

THE ECONOMIC LOGIC OF FORMALITY IN PROPERTY LAW

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ABSTRACT

The feature of property rights that renders them distinct from other legal rights is the capacity to transfer by private treaty *in rem* obligations affecting a potentially indefinite set of third persons. Roman law, prescribing a series of more or less onerous public formalities for the transfer of property, can be understood as a response to a paradox inherent in the idea of property rights, whereby rights against the whole world can be alienated by means of a private treaty to which far less than the whole world is privy. One of the Roman formalities, *traditio* (delivery), inhered in western legal systems for significant periods of time. But in the name of promoting contractual liberty, the formalities required for transfers of personal property have been progressively eroded. The contemporary consensus across legal systems is that transfer of title to chattels may take place without delivery formalities, permitting creation of security interests for credit transactions, based on separation of possession and ownership. Even in contemporary German-based legal systems, where lip service is still paid to delivery formalities derived from the Roman era, legal constructs are used to permit creation of these interests. But there remains a valuable publicity benefit to the formalities Roman law established for property transfers, that derives from the *in rem* nature of property rights. Efficiency requires a balancing act between two types of transaction cost: those paid by parties to a transaction in which title to property is transferred, and those paid in transactions in which third parties subsequently deal with the property. The latter transaction costs are multiplied across an infinite potentiality of third parties, generally rendering them the more important consideration. For lower value transactions, a simple delivery formality remains rational, as there is generally minimal cooperative surplus in permitting creation of a security interest over a low-value object. For higher value transactions, the transaction costs of public acts signifying separation of possession and title will be outweighed by the due diligence savings for third parties. If that was true in the Roman era, it is even more so in the age of information technology, where public registries can be easily created. The economic logic of transfer formalities suggests that the tendency toward contractual liberty, at least for transfer of *in rem* rights in personalty, is not always the most efficient result.

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I. INTRODUCTION

The very idea of a property right is cryptic. Philosophers have long puzzled over how to define what it means to say that something *belongs* to someone, and there are no sacrosanct definitions or models of what property ownership involves or who should own what. The notion of property is a diffuse cluster of different concepts in law and ethics, including rights of use, fairness of distribution, and freedom of transfer. As Hume said, “[t]is very preposterous ... to imagine, that we can have any idea of property, without fully comprehending the nature of justice, and shewing its origin in the artifice and contrivance of man. The origin of justice explains that of property. The same artifice gives rise to both.”¹ Property is an essentially contested concept, about which no *a priori* consensus can form.²

If the concept of property is so enigmatic, then it should come as no surprise if different strands within it raise inconsistencies. This paper seeks to lay bare one such inconsistency, exposing a fundamental dilemma in legal analysis of property rights that does not arise for other areas of law. I will suggest that the distinguishing feature of property rights, as opposed to other legal rights, lies in the unique modalities of their transfer from one person to another. These qualities naturally give rise to the question of just how any such transfer should be consummated.

“Property” describes a series of rules governing access to and use of material resources. Property rights are (for the most part) created by private agreement; but they are valid against

¹ David Hume, *A Treatise of Human Nature*, L.A. Selby-Bigge and P. H. Nidditch, ed.s (Clarendon 1978), 491.

² Jeremy Waldron, *The Right to Private Property* (Clarendon 1988), 51-2.

others who are not party to that private agreement. If I own this horse, you who sold it to me can no longer go to the stable and ride it at whim – at least, not without my permission. But neither can the gentleman who watches at the door of the stables every morning. Before our sale transaction, he could still not do so; now if he does so, he is accountable to a different person for his wrong. From his perspective, this arguably seems strange, because he may not have known about our transaction, which was entirely private. This stands in contrast to the contract he has with you, to provide services to muck out daily the stable where the horse resides. The stable-keeper owes that duty to you, and to you only. The fact that you have sold the subject-matter of his service contract to me does not novate his service contract from you to me – at least, not without his knowledge and consent. A right against him in respect of the horse can be transferred without his even being aware, but a right against him in respect of his duty to provide services can be transferred only with his permission. Property rights exist in the horse, but no property rights exist in the stable-keeper's services.

It is sometimes said that what distinguishes property rights from other legal rights is that they are valid against the whole world – they are valid *in rem*. This is undoubtedly true, but we must consider carefully what we mean by this. There is a sense in which contractual rights and tortious rights are likewise valid against the whole world. Your right to provision of stable-cleaning services from the stable-keeper is valid against the whole world, in the sense that if any third party pays the stable-keeper not to perform, he unlawfully interferes with your contractual rights, and you can sue him for causing breach of the contract. Likewise, my obligation in tort to drive carefully to the stable to visit my horse is owed to the whole world. It is a duty to other road-users, who may in principle be anyone who comes near me. As a road user, I likewise have a right against all other road users, that they drive carefully in my proximity. So it is with property rights, and with contractual rights: anyone in my proximity who interferes with

my property rights, my contractual rights, or my tortious rights, is liable to suit. The distinguishing feature of property rights must be something more.

