacre at the time of the transfer,[195] but in either case is entitled to either a lien on the property returned or a reduction in liability to the extent of the $400,000 paid if Transferee acted in good faith.[196] If Transferee did not act in good faith, Transferee remains liable for the $1 million value of Blackacre but gets no protection for the amount Transferee paid to Transferor.

In contemplating this illustration, it is important to recognize that, even if Transferee is deemed to have acted in good faith, Transferee remains liable for the net benefit received from the transfer ($600,000), and this amount fully compensates Transferor's creditors for the harm suffered as a result of the transfer for less than reasonably equivalent value.[197] If Transferee is deemed not to

192. The purchaser would also have a claim if the grantor provided a special warranty deed and the unrecorded interest arose directly or indirectly from the grantor.

193. *See* 11 U.S.C. § 548(c); UVTA § 8(d). Note, in bankruptcy, the recipient of an avoidable preferential transfer has an allowable claim for the debt that is thereby revived. *See* 11 U.S.C. § 502(h). The recipient of an avoidable fraudulent transfer does not. *In re* E. Coast Foods, Inc., 2017 WL 3701211 (Bankr. C.D. Cal. Aug. 25, 2017); *see also In re* Teleservices Grp., Inc., 444 B.R. 767, 804 (Bankr. W.D. Mich. 2011) ("not only would a transferee taking in bad faith have to return the fraudulently transferred property, he would also forfeit the consideration he had paid").

194. *See* UVTA § 7(a)(1) (authorizing relief consisting of avoidance of the transfer).

195. *See id.* § 8(b)(1) (indicating that liability is based on the value of the property transferred). If the plaintiff's claim were for a lesser amount than this total, Transferee would be liable for only that lesser amount. *Id.* § 8(b)(1).

196. *See id.* § 8(d).

197. If the transfer is avoided under the UVTA and judgment is for the value of Blackacre, rather than for return of the property, Transferor's creditors also stand to lose whatever the appreciation in Blackacre since the transfer. *See id.* § 8(c) (indicating that judgment is based on the value of the property at the time of the avoided transfer). However, that loss is not a consequence of the failure of Transferee to pay reasonably equivalent value, it is a function of the transfer itself. Moreover, if the transfer is avoided under the Bankruptcy Code—either under section 548 or through a combination of the UVTA and section 544(b)—Transferor's creditors might not lose the appreciation in Blackacre. Nothing in the Bankruptcy Code expressly indicates on what date value is to be determined. But section 550(e), which protects the buyer for the cost of improvements made after the transfer, suggests that the relevant date is not the date of transfer but some later date, such as when the complaint was filed or when judgment was entered. If value were determined as of the date of the transfer, there would be no need to add a protection for value added later by the transferee. *See also In re* Seitz, 400 B.R. 707, 722 (Bankr. E.D. Mo. 2008) ("[T]here is both case law and a strong equitable argument for allowing the trustee to recover either the greater of the value of the transferred property at the transfer date or the value at the time of the recovery."); *In re* Brun, 360

have acted in good faith, Transferee will either have paid $1.4 million for Blackacre ($400,000 to Transferor and $1 million to the plaintiff) or have paid $400,000 and have nothing to show for it. Thus, Transferee stands to suffer a significant loss, and the creditors of Transferor stand to significantly benefit, if Transferee is deemed not to have acted in good faith.

In sum, under fraudulent transfer law, a lack of good faith:

(i) subordinates the transferee to creditors who have no specific claim to or interest in the property transferred;

(ii) can lead to the reversal of a transaction that was long ago completed, and thus undermine the settled expectations that it created;[198] and

(iii) results in a rather draconian punishment.

Moreover, it does all this in connection with a transfer of any type of property in almost type of transaction, so that no single level of due diligence can be expected of the transferee. Arguably, therefore, good faith should be interpreted broadly (and the lack of good faith narrowly), so that most transferees are deemed to have acted in good faith. At a minimum, it shows that the standards used in other contexts to determine the good faith of a purchaser are likely to be based on policies and considerations that do not apply to fraudulent transfers.

