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Fourth Circuit Affirms Lender's Good Faith in Fraudulent Transfer Case

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This article discusses a recent U.S. Court of Appeals for the Fourth Circuit decision affirming the dismissal of a bankruptcy trustee's fraudulent transfer complaint against a "warehouse" lender who had been paid by a distressed home mortgage originator several months prior to the originator's bankruptcy.

The U.S. Court of Appeals for the Fourth Circuit recently affirmed the dismissal of a bankruptcy trustee's fraudulent transfer complaint against a "warehouse" lender who had been paid by a distressed home mortgage originator several months prior to the originator's bankruptcy.[1] Affirming the lower courts, the Fourth Circuit in *Gold v. First Tennessee Bank, N.A.*, held that "the bank accepted the payments" from its borrower "in good faith."[2] Moreover, the lower courts had "correctly applied the objective good-faith standard" in accepting the lender's testimony regarding its good faith.[3] The dissenting judge, however, argued that the bank had "failed to proffer any evidence [showing] objective good faith in the face of several alleged red flags."[4]

The debtor's loan repayments were outside the 90-day preference reach-back period of Bankruptcy Code ("Code") §547(b)(4)(A). The trustee thus

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alleged in his suit that the debtor had repaid $4 million to the bank "fraudulently" — with "actual intent to hinder, delay or defraud" creditors, relying on Code §548(a)(1)(A).[5] In response, the bank showed that it had received the payments "for value and in good faith," relying on Code §548(c).[6] Because the "for value" element was "not at issue," the central focus in the case was whether the bank had "satisfied its burden of proving that it accepted the transfers in good faith."[7]

RELEVANCE OF THE CASE

The "good faith" defense is fact-intensive. As a result, lenders regularly litigate the issue. This case shows how a trustee can challenge the credibility of two honest, experienced, effective bank officers simply trying to recover on a loan after being deceived by their corrupt borrower. Not only did the trustee attack the officers' credibility, but he also argued they should have known of the debtor's fraud. Fortunately, the Fourth Circuit sensibly reconciled the facts to reach a sound legal result.

FACTS

The lender in *Gold* investigated the debtor before beginning its relationship. It "analyzed financial statements and tax returns [,]…conducted research using a 'private mortgage database' containing various information regarding mortgage 'irregularities, reports of fraud, and material suspicions of fraud'….[It also] contacted [the debtor's] references and examined [its] 'quality control plan.' The bank's investigation did not reveal any negative business information involving [the debtor]."[8]

The lender provided the debtor with a $15 million line of credit in July 2007, pursuant to a loan agreement. The "lending relationship was short-lived, and the bank ultimately made advances to [the debtor] for a period of only about 4 months between August and early November 2007."[9] Although the debtor repaid roughly $1 million to the lender in September 2007, it still owed about $12 million as of mid-October 2007, causing the bank to "suspend…payment of any additional advances…."[10]

Between November 2007 and January 2008, the bank pressed the debtor for repayment of the loan balance. It met with the debtor's principal repeatedly, learning that the debtor could not sell its mortgage loans to secondary purchasers in order to repay the lender. The debtor offered excuses such as the departure of a loan processor and a decline in loan value due to adverse market conditions. The debtor's counsel repeatedly assured the bank's representatives there was "no problem."[11] The bank's two officers, experienced lenders, visited properties "that served as security for [the debtor's] mortgage loans; reviewed appraisals…and confirmed that [the debtor] was listed…on the deeds of trust placed on those properties."[12] The bank and the debtor later entered into a forbearance agreement providing the bank with additional collateral. The debtor later made two interest payments totaling $76,000 in February and March 2008.[13]

Not until April 2008, did the bank "learn…that the deeds of trust securing the mortgage notes held by [it] were not valid and had been falsified."[14] It immediately declared the debtor in default and eventually "lost more than $5.6 million."[15] The debtor later filed a Chapter 11 petition in June 2008, and the court approved the appointment of a trustee for the debtor's estate.[16]

BANKRUPTCY COURT TRIAL AND FINDINGS

The bankruptcy court conducted a three-day trial on the trustee's complaint, receiving testimony and "substantial documentary evidence regarding the fraudulent conduct" of the debtor.[17] To support its good faith defense, the bank relied on the testimony of its two senior lending officers who testified about "their knowledge of the warehouse lending industry, based primarily on their long careers at the bank and other institutions."[18] As for the relevant time period, 2007-2008, they testified without contradiction that "the secondary mortgage market was imploding….If you owned a mortgage-backed security you didn't have a market on which to sell it."[19] Moreover, "during the 'market meltdown' more loans remained outstanding on the bank's warehouse lines of credit than ever had been the case in previous years."[20] As the bankruptcy court found, "the bank reasonably thought that the lagging secondary mortgage market, rather than any inappropriate conduct by [the debtor] was the cause of [the debtor's] delayed sales" of the mortgages it had originated.[21]