The difference between property, contractual, and tortious rights is the manner by which the respective rights and obligations are acquired or transferred. Tortious obligations derive not from consent but merely from proximity – being sufficiently close to another person, in a legally relevant sense, that one owes them an obligation of care, or a duty not to harm them. It makes no sense to talk of tortious duties being “transferred” – the only way to evade a tortious obligation is not to enter into a relationship of proximity³ with the right-holder in the first place. Contractual obligations are created exclusively by consent. Contractual obligations can therefore be assigned only with consent (although in some legal systems contractual rights can be assigned without consent).⁴ You cannot assign to me your right to have the stables cleaned by the stable-keeper. By contrast, you can assign to me your right that the stable-keeper will not abscond with the horse. The benefit of the stable-keeper’s obligation not to ride the horse can be transferred without the stable-keeper’s consent. Therefore, like contractual obligations but unlike tortious obligations, obligations in property law can be transferred only with the consent of the person holding the right; but unlike contractual obligations, such a transfer affects the duties of obligors without their consent. It is this unusual feature of property rights – that consent is required for transfer of benefits but not for transfer of obligations – which makes them distinctive.

³ This need not imply physical proximity, although that is apparently necessary in the driving example. Misrepresentation (whether fraudulent or negligent) may be a tort, committed by a person against anyone who receives and relies upon the misrepresentation, usually provided that the person making the misrepresentation intended, anticipated, or should have anticipated, that the person would receive the representation and rely upon it. A different sort of proximity is required, to which physical closeness is not necessarily relevant.

⁴ In England, see section 136 Law of Property Act 1925.

We live in a world in which the private property transactions of others are constantly amending our legal obligations in a ceaseless flux. The capacity of individual consensual transactions to affect the legal relationships of those individuals with potentially every other individual in the world is what we mean when we say property rights exist *in rem*.

If this is the correct analysis of what makes property rights distinctive, then we can understand how intangible objects – intellectual property, shares, and securities – can likewise become the subjects of property rights. The essence of property is not that it is an object or resource, but that it is something in respect of which legal rights inhere, that may be transferred without the consent of those against whom they exist as obligations. Any negotiable instrument – a bill of lading, a share certificate, or a bond – may be regarded as having associated property rights. If the stable-keeper had agreed in advance that you could novate his service contract to anybody else without his consent, it might make sense to say that you had a property right to his services. Negotiability is the essence of a property right; it is a bundle of contractual rights that can be passed from one person to another by private treaty, binding the whole world as they pass.

The dilemma that arises, then, in property rights, is this. How can it be that a right affecting the whole world may be passed by private treaty? Is it fair and reasonable that my rights and those of potentially countless billions of others should be affected by a private agreement to which I am not party, and of which I know nothing and indeed could know nothing? The answer to that question depends upon the nature of my proposed interaction with the true owner. If I am a passer-by in need of urgent transport, and I see an unlocked car with the key in the ignition, then it is reasonable for me to assume that it belongs to someone who would object to my taking it. The fact that I am not privy to the series of transactions by which legal title was transferred from manufacturer to dealer to first purchaser to second purchaser, and thus I have

no idea just who does own the car, does not matter. The chances that it has either no owner or an owner who would not mind my taking it are so miniscule that I am undoubtedly a thief if I take off with it. However, if I am presented with a piece of furniture by a person with possession of the object, who offers it to me for sale, then I may legitimately be faced with the question of whether the person who offers it to me for sale in fact owns it. My rights and obligations – my right to buy it, and my obligation to its true owner – may be affected in those circumstances by the question of whether the property has been validly transferred to the person who now purports to sell it to me, or whether he is a thief (or an unwitting custodian of stolen goods).

The distinction between these two scenarios is this. If my proposed interaction with the property of another is likely to be wrongful whoever the true owner is, then the fact that I am not privy to the transactions by which ownership ended up with the current titleholder is irrelevant to my legal liability. I am bound by my ever-shifting property obligations, even though I may not know to whom they have most recently shifted. However, if my transaction *will* be lawful if the owner is A, but unlawful if the owner is B, then it is proper for me to be able to enquire into the private agreements by which title to the property has transferred up until the present day. It must be within my reasonable capacity to undertake due diligence that will satisfy me that the proposed transaction I am now contemplating is lawful. In laymen's terms, the law would be an ass, were it not to make provision for me to be able reasonably to verify the propriety of property transactions. In the economist's terms, the law would be *inefficient*: it would increase the transaction costs of acquiring property rights, by requiring incorporation of a risk premium to hedge against the chances that the vendor did not have the title he purported to hold. It would also render property markets illiquid, as those transaction costs might be of such a magnitude as to militate against the economic rationality of property transactions altogether.

A purchaser of property can always *ask* the vendor for evidence that he owns it. But that may be a burdensome affair. The investigation may have no logical conclusion, because the trail of title documents may go indefinitely far back. The evidence may have been lost. The vendor may be dishonest, furnishing fraudulent evidence. The question therefore arises, whether the law should take steps to alleviate the burden of this transaction cost, by imposing a public formality in connection with transfers of legal title to private property. This thought may at first sight seem unusual, but it is not so. For real property, it is the norm. Almost all developed countries maintain land registries, which record diverse legal interests in real estate. For private property, it may surprise the reader to discover that this is an idea with a substantially longer heritage. The notion that property rights should be subject to public acts of transfer goes back as far as Roman law, and vestiges of that tradition can be found in several modern legal systems. It is to the Roman origins of this notion that I now turn.