In part because actually and constructively fraudulent transfers are fundamentally different from the perspective of both the transferor and the transferee, and in part due to the draconian sanction for lacking good faith, it is appropriate to consider whether the standards for good faith should be the same with respect to both types of transfer. Accordingly, the discussion that follows analyzes the two types of fraudulent transfer separately.

Actually Fraudulent Transfers

When the transferor acts with actual intent to hinder, delay, or defraud one or more creditors, the transferor is engaging in conduct that is both morally wrong and likely to cause economic injury. The law gives a full or partial defense to transferees who act in good faith largely based on the judgment that not all trans-

B.R. 669 (Bankr. C.D. Cal. 2007) (the trustee is entitled under section 550 to recover the full current value of property subject to a fraudulent transfer avoidable under a combination of section 544(b) and state law, even though that state law limits liability to the debtor's nonexempt equity on the date of the transfer).

Transferor's creditors might also suffer the expense of prosecuting the fraudulent transfer claim. But that is a function of the normal rule in this country that each party to litigation bear its own costs. Moreover, it cannot be that the sanction for Transferee being in bad faith is intended to compensate for these costs because that sanction—no defense for the value provided, which in this illustration is $400,000—might bear no relation to the costs of bringing the fraudulent transfer claim.

198. It is the avoidance of the fraudulent transfer that produces this effect, and the good faith of the transferee is generally relevant to whether the transferee receives protection for the value the transferee provided, not to whether the transfer is avoidable. However, good faith is a complete defense to the avoidance of an intentionally fraudulent transfer in exchange for reasonably equivalent value under the UVTA. *See* UVTA § 8(a).

ferees should be responsible for the bad acts and bad intent of the transferor. In short, good faith is some assessment of the transferee's moral culpability for the transferor's bad behavior. It therefore properly looks to the transferee's mental state.

When viewed in this light, it is useful to think of the transferee as falling somewhere on the following continuum:

No Notice of Fraud	Notice of (Reason to Suspect) Fraud	Knowledge of Fraud	Participant in (Benefits from) Fraud

An example of a transferee with no notice of the fraud—at the left-most end of the continuum—would be an individual shareholder of a company sold in a leveraged buyout that is later determined not to have been for reasonably equivalent value and which rendered the company insolvent. Such a shareholder might have had no knowledge of specific terms of the buyout or choice about whether to participate, particularly if the shares in the company were publically traded and the individual had only a few shares. A transferee at the right-most end of the continuum might be an insider or person in control of the transferor, and might have been the principal architect of the fraudulent transfer.

There can be little doubt that a transferee at the left-most end is in good faith and a transferee at the right-most end is not. Moreover, few would dispute that a transferee who knows of the fraud is also undeserving of protection and hence is not in good faith. The difficult question is whether the transferee must be without notice of the fraud—that is, lack reason to suspect fraud—to be in good faith and, if so, what constitutes notice and what amount of inquiry the law should expect of a transferee with notice.

At least with respect to fraudulent transfers under the Bankruptcy Code, there is a reasonable statutory argument that a transferee with notice of the fraud is not in good faith. Section 548(c) protects a direct transferee who acts in good faith. Section 550(b)(1) protects a subsequent transferee who acts in good faith and "without knowledge of the voidability of the transfer."[199] "Good faith" in section 550(b)(1) cannot mean simply knowledge of the avoidability of the transfer because then the standard would be duplicative.[200] Of course, it can still cover other things, such as genuineness. More likely, though, it also covers notice: reason to know that the transfer is avoidable. Then, assuming "good faith" in section 548(c) means the same thing as in section 550(b)(1),[201] section 548(c) re-

199. 11 U.S.C. § 550(b)(1).

200. *See In re* Teleservices Grp., Inc., 444 B.R. 767, 812 (Bankr. W.D. Mich. 2011).