The bankruptcy court further found that the lender had no "information that would [reasonably] have led it to investigate further, and the bank's actions were in accord with the bank's and the industry's usual practices."[22] Not only were the bank's officers "knowledgeable in the bank's practices, [its] relationship with [the debtor], the transactions in issue and the mortgage warehouse industry," but their "testimony was credible that…the Bank did not have any actual knowledge of the [debtor's]" fraud….[23] Moreover, the bank had no "information that would [reasonably] have led it to investigate further" and its actions "were in accord with [its] and the industry's usual practices."[24]

FOURTH CIRCUIT ANALYSIS

The court stressed that the "good-faith" issue is "primarily a factual determination."[25] It rejected the trustee's argument that the trial court had (a) misapplied the objective good-faith standard and (b) "clearly erred" in accepting the bank's good faith defense.[26]

Noting that the Code does not define "good faith," the court had, in another case, previously accepted a good faith defense by focusing on "'what the transferee [actually] knew or should have known'" when it accepted the transfers.[27] Specifically, "'good faith' has both…subjective ('honesty in fact') and…objective ('observance of reasonable commercial standards') components."[28] In short, reasoned the court, it had "to consider whether the transferee [lender] was aware or should have been aware, at the time of the transfers and in accordance with routine business practices, that the transferor-debtor intended to 'hinder, delay or defraud any entity to which the Debtor was or became…indebted.'"[29]

The trustee never asserted that the "bank actually knew about" the debtor's fraud prior to April 2008.[30] Thus, the court limited its analysis to "whether the bank should have known about the fraudulent conduct of [the debtor], 'taking into consideration the customary practices of the industry in which the [bank] operates.'"[31]

Rejecting the trustee's nit-picking approach, the court declined "to adopt a bright-line rule, requiring that a party asserting a good-faith defense present evidence that his every action concerning the relevant transfers was objec-

tively reasonable in light of industry standards."[32] Instead, the court reviewed industry standards "to establish the correct context in which to consider what the transferee knew or should have known."[33]

Nor did the court require the lender to provide "third-party expert testimony in order to establish prevailing industry standards."[34] To require expert testimony in every case, reasoned the court, "would restrict the presentation of a defense that ordinarily is based on the facts and circumstances of each case and on a particular witness'[s] knowledge of the significance of such evidence."[35]

The court also rejected the trustee's argument that the testimony of the two bank officers was "purely subjective."[36] In the court's view, "the objective component of the good-faith defense may be established by lay or expert testimony, or both, depending on the nature of the evidence at issue. Here, the parties' dispute centered on the general practices in the warehouse-lending industry and the indicators of fraudulent conduct, if any, that were apparent from the particular facts known to the bank's officials."[37] In fact, the bankruptcy court acknowledged that the two bank officers were employees "in assessing the weight to be given their testimony," and the trustee never objected to their testimony "relating to the warehouse-lending industry or the conditions in the market for mortgage-backed securities in 2007 and 2008."[38]

Nor did the purported red flags relied on by the trustee persuade the court (e.g., the debtor's delay in providing collateral documents; the debtor's failure to sell many of its mortgage loans in the secondary market; and the departure of one of the debtor's loan processors). First, the delays in providing collateral documents were common in the industry, and "the bank always received from [the debtor]…the most vital document, the original promissory note that perfected the…security interest."[39]

The debtor's failure to sell mortgage loans in the secondary market during 2007 and 2008 was common because of the "extraordinary time" that the warehouse lending industry was experiencing.[40] Moreover, during this period many other mortgage bankers delayed selling mortgages because they viewed the market decline as merely "temporary."[41]

The debtor was contractually required to make direct payments to the bank regardless of whether it had sold its mortgage loans to secondary purchasers. As the trustee's own witness conceded, the debtor's direct payments

were not "an indication of fraudulent conduct."[42]