II. HOW TO TRANSFER PROPERTY: FROM ROMAN TO ENGLISH LAW

For both movable and immovable property, Roman law (unlike the common law)⁵ contained the idea of absolute ownership, which it called *dominium*. Because ownership was absolute,

⁵ Decisions of common law courts about property rights do not, save in certain specialist proceedings (e.g. some admiralty claims), have *in rem* effects. In common law, the Court's adjudication of ownership is in a dispute typically between two parties, that will only identify priority of entitlement, not absolute ownership: *Waverley Borough Council v Fletcher* [1966] QB 334, 345, per Auld LJ. The practical consequence of this is that, in the common law system, it is never open to the Court to identify a party as having absolute ownership of a chattel, as another party with some superior title claim could always come along later. Roman courts were more ambitious; it may have been the publicity requirements for transfers of property in Roman law that tempted them to be so.

transfer of *dominium* required special formalities to consecrate this absolute act. Initially, the principal type of ceremony used, called *mancipatio*, involved five witnesses (being male adult Roman citizens), a pair of scales, a Bronze or copper ingot, and a ritual incantation: “I assert that this thing is mine by Quiritarian law; and let it have been bought by me with this piece of copper and these copper scales”. The ingot would then be used to strike the scales, and would be handed to the transferor.⁶ The transaction costs of undergoing this ritual for every simple exchange were somewhat burdensome. Almost as costly to oiling the wheels of everyday commerce was an alternative ritual, *in iure cessio*, in which a lawsuit was commenced by the transferee declaring ownership of a chattel, which was admitted by the transferor and then sanctioned by judicial order.⁷ But the underlying concern was a legitimate one: that absolute rights, binding *in rem* against all the world, were transferred by some means of sufficient gravity that all the world could, in principle, be aware of them.

In time, the burdensome nature of these formalities gave way to modes of acquisition of title based upon possession. Ownerless goods could be acquired through *de facto* possession by a Roman citizen (*occupatio*);⁸ a doctrine of adverse possession developed, whereby

⁶ Described by Gaius, in his *Institutiones*, I §§ 119-22, who cites the ritual incantation: “*Hunc ego hominem ex iure quiritorium meum esse aio isque mihi emptus esto hoc aere aeneaque libra*”. The ritual applied only to objects classified as *res mancipi*, which Gaius (at I § 120) describes as including slaves, oxen, horses, mules, asses, Italian land and (at II § 29) rustic servitudes.

⁷ *In iure cessio* is described by Gaius in II § 24. It seems that *in iure cessio* could also apply to *res nec mancipi*: see Alan Watson, *The Law of Property in the Later Roman Republic* (Clarendon 1968), 21. Both these forms of transfer of “Quiritarian” (absolute) ownership are also described by Justinian: see Fred Blume, *Annotated Justinian Code* (University of Wyoming 2009), Book VII, Title XXV: *De nudo ex iure quiritorium tollendo* (Concerning the naked Quiritarian right).

⁸ Justinian, *Digesta* 41.1.5.1.

continuous possession of another's goods for a set time could create a supervening ownership interest (*usucapio*);⁹ a doctrine of accession developed, whereby goods belonging to one person would be deemed transferred to another if attached to property in that other person's possession (*accessio*);¹⁰ Justinian law developed a doctrine called *specificatio*, whereby a person who irreversibly transformed property belonging to another would acquire title to it.¹¹ Many civil law systems retain these doctrines in one form or another today.¹² Perhaps the most significant innovation of Roman law, though, was the doctrine of *traditio*, initially created as part of the *ius gentium* (the law applicable to foreign relations),¹³ which was eventually transformed (through a notion of "bonitary ownership", abolished by Justinian)¹⁴ into a doctrine of transfer of

⁹ See e.g. Cicero, *De Haruspicum Responsis* XIV § 32, opining *usucapio* to be part of the *ius gentium* (law applicable to foreigners). This view appears to have been contested: see Watson, *ibid.*, 21 *et seq.*

¹⁰ See e.g. Ulpian, in Justinian's *Digesta* 39.2.9.2.

¹¹ See e.g. Servius, in Justinian's *Digesta* 41.1.24, 26.

¹² For example, German law retains a prescription doctrine equivalent to *usucapio* (Articles 937-945 German Civil Code); a doctrine of accession (Article 947); and a transformation doctrine equivalent to *specificatio* (Article 950). In the Spanish Civil Code, see Article 375 (accession) and Article 383 (*specificatio*). In the French Civil Code, for *specificatio* see Article 571; for accession Article 566; for prescription Articles 2219 to 2227. The Brazilian Code maintains the label *usucapião* (Articles 1260-2), and also has doctrines of specification (Articles 1269-70) and adjunction (akin to accession) (Article 1272(2)).

¹³ The *ius gentium* prescribed standards of treatment of foreign citizens, and included recognition that foreigners might acquire bonitary ownership of property through delivery and possession (*traditio*) rather than through the *mancipatio* or *in iure cessio* rituals in which only Roman citizens could participate.

¹⁴ Originally, *res Mancipi* could only be transferred through the rituals of *mancipatio* or *in iure cessio*, whereas all other objects (*res nec Mancipi*) could be transferred by *traditio*. Transfer by *traditio* of *res Mancipi* conferred ownership *in bonis* rather than the superior type of (absolute) ownership *in dominus* that was transferred by *res Mancipi* rituals. The practical effects of the distinction between the two types

title simply by delivery and without further ritual. *Traditio* remains a formal doctrine in a number of legal systems even today, including Swiss, German and Brazilian law. Article 929 of the German Civil Code prescribes that “[f]or the transfer of the ownership of a movable thing, it is necessary that the owner delivers the thing to the acquirer and both agree that ownership is to pass.” Article 714(1) of the Swiss Civil Code provides that “[t]ransfer of possession is necessary for transfer of ownership of personal property”.¹⁵ In a direct echo of the Roman terminology, the Brazilian Civil Code (in Article 1267) provides that “Ownership of things is not transferred by legal transactions prior to *tradição*”.