201. *See In re* Taneja, 743 F.3d 423, 430 (4th Cir. 2014) (concluding that the standard for "good faith" under section 550(b)(1) also applies in section 548(c)).

quires a transferee to have no knowledge or reason to know that the transfer is avoidable to be in good faith.

In the context of an actually fraudulent transfer, that means reason to know of the transferor's intention to hinder, delay, or defraud.[202] Some courts, perhaps unwittingly, conflate the standards for avoidance of actual and constructively fraudulent transfers and combine them into a single test of good faith: whether the transferee had notice of either "that the transferor was insolvent or that the transfer might be made with a fraudulent purpose."[203] But given that the transferor's insolvency is, by itself, an insufficient basis for concluding that the transfer is avoidable as an actually fraudulent transfer, the transferee's notice or even knowledge of the transferor's insolvency should not be sufficient to undermine the transferee's good faith with respect to an actually fraudulent transfer. Even insolvent entities are permitted to engage in commercial transactions and to transfer property, and the authorities these courts relied on do not really support their statement.[204]

But even if knowledge or notice of insolvency is ignored, and the focus is on knowledge of notice of the transferor's intent to hinder, delay, or defraud, application of that standard is problematic. Consider the following illustration.

Illustration Five

> Desperate, the defendant in a pending lawsuit, advertises a parcel of real property for immediate sale in an all-cash transaction. The property has an assessed value of \$100,000 but probably has a slightly higher value. During negotiations with Buyer, Desperate states, "I hate to sell this property because I think it will go up in value, but I'm about to lose a lawsuit and I'd rather sell it now than lose it later." Buyer purchases the property for \$75,000. Desperate took the proceeds of the sale and deposited them in a foreign bank account under an assumed name. Shortly thereafter, the plaintiff obtained a judgment against Desperate. Desperate then filed

202. Under the UVTA, the transferee would also have to have reason to know that the transfer is for less than reasonably equivalent value.

203. *E.g.*, *In re* Bayou Grp., LLC, 439 B.R. 284, 310 (S.D.N.Y. 2010); *see also* Hays v. Jimmy Swaggart Ministries, 263 B.R. 203, 212 (M.D. La. 1999); *In re* O'Neill, 550 B.R. 482, 501 (Bankr. D.N.D. 2016); *In re* Evergreen Security, Ltd., 319 B.R. 245, 254 (Bankr. N.D. Fla. 2003).

204. The court in *Bayou Group* relied on one case for the proposition that knowledge or notice of the transferor's insolvency was sufficient to prevent the transferee from acting in good faith: Banner v. Kassow, 1996 WL 680760 (2d Cir. Nov. 22, 1996). *See* 439 B.R. at 310. The *Banner* court did state that "a transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency," 1996 WL 680760, at *2 (quoting *In re* Sherman, 67 F.3d 1348, 1355 (8th Cir. 1995)), and that the transferee "undoubtedly knew" of the transferor's dire financial straits. However, the court actually ruled that the transferee was aware the avoidability of the transfer, having "set up the whole scheme." *Id.* The *Sherman* decision that the *Banner* court relied on did rule that transferees were on notice of the transferor's insolvency, and this prevented them from being in good faith for the purposes of section 548(c). 67 F.3d at 1355–56. But the court offered no explanation why this should be and in the single case it in turn relied on, the court actually concluded that the transferees "participated in the indications of fraud." *In re* Anchorage Marina, Inc., 93 B.R. 686, 693 (Bankr. D.N.D. 1988).

> a bankruptcy petition. The bankruptcy trustee brings an action against Buyer seeking to avoid the sale under both section 548 of the Bankruptcy Code and the UVTA.[205] The bankruptcy court finds that Desperate acted with intent to hinder, delay, or defraud the plaintiff.

