BANKRUPTCY LAW

How to Measure Good Faith?

By Robert Kugler

Courts considering good faith acknowledge that the bankruptcy code does not provide a definition of the good faith concept, nor is the concept susceptible of a precise definition. Courts in the modern era have struggled with whether good faith means general honesty of purpose, lack of knowledge of fraud, or actual knowledge of fraud or facts sufficient to put a transferee on notice combined with an obligation of due diligence.

For instance, one court held that knowledge of fraud, without more, was insufficient to cause a transferee to lose the protections afforded a good faith transferee. *In re: Sharp International Corp.*, 403 F.3d 43 (2d Cir. 2005) (addressing similar New York fraudulent conveyance statute). In another court, the "should have known" analysis was measured by the comparison of the conduct of the transferee to customary business practices, *Goldman v. City Capital Mortg. Corp (In re Nieves)*, 648 F.3d 232, 237 (4th Cir. 2011) (analyzing good faith under 11 U.S.C. § 550(b)(1)). And in another court, good faith required proof of a diligent investigation once it was established that the transferee had been put on inquiry notice of either the transferor's possible insolvency or of the possibly fraudulent purpose of the transfer. *Christian Bros. High School Endowment v. Bayou No Leverage Fund LLC (In re Bayou Group LLC)*, 439 B.R. 284, 312 (S.D.N.Y. 2010).

In the context of Section 548(c), the 4th Circuit recently analyzed and upheld the good faith defense. In the case of *Gold v. First Tennessee Bank National Association (In re Taneja)*, 743 F.3d 423 (4th Cir. 2014) the circuit court thoroughly analyzed the conduct of the transferee and concluded that the transferee acted in good faith. Helpfully, the court also made clear that the analysis of good faith is the same whether it arises under Section 548(c) (initial transferees) or under Section 550(b)(1) (subsequent transferees).

In *Taneja*, the bank entered into a warehouse lending relationship with the debtor whereby it was agreed that the bank would loan to the debtor the funds necessary to allow the debtor to close the loans. The debtor would then package the loans into groups for subsequent sale to investors. Upon the sale of the loans, the debtor would pay the bank. In the interim, the debtor would forward the note and related loan documents to the bank as collateral. Eventually, the debtor experienced difficulty selling the packaged loans to investors and engaged in fraudulent conduct, including selling the same mortgage loans to several different investors. Ultimately, the scheme collapsed and the debtor filed for bankruptcy. A trustee was appointed and he commenced an adversary proceeding against the bank seeking to recover payments made to the bank by the debtor. The bank defended, in part, on Section 548(c) grounds because it took for value and in good faith. Since the taking for value element was not contested, the analysis focused on the good faith of the bank.

The court's decision pivoted on its analysis of whether the bank should have known of the fraud, taking into consideration the customary practices of the industry in which the bank operated. The trustee urged the court to require the bank to establish a "bright line" defense – that each and every action taken by the bank constituted reasonably prudent conduct by a mortgage warehouse lender – and that the only way to demonstrate such compliance was through the testimony of an expert witness. The 4th Circuit declined to adopt the bright line test or require expert testimony urged by the trustee. Instead, the court considered the customary practices of the industry in which the bank operated to establish the correct context in which to consider whether the bank should have known of the fraudulent conduct. To establish customary practices, the court accepted the testimony of experienced bank officers with extensive knowledge of the warehouse lending industry, despite the discomfort that the witnesses were also bank employees. To hold otherwise, the 4th Circuit concluded, would restrict the presentation of a defense that is ordinarily "based on the facts and circumstances of each case and on a particular witness' knowledge of the significance of such evidence." *Tenaja*, 743 F.3d at 431, citing *Meeks v. Red River Entm't (In re Armstrong)*, 285 F.3d 1092, 1096 (8th Cir. 2002). The relationship between the witnesses and the bank simply went to the weight of the evidence – not the admissibility.

The court dismissed each example that the trustee raised to demonstrate that the bank should have known of the fraud (including evidence that the bank's attorney asked the debtor's attorney if the loans were fraudulent). In each instance, the court confirmed that the testimony provided by the loan officers was sufficient to demonstrate that the trustee's *red-flags* were not, in fact, signals that the debtor was engaged in fraudulent conduct. The 4th Circuit accorded the bankruptcy court great deference on these determinations in its affirmance.

While it does not fully answer all questions on good faith, *Tenaja* provides an example of a practical analysis of good faith that is helpful in any litigation under the bankruptcy code where good faith is at issue

Rob Kugler, deputy chair of the bankruptcy and creditors' rights practice at the new Stinson Leonard Street, focuses his practice on maximizing value and minimizing exposure for creditors, shareholders, governance boards, trustees and committees in bankruptcy proceedings. Rob represents clients in bankruptcy protection and litigation matters, serves as trustee to post-bankruptcy creditor trusts and litigates complex commercial litigation disputes on behalf of lenders, lessors, developers, manufacturers and retailers across the country. Rob can be reached at robert.kugler@stinsonleonard.com.