The notion that title could pass only upon delivery even entered the common law for a period, albeit apparently disappearing by the sixteenth century. In the words of Fry LJ, in *Cochrane v Moore* (1890) LR 25 QBD 57, 64-65:

The law enunciated by Bracton¹⁶ in his book "de acquirendo rerum dominio", seems clear to the effect that no gift was complete without tradition of the subject of the gift. ...

In Bracton's day, seisin was a most important element of the law of property in general; and, however strange it may sound to jurists of our day and country, the lawyers of that day applied the term as freely to a pig's ham. ... The law recognised seisin as the common incident of all property in corporeal things, and tradition or the delivery of that seisin from one man to another as essential to the transfer of the property in that thing, whether it were land or a horse, and whether by way of sale or of gift,

of ownership rested upon a series of more or less cryptic legal doctrines: see William Buckland, *A Textbook of Roman Law* (CUP 2007), § LXX-LXXI. The distinction was abolished altogether by Justinian: *ibid.*, VII § XXV.1.

¹⁵ In this paper, translations from the French, Swiss and German Civil Codes are the author's own; translations from the Brazilian Civil Code are courtesy of Lesley Rose, *The Brazilian Civil Code in English* (Renovar, Rio de Janeiro 2008).

¹⁶ The reference is to Henry de Bracton, ca.1210-1268, an English jurist, known for his early work on English law. Seisin was a category of legal interest in feudal property law that only free men could hold.

However, in modern times the principle of *traditio* – that title passes only upon delivery – has come to be seen as unduly restrictive and inconsistent with contractual autonomy. The common law was the first to abandon a delivery precept, coming to the view that for both gifts and dispositions for consideration, title passes whenever the parties to a transaction intend it to pass. The modern English rule is stated in section 17 Sale of Goods Act 1979, reflecting a principle first codified in 1893¹⁷ but existing in English legal history since time immemorial:¹⁸

(1) Where there is a contract for the sale of specific or ascertained goods the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred.

(2) For the purpose of ascertaining the intention of the parties regard shall be had to the terms of the contract, the conduct of the parties and the circumstances of the case.

The law may provide for a default rule as to when title passes, absent clear expression of intention. In the common law this is typically the point at which goods are “appropriated” to a

¹⁷ The text of section 17 Sale of Goods Act 1979 copies exactly section 17 Sale of Goods Act 1893.

¹⁸ The development of the common law principle that delivery is not necessary for title to pass developed gradually in the common law. Delivery was apparently still a prerequisite at the end of the thirteenth century: see Andrew Horn, *Mirror of Justices*, Chap V, §1, 75. By the late fifteenth century it was possible to execute transfer of title by deed (i.e. a document signed, sealed and delivered) without delivery: 7 Edw. 4, pl. 21, fol. 20. In the late sixteenth century the general rule was still that title could not pass prior to delivery: *Flower’s Case*, Noy. 67. However, by the seventeenth century matters seemed to have changed. Coke was of the view in *Wortes v Clifton*, Mich. 12 James 1 that one of the defining differences between the civil law and the common law was that *traditio* was a principle of the former but not the latter. See *Cochrane v Moore*, *ibid.*, for a more fulsome account of the development of the delivery requirement in English law through to the beginning of the nineteenth century. Delivery remains a necessary formality in English law to perfect transfer of title to gifts, absent a deed or consideration: *Re Cole* [1964] 1 Ch 175.

sale contract,¹⁹ for example by being selected from the warehouse as being the goods that will be delivered. In legal systems influenced by the Germanic tradition, the default rule will be that title is transferred upon delivery. But commercial men sometimes want to depart from the default rule, and both the common law and the civil law have thus shown flexibility to allow merchants to tailor transfer of title provisions to their particular needs. In the common law tradition, the parties can agree anything they want about when title transfers, and sale contracts frequently specify when title passes. Parties to a contract for the sale of goods routinely use clauses relating to legal title as a form of security interest, by providing that where goods are sold on credit, title remains with the seller even after delivery, until the goods are fully paid for. (This is known in England as a “Romalpa” clause, after the case that validated them.)²⁰ If the buyer subsequently defaults on his payment obligations, or even becomes insolvent, this allows the seller to remove the goods from the warehouse. The goods will not become part of the insolvent buyer’s estate for distribution amongst creditors at large; they will be reserved for the benefit of the buyer. Such clauses are economically attractive, because by providing increased security to the seller they lower the cost of providing credit and thus reduce the transaction costs of sales of goods.

In the civil law tradition, a series of doctrines have been developed notwithstanding the principle of *traditio*, which allow for title to pass even before delivery. Thus “symbolic” delivery can suffice, which has come to mean passage of an item which represents the chattel being sold (such as a bill of sale, or the keys and logbook to a car).²¹ Thus we find in the Swiss Civil

¹⁹ Sections 16 and 18 (Rule 1, Rule 2) Sale of Goods Act 1979.

²⁰ *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd* [1976] 1 WLR 676.

²¹ Even Roman law in the period of the late Republic began to recognise symbolic delivery: see Justinian’s *Digesta* 18.6.1.2; 18.6.15.1 (delivery deemed by placing of seal on goods).

