Drug Forfeiture Statute Poses Risks for Secured Lenders

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Casenote: Drug Forfeiture Statute Poses Risks for Secured Lenders

By Alvin C. Harrell

The flurry of recent cases involving use of the civil forfeiture statute to seize property tied to drug-related transactions includes several decisions of interest (and potential concern) to lenders. In these situations the result may be loss of a lender's collateral if the court concludes that the collateral was originally acquired by the borrower with the proceeds of drug transactions.

In United States v. One Single Family Residence Located at 6960 Miraflores Ave., the court held that the mortgagee's interest in the property was subject to forfeiture under 12 U.S.C. section 881 because the lender ignored certain “red flags” when making the loan. While the court, at trialer of fact, may have a perspective that goes beyond the basic facts recited in the court's opinion, and your author certainly does not wish to express any sympathy for those involved in drug-related transactions, it seems that some of the factors cited by the court as evidence of suspicious activity are in fact common in ordinary lending transactions. As a result lenders should carefully review this case in order to avoid inadvertently replicating these “suspicious circumstances.”

In 6960 Miraflores one Igelias (a “known drug trafficker”) used a Panamanian “shell” corporation to purchase a $1.2 million residence in Florida, apparently with the proceeds of drug-related transactions. When Igelias learned that he was being investigated by the IRS, he immediately began efforts to “recoup his financial investment before possible government action.” He put the house up for sale and approached Republic National Bank of Miami (as well as other lenders) about the possibility of obtaining a mortgage loan on the premises. Republic extended an $800,000 loan pursuant to a one-year balloon note secured by a mortgage on the

subject property. The loan proceeds were transferred to the borrower's Swiss bank account and Igelias apparently followed shortly thereafter. The government seized the property securing the bank's loan, on grounds that it was acquired with the proceeds of drug-related transactions, and the bank was left with an unsecured loan.

Republic argued that the government had failed to establish any “nexus” between the property and specific drug transactions. The court noted that this reflected a misunderstanding of the government's burden. The government does not have to actually trace the proceeds of drug transactions, or even establish a connection to drug dealing by a preponderance of the evidence. Instead its only burden is to show “probable cause” that a “substantial connection” exists between the property and drug-related offenses. The government’s burden of proof is “less than prima facia proof but more than mere suspicion.” The court found sufficient probable cause to subject 6960 Miraflores to civil forfeiture under section 881, and noted that a judgment of forfeiture “merely confirms the government’s interest and therefore relates back to the time of the offense,” thereby precluding subsequent parties (including a mortgagee) from claiming any interest in the property unless they are protected by the statutory “innocent owner” exception.

The court’s opinion then focused on the narrow issue in the case, i.e., whether Republic met the standards for the “innocent owner” exception. This exception requires that the offense be committed without the “knowledge or consent” of the claimant, under subsection 881(a)(7). Republic argued that this requires the government to prove that the claimant (Republic) had actual knowledge of its borrower's misdeeds. The court vigorously rejected this argument, essentially concluding that the “suspicious circumstances” surrounding this loan were sufficient to deprive Republic of the exception applicable to innocent parties.

In describing these “suspicious circumstances,” the 6960 Miraflores court concluded that Republic was not entitled to the innocent owner defense because of the “following factual findings on the issue of Republic's state of knowledge”:

1. Thule, the borrower, is a Panamanian shell corporation;
2. The borrower's primary asset is a residence;
3. The residence was vacant at the time;
4. The borrower was about to sell its primary asset;
5. The lender did not ask the purpose of the loan;
6. The lender failed to conduct a title search;
7. The corporate borrower and Antonio Munoz Caballero ("Munoz"), the sole stockholder and a guarantor on the mortgage, were unknown to the lender;