The debtor's explanations (*e.g.*, the departure of a loan processor) for delay in producing loan documentation was, according to the court, reasonable. Secondary purchasers "had tightened their standards for loan documentation in 2007 and 2008," which meant that complete documentation was required.[43] In fact, a bank officer also confirmed with a major secondary purchaser of the debtor's loans "that the outstanding mortgage loans remained unsold because the loan documentation was incomplete."[44]

Finally, the representation as to the "arms-length" nature of the debtor's loan transactions was reasonable during the course of their work-out negotiations. Any decrease in the market value of mortgage loans in the secondary market "was an industry-wide problem in 2007 and 2008."[45] In fact, the bank officers "conducted additional investigation into the collateral securing" the debtor's loans and "did not discover any problems at that time."[46]

In sum, "when considered as a whole, the circumstances relied on by the trustee indicated only that [the debtor] had financial difficulties, which was not uncommon in the warehouse lending industry during 2007 and 2008."[47] The bank's officers "were credible and knowledgeable witnesses…."[48]

The dissent strongly disagreed with the majority's holding. It asserted that the defendant bank had "failed to proffer any evidence or elicit any testimony to support a finding that it received transfers from [the debtor] with objective good faith in the face of certain alleged red flags."[49] For that reason, it would have reversed the lower court on the basis that the bankruptcy court had been clearly erroneous in making an "unsupported objective good faith finding."[50]

COMMENTS

Good Faith Defined by the Courts

The presence of good faith turns on whether the "'transaction carries the earmarks of an arms-length bargain.'"[51] In New York, for example, to show good faith, the transferee lender must show "(1) an honest belief in the propriety of the activities in question; (2) no intent to take unconscionable advantage of others; and (3) no intent to, or knowledge of the fact that the ac-

tivities in question will hinder, delay or defraud others."[52] The Second Circuit has broadly defined good faith, finding that a lender has no fiduciary duty to its borrower or to other creditors.[53]

Relevance of Transferee Lender's Knowledge

The transferee's knowledge of the debtor's insolvency at the time of the transfer may, depending on the facts and the Circuit, refute a claim of good faith on the part of the transferee lender.[54]

Objective Standard

Courts measure good faith with an objective standard. If, for example "the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent."[55] But it does not "matter that the preferred creditor knows that the debtor is insolvent."[56] Inquiry notice is thus triggered if a transferee possesses information suggesting that an insolvent debtor had a fraudulent purpose in making the transfer.[57]

NOTES

1 *Gold v. First Tennessee Bank, N.A.*, 2014 U.S. App. LEXIS 3279 (4th Cir. Feb. 21, 2014) (2-1).
2 *Id.*, at *2.
3 *Id.*
4 *Id.*, at *30.
5 *Id.*, at *9.
6 *Id.*
7 *Id.*, at *15.
8 *Id.*, at *4.
9 *Id.*, at *4-*5.
10 *Id.*, at *5.
11 *Id.*, at *7.
12 *Id.*, at *7.
13 *Id.*, at *8.

[14] *Id.*
[15] *Id.*
[16] *Id.*, at *9.
[17] *Id.*
[18] *Id.*
[19] *Id.*, at *10.
[20] *Id.*, at *11.
[21] *Id.*, at *12.
[22] *Id.*, at *12.
[23] *Id.*
[24] *Id.*, at *13.
[25] *Id.*, at *14.
[26] *Id.*
[27] *Id.*, at *16, *quoting In re Nieves*, 648 F.3d 232, 237 (4th Cir. 2011).
[28] *Id.*, at *16, *citing Nieves* at 239.
[29] *Id.*, at *17, *quoting Nieves*, at 238.
[30] *Id.*, at *17-18.
[31] *Id.*, at *18, *citing Nieves*, at 240.
[32] *Id.*, at *19.
[33] *Id.*
[34] *Id.*
[35] *Id.*, at *20 (citations omitted).
[36] *Id.*
[37] *Id.*, at *21.
[38] *Id.*, at *22.
[39] *Id.*, at *23.
[40] *Id.*, at *24.
[41] *Id.*
[42] *Id.*, at *25.
[43] *Id.*, at *26.
[44] *Id.*, at *26.
[45] *Id.*, at *27.
[46] *Id.*, at *27.
[47] *Id.*, at *27-*28.
[48] *Id.*, at*28.
[49] *Id.*, at *40.
[50] *Id.*

[51] *Bullard v. Aluminum Co. of Am*., 468 F.2d 11, 13 (7th Cir. 1972).

[52] *Southern Indus., Inc. v. Jeremias*, 68 A.D. 2d 178, 183 (App. Div. 2d Dept. 1978).