Code the rule that “[d]elivery of title documents representing goods entrusted to a carrier or a warehouse is equivalent to *tradition* of the goods themselves”.²² Beyond even that, doctrines of “continuous possession” (in French, *constitut possessoire*; in German, *Besitzkonstitut*) distinguish actual and “legal” possession, creating a fiction that legal possession (and with it title) has transferred even if actual possession has not. Article 930 of the German Civil Code provides that “[i]f the owner is in possession of a chattel, delivery may be replaced by a legal relationship agreed between the owner and the acquirer obtains indirect possession”. Although the notion of “indirect possession” (*mittelbaren Besitz*) may sound cryptic, the fundamental idea is straightforward: the parties display an intention to pass title, notwithstanding the fact that possession remains with the transferor.

Article 924(1) of the Swiss Civil Code is a little more explicit about how this is supposed to work, saying “[p]ossession can be acquired without delivery if a third party or the transferor himself remain in possession of the chattel pursuant to a legal relationship”. The commentary to the Article explains that “[t]ransfer without *tradition* need not take place using any particular form”. The net result of these doctrines is sufficient flexibility to do justice to whatever reasonable intention appears from the parties’ conduct and contracts. However, it is noteworthy that although this doctrine permits title to pass prior to delivery (useful where buyers provide sellers credit by advance payment), in Swiss law at least, the converse result – *Romalpa* clauses, allowing transfer of title *after* delivery – cannot be freely created, without being publicly registered. Article 715(1) of the Swiss Civil Code provides that “[r]etention of title to a chattel possession of which has been transferred is valid only if it is entered in a public register kept by

²² Article 925(1) Swiss Civil Code.

the *office des poursuites*²³ in the transferee's place of residence. A public registration formality is a prerequisite to create this type of security interest.

Moreover, there is one area in which the notion that formalities are necessary to perfect a transfer of title remains a pervasive feature of all legal systems: immovable property. Most developed nations²⁴ now have registers of title to land; without registration, a transfer of legal title to realty does not take effect (or not fully). Generally, an entry in the land register serves as a legal guarantee of ownership or another right over the property. The fact that such registers do not, in general, exist for personalty, suggests there are two competing interests at stake. The desire that it is transparent and clear who owns or has other interests in property suggests a public system of registers and formalities. The desire that parties to a private transaction should have maximum flexibility to tailor their arrangements to their circumstances without government regulation – in particular to create security interests – suggests a common law rule in which title passes in accordance with intentions. Both arguments deserve economic analysis.

²³ The *office des poursuites* is a Swiss public service that enforces civil debts at the instance of creditors.

²⁴ The only European countries not to have had a public land register in modern times are Greece and Albania; both countries are developing systems at the time of writing. In a number of formerly communist countries in Eastern Europe, the land registers are to varying degrees unsatisfactory indices of interests: they were not updated during socialist rule, as people privately traded *de facto* rights in real estate notwithstanding various types of legal fiction that all real estate was owned by the government or “socially owned”.

III. BALANCING THE TRANSACTION COSTS OF DIFFERENT RULES

The rule that parties to a contract should be free to transfer title when they desire permits them to create security in a credit transaction. In a “point” transaction, in which goods are exchanged for cash at a fixed time and place, there is no need for title to transfer at any moment other than upon delivery. It is where a gap in time arises between payment and delivery – for example mail order, purchase on credit, or construction of tailor-made goods - that the point when title transfers becomes important. In a mail order transaction, a customer pays before receiving the goods. The default English rule under such circumstances is that title transfers before delivery, as soon as the contract is made,²⁵ but this rule is frequently amended. Where a commercial supplier provides regular deliveries with invoices to be paid in thirty days, title may be agreed not to pass until payment of the relevant invoice; this is a *Romalpa* clause discussed above. In a shipbuilding contract, payments are typically made before the vessel is completed and delivered, and the contract may seek to transfer title to the vessel while it is still under construction.²⁶

Where contractual provision of this kind has been made, upon insolvency of one of the parties or other failure to pay, legal ownership will entitle a person who has delivered but not been paid, or who has paid but has not received, to claim (or claim back) the goods. Otherwise, title to goods will lie with the debtor (whether seller or purchaser), who may have sold them on, in which case they are lost forever; or they may form part of that party’s insolvent estate, to be distributed thinly between all creditors and not just the unpaid counterparty. The ability to tailor transfer of title clauses to create security arrangements in a contract with a credit element will

²⁵ Section 18 Rule (1) Sale of Goods Act 1979, subject to some exceptions, e.g. section 20A (undivided shares in goods forming part of a bulk: title passes when bulk identified and buyer has paid).

²⁶ See Simon Curtis, *Law of Shipbuilding Contracts* (2nd edition LLP 1996), 117 *et seq.*

ultimately reduce prices for commodities and increase the availability of credit, as the market price will not have to include a premium to reflect credit risk. Just as a loan secured against the mortgage of a house attracts a lower interest rate than an unsecured loan, so goods bought on credit where the goods are security for the credit risk being taken are liable to attract a lower risk premium than where no such credit is available due to the inflexibility of the law.