If Buyer acted in good faith, the transfer will nevertheless be avoidable under section 548. As a result, Buyer will have to return the property and lose the benefit of the bargain and any post-transfer appreciation of the property. However, Buyer will have a lien on the property returned for the $75,000 Buyer paid. Under the UVTA, the transfer will not be avoidable if Buyer gave reasonably equivalent value, a fact which is likely to be in dispute. If Buyer did not give reasonably equivalent value, Buyer's liability will be similar to those under section 548. If Buyer did not act in good faith, under both regimes Buyer loses the property and receives no protection of what Buyer paid.

Has Buyer acted in good faith? Buyer certainly knows of the pending lawsuit and has reason to believe that Desperate is, well, desperate. But is that enough to put Buyer on notice of Desperate's intent to hinder, delay, or defraud? If it is, what investigation should Buyer have performed, or should Buyer simply have refused to deal with Desperate? What if Buyer wired the purchase price to the foreign bank account at the closing?

There are no clear answers to these questions. The following sample of recent decisions is informative, but hardly provides definitive guidance on how to answer these questions or, more generally, how to determine when a transferee is on notice of the transferor's fraud.

In *In re Taneja*,[206] a bank that provided warehouse lending to a mortgage loan originator engaged in massive fraud acted in good faith when it accepted payments. The originator's brief delay in providing loan documents to the bank, its failure to sell many of the mortgage loans when the market for them collapsed, and its direct payment to the bank on loans for which payment should have come from purchasers of the loans were insufficient to put the bank on notice of the originator's fraud.

In *In re Equipment Acquisition Resources, Inc.*,[207] a casino had no way of knowing that the funds used by a former owner of a corporation to gamble at the casino had been obtained through fraud on corporate creditors. Thus, the casino was not closing its eyes to the creditors' plight, and was a good faith transferee.

In *In re Teleservices Group, Inc.*,[208] a bank initially acted in good faith in receiving payment on its loan despite the fact that payment came from an entity related to its borrower, but once the bank's representatives learned of the principal's

205. The trustee is empowered to use the UVTA by section 544(b) of the Bankruptcy Code. *See supra* note 177.
206. 743 F.3d 423 (4th Cir. 2014).
207. 803 F.3d 835 (7th Cir. 2015).
208. 848 F.3d 716 (6th Cir. 2017).

well documented history of defrauding people,[209] the bank could not assert its good faith in defense of liability on fraudulent transfer claims for recovery of subsequent indirect and direct loan repayments.[210]

In *In re Sentinel Management Group, Inc.*,[211] a bank that had loaned hundreds of millions of dollars to a cash management firm and obtained a security interest in the firm's assets did not act in good faith because it had reason to know—and one of its representatives actually suspected—that the firm was pledging its customers assets, an act prohibited by federal law.

In *In re Nieves*,[212] a lender that acquired a mortgage on real property of a limited liability company, which property was previously the subject of a fraudulent transfer, did not act in good faith because numerous facts known to it would have led a reasonable person to inquire further as to the voidability of the earlier transfer. These facts included the owner's confusion about the name of his own company and the fact that the company's certificate of good standing was a only month old when the mortgage loan was made. Moreover, the lender did not conduct a title search to confirm ownership by the company and, if it had conducted such a search, it would have discovered a prior transfer to the debtor's brother for no consideration shortly before the debtor's bankruptcy and a subsequent transfer by the debtor's brother for substantially less than market value.

In *In re LLS America, LLC*,[213] investors in what turned out to be a Ponzi scheme did not act in good faith because there were several red flags, such as missed payments, lack of financial statements, and high rates of return on investments, and because they should have been wary of the extremely lucrative compensation that was offered in exchange for their efforts to bring new investors into the enterprise.

In *SEC v. Helms*,[214] another Ponzi scheme investor did not act in good faith because his expected rate of return of two-and-a-half to three times the amount of the investment in three months was too good to be true, the side letter he obtained to collateralize his investment contradicted terms in the Partnership Agreement for the investment vehicle and therefore should have led him to believe that it breached the general partner's fiduciary duty to the limited partners, and a reasonably prudent investor should know that collateralizing his investment so as to get preferential treatment over other partners is unusual, and should have prompted a thorough investigation.