[53] *In re Sharp Int'l Corp. & Sharp Sales Corp*., 403 F.3d 43, 52 (2d Cir. 2005) (debtor raised new funds from its Noteholders to pay off its bank; bank "gave no warnings and blew no whistles, ignored inquiring calls from the Noteholders, preserved [debtor's] line of credit when it had the right to foreclose and pull the plug, and gave [the borrower] its needed consent to the new indebtedness…. One could say that the [bank] failed to tell someone that his coat was on fire; or one could say that it simply grabbed a seat when the music stopped….Whatever [the bank] knew about [management's] fraud, [it came] by that information through diligent inquiries that any other lender could have made. [Plaintiff] fails to identify any duty on [the bank's] part to precipitate its own loss in order to protect lenders that were less diligent."); *BELT, Inc. v. Wachovia Corp*., 403 F.3d 474, 476 (7th Cir. 2005) ("Illinois, like most other states, does not require business ventures to do good turns for their rivals.").

[54] *In re Armstrong*, 285 F.3d 1092 (8th Cir. 2002) (held, casino acted in bad faith when it accepted payment from financially troubled debtor; it had failed to check true extent of debtor's assets and liabilities; it increased his credit line, with actual knowledge of a tax lien having been filed against him; casino also ignored borrowing of funds by debtor's friend for him to keep gambling; casino also knew of a tax lien asserted against debtor's bank account; moreover, casino had acknowledged in its files that debtor was in "over his head"; rejected bankruptcy court's "good faith" finding as "clearly erroneous."); *United States v. Tabor Court Realty Corp*., 803 F.2d 1288 (3d Cir. 1986) (transferee lacked good faith when it knew debtor would receive no consideration and would be rendered insolvent as a result of transfer). But see *In re Hannover Corp*., 310 F.3d 796, 800 (5th Cir. 2002) (held, independent third party unaffiliated with debtors acted in good faith when it accepted payments from debtors on contract that had been negotiated at arms-length; transferee's "state of mind" important; no way of learning of debtor's insolvency; knew of SEC suit from newspapers, but "undertook its own investigation, contacting the SEC and… receiving assurances…from the… court…."); *Atlanta Shipping Corp. v. Chemical Bank*, 818 F.2d 240, 249 (2d Cir. 1987) (lender with knowledge of debtor's poor financial conditional acts in good faith when it knows loan proceeds will repay creditor indebtedness and not adversely affect debtor's balance sheet); *In re Sharp*, *supra*, 403 F.3d at 44 (2d Cir. 2005) (bank discovered fraud by borrower; demanded repayment; consented to

borrower's raising new funds from investors with false financials; no bad faith; bank allowed to keep loan repayment; "…a mere preference between creditors does not constitute bad faith"); *Boston Trading Group, Inc. v. Burnazos*, 835 F. 2d 1504, 1512 (1st Cir. 1988) (Breyer, J.) (good faith "does not ordinarily refer to the transferee's knowledge of the source of the debtor's monies…obtained at the expense of other creditors"; transferee's lack of participation in debtor's dishonesty held material).

[55] *In re M&L Business Machine Co.*, 84 F.3d 1330, 1338 (10th Cir. 1996) (investor in Ponzi scheme not entitled to claim good faith when he should have known of fraudulent intent); *In re Sherman*, 67 F.3d 1348, 1355 (8th Cir. 1995) (held, transferees lacked good faith under Code §548(c) when "they were aware of sufficient facts concerning the debtor's precarious financial situation to place [them] on inquiry notice of debtor's insolvency and looming bankruptcy.").

[56] *Sharp*, *supra*, 403 F.3d at 54 (2d Cir. 2005).

[57] *In re Bayou Group, LLC*, 439 B.R. 284, 314-15 (S.D.N.Y. 2010) (reversing bankruptcy court; held, information suggesting mere "infirmity in [debtor] or in integrity of its management" is insufficient to trigger inquiry notice; "the great weight of authority holds that it is information suggesting insolvency or fraudulent purpose in making a transfer that triggers inquiry notice," but an investigation may not be required if the transferee can establish that a diligent investigation would not have uncovered debtor's insolvency or fraudulent purpose; "a transferee is entitled to offer evidence to argue to the finder of fact that no diligent investigation would have disclosed the transferor's insolvency or fraudulent purpose. If the transferee can meet its burden of demonstrating that a diligent investigation would not have led to discovery of the fraud, it may prevail on this prong of the good faith affirmative defense.").