The problem with a legal rule that enables title to pass whenever the parties intend it to do so is that the question is delegated to a private contract to which third parties are not privy. This places third parties in an invidious position when they need to know who the true owner is. Whereas it is appropriate that the parties to a private contract can create rights between one-another by means of a private document, it is not at all clear, as a point of principle, that they should be able to affect the rights of third parties in this way. The third party wishing to subsequently deal in this property finds himself or herself in a position of ignorance, facing an information problem on account of the fact the apparent possessor of a chattel may not be the true owner, and all the information needed to establish the true owner is, in principle, private. The third party may use all reasonable due diligence; but there is no guarantee that the person apparently having possessory rights over a chattel in fact owns title. It is this dilemma that causes Malcolm Bridge to aver that “[a]ll title disputes can be simplified to involve three parties, O, R and T. O, the owner, is unlawfully dispossessed of a chattel, or is deceived into surrendering possession of it to, R, a rogue.²⁷ R later enters into a transaction purporting to confer a legal interest on T, an innocent third party. Having obtained value, R then disappears leaving O and T to fight over entitlement to the chattel, ...”²⁸

²⁷ Roguery in this context is a broad term. It may refer to a thief or fraudster; but it may also include a person who buys on credit that which he cannot pay for, or who becomes insolvent before paying.

²⁸ Malcolm Bridge, *Personal Property Law* (OUP 2002) chapter 5, 115.

Dilemmas of this kind are particularly acute for legal systems embracing the common law rule, because there is no rule of law as to when title passes, on which T may rely with confidence. Given this uncertainty, there are two resolutions to the dilemma. One is to follow the spirit of the now ancient idiom that possession is nine-tenths of the law, and to provide that T obtains good title if he transacts in good faith with R, who is in possession and therefore apparently in ownership. But this rule sits uneasily with the common law precept that divides possession and ownership. The idiom appears more appropriate as a precept of the Germano-Romanic doctrine of *traditio*, whereby transfer of possession is rendered coterminous with transfer of ownership. The usual common law rule, instead, is *nemo dat quod non habet*: one cannot pass title to that which one does not have. The essence of this rule is that where possession and ownership are divorced, the possessor cannot convey good title; the one-tenth of the law eclipses the nine-tenths. The *nemo dat* rule is therefore a corollary of the common law rule that title passes in accordance with the intentions of the parties: that is to say, there is no necessary relationship between possession and ownership in a property transaction.

The problem with this rule is that it is so palpably unfair to T. It places all the burdens of due diligence, to establish R's title to the property, upon T; none are placed upon O, who may have been negligent or even intentional in his departure of possession in R's favour. T is not entitled to rely upon possession by R; O is, even though it was O that placed his chattel in R's hands. Faced with such a rule, T may undertake due diligence enquiries. He may ask R for a copy of the sale contract between O and R, pursuant to which R purportedly acquired title. But if P and R have maximum flexibility in how they transfer title, such a contract may not be easy to interpret. It may provide that title transfers only upon satisfaction of a series of conditions – for example, that all the outstanding debts owed by R to O are paid. The far-reaching enquiry necessary for T to properly satisfy himself that these conditions are in fact satisfied may raise

transaction costs to such an extent that the potential cooperative surplus from the transaction is wiped out. Alternatively, the information needed to investigate title may simply not be available. This is particularly likely for a purchaser at the end of an extended chain, in which it is impossible to investigate every link. T is expected just to take the risk – which is both unfair in the particular case, and in the general case will hinder the transaction from taking place at all.

The common law has mitigated the effects of these problems by introducing various exceptions to the *nemo dat* rule. The exceptions are generally thought to be irrational and piecemeal, and reveal no coherent policy. Thus certain sorts of mercantile agent can dispose of property even if they have no authority to do so from their principals. This includes an antiques dealer (*Lowther v Harris* [1927] 1 QB 343) but not a car hire agency (*Astley v Miller* [1968] 2 All ER 36). There are also exceptions to the *nemo dat* principle where a seller transfers title to goods but remains in possession of them, such as in a mail order contract. The seller can thereafter transfer title to a third party; it does not matter why the seller continues to hold possession, but the seller's possession must be continuous: *Pacific Motor Auctions v Motor Credits* [1965] AC 867. This exception does great injury to the security afforded to the buyer in a transaction where payment is tendered prior to delivery. There is also an exception under conditional sale contracts, where a buyer receives possession but the seller retains title until full payment is met: *Lee v Butler* [1893] 2 QB 318. This would seem to apply to a *Romalpa* clause where the purchaser decides to sell on assets subject to the clause acquired on credit, rendering *Romalpa* security susceptible to facile frustration. However, under a hire-purchase contract where an option must be formally exercised after payment of the final instalment (even if the consideration for exercise of the option is nominal), no such exception exists: *Helby v Matthews* [1895] AC 471. The rationale for the difference between this rule and that in *Lee v Butler* is opaque at best.

If we despair at this morass of artificial distinctions, we might find ourselves in sympathy with Bridge when he says, “[t]he law has started from the policy of property protection ... Upon this general rule there has been grafted a series of exceptions designed to create a pragmatic balance with the policy of commercial security. As a coherent whole, the law leaves ... a great deal to be desired.”²⁹ Economic analysis of the law does, however, prescribe a principle by which such cases ought to be decided. In the quest to do justice between two innocent parties, O and T, where R has disappeared or is no longer creditworthy, economics prescribes that the risk of loss in such cases ought to fall on that party best placed to avoid the risk at least cost. According to Judge Learned Hand’s formula,³⁰ one party should be held liable for the loss of another if that party could take precautions to prevent the risk of loss, and the cost of taking those precautions is less than the cost of the loss multiplied by the probability that it occurs absent the precautions. In other words, a party is liable for another’s loss if (and only if):

$$B < (P \times L)$$

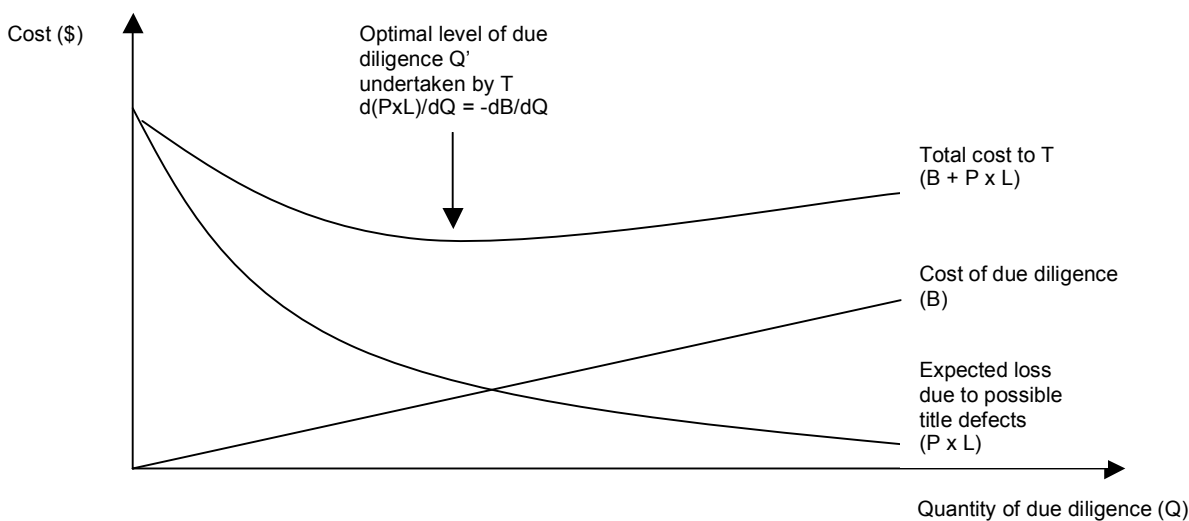
where B is the cost of taking the precaution, L is the cost of the loss to be avoided, and P is the probability of the loss if the precaution is not undertaken.

Learned Hand used this formula as a touchstone of the test of negligence, where both the defendant and the victim could take precautions to prevent an accident. For both parties, the test of whether (s)he is negligent (or liable in contributory negligence, for the victim) in not taking a precaution is whether the cost B of taking that precaution is greater or less than P x L. The

²⁹ Malcolm Bridge, *ibid.*, chapter 6, 117-18.

³⁰ United States v Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947), discussed by Richard Posner, *Economic Analysis of Law* (Aspen, 6th edition 2003), 168.

formula is equally applicable here, where there are costs that both T and O can pay to prevent the risk of loss at the hands of R. T can pay a due diligence price; he can insist on seeing documents by which title has been transferred to R, or authority to sell has been granted; he can insist in tracing the relationship between T and R to ensure that all the conditions for title to transfer contractually have been passed. It may be that no level of due diligence can provide T with complete certainty; but the risk of title being defective will be less, the greater the due diligence undertaken. There will therefore be an optimal level of due diligence, at which the marginal cost of doing extra due diligence (dB / dQ)³¹ equals the marginal reduction in risk ($d(PL) / dQ$). Should risk always lie with T, prudent T will undertake this level of due diligence, but no more.



Is there some other legal rule that, for the triangular case, can reduce transaction costs below the level shown on the above graph? One option is to place all risks of loss with O. O can likewise take precautions to prevent losses of this kind. On the one hand, he can simply refuse

³¹ Q being the quantity of due diligence undertaken. The units of due diligence do not matter, as long as it is assumed that the quantity of due diligence can be measured in some way (for example in terms of the number of billable hours of lawyers' time).

to enter into agency or credit transactions in which ownership and possession are divided. The law could facilitate this approach, by adopting a strictly Roman rule of *traditio* and refusing to recognise attempts to divide possession and ownership in the context of a sale transaction. However, were the law to adopt that course it would deprive parties to sale of goods transactions of the efficiency gains harnessed in providing security for credit transactions. It is not immediately clear that the due diligence costs to T will always be more than the costs to O and R of foregoing credit transactions.

It is arguable that given a rule that title can be transferred pursuant to the terms of a private contract, the burden of risk should fall upon O, because O is party to the transaction pursuant to which title is transferred, and O is parting with public possession of property but retaining some interest in it pursuant to a private agreement with R. Therefore any risk of private arrangements in which possession is divorced from ownership going awry, ought to be born by the party who initially consented to them. It is not efficient to place the risk of such arrangements upon a third party who comes to them later, for that requires him to undertake a due diligence exercise for which he is scarcely the best equipped. Given a flexible transfer of title rule, the vendor should be told, yes you can create whatever arrangements you want regarding retention of title; but should you do so, and you become embroiled with an innocent third party with whom your buyer subsequently contracts, you bear the risk. This logic is even more compelling when one ponders the existence of a potential infinity of Ts, including every third party who may subsequently contemplate entering into a proprietary relationship with the chattel. This includes not just every subsequent acquirer in the chain of possession / ownership, but also every person contemplating the acquisition. The disutility of all these parties' due diligence obligations must be aggregated, when comparing the relative efficiency of placing title risks upon T rather than O.