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209. The bank employee who had been asked to investigate the borrower's principal inexplicably did not disclose that information to the individual at the bank who was responsible for the loan, *id.* at 722, but the bank was nevertheless charged with having this information, *id.* at 731.

210. *Cf. In re* Int'l Mfg. Grp., Inc., 2018 WL 773497 (Bankr. E.D. Cal. Feb. 7, 2018) (the fact that a bank received payment on a secured loan from someone other than the obligor was insufficient to suggest that the bank had notice that the payment was an intentionally fraudulent transfer, and thus the bank received payment in good faith).

211. 809 F.3d 958 (7th Cir. 2016).

212. 648 F.3d 232 (4th Cir. 2011).

213. 2014 WL 7344012 (E.D. Wash. Dec. 23, 2014), *aff'd*, 701 F. App'x 565 (9th Cir. 2017).

214. 2015 WL 1040443 (W.D. Tex. Aug. 21, 2015).

Collectively, these cases suggest that knowledge of some impropriety is not enough to put a transferee on notice of the transferor's fraudulent intent. But what more will do so is not clear. Moreover, several of these decisions are not entirely persuasive. For example, it is far from obvious that learning of the transferor's prior fraudulent conduct should provide notice of fraudulent intent with respect to current transactions. Yet the court ruled that it did so in *Teleservices Group*. In *Helms*, the transferee's bad faith was demonstrated in part based on his prudence in protecting his investment.

Perhaps in part because of the problems in applying a notice-based standard, and in part due to underlying concerns about the appropriateness of the standard, some courts have begun to push back. For example, one court, in interpreting the UVTA or UFTA, recently rejected the focus on notice and concluded that a transferee lacks good faith only "if the transferee had actual knowledge of facts showing the transferor had fraudulent intent."[215] Another court recently concluded that an objective, notice-based standard should apply only to insiders, who are properly charged with knowledge of facts that should come to their attention as a result of a proper inquiry into red flags, but that an actual-knowledge standard should apply "when the transfers are to an unaffiliated third-party in arm's-length transactions that occur in the ordinary course of business on ordinary business terms and the debtor receives contemporaneous and exactly equivalent value for the transfer."[216] After all, such a transferee has not obtained any advantage over the transferor's creditors and "application of an objective standard of good faith in the context of ordinary business transactions would impose an unreasonable burden on ordinary commerce and is beyond the purpose and intent of the fraudulent transfer laws."[217]

There is much to be said for each of these approaches. Given the draconian sanction for lacking good faith and the difficulty in determine what constitutes reasonable notice and how much investigation a reasonable transferee should be expected to perform, courts should reconsider the notice-based standard for the good faith of a transferee of an actually fraudulent transfer. A notice-based standard essentially conscripts purchasers of property, creditors accepting payment, and other transferees into the commercial police; it punishes them if they fail to monitor the practices and intent of those with whom they do business. Fraudulent transfer law was not designed to do that.

Constructively Fraudulent Transfers

Nothing in the Bankruptcy Code or the UVTA expressly suggests that the phrase "good faith" means something different in connection with constructively fraudulent transfers than it does with respect to actually fraudulent transfers. But

215. Nautilus, Inc. v. Yang, 217 Cal. Rptr. 3d 458, 468 (Ct. App. 2017) (refusing to refer to "a reason to know" or to facts that "suggest to a reasonable person" so as to not create a duty to investigate for the purposes of good faith under the UFTA).

216. *In re* Int'l Mgmt. Assocs., LLC, 563 B.R. 393, 422 (Bankr. N.D. Ga. 2017).

217. *Id.*

transferring to constructively fraudulent transfers the standard for good faith used with respect to actually fraudulent transfers depends on how broadly or narrowly the standard is worded.