3. Id. at 1566.
4. Id.
5. Id.
6. Id., citing United States v. $41,305.00 in Currency and Traveler’s Checks, 802 F.2d 1339 (11th Cir. 1986) United States v. Four Million, Two Hundred and Fifty Thousand Dollars, 762 F.2d 895, 903 (11th Cir. 1985) (after citations omitted).
7. Id., citing United States v. Four Parcels of Real Property in Greene and Tuscola Counties, 911 F.2d 1245 (11th Cir. 1990).
8. 731 F.Supp at 1567-48. The court rejected the government’s argument that the innocent owner exception applies only to interests owned at the time of the offense and therefore does not protect subsequent parties. Id.
9. 731 F.Supp at 1570. The court recognized that Four Million, 762 F.2d 895, supports Republic’s contention that only actual knowledge will bar forfeiture; however, the court adopted the view of United States v. One Between 58’ Meter Yacht, 874 F.2d 894, 888-89 at 11th Cir. 1989, holding that the claimant must prove not only that it was “uninformed and unaware of the activity . . . but also that it did everything that reasonably could be expected of it to prevent the activity.” It is not clear what a subsequent mortgagee, like Republic, can do to prove it was both unaware of the activity and in the same time frame to prevent the activity, or to prevent behavior that occurred before the mortgagee received the loan application. The 6960 Miraflores court also noted that the claimant bears the burden of proof on these issues.
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8. Ramon Puentes, the second guarantor, had no known connection with the borrower;
9. Puentes made inconsistent statements of ownership;
10. The lender offered an $800,000 one-year balloon note on property valued at $2.1 million;
11. The borrower had no known source of repayment;
12. Fred de la Mata, president of Republic, was intimately involved in the transaction;
13. The lender quickly approved the loan outside normal channels;
14. The lender cannot document board approval of the loan, although documents indicate the board endorsed the loan after the closing;
15. Puentes, the guarantor, used part of the loan proceeds to buy expensive gifts for the bank president's family, and to buy an airplane ticket to Geneva for Iglesias;
16. The lender transferred the proceeds of the loan to the borrower's Swiss bank account.

As basis for the decision, this list may be of some concern to secured lenders, for it would seem that many of these factors could be present in an ordinary lending transaction. Indeed, just what is argues, emphasizing that the loan was well secured and was guaranteed by a good customer of the bank (Puentes) and that these factors made it attractive despite the other weaknesses in the credit. The bank president testified consistently that he did not investigate the primary borrower because the loan was guaranteed by Puentes, known to be a good customer, who requested the loan and was expected to repay it. The court responded to this by noting that the question is not whether this was a commercially sound loan. Rather, the court must consider whether the lender knew that the property had been acquired with drug proceeds. In this regard the court emphasized again the following "suspicious circumstances": "The [primary] borrower was not doing business and had no source of income"; the bank made a term loan with no repayment schedule; the loan was "sizeable"; "Although the collateral was sufficient to cover the loan, we do not believe that banks are in the business of lending money with the intent to force sale of the property"; the president of the bank had a close involvement with the loan transaction and along with other bank officers personally inspected the collateral; the bank president claimed to have obtained board of directors approval during a break at a hotel convention, but the only documentation showed board approval subsequent to closing; the guarantor subsequently paid for the bank president's son's Caribbean honeymoon; the loan proceeds were transferred to a Swiss bank; and this transfer was handled by the bank president's personal assistant. Perhaps your author is missing something here, but it does not seem apparent just what it was about these factors that supports the court's ultimate finding that the bank had actual knowledge that the property was acquired with drug money. It does not seem apparent from the court's description of the evidence that the bank knew that the drug dealer (Iglesias) controlled the corporation that obtained the loan or that Iglesias even existed, much less that he had had acquired this property with the proceeds of drug deals. To again quote the court: "We emphasize that it is the totality of the circumstances that underlies our finding of actual knowledge. . . . An unusual loan transaction is . . . evidence of the lender's knowledge. . . . [T]he face of overwhelming evidence, [the banker's] choice to look the other way." The court concluded that "[t]hese facts, when considered in their totality, suggest actual knowledge, if not complicity, on the part of the lender." The result was forfeiture of the lender's $800,000 mortgage on the property. In conjunction with other recent cases, 6960 Miraflores serves as a reminder of the extent to which drug enforcement cases have come to dominate the caseload of the federal courts, and of the risks to lenders posed by these cases. The Comptroller of the Currency (OCC) has become sufficiently concerned about the impact of such cases on banks that it recently issued an "OCC Advisory" describing 6960 Miraflores and two other cases, and advising national banks to make sure they follow the "Fundamental "know your customer" principle." The Advisory urges special caution with regard to "loans fully collateralized by cash equivalents to determine if there is a legitimate business purpose for the loan. This Advisory was subsequently distributed to banks by the Office of Thrift Supervision. A high level of concern seems well warranted. Until the federal courts have more clearly explained their views on forfeiture of a lender's collateral under section 811, it would seem that prudent lenders must be sure that they "know their borrowers" to the fullest extent possible and that they can document the source of that knowledge and the results of any relevant inquiries, as to all persons connected in any way with the loan transactions. In the meantime, courts adopting this view should be well aware of the burdens they are placing on lenders and their customers and of the inherent societal costs that such burdens represent.