This conclusion is, however, tantamount to denying the propriety of the *nemo dat* rule altogether. It suggests that all (or almost all) of the triangular cases should have been resolved against the *nemo dat* rule, and in favour of the third party. Every exception to the *nemo dat* rule is an exception to the principle that property rights exist *in rem*: they are cases where a property owner's rights are limited to his contractual counterparty and do not extend to a third party to the transaction. The third party takes the chattel at the expense of its true owner. There are three principles which, taken together, are inconsistent: the idea of *in rem* rights (transferable without the consent of the obligor); the notion that *in rem* rights can be transferred privately; and the prescription, derived from the law and economics tradition, that the law should place the burden of risks in a transaction upon the party able to avoid them at least cost. The logical consequence of admitting the possibility of private agreements to distribute rights that affect third parties is that to avoid gross unfairness and intolerable transaction costs, we have to whittle down the *nemo dat* rule until there is nothing left of the concept of an *in rem* right at all.

IV. CORRECTING THE INFORMATION PROBLEM

In requiring public formalities for the transfer of property, the Romans captured an insight that, in the name of contractual liberty, modern law seems to have lost. The notion of universal rights presupposes the idea that those rights are publicly ascertainable. It is neither fair nor efficient that a third party to a transaction involving *in rem* rights has no easy access to reliable information about who enjoys those rights. O can alleviate this problem by ensuring that whatever relationship he enters into with R is transparent, so that the due diligence costs for any prospective T are lower. This may be encouraged by a legal rule, in the Germano-Romanic tradition, compelling title and possession to pass simultaneously in a sale of goods transaction. Such a rule precludes use of legal title as a form of security in credit transactions. For lower-

value transactions, this loss is nominal; for the costs of enforcing the security may exceed its value. (Banks do not accept pledges of title over household chattels as security for personal loans, for this reason.)

For higher-value transactions, the risk premium in failure to provide security may be substantial. But in such cases the burden of due diligence for T may be alleviated, consistent with permitting creation of security interests by way of legal title, by a simple legal tool. The law may create public registers of interests for substantial chattels which show to the world who owns what. This is already available (or even compulsory) in many jurisdictions for ships, aeroplanes and cars. There is no reason why it might not also be undertaken for works of art, jewellery and other high-value chattels.

Justification of the costs incurred in creating a public register might be sought on the ground that for chattels likely to be registered, their property values are sufficiently high that the costs of title errors are higher; thus heightened due diligence is otherwise required, which will be more costly than creation of the register. This must be the economic justification of the costs involved in creating land registers; and realty is not always of higher value than chattels. Certain categories of chattel typically of high value are therefore found to have public registers of ownership; but practice varies upon just how public those registers are, and whether the register is conclusive of ownership. If it is, the keeper of the register must carefully vet every application to make an entry on the register, creating the potential for bureaucratic delay. The preferable method may be to have a rule that presence of an entry on a register is a necessary but condition for a person other than the possessor to assert a title claim in the way of a security interest; but it is not conclusive, and an assertion on a register may be challenged without prejudice in Court. To make an entry on the register, a short form signed by both parties to the security transaction would be filed, plus a copy of the document creating the security interest.

The advent of the internet makes the cost of establishing public registers far lower than it has been in the past when cumbersome government agencies were established to keep and process paper records. There is no reason why, in principle, a public record for ownership of chattels could not be accessed and amended from one's home computer. The increased transaction costs of registering a transfer of legal title can be made sufficiently low that they will generally be smaller than an otherwise open-ended due diligence process involved in tracing title to unregistered personalty through a series of private treaties. Needless to say, there will be a threshold value beneath which people may prefer not to register title interests in personalty, because the risks are perceived to be sufficiently small. This register would not interfere with weekly family trips to the supermarket. But a voluntary register, in which individual parties to a transaction decide whether to register a disposition, might make good sense.

In the absence of a decision to register, the act of transfer of title should be made as public as possible. Five witnesses and a bronze ingot need no longer be assembled in the market square. Usually, transfer should rest upon delivery, as an act with public consequences. Even if the act of delivery takes place in private, the fact that it has occurred is readily ascertainable by the fact that the transferee now possesses it. The ordinary assumption on which we base our transactions with others is that the possessor of a chattel owns it. If parties to a property transaction want to cleave possession / delivery and legal title, to create a security interest to facilitate credit transactions, by all means they should be allowed to do so, but such a separation is inconsistent with the ordinary assumptions of human property interactions. To accommodate such transactions, a public register of security interests can be created, an entry in which flags that the usual assumption is not applicable. This is the approach partially adopted in US states that have public registers of mechanics' liens. If parties to a credit transaction do

not use that register, the usual rule will be that title passes with delivery, and the parties will not be free to reach a purely private agreement to the contrary.

The Romans developed their property law in a period of technological development where the costs of maintaining public registers were very much higher than they are today. Nonetheless, they acknowledged the public nature of *in rem* rights, by requiring elaborate public rituals to underscore transfers of property. The high transaction costs associated with those rituals saw development of the doctrine of *traditio*, in which the public events of delivery and its corollary, possession, marked the transfer of legal title. In time, even that doctrine was perceived as too rigid, and gradually give way to the common law approach of allowing parties contractual freedom in determining when property should pass. Contractual freedom is the usual method of maximising the cooperative surplus, and in general is to be commended. But a contradiction arises where parties to a private contract can agree how a distribution of property rights between them will affect third parties not subject to the privity. Where that occurs, there should be a public record of the fact that an agreement has been made which may affect them. “Romalpa” clauses are efficient, but they cannot be private, since the purpose of them is to affect relations with third persons.