Accepting as a given the objective, notice-based standard for actually fraudulent transfers discussed but criticized above, then, the phrase "good faith" means: (i) in general terms, "no knowledge or reason to know the transfer is avoidable"; or (ii) in more specific terms, "no knowledge or reason to know of the transferor's intent to hinder, delay, or defraud." When dealing with constructively fraudulent transfers, courts have analogized to the more general phrasing. They thus treat a transferee as acting in good faith if the transferee had no knowledge or reason to know of the transferor's insolvency.[218] Notice, this is not precisely the same thing as asking if the transferee had knowledge or reason to know of the avoidability of the transfer because there are two elements to avoidability: the transferor's insolvency and the fact that the transfer is not for reasonably equivalent value.[219] However, the transferee would normally be expected to know or have reason to know whether it is providing reasonably equivalent value in exchange for the transferred property, so perhaps courts should not be faulted for overlooking this element and focusing only on knowledge or notice of insolvency. The bigger problem is that courts have focused on the broader wording of the standard rather than the specific wording.

Given the draconian sanction for lacking good faith, the issue should be—for both actually and constructively fraudulent transfers—not whether the transferee had knowledge or reason to know the transfer is avoidable, but whether the transferee knew or had reason to know that the debtor was engaged in fraud.[220]

As one court noted after an extensive and thoughtful discussion of the historical treatment of fraudulent transfers under the bankruptcy law, constructively fraudulent transfers are more analogous to preferences than to actually fraudulent transfers.[221] As the court put it, a constructively fraudulent transfer is *malum prohibitum* (wrong because prohibited), not *malum per se* (wrong in itself). Stated another way, "constructively fraudulent transfers, like preferences, are not avoidable because they are inherently bad. Rather, they are avoidable only because Congress has prohibited them in order to accomplish a fairer distribution of the debtor's assets."[222] The court then concluded that a transferee of a fraudulent transfer should not be deemed to lack good faith—and therefore denied credit for the value it did provide—unless the transferee was "tainted with dishonesty," which the court ac-

218. *E.g., In re* Am. Hous. Found., 544 F. App'x 516, 520 (5th Cir. 2013); *In re* Kudzu Marine, Inc., 569 B.R. 192, 209 (Bankr. S.D. Ala. 2017); *In re* Galbreath, 286 B.R. 185, 214 (Bankr. S.D. Ga. 2002).

219. *See* Robert J. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. Pa. L. Rev. 235, 251–52 (1976) (suggesting that courts err by not looking at the second element).

220. *See Nautilus*, 217 Cal. Rptr. 3d at 467 ("Our formulation of the test seeks to avoid framing the issue in terms of voidability. Instead, we frame the issue in terms of 'fraudulent intent.'").

221. *In re* Teleservices Grp., Inc., 444 B.R. 767, 805 (Bankr. W.D. Mich. 2011).

222. *Id.*

knowledged would never be the case when the transfer was merely constructively fraudulent.[223]

This makes good sense and might explain why there are comparatively few cases dealing with the good faith of a transferee of a constructively fraudulent transfer.

Conclusion

This article has explored only a few of the numerous statutory protections for good faith purchasers. In so doing, it has attempted to show that the applicable standard for good faith varies. Determining what "good faith" means in any specific context requires an examination of the statutory text and an appreciation of both the policies that the statute is designed to achieve and the potentially different policies underlying its protection for good faith purchasers.

For a protection that applies to only a one type of property or to only a particular transaction, the analysis must start with and concentrate on an assessment of the competing claimants' comparative responsibility for the circumstances giving rise to the dispute, and in particular what level of due diligence should the law expect from the purchaser. For more broadly applicable protections, courts must be careful not to impose, through their selection of a standard for good faith, a level of due diligence that is properly applicable to only a narrower class of transactions. Courts should also be highly conscious of the consequences for that flow from a lack of good faith. The harsher the sanction, the less demanding the standard.

223. *Id.* at